News & Analysis

CLO report: Future perspectives

By **Andrew Woodman** - 3 July 2018

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Our industry panel

Deborah Shire, head of structured finance, AXA Investment Managers
Seth Painter, senior vice-president of structured products, Antares
Joyce DeLucca, managing director and portfolio manager in the US for high-yield and syndicated loans, Hayfin Capital Management

Q What is your outlook for the CLO market over the next five years?

DS: We expect the CLO market to continue its transformation in terms of demand. Over the past five to six years, the most senior tranches of CLO have become strategic, long-term asset classes for large institutional investors. They provide stable capital for the development of the CLO market and we expect this to continue. At the junior level, we believe one can create diversification through exposure to managers with different styles and the ability to generate gains through active management.

SP: The next five years is difficult to predict, but we believe the cycle will likely play out and it will be critical for investors to be partnered with experienced managers with seasoned credit professionals who've worked together through a cycle. Overall and beyond the next cycle, we believe the CLO market will continue to be a meaningful source of financing for leverage loans.

JD: It's difficult to predict where the market will be but one thing that we have learned, having gone through several cycles, including the financial crisis, is that the CLO structure is robust. It provides access to a diversified pool of leveraged loans and offers multiple options to express that exposure depending on the investor's risk appetite. It offers good current income and potentially strong total return over time in the lower tranches.

Q How do you think another global economic downturn is likely to impact appetite for CLOs?

DS: In the past 20 years, CLO tranches have demonstrated their ability to go through economic downturns without meaningful damages in terms of credit value. This is the reason large institutions became strategic investors in this area. We expect these big players to maintain a growing appetite for CLO tranches the next time we face an economic downturn. We have already seen evidence of this in Q1 2016 with the oil and gas crisis.

SP: CLOs performed well fundamentally relative to other comparable asset classes during the crisis. Certainly, mark-to-market investors and funds realised losses during the crisis. However fewer MTM vehicles are invested in CLOs post-

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crisis. The different investor base coupled with more structural protections/credit enhancement included in post-crisis deals may help mitigate losses in the next downturn. Also, expect more capital raised to source distressed opportunities if the CLO market does sell off.

JD: The CLO market has remained viable in most environments with the exception of the two most severe years of the credit crisis, 2008 and 2009. Even if the next downturn is milder, there will be some adjustment. As the market shifts to risk-off, equity investors demand higher returns, which can result in a period of lower issuance volume as the market adjusts. However, in that environment, one would expect defaults to also be higher and asset prices to be lower, which is often an attractive time to be putting portfolios together.

Q What do you think are the biggest headwinds facing the CLO market today?

DS: CLOs have always faced a changing arbitrage for the equity tranche. We capitalise on our established presence in this market (over 20 years) to secure access to what we consider first-tier CLO managers, providing warehouse solutions prior to the CLO, being able to reach controlling positions, with good economics terms and adapted CLO documentations. Although short-term high cashflows are key to generating performance to the equity positions we continue to partner with CLO managers who share our view that a CLO must maintain cushions to be able to benefit further from potential market movements.

SP: I believe the biggest headwind facing the market today is loan supply. Deals are still getting done, but the most selective managers are cautiously investing as they look to avoid the more aggressive pricing and terms.

JD: The current market remains robust for CLO issuance. The biggest challenge facing portfolio managers today is access to quality collateral, given that primary market volumes have been light. With liability spreads currently range-bound to slightly wider and stiff competition for assets, the arbitrage is a little less attractive. We have had some relief recently as the new-issue market has picked up, as is typical on a seasonal basis. As always, managers will differentiate themselves through credit selection, strong risk controls, and market relationships that provide access to collateral, particularly new-issue loans.

Q In terms of geography, which CLO market do you think is most promising and why?

DS: As a global player in the CLO market we acknowledge the merits of a deep market in the US but also recognise the good progress made in Europe. The US offers a greater ability to develop various strategies (manager style, industry bets) and to generate gains through trading. However, the rollback of the risk-retention rules should increase the supply and the launch of new platforms that need to be evaluated. The European CLO markets, thanks to the increasing size of the European loan markets, have made good progress in terms of diversification, so much so that today our portfolios have an increased exposure to Europe than they did 10 years ago.

SP: Both the US and Euro markets are unique and can be appealing for different investors. The US market is clearly more developed and offers a stronger pipeline with more manager diversity. The Euro market may offer equity investors more excess spread and upside.

JD: I wouldn't characterise either the European or the US market as better or worse; they are different. The market for the underlying collateral is deeper and more liquid in the US, but there are also good returns to be found in the European markets. Right now, both markets are experiencing growth, in both underlying loan volumes as well as new managers entering the market.

Q What kinds of LPs do you think are likely to find CLO funds most attractive?

DS: Large institutional investors will continue being long-term investors in the highest rated tranches of CLO. Although carrying higher risk, some have also made long-term allocations to CLO equity tranches recognising the strong performances and income generated historically as well as the optionality that these tranches can provide at this point of the cycle. BB-rated CLO tranches are still mainly the place for opportunistic investors (ie, classic investment managers and hedge funds).

SP: Generally, CLOs are appealing to investors who are looking for floating rate assets, particularly in a rising rate environment. As it relates to risk-adjusted returns, CLOs are appealing to many different investor groups (banks, insurance, asset managers, private equity, hedge funds). The tranched structure offers a variety of risk profiles and investors can determine suitability based on their mandate and return objectives.

JD: Investors looking for current income through exposure to a diversified pool of leveraged loans can invest in the various tranches of the CLO depending on their risk appetite. In recent years we have seen broader institutional investor acceptance of the CLO product as an important part of an alternatives portfolio. I expect that trend to continue in an environment where investors show strong demand for current-income products. In the riskier tranches, investors can achieve strong total returns and excess spread over comparably rated corporate products, while at the same time reducing risk through a diversified pool.