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CLOs Revisited – Ratings, Risks, and Returns (Second of a Series)

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“The world has put all its Covid eggs into the vaccine basket. There is no Plan B.” – CLO manager.

What happened to CLOs during Covid? We asked a number of experts on the topic, including rating agency friends and top credit managers. Here’s a summary of their opinions:

First, because CLO assets represent roughly 70% of the leveraged loan market, the health of one directly impacts the health of the other. When the world came to a stand-still last March, as our own CLO manager, Kelli Marti, told us, “everyone looked first to their health of their portfolios. The key was preserving the value of the underlying collateral.

“Two things particularly occupied our time then: triple-C exposure and OC cushions,” Kelli continued. “If the highest-risk assets exceed permitted levels, it hurts the vehicle’s over-collateralization ratios, which measure underlying asset quality. Then fund flows have to be redirected, suspending payments to the lower debt and equity tranches.”

Prior to Covid, 5% of the LSTA Leveraged Loan index was rated triple-C. Adding B- assets brings you to a combined 25%, a marked increase from the 15% level two years earlier. Rating agencies noted – as did a Moody’s report dated December 10, 2019 – that “investor protections will weaken amid the easy market conditions, with loosened criteria for asset selection, trading and other activities.”

Few anticipated the subsequent precipitous performance drop across consumer-sensitive sectors. The pandemic’s onset led to a massive wave of downgrades: 432 index names in the 3 month period ended May, 2020 – a downgrade-to-upgrade ratio of 43:1 – with over half of Index loans downgraded in the year ended July, 2020.

Yet as the year wore on, analysts found the downturn less severe than that of 2008-09. In part this was due to significantly more liquidity in the system and being applied to struggling issuers. “Sponsors and investors were quicker this time to react,” said an S&P analyst. “Both addressing liquidity needs and covenant flexibility. In March and April while 80% of spec grade issuers were downgrade, only 30% of the collateral was.”

“You began to see how managers navigated the Covid environment,” a Moody’s CLO specialist told us. “Some traded, some were frozen. Those who traded produced pretty good results. Oil and gas assets traded off. But then they were either upgraded or they fell out of the population.”

Himani Trivedi, Head of Structured Credit at Nuveen Leveraged Finance, reported that the market’s expectations for CLOs going into Covid were dismal. “We heard concerns that the loan market was frothy and over-leveraged,” she said. “That managers would be forced to sell assets. Nothing as severe as was feared appears to have happened. Yes, March 2020 saw approximately 25% downgrades across all ratings by the end of the month, and as much as 20% of BSL CLOs shut off distributions to equity, but conditions turned around significantly as the underlying loan market rebounded.”

Next week: The CLO Recovery