

Why Are CLOs Increasingly Attractive?

Current market dynamics are generating strong opportunities in private debt for investors with the right strategy.

February 22, 2023

Sponsored by Antares Capital



Opportunities in private debt

As changing economic conditions continue to test the resilience of portfolios globally, they're also enhancing opportunities for investors in specific areas. Private debt is a key example, says **Seth Painter, Managing Director of Structured Products at Antares Capital**. The funds and structured credit vehicles that allow investors to access this varied asset class (such as collateralized loan obligations) are now often delivering higher yields than traditional products

with similar risk levels – while making portfolios more diverse and recession resistant, he says.

We spoke with Painter about how institutional investors with the right capital, timeline goal and investment strategy can tap into these opportunities in private debt, why many investors still view the asset class as a risky, homogeneous niche, and what's behind Antares' imminent expansion into the liquid credit market space – its first foray into this space since its founding in 1996.

Antares believes that structured credit vehicles can offer institutional investors advantages over traditional choices, including in fixed income. How so?

Seth Painter: More traditional products often don't yield enough to meet investor return objectives. CLOs and other structured credit vehicles can offer a higher yield and greater recession resiliency – for similar risk and similar ratings. Why? Because we believe that the additional yield isn't necessarily being driven by credit risk, but rather by investors' perception that CLOs are structurally complex along with their preference for immediate liquidity.

First, we spend time educating investors on the structure to ensure that they understand its inherent risks and benefits. As for investors favoring vehicles with immediate liquidity, this bias causes many to lean away from private debt and structured credit – even though there's a healthy secondary market for CLOs.

These two factors are helping to create attractive opportunities for investors that understand structured credit vehicles, don't need immediate liquidity, and have the right type of capital – such as non-mark-to-market. For those investors with long term, non-mark-to-market capital, they can benefit from what we believe to be an illiquidity premium, not a credit risk premium. In the current economy, many investors are picking up CLOs with extremely attractive premiums and risk levels while making their portfolios more recession resistant.



Speaking of opportunities, Antares is launching its first liquid credit product later this year.

Painter: Yes, we're excited to be entering the liquid credit space at this opportune time in the market. We anticipate issuing two to three BSL-CLOs per year, similar to our issuance cycle on the middle-market side. Expanding into liquid credit is a natural extension of what we already do. We have deep experience in loan underwriting and we have the infrastructure and technology in place. And importantly it allows us to further meet the demands of our investor base.

We've made a key hire in Seth Katzenstein, who will lead our liquid credit strategy. Seth participated in building the U.S. loan business at Intermediate Capital Group and has extensive experience in managing liquid credit strategies and building credit platforms. He's building a team of internal and external professionals to support the launch of this business.

Why is your timing fortunate? Many analysts expect the U.S. loan market to be choppy through 2024.

Painter: There are important reasons why the timing works. First, it could be a good time to take advantage of the sell-off in the secondary market. With some loans trading in the mid/low 90s, we're seeing strong value.

We don't have a legacy portfolio or warehouse that was constructed pre-market dislocation that now has a lot of CCC assets. We can construct a high-quality portfolio with a very attractive yield using today's visibility and asset yields — not last year's. And again, even with current CLO liability pricing, the arbitrage can still work.

We believe that's a powerful advantage.

So the current economic climate is actually creating some positives for Antares...

Painter: That's right. Certain features of this market are likely to be net positives for us. One is higher rates. Our portfolio is 100% floating rate, so as rates rise, our portfolio produces a higher net income for our equity investors. We also mostly use a hold-to-maturity strategy on the direct lending side, so we don't have the mark-to-market volatility and considerations that other managers may confront.

Secondly, we're seeing more lender-friendly terms. Spreads and original issue discounts are far higher than they were in early 2022. Leverage has come down and loan-to-value ratios are lower - we're seeing significantly higher equity amounts below our debt.

We assume loss rates will increase through 2023 - but we anticipate the enhanced economics we're earning across the portfolio to more than offset that. We believe the market is effectively pricing in higher losses than will be realized, and we see that as a net positive to our equity investors.

Overall, this is an attractive market for us to deploy capital - prudently. Of course, rates and spreads are higher because there's a perception of greater risk and a higher probability of default. In sticking to our strategy, we're continuing to be extremely selective in choosing solid deals with strong, risk-adjusted yields.



Can you say more about your strategy?

Painter: We allocate to private businesses in more defensive, recession-resilient sectors - meaning companies that can pass through inflationary costs and have stable product demand regardless of market volatility. We are senior in the capital structure, 99% first-lien. And we have one of the largest and most diverse portfolios in the private debt space, with nearly 500 portfolio companies.

Why is our approach important? Because going forward, investors should expect to see significant differentiation in private debt performance based on the manager's specific approach. And we believe managers like Antares – with a diverse, senior-secured, recession-resilient portfolio – will outperform through 2024.

Many investors view private debt as an asset class that doesn't really lend itself to differing strategies...

Painter: Yes, they often group the entire asset class together and think, "private debt is going to perform this way." In reality, managers use different investment strategies that can deliver varying results – and institutional investors would benefit from focusing on certain key differentiators so they can choose a manager with an approach that best aligns with their goals. For example, they should ask, "Is this manager allocated in defensive sectors with less cyclical exposure? Are they entirely allocated to private equity-owned businesses? What is this manager's demonstrated ability to trade out of CCCs – or even BB or B- names at risk of being downgraded – and optimize their portfolio without taking on material trading losses?"

We also believe it's important to have alignment of interests with our investors. In both our middle-market CLO and fund offerings, we hold meaningful exposure on our own balance sheet. This is relatively unique to Antares, and it has really resonated with investors.

Why is being 100% sponsor-backed a key differentiator for Antares?

Painter: Not only do private equity sponsors bring ongoing operational rigor to the companies in our portfolio, but they also work with us when a deal is challenged. For example, at the start of the pandemic in 2020, when portfolio companies experienced liquidity issues, we worked with their sponsors to provide relief on covenants and interest payments in exchange for more equity in the deal. Private equity sponsors have the financial wherewithal to further support their companies in challenging market environments.

Any final insights on what we'll see in the private debt market into 2024?

Painter: We agree with the analysts who say the market will continue to be choppy. We anticipate new issues of CLOs to continue to be relatively light in Q1 2023 as macroeconomic uncertainty persists.

While CLO borrowing costs have increased substantially, year over year, we think they've likely peaked – and because the underlying asset yields have increased as well, the net income and arbitrage to equity investors remains quite strong.

CLOs have proven time and time again to be a highly resilient asset class for investors, including throughout the 2008 financial crisis. We believe that the CLO structure inherently offers investors strong credit protection and credit enhancement. Both debt and equity investors can do well. They just have to pick their spots.

[See more market insights from Antares.](#)