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PUBLIC FIXED INCOME

CLO Equity: 101

INSIGHTS

From quarterly cashflows to compelling total return potential, CLO equity offers a number of potential benefits. But the asset class is often overlooked, due in large part to its perceived complexity relative to more traditional fixed income investments.

Adrienne Butler
Head of Global CLOs

Bo Trant
Client Portfolio Manager, Structured Credit

What is CLO Equity?

Collateralized loan obligations (CLOs) are structured vehicles that invest in pools of senior secured loans from corporate borrowers and exhibit a few key characteristics:

- They provide investors access to a highly diverse portfolio of senior secured loans across issuers (typically 150–200 issuers) and industries (typically 15–25).
- They offer transparency, as the underlying holdings are reported to investors on a monthly basis.
- The collateral pools are actively managed by experienced asset managers who have teams to underwrite each of the corporate loans held.
- They have term financing, making them more resilient to changes in the mark-to-market of the underlying collateral, allowing managers to focus on limiting credit risk and increasing value for equity tranche investors.

CLO equity is the common name for the subordinate note (residual tranche) of the CLO structure. This tranche generally receives the residual cash flows generated by the loan portfolio after the CLO debt tranches receive their contracted interest payments. The equity tranche typically represents 8–10% of the capital structure of the CLO, meaning it provides CLO equity investors with 8–10x levered exposure to a portfolio of senior secured loans. This exposure represents a materially lower capital commitment than a direct investment in a senior secured loan portfolio, and also positions investors for potentially higher total returns.

Investors in CLO equity have the ability to invest either as a majority equity investor, meaning they hold more than 50% of the outstanding equity tranche of a CLO, or as a minority equity investor that holds less than 50%.

Figure 1: CLO Deal Structure

CLO Debt Tranches	Class A (AAA): 60–63%
	Class B (AA): 10–13%
	Class C (A): 7–9%
	Class D (BBB): 4–6%
	Class E (BB): 4–6%
CLO Equity Tranche	Subordinate Notes (Not Rated): 8–10%

Sources: Barings.

1. Source: BofA. As of June 25, 2024.

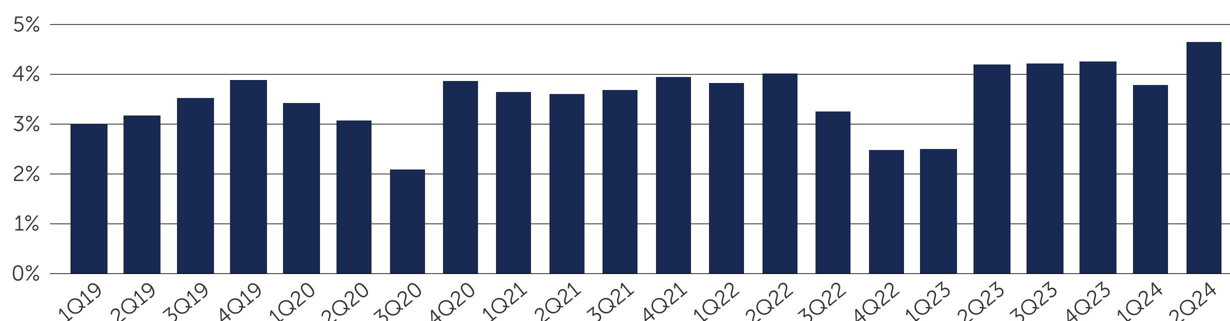
Why is CLO Equity Attractive?

There are a number of reasons why CLO equity is worth consideration, with **cash generation**, **total return potential** and **control features** chief among them.

CASH GENERATION

CLOs receive quarterly cash distributions throughout their lives **(Figure 2)**. This quarterly return of capital immediately reduces the initial investment and thus helps to mitigate downside capital loss on a net basis. These residual cash distributions have averaged 3–4% per quarter over the last 11 years.[1] Often, the earlier quarterly distributions can be somewhat higher due to warehouse carry, par creation opportunities, and longer accrual periods. With this in mind, the average CLO equity tranche can potentially produce 18–20% of its returns in the first year after a CLO is issued, subject to market conditions and ramp schedules.

