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

THE LEAD | April 21, 2021

News reached us from Mars of the first powered Earth aircraft to fly on another planet. *Ingenuity*, a helicopter with four foot wide blades (and carrying a small swatch from the original Wright Brothers bi-plane), hovered at ten feet for 30 seconds then lightly touched back down. More flights are planned.

“What the Ingenuity team has done,” a NASA official said, “is give us the third dimension.”

As we wrap our series on CLOs and Covid, let’s provide an extra dimension to these vehicles; namely, how should investors think about evolving risks for CLO liabilities and the firms who manage their portfolio of assets?

CLO capital structures are organized with the least risky, lowest-spread debt (triple-A rated) at the top of the cash flow waterfall. Below that tranche are more risky, higher-spread liabilities, with the equity at the bottom. There exists active primary and secondary markets for these investments, with spreads varying on elements such as market conditions and management expertise.

But perhaps of primary importance is asset mix. The creditworthiness of CLOs is no better than the quality of the loans in which they invest. Our friends at Moody’s have commented on the deterioration of leveraged loan quality in recent years, separate from the pandemic. Credit agreements are providing less protection for investors, they report. First liens are reaching lower down into balance sheets than a decade ago: “More debt above and less debt below.”

That is reflected in lower expected recoveries, 57-60 on the dollar, versus 80 in the past. But as our S&P partners have shown in published studies, middle market CLOs fared better on average in 2020 than BSLs in maintaining par values. They also retained more OC cushion.

Nuveen’s head of structured finance, Himani Trivedi, spoke to other CLO advantages. “There are a variety of reasons CLOs have generated strong support from investors. There’s the diversity of managers and their investment styles. There’s also the mix of public and private borrowers.

“Floating rate duration and floating rate assets makes loan vehicles attractive and cheaper versus ABS, RBS, CMBS,” she continued. “And Libor floors are a windfall for equity buyers.

“Finally, as we discussed in a recent white paper, 2020’s market volatility demonstrated the importance of active management. An example was switching from out-of-favor retail services (e.g. movie theater chains) to specialty retailers such as Jo-Ann Stores.

“For astute CLO managers with forward-looking perspectives,” she concluded, “and robust credit underwriting capabilities, this period of time provided a window of opportunity.”

As happened during the year of Covid, we believe the distinction in CLO manager competence, indeed with all credit investments, will continue to become more apparent in its aftermath.