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

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Competition in leveraged loans, keen as it is, pales in comparison to the 2021 Mrs. Sri Lanka pageant. Reigning Mrs. World champion, Caroline Jurie yanked the tiara off newly-crowned winner Pushpika DeSilva, charging Mrs. DeSilva was not married. Mrs. DeSilva fled the stage in tears.

Order was eventually restored. Mrs. DeSilva reclaimed her crown, and Mrs. Jurie resigned hers. We look forward to the 2021 Mrs. World pageant to be held later this year…in Sri Lanka.

Meanwhile in the less dramatic world of middle market CLOs, managers made it successfully through the pandemic, and are positioned for the rebound.

For some perspective, MM CLOs represent about 14% of the total CLO market, both in terms of issuance and outstandings. According to S&P/LCD the number of new vehicles launched over the past six years has increased annually. At the moment there are about 111 rated by S&P.

Our white paper (“Why CLOs Matter”) details differences between midcap and large cap vehicles, but generally they come down to assets and strategies. BSL loans are liquid and rated; managers actively trade them. MM loans are illiquid and mostly unrated; managers buy and hold them.

Because MM CLOs rely on credit estimates rather than public ratings, Churchill’s Kelli Marti told us, “ratings” are only refreshed annually. So while BSL managers suffered a massive wave of downgrades last spring, the impact on middle market CLOs was more gradual.

“Middle market CLOs also have more generous CCC buckets than BSL CLOs,” she said, “as credit estimates tend to be more conservative than public ratings. Despite the impact of credit stress experienced in 2020, very few middle market CLOs reported junior OC test failures.

“For the most part,” Kelli went on, “middle market CLOs performed well during the pandemic. The structure of middle market loans (including financial maintenance covenants) provides lenders more notice to spark dialogue with borrowers and sponsors if performance weakens. Measures can then be taken to obtain sponsor support for enhanced liquidity or lender concessions.”

When 4Q 2020 brought a strong rebound in middle market leveraged loan issuance and improved liability pricing, CLO managers were anxious to focus on new opportunities. Many projected a strong year with new issue guesstimates of $10-15 billion. Liability spreads have tightened, but competition for assets has intensified. Pricing on new loan issuance has dipped close to pre-Covid levels, with borrowers seeking refinancing of terms set a year ago at Covid’s onset.

As our *Chart of the Week* shows, MM CLO issuance is off to a strong start. 2021 activity is $4.7 billion for the first quarter as managers take advantage of favorable liability pricing. One structural consideration managers are requesting is larger CCC buckets. Three MM CLOs issued in 2021 have included CCC baskets of 20%, which is a welcome enhancement from an issuer’s perspective.

Next week: How should investors think about risk/reward dynamics for CLOs?