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Letter from Tokyo (First of a Series)

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We began our visit to Tokyo this week attending S&P's Structured Finance Seminar 2025. Along with almost 200 Japanese bankers and investors, we heard senior ratings analysts and leading CLO market participants discuss trends and outlooks for global leveraged finance, CLOs and other securitized strategies. Our panel was entitled, "Private Credit, Middle Market CLOs and Fund Finance." Here's a summary of the discussion, with additional color.

Private credit CLOs have seen a natural evolution. They began as balance sheet financing tools for specialty finance companies. Now they provide attractive financing within a levered fund, typically as replacement for asset-based facilities.

While CLO technology has been around since the late 1990s, the structures and market have evolved considerably. Just ten years ago, the private credit CLO market was less than $20 billion. With fewer than ten transactions done annually, it was only 5% of the overall CLO landscape. Today PCLOs have grown to $135 billion, or 13% of the market (per Bank of America Global Research). So far this year, PCLOs comprise about 18% of new-issue US transactions, and growing as the product and market gain more acceptance.

CLOs are attractive as standalone investments for equity investors seeking mid-to-high-teen returns and consistent quarterly cash distributions. When used as financing technology in fund complexes, CLOs provide strong economics (in a functioning market), better leverage, attractive durations (4-to-5-year reinvestment periods) and predictable ratings for ramped pools of collateral. For BDCs, commingled funds, and SMAs, CLOs are typically cheaper alternatives to ramping vehicles from banks financing the assets, the former with spreads of 160-170 bps, and the latter, low 200 bps for comparable leverage profiles.

How are managers dealing with the current environment? If you are one of the 5% of direct lenders with track records before the GFC, you learned to construct portfolios with US-centric, middle market borrowers in service sectors, backed by top PE firms. This allows your portfolios to withstand various rate environments and economic cycles. Whatever the cause of portfolio stress is, the potential impacts are similar. Niche leading businesses with high barriers to entry and flexible cap structures can stay resilient through a downturn or shock. Interestingly, 74% of our borrowers showed positive Ebitda growth last quarter, up from 66% in Q4 2024.

What are the differences in BSL CLO and middle-market CLO collateral and structures? Leverage, for one thing – 6x for full capital structure or arbitrage PCLOs, vs. 10x for BSL, and 3-4x for CLOs issued out of BDCs or private commingled funds. Supply for another. There's simply not enough loan creation in BSL to go around. Private credit annual CLO issuances have grown from 10% of the market to about 20% as BSL CLOs amortize and more private credit managers use the technology as a financing tool or AUM generator. Triple-A spreads for BSL are 135-140 bps vs. 160-165 for PC. That differential has compressed to 25-ish bps versus a 40-50 bps delta historically. Finally, triple-C baskets for PC are 17.5% vs. 7.5% for BSLs. PCLOs receive underlying asset ratings primarily with credit estimates issued by rating agencies.