CLOs Revisited – Ratings, Risks, and Returns (First of a Series)

THE LEAD | March 24, 2021

“Anytime loan market technicals shift, there’s always a view that CLOs are the end of Western civilization as we know it.”

So a top CLO manager related his experience over several decades. Regardless of actual historical performance, collateralized loan obligations are periodically hauled out by the media, excoriated for reckless behavior, and dismissed as just another unfortunate feature of “risky loans.”

As a corrective, we ran a series of articles in 2014 (“Why CLOs Matter”), and converted to a white paper [link]. Besides serving as a primer on these securitized vehicles, it examined their supply and demand equation and the way CLOs have adapted to changing market conditions over their history. We also looked at the value of middle market CLOs relative to broadly syndicated CLOs.

Most importantly, we provided a level-headed assessment of these vehicles’ remarkable track record over many business cycles. Not only as institutional investments across the capital stack, but also as the fundamental building blocks for a $1.2 trillion universe of buyout loan financings.

Seven years later, the leveraged loan market has once again emerged from a sharp economic downturn largely intact. Similarly CLOs came through the past twelve months in good shape, especially considering the breadth of sectors their assets represent. We know the challenges travel, retail, energy, and hospitality-related businesses faced during this pandemic. But in many cases those industries are beginning to heal.

The good news for CLO managers is the massive ratings downgrade wave appears to have abated. In the three months ended January 2021, the count of upgrades in the S&P/LSTA Leveraged Loan Index has nearly reached parity with downgrades. The last time that happened was February, 2017.

New vehicle formation is responding. As our *Chart of the Week* highlights, CLO volume in the US declined last year to about $90 billion from just under $120 billion the year prior. But year-to-date activity is up to $30-ish billion, from $20 billion for the same period in 2020.

“Last year was all about the asset side,” one source told us. “This year it’s all about the liabilities. Spreads are coming in for triple-As which makes the equity story more compelling for investors. That’s what’s driving new deals, and I expect that trend to continue.”

Over the next few weeks we will be revisiting the state of the CLO market in this (almost) post-Covid environment. We’ll look at how the rating agencies responded to the changing risk climate zones we passed through last year. We’ll also re-examine the supply/demand technicals for both CLO assets and liabilities.

Finally we’ll spend time on middle market CLOs. How did they fare last year in the wake of the pandemic, and how are they positioned for the rebound?

Next week: How did Covid impact CLOs?