CIO Office Insights

Investing in CLO Equity

March 2024

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KEY TAKEAWAYS

Collateralized loan obligation (CLO) although considered as a risky asset class have the lowest loss rate among structured credit. AAA and AA tranches have never experienced a default since 1994.

CLOs are characterized as counter cyclical, with outperformance during down-turns. CLO equity during late cycle and post recession vintages (2005-2007 and 2010-2011) have produced median realized IRR of 19%.

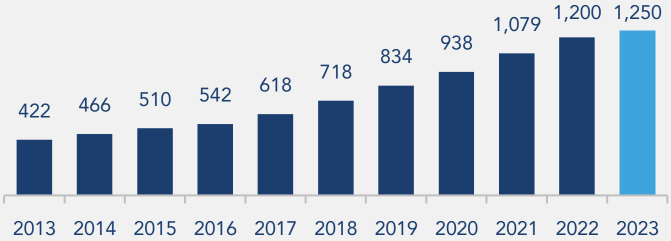
Investing in a majority position along with a skilled CLO manager with track record of low default rate are the two most critical elements of investing in CLO equity.

MARKET OVERVIEW AND CYCLICALITY

Collateralized loan obligation (CLOs) in recent years have started to spark investor interest given their attractive risk-adjusted returns. This attraction has pushed CLOs to emerge into a $1.25 trillion pillar of the corporate financing market, representing about 70% of demand for US corporate loans today[1].

The structure of a CLO offers attractive opportunities for all investors with varied risk profiles. Within the CLO structure, the equity tranche, which captures the difference between what a CLO earns as loan interest and what it pays forward to CLO debt tranches, have significantly drawn more attention because of its alpha generating capabilities.

Global CLO Market Size ($ Bn)



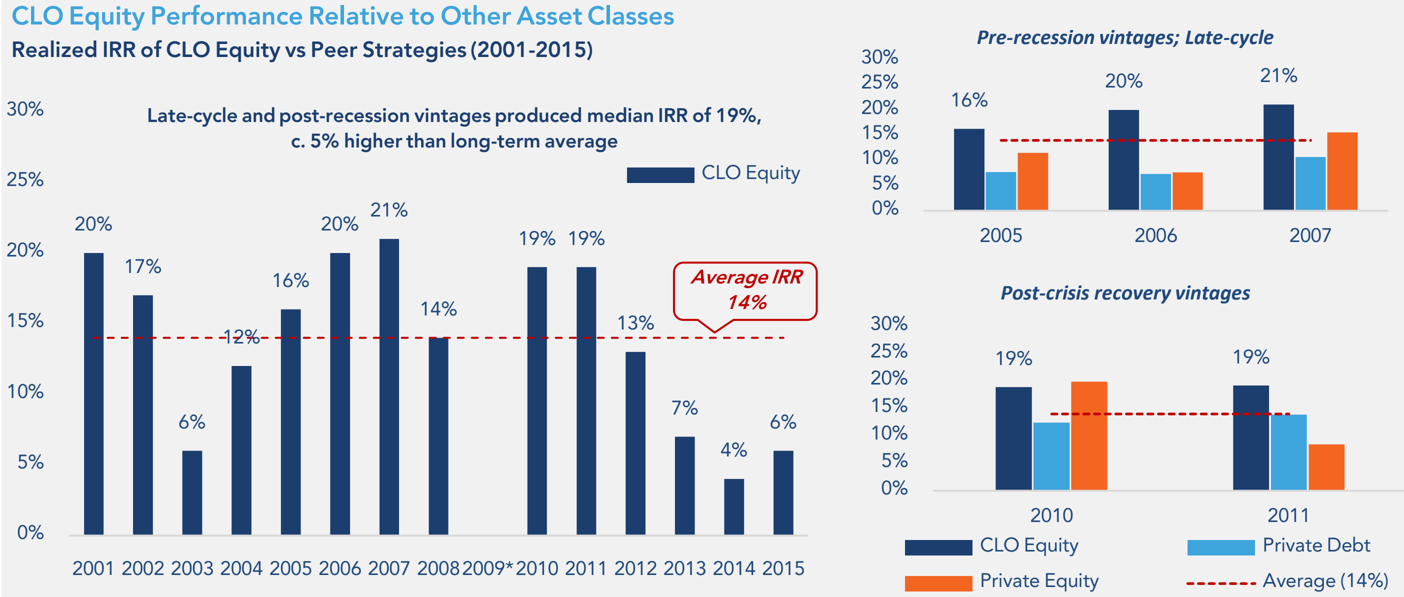
Source: BofA

The unique nature of CLO equity of being an idiosyncratic credit allocation sets it apart from its peers in the alternative segment. This asset class is characterized as benefiting most in "late cycle", as the reinvestment opportunities outweigh default risks prevalent in the downturns, so CLO managers would have the ability to buy good quality loans for discounted prices.

