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CLO Awakening (Second of Two Parts)

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As the leveraged loan market woke up this past January, as confidence in the economy and rate expectations grew, so the CLO market has rebounded. Not just in the US, as we detailed last week, but in Europe as well.

Our friends at Creditflux highlighted this phenomenon, quoting one leading manager as saying: “Given the number of CLO issuances year to date, we see 2024 breaking records for gross new issue volumes in Europe.”

As our Chart of the Week shows, European issuance year-to-date totals about €27 billion 2024, almost double 2023’s €15 billion of activity, per PitchBook LCD. Contrast that with US issuance of about $115 billion and $60 billion, respectively for this year and last year.

From a pricing perspective, both US and Europe have seen the cost of triple-A liabilities come down in the same way loan spreads have compressed. Recent European vehicles have been issued at their tights slightly below 130 bps with their US counterparts a bit above that.

The refinancing and repricing dynamic we covered for US CLO issuance last week happens in Europe. While overall volume is at record high levels, activity net of liquidations and amortizations is not as exuberant. PitchBook quoted BofA: “Triple-A net supply has remained positive in both quarters, unlike in the US where triple-A net supply was negative in Q2.”

Turning to the US middle market, private credit CLO issuance is expected to stay on record pace again this year. Year-to-date issuance of middle market/private credit deals totaled $21 billion, roughly 77% ahead of the same period in 2023.

2024 MM/PC issuance is forecast to end up somewhere between $35-40 billion. A large portion of the growth in CLOs is the common practice of PC asset managers issuing CLOs out of managed funds, including BDCs.

Recent mid cap prints have been in the low 170 context, demonstrating continued interest in the space; this level represents a 30-40bp discount from AAA pricing at the start of the year.

From a risk perspective, CLO defaults are rare; no AAA tranche in either US or European CLOs has ever defaulted. The historical default rate for all CLO tranches is just 0.11%, and none occurred post-GFC until 2021. Then only after portfolios had been partially weakened from loan credit quality issues emerging during the Covid-19 pandemic.

In a similar vein, Barclays analysts reported that BSL CLO exposure to S&P-rated CCC assets dipped month-over-month. The median exposure fell to 6.2% in July from 6.5% in June. Only 27.1% of CLOs have in excess of 7.5% of CCC or below rated assets compared to 32.9% in June, according to Barclays.