Figure 2: Quarterly CLO Equity Returns

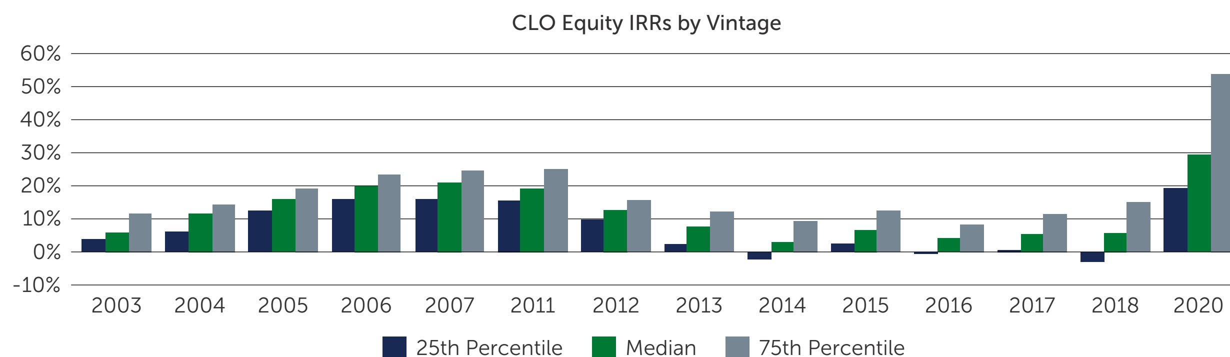


Source: BofA. As of June 25, 2024. Median Cash on Cash Quarterly Returns. Cash on Cash return measures the amount of cash flow relative to the amount of cash invested in an equity tranche.

COMPELLING TOTAL RETURN POTENTIAL

CLO equity has a long history of positive performance, having produced double-digit returns for investors through multiple market cycles. From 2003 through the first half of 2024, the median internal rate of return (IRR) was 13.2%. During that time, 25% of CLO equity tranches produced IRRs above 20% and more than 87% had IRRs above zero **(Figure 3)**.

Figure 3: CLO Equity has a Long History of Positive Performance



Source: BofA. June 25, 2024. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

1. Source: BofA. As of June 25, 2024.

"Often, volatile markets also provide opportunities for prudent credit selectors to generate alpha by purchasing high-conviction loans at discounted prices."

CLO EQUITY RETURN COMPONENTS

To better understand the long-term performance of CLO equity, and particularly why CLOs may often perform better during times of volatility, it is important to highlight the benefits of Excess Spread and Active Management.

Excess Spread

The excess spread component is synonymous with the term deal arbitrage (arb). It is measured by taking the amount of interest earned on the underlying pool of loans and subtracting both administrative fees and liability interest cost. Fees include trustee expenses as well as the manager's fee. Liability interest cost includes the all-in cost of capital, inclusive of all the CLO liability tranches.

Excess Spread (Arb) = Interest Earned on Underlying Loans – Cost of Interest + Fees

For simplicity's sake, assume the assets of the CLO, a diversified pool of loans, may earn SOFR+350 bps while accruing all-in liability costs of SOFR+250 bps. The net 100 bps (1%) difference is considered the deal arb or excess spread. As equity can be up to 10x leveraged, this excess spread can potentially lead to meaningful double digit returns. Strong underlying market conditions often lead to increased demand for CLO liabilities, which can translate into tighter liability pricing providing improved arbitrage to the equity slice over the life of the transaction.

It is important to note that CLO liabilities typically contain a 1–2 year non-call period after which these bonds can be either refinanced or reset to better capitalize on an improved pricing environment, in the event that liabilities tighten after the initial CLO close. This feature allows CLO equity to improve their returns and not be "locked in" to an outdated or higher cost of capital. The feature to refinance the liability structure is controlled by majority equity.

Active Management

Active management is designed to not only maximize equity returns, but also minimize losses. While initial credit selection of the portfolio should be a meticulous and well-thought-out process, the active management of the portfolio after closing—throughout what is typically a 5-year reinvestment period—may be even more critical to the ultimate long-term equity return.

In strong markets, active portfolio managers with established trading desks are well-positioned to actively trade a portfolio in a way that maintains strong credit quality while also generating trading gains. Managers with deep research teams can further bolster the credit quality of the CLO by overweighting or underweighting exposure to specific industries or issuers. Understanding not only macro market dynamics, but also loan-specific risks is also critical to active management and enhanced equity returns.

In volatile markets, experienced active managers can help mitigate credit losses by trading out of distressed situations early or by providing expert guidance through workout teams to minimize credit losses or maximize upside potential. Often, volatile markets also provide opportunities for prudent credit selectors to generate alpha by purchasing high-conviction loans at discounted prices. Buying loans at a discount can be accretive to the overall CLO structure as it increases the size of the asset pool, and hence improves the arbitrage and enhances equity returns. It is important to note that while CLOs are not forced sellers in any credit situation, active and early portfolio management is crucial to maximizing long-tern returns during periods of volatility. Interestingly, some of the best performing CLO vintages were managed through volatile periods such as the great financial crisis and the Covid pandemic.

CONTROL FEATURES

CLO legal documents provide equity investors with certain voting rights, including the ability to call, refinance or reset a transaction. Most CLOs have a 1–2 year non-call provision; although after this time, transactions can be called, refinanced (spreads lowered but reinvestment periods remain untouched), or reset (spreads lowered with extended reinvestment periods). These features can be beneficial to the arbitrage or ultimate IRR of a CLO.