This enduring resilience of the asset class makes sense, as CLOs have strong credit quality focusing on leveraged loans relative to traditional high-yield corporate bonds, allowing them to experience low default rates.

CLO Equity Performance Relative to Other Asset Classes

Realized IRR of CLO Equity vs Peer Strategies (2001-2015)



Note: No CLO issuance in 2009* due to high liability pricing environment. 2016 and later vintage returns for the market not shown as there were no redemptions. Source: CLO equity returns: BofA Research; Private Debt: Preqin (includes direct lending, mezzanine, special situations, and distressed debt); Private Equity: Preqin. Includes private equity buyouts and growth strategies.

(1) BofA CLO Factbook as of 7 February 2024.

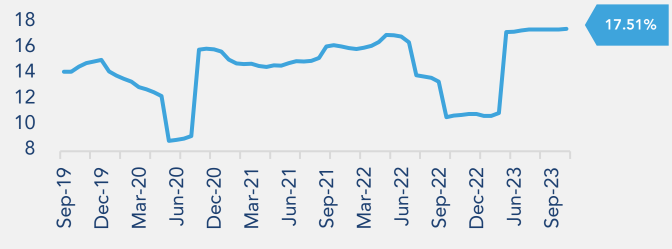
PERFORMANCE AND OUTLOOK

CLO equity returns are generated by the cash flow produced by the underlying portfolio, as arbitrage on the capital structure and the potential par build through active management of the portfolio. Par build are capital gains earned when CLO manager actively seek opportunity to sell overvalued loans in exchange of undervalued loans in the market. Although the distributions received by equity holders can fluctuate over time, historically it has remained strong, even during periods of stress.

The performance of CLO equity is influenced by 3 principal factors which affects its capital structure, cost of financing and the quality of a underlying loans:

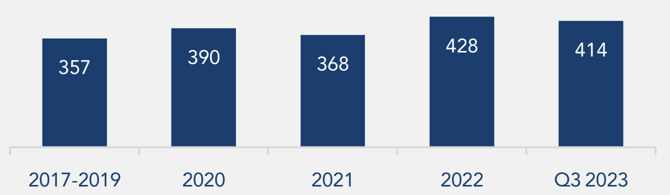
1. **Institutional loan spreads on new issuances:** This is influenced by the market's expectation of risk-return compensation, given the market volatility along with issuance activity (M&A) in the market. Historically we have seen that the new issuance spreads from pre-covid period (2017-2019) have steadily increased from 357bps to 414bps through September 2023.[1]

US CLO Equity Distribution



Source: Intex

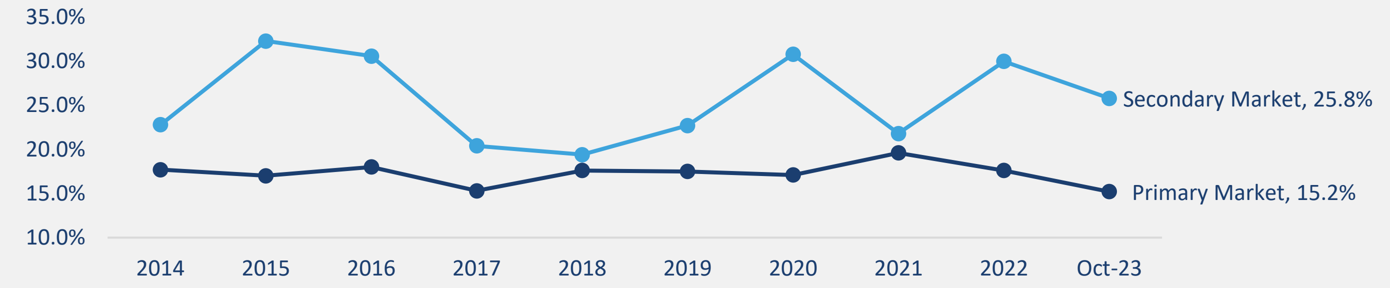
Institutional Loan new Issues Spread (bps)



Source: LCD

2. **Equity arbitrage opportunities on primary and secondary loan market:** This performance factor takes advantage of a unique structural characteristic of a CLO which allows CLO managers to dynamically select loans from either primary or secondary markets duringthe ramping up/ reinvestment stage, depending on which presents a more attractive arbitrage opportunity.

