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

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By blocking the Suez Canal last month, the *Ever Given* made headlines and created a massive shipping traffic jam. Three football fields long and weighing 250 thousand tons (by comparison, the Statue of Liberty is 125 tons), the monster container vessel represents the new global transportation reality: 90% of the world's goods travel by sea.

To this journalist, the incident also recalled features of CLOs. Here are vehicles that transport 70% of all leveraged loans, each CLO containing hundreds of assets. They also move sideways when stiff market cross-winds blow and worry institutional clients when beached.

CLOs are businesses unto themselves with their own balance sheets and income statements. The loans in which they invest are the assets, the financings that support the investment programs represent the liabilities, and equity investors earn an arbitraged return on the difference between the cost of the liabilities and the asset yield.

As was the case with the leveraged loan market during 2020, CLO liability pricing reflected the varying risk climates as Covid progressed through stages. Our *Chart of the Week* (courtesy S&P) clearly highlights that trend.

"Triple-As [the least risky and cheapest liability tranche in the CLO capital structure] were priced at L+160 bps or higher during the crisis," our friends at Moody's told us, "then 150, 140 and dropped from there as things improved."

Our Nuveen CLO expert, Himani Trivedi, agreed. "On the liabilities side all-in pricing pre-Covid was L+175-185, but tightened to L+140-145. Compare that to 2018 when spreads were in the 130s, close to tights."

Churchill's CLO manager, Kelli Marti, reported liability pricing is a huge driver behind the massive wave of CLO issuance. "2021 was expected to be a rebound year for CLO issuance," she said, "and it definitely has been so far. 1Q 2021 was the most active quarter for CLO issuance on record.

"Besides new deals, a big theme right now is the refinancing of 2019 vintage CLOs. As 2019 deals come off their two-year non-call period, managers are eager to refi into lower priced liabilities on offer now. Triple-A pricing is 25-28 bps tighter in today's market."

Kelli continued: "From a structural perspective, while CLOs issued during high Covid months carried a three year reinvestment/one year non call, more traditional 5/2 structures have returned. Of course, CLO issuance is also driven by deal volume, which has been robust. M&A activity has picked up, with March having the most M&A loan issuance since January, 2020."

Next week: Covid and middle market CLOs.