Voting rights attached to many of the control features of the CLO lie in the hands of majority equity, typically defined in the credit documents as 51% of the holders of the residual equity tranche of the CLO. The ability to control the liability features of a CLO is important because CLOs are launched at different points in time (vintages), with the pool of loans and the trading levels at which they were purchased differing by each individual CLO. The cost of capital of CLO debt tranches also tends to fluctuate based on market cycles. Therefore, the timing of each of these decisions has the potential to meaningfully affect the return to equity tranche investors.

- ***Call—***After the 1–2 year non-call period (as outlined in CLO legal documents) a CLO can be called. This means that the portfolio is liquidated, the debt tranches are repaid, and the equity investors receive the residual value. As such, being in a position to decide when to liquidate the portfolio is important.
- ***Refinance—***After the non-call period, CLO equity investors can also choose to refinance the debt tranches. This is similar to refinancing a mortgage and tends to occur if or when interest rates are lower than they were at the time the CLO was issued. Refinancing the debt tranches lowers the cost of capital and increases the excess spread available to equity.
- ***Reset—***Rather than just refinancing the debt tranches, CLO equity investors can also "reset" the CLO. In addition to lowering the spread, a reset also allows equity investors to make further amendments to the CLO such as extending the reinvestment period, pushing out the maturity date, or adding additional capital. Equity investors typically choose to reset in order to either improve excess spread, enhance documentation and/or add additional value through further relative value trading.

These control features can be particularly (and extremely) valuable to investors who entered a CLO equity position during a period of expensive or wide CLO debt with cheap loan prices—in essence, positioning a collateral manager to build a portfolio of cheap assets and refinance into a capital structure of cheap debt, resulting in an optimized CLO return structure for equity.

Where does CLO Equity fit in Investors' Portfolios?

As asset allocators evaluate the merits of CLO equity as part of their broader investment portfolios, it is worth noting that CLO equity has been allocated to multiple buckets throughout its existence.

- ***Privates—***Certain allocators may place CLO equity in the same class as private assets due to its non-mark-to-market features, relative illiquidity and high targeted returns.
- ***High Yield/Fixed Income—***Because the underlying asset pool is made up of corporate loans that make quarterly payments, many investors place CLO investments in their high yield/ public fixed income bucket.
- ***Alternatives—***Given its perceived niche nature and higher potential IRR, some investors opt to place CLO equity outside of more traditional asset classes, in areas like alternative investments or alongside strategies such as capital solutions, opportunistic and distressed investing.

> *"Strong structured credit managers typically offer greater access to deal flow and market intelligence that may not be available to direct investors."*

INVESTORS CAN GAIN ACCESS TO CLO EQUITY IN MULTIPLE WAYS:

1. *Direct investment*—One way investors can access CLO equity is by investing in majority or minority positions directly in an individual manager's CLO. This requires individual manager and CLO deal diligence. Investors must also be well connected to the platform and deal placement agent in order to get access to the specific transaction and be in a position to negotiate deal specifics.
2. *Third party structured credit manager*—Another way investors can access this opportunity is through a third-party equity tranche investment manager. This method outsources the deal and manager diligence to a broader structured credit team that can access multiple CLO managers' CLO equity in both the primary and secondary market. Strong structured credit managers typically offer greater access to deal flow and market intelligence that may not be available to direct investors.
3. *Captive equity fund*—A growing trend in the market is for investors to invest in a specific manager's captive equity fund. This provides investors with simplified diligence, allocation certainty, and vintage diversity. Moreover, these funds often come with enhanced economic features through fee rebates and opportunities for warehouse carry that can further boost returns.

Key Takeaway

CLO equity is often overlooked, due in part to its perceived complexity relative to more traditional fixed income investments. However, the asset class offers a number of potential benefits, including:

- ***Cash Generation—***Investors receive residual cash flows on a quarterly basis that have averaged 3-4% over the last 11 years.
- ***Compelling Total Return Through Excess Spread and Active Management—***Since 2003, the median internal rate of return for called CLO equity tranches has exceeded 13%.
- ***Control Features That May Further Improve Performance—***CLO equity investors hold voting rights, with the majority investors influencing key decisions that can affect total return.

As with all investments, there are risks involved as well. The key risks in CLO equity investing are credit and liquidity risk, which tend to be directly tied to the selection of the CLO collateral manager and the portfolio of bank loans that manager purchases, both initially and on an ongoing basis. For this reason, when investing in CLO equity, allocators should carefully consider partnering with managers whose style matches their risk and return objectives. In addition to ensuring a CLO manager has a strong credit team and large investor following, it is important to look for a manager who exhibits steady issuance and performance across market cycles. These features can provide for reliable investment opportunities and better long-term liquidity.

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GLOBAL CLO CAPABILITIES

Our CLO team has managed through multiple credit cycles and market dislocations.

1998	100+	Top 20	60+
Inception of CLO Platform	CLOs Managed	Global CLO Issuer by AUM	Dedicated Investment Professionals

Source: Barings. As of June 30, 2024.

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