CIO Office Insights

الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Introduction to CLO

February 2024

KEY TAKEAWAYS

A CLO is a portfolio of leveraged loans that is securitized and managed as a fund by specialized asset managers.

A CLO operates like a bank benefitting from the spread between assets and liabilities.

CLOs assets consist of diversified portfolio of first-lien loans, with floating rates.

CLO Liabilities comprises of around five debt tranches and an equity tranche. Each tranche corresponds to a different risk-return profile.

A collateralized loan obligation (CLO) has frequently been characterized as a synonym for complexity. Despite this, lately it has gained recognition for offering an appealing risk-return compared to other alternative investment options.

WHAT IS A CLO?

1. A CLO in its simplest definition is a portfolio of loans with high yield; provided to corporates with historically stable credit performance.

2. Typically, these portfolio of loans consist of ~200 to 500 individual first-lien bank loans or as more popularly known as senior secured loans with priority payment over other claimants.

3. These CLO structures are issued and managed by specialized asset managers. These managers ensure that these structures are well diversified, all-weather portfolio of loans.

4. On the asset side, the CLO managers accumulate these loans in a structure as a series of tranches to form a collateral pool of loans.

5. On the liability side, the CLO manager builds a capital structure using both debt and equity. While selling stakes in the bundled loan to investors based on their individual risk appetite.

6. Each debt tranche has a distinct risk/return profile, and the collateral pool produces principal and interest cash flows that are allocated to investors, depending on their position in the structure.

7. After all debt tranche commitments have been satisfied, the residual cash flow will be claimed by the equity tranche.

8. A CLO manager can purchase and sell specific bank loans to maximize profits and reduce losses, with quality collateral securing debt.

HOW DOES A CLO WORK ?

The CLO Structure is made up of two parts: the pool of loans or the portfolio of assets, also known as the collateral, and various capital tranches forming the liabilities of the CLO. The managed pool of bank loans is owned by the CLO equity investor, and the same pool of loans is term-financed by the CLO debt investors. A CLO can be viewed as an assurance to pay investors according to a predetermined priority sequence, just like any other securities backed by assets

Collateralized loan obligations, or CLOs, are diversified portfolios of senior secured, first lien loans that are actively managed and have no recourse or mark-to-market (MTM). Investors in different parts of the capital structure have different risk / return expectations. We can understand this functionality using an illustration replicating a generic US CLO:

Typical companies held in a CLO portfolio

Virgin media, Dole, Uber, McAfee

CLO Loan Portfolio

Diversified portfolio of loans *(Illustration)*

- **Portfolio Loan:** $500mm
- **Credit Rating:** B1/B2
- **Interest Rate:** 8.9% (SOFR (5.3%) +350bps)

Available Interest Proceeds $41,805,050

	AAA	AA	A	BBB	BB	Equity
Liabilities	$318mm SOFR +150bps	$53mm SOFR+250bps	$30mm SOFR +300bps	$29mm SOFR +400bps	$20mm SOFR +600 bps	17% Excess
Illustration: **Annual Interest Due**	($21,818,012)	($4,166,335)	($2,508,303)	($2,714,693)	($2,272,202)	$8,325,505

Order of Payments →

CLO Loan Portfolio	$500,000,000
CLO Loan Portfolio Interest (*8.9%*)	$44,305,050
CLO Expenses (0.1%)	($500,000)
CLO Loan Manager Fees (0.4%)	($2,000,000)
Available Interest Proceeds	**$41,805,050**
CLO Debt Securities Interest Expenses	$33,479,545
CLO Equity Net Income	**$8,325,505**

Asset Characteristics:

- Low default rates/high recoveries
- Actively managed
- Diversified
- Floating rate

A CLO's funding is organized via CLO equity and tier-based debt issuance

Funding Characteristics

- Long-term
- Non-mark-to-market
- Fixed spread above Libor/SOFR

The types of investors in CLOs can be bifurcated across three categories:

- The most risk averse investors opt for the **Senior Tranche**, which comprises of the debts **rated as AAA or AA**. They are generally subscribed by Banks, Insurance Companies, amongst others.
- The loans rated **A, BBB and BB** form the **Mezzanine Tranche** and is generally subscribed by Institutional Asset Managers, Pension Funds, Structured Credit Funds, amongst others.
- The most risk loving investors generally go for the **Equity Tranche**, and it is subscribed by CLO Managers, Hedge Funds, Private Equity Funds, Sovereign Wealth Funds/Family Offices, amongst others.

HOW DOES A CLO PROGRESS OVER ITS LIFECYCLE?

CLOs typically have an average term of 6-9 years, as the securities are intended to be repaid earlier through the natural amortization of principal through loan repayments. There are ~4 distinct periods over a CLO's life cycle.

Start — **Deal specific** — **6 months** — **2 years** — **5 years** — **Legal maturity**

Pricing date — Closing date — Effective date — End of the reinvestment period

Warehouse period

During this period warehouse provider finances the CLO manager's acquisition of leveraged loan assets.

Ramp-up period

After closing, the CLO manager uses the proceeds from the CLO issuance to purchase additional assets.

Reinvestment period

Non-call period

The CLO cannot be redeemed by the equity holders until the end of the non-call period.

CLO collateral manager is permitted to actively trade underlying assets and use principal cash flows from underlying assets to purchase new assets.

Amortization period

Cash flows from assets are used to pay back the outstanding notes.

WHAT ARE THE MERITS VS RISK OF A CLO ?

Attractiveness of CLO

Varied Risk and Return: Investors can purchase CLOs at their desired risk and return level because of their tranche structure.

Diversification: CLOs have low issuer and industry concentrations and are well diversified across industries.

Floating Rate and Match Funding: For CLOs, most of their liabilities and assets are floating rate instruments, making investors relatively less sensitive to interest rate fluctuations.

Active Management: Since most CLO portfolios are actively managed, a competent manager may be able to achieve superior performance.

Risks Associated with CLO

Collateral Risk: The CLO portfolio, heavily leveraged, is susceptible to risks associated with debt below investment grade, like default risks.

Liquidity Risk: CLO instruments and their underlying loan collateral can face liquidity crunch in times of market stress with implications on distribution and recovery of capital.

Prepayment Risk: CLOs can be called early after the non-call period, with average lifetimes shorter than stated maturities.

Market Risk: Political and macroeconomic developments may have an unforeseen effect on the underlying portfolio's pricing and liquidity.

CLO with these features play a prominent role in the private credit market by providing liquidity and credit in the financial markets. Compared to other structured products CLOs have a solid track record demonstrating resilience across economic cycles with minimal default rates (less than 1%). With these merits CLOs continue to build-up a strong reputation and carve out a niche segment in a multi-asset portfolio.

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