Letter from Tokyo (Second of a Series)

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Last week we came to Tokyo for meetings with our investors and friends in the region, as well as participating in S&P's stellar Structured Finance Seminar 2025. Along with almost 200 attendees we heard senior ratings analysts and leading CLO market participants discuss trends and outlooks for global leveraged finance, CLOs and other securitized strategies.

For our panel, "Private Credit, Middle Market CLOs and Fund Finance," we discussed why the illiquid asset class has spawned so much growth in so many areas of structured finance. In part it's the growing sophistication of financial engineering around CLOs and related vehicles. Dropdown structures, for example, are increasingly employed to leverage a variety of funds including BDCs, funds, and SMAs.

As S&P analysts highlighted, the smaller size and lower liquidity of PC assets mean they receive a notch or two lower rating than publicly rated loans. PC CLOs also historically have shorter reinvestment periods than BSL transactions; say, four vs. five years. They also have less ability to reinvest after that period ends, with prepayments and recovery proceeds paying down debt. Both these items serve as further investor protections given the illiquidity of the assets.

In managing portfolios, how do middle-market CLOs differ from BSL CLOs? What are the differences in required manager skillsets? There's scarce liquidity for MM loans, but managers can create liquidity within CLOs by transferring assets from them up to the fund level. Of course, BSL managers can trade loans in their CLOs, which can provide an opportunity to build par depending on market conditions and collateral strength. PC CLO managers can't trade, so good managers focus more on portfolio management, asset selection and high levels of diversification. Diligenced manager selection is thus critical when investing in PC CLOs.

What is one significant change or evolution we expect to see over the next year? One is the use of CLO technology in other areas of the market. PC CLOs are becoming more of a focus for domestic insurance companies looking to improve risk-based capital charges for private credit loans on their balance sheet as well as improve operational efficiency. We also believe using PC CLOs as an AUM generator for managers by raising third party capital via distinct SMAs or funds will also continue to grow.

Finally, what changes have we seen in the middle-market CLO investor base, and will it continue to grow? Japanese banks (both large domestics and regionals) are back and active in triple-A tranche investing. Many who are approved for BSL investing are in various stages of diligence of the private credit space, with an increasing number of participants receiving approval for investing in PC triple-A. European banks are showing increased interest, as are US and MENA banks. Insurance companies, pension funds, family offices and asset managers are looking at tranches further down the CLO capital stack.

?There is consistent interest from existing investors in BSL CLOs to explore new opportunities in PC CLOs, given the increased yield and stronger structural protections (leverage) relative to BSL counterparts. As discussed last week, PC CLOs are also growing as a percentage of the overall CLO market, increasing the opportunity set for traditional BSL investors who have gotten comfortable with the private credit market and manager landscape.

In short, private credit CLOs will continue to grow in popularity and usefulness as the overall private market expands into fund finance and more complex securitizations. Innovation will be the watchword in the fastest growing area of the capital markets.

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