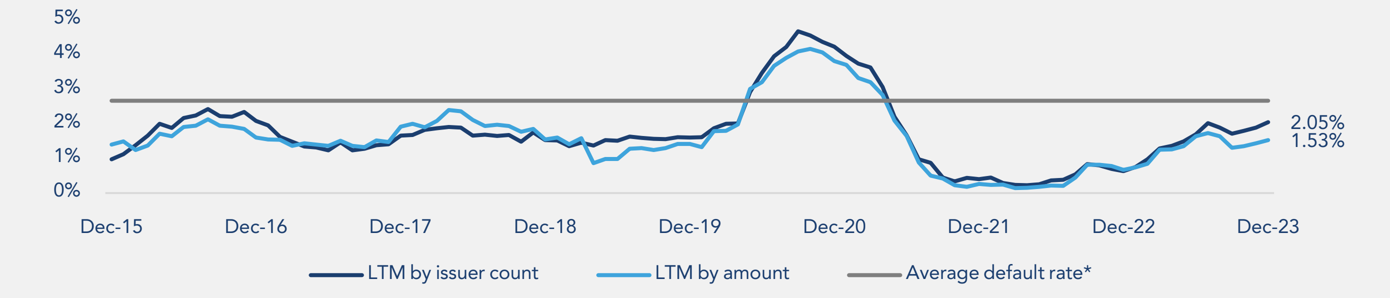
CLO Equity Spread Arbitrage (Using Primary and Secondary Market Loans)



Source: LCD. Note: This is a simplified calculation ((New Issue Loan Spread - WACC) x 10) used as a proxy for net arbitrage including CLOs issued from top 40 CLO managers by AUM. Excludes refi/reset deals, middle market CLOs and CLOs in which no WACC is provided. Spreads post -December 31, 2021 are benchmarked to SOFR; spreads pre-December 31, 2021 were benchmarked to Libor.

3. **Default rates:** Compared to high yield corporate bonds, CLOs have typically had lower default, higher recovery, and lower credit volatility rates. S&P's noted that CLO tranches with ratings of AAA and AA have never experienced a default since 1994. As per Morningstar LSTA leverage loan index the last twelve-month (LTM) default rates through 2023, stood at 1.53% as of December 31. The default rate continues to run considerably below its historical average of just under 2.67%.[1]

Annual global default rates for CLOs and corporate issuers



Source: PitchBook | LCD; Morningstar LSTA US Leveraged Loan Index | * Since 1999

In our opinion, CLO equities is an attractive investment opportunity considering the current unstable macroenvironment and the late cycle standing. Skilled managers along with majority CLO equity investors are well positioned to use their option to reset or refinance existing CLO debt stacks with more defensive loans. As the market is currently presenting opportunities to capitalize on price dislocations on acquiring high-quality loans at attractive discounts.

(1) Pitchbook

ALLOCATING TO CLO EQUITY

Despite the long history of being in existence, CLO equity remains a relatively niche and unrecognized investment strategy. Investors often wonder about which allocation bucket a CLO equity should be pooled in; either as equity, fixed income, or alternatives. Equity because of its position in a CLO capital structure; fixed income because it is based on a portfolio of leveraged loans; and alternatives because of the asset class's relative illiquid nature. The uniqueness of this asset class, allows the investors to reap equity-like returns that are based on a structured credit, diversified and with low correlation to the traditional asset allocations.

On the risk side, the flexibility of the CLO structure to actively trade can also create temptation for the managers to provide an outsized yield by seeking riskier assets into the portfolio. The investors should remain vigilant that higher returns are often enough associated with higher risk, which they may not be comfortable accepting.

Because of this not all CLO equity investments are created equal; factors like CLO manager quality, experience and strategy execution capacity and as well as investors positioning within equity tranche, can greatly impact the returns of the investors.

When thinking about investing in CLO equity, an investor should evaluate the following investment approach and standard for manager selection:

Investment control

- An investor should lookout for a majority position availability in the CLO equity structure. A controlling position allows the investor to negotiate the terms more favorably.
- The control optionality such as right to reset, refinance or call a CLO , can create significant value.

Optimal capital structuring

- Generally, more established CLO managers, are able to secure lower cost of financing.
- An established brand allows them to attract a pipeline of opportune loans in primary and secondary market.

Ability to mitigate and manage risk

- A CLO manager should have sound internal capability to underwrite their loan portfolio to manage credit risk, monitor downgrades and avoid defaults and losses among the loans that are held in the portfolio.
- These risk management capability should reflect over a multi-cycle track-record while maintain an above average performance.

Strong fundamentals and skill-set

- Managers should have a robust investment decision making process, allowing them to actively manage the portfolio during the reinvestment stage.
- A manager must showcase the capability to Par-built in volatile market, while avoiding excessive low rated loans (triple-C loans).

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