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CLO Awakening (Part One of Two)

THE LEAD | July 17, 2024

The first half of 2024 kept us busy tracking volume in the newly energized BSL market. Remarkable, but not unexpected, was its ability with fresh capital to refinance higher-cost existing deals away from the direct lenders.

Left unexplained more fully was the driver of this activity. This special series explores how collateralized loan obligations (CLOs) are propelling both BSL and direct lending activity to record levels. To bring an expert's perspective, we spoke with Kelli Marti, our head of CLO management.

We asked Kelli to give us a sense of the numbers. "Year-to-date volume of freshly minted CLO vehicles is almost $105 billion, according to PitchBook LCD," Kelli told us. "That's across 221 transactions – way ahead of last year's $56 billion from 129 deals. Including resets and refinancings, a growing trend, that adds about $120 billion across 272 transactions."

What's driving those refinancings? "Managers are taking advantage of favorable market conditions as two-year non-calls roll off from 2022 vintage deals," she said. "There's also the same dynamic of spread compression in the broadly syndicated triple-A CLO market that's occurring in leveraged loans."

Buyers of triple-A liabilities tend to be largely Japanese banks, correct? "Yes, although the CLO AAA investor base includes domestic and European buyers, and has spread globally into the Middle East as well" said Kelli. "With refreshed bank budgets for a new fiscal year, plus significant amortization in the market, triple-A CLO spreads continue to tighten. We've seen averages fall from a high of 225 bps in 4Q 2022 to 150 bps at the end of last quarter. And now for 5-year reinvestment period/2-year non-call transactions for tier 1 BSL managers, spreads are in the 135-140 range."

Let's talk about supply/demand in BSLs. Isn't the surge of CLO issuance making worse the imbalance of deals available vs. appetite for new paper? "Especially given the minimal pace of new LBO activity," Kelli reported. "So that cash tends to be put to less productive uses, such as the relentless wave of refis and repricings on the asset side we're experiencing."

In a note last week, our content partners at PitchBook LCD highlighted "the high level of CLO paydowns and deal calls, which has pushed more than $50 billion back into investors' hands — and could add up to $90 billion more." These paydowns totaled over $52 billion so far this year, more than the combined $58.6 billion of paydowns and vehicle liquidations for 2022 and 2023.

This dynamic is not helping the supply/demand imbalance in the BSL market. Cutting into CLO capacity affects the purchasing power of these vehicles, which represent almost 70% of liquid loan appetite. As PitchBook quoted one top credit manager, the trend "sharpens the technical supply/demand impact that is sending spreads tighter throughout the leveraged finance market."