



**Thomas Majewski**

*Founder & managing partner*

*Eagle Point Credit Management*

**Cash-on-cash returns, default records and leverage statistics don't always give CLO investors the full picture**

**C**LO equity has been earning its stripes again through the latest cycle and this has invited growth and some new market entrants searching for yield. However, the arrival of new CLO collateral managers makes picking investment opportunities increasingly challenging. We again have to flag up certain information in marketing pitches that, for years, has been giving investors unrealistic expectations.

**Cash-on-cash returns aren't equity returns**

One slide in nearly every CLO collateral manager's pitchbook quotes the cash-on-cash equity returns of each CLO under management. In other words, the amount of cash paid to equity investors annually as a percentage of the tranche's par value. These slides often display returns of 15% or better.

However, this figure ignores that CLO equity rarely receives 100 cents on the dollar back at the end of a CLO's life. Instead, the final equity payment is dictated by the equity liquidation NAV, which typically ranges from 30 to 70 cents.

In other words, while you may receive high cash interest payments, the overall return of the investment will be lower than your cash-on-cash returns. Don't confuse cash on cash with internal rate of return — they are not the same.

A few slides away from the cash-on-cash slide is likely one describing the CLO collateral

when you consider the knock-on effects to trading each downgrade or default has through the application of rating agency tests — but it is important to understand the full picture.

At the end of a CLO's life, all that matters are prior cashflows and the equity NAV on that day.

**Low-leverage only implies lower returns**

The low-levered CLO is not a new concept. Seasoned market participants will recall these structures from before the financial crisis. The pitch is always the same — that by seeking reduced leverage and targeting lower yields, the CLO will be less volatile and less risky. That all sounds good, but it just doesn't actually occur.

One of the crucial risk-mitigating forces in CLO equity is the strong cash-on-cash returns. By over-equitising the low-levered CLO, the equity investors in effect put up capital in lieu of lower-rated debt tranches. Though there is less debt interest to pay, the cost of the equity capital put up is significantly more expensive than the debt that would have otherwise been sold away — leading to materially lower cashflows as a percentage of equity par.

At the same time, this larger equity tranche is exposed to any default or credit sale in the same way as regularly levered CLO equity. This leads to similar mark-to-market drawdowns in volatility, despite the lower leverage, as we saw in 2020



# We again have to flag up information in CLO marketing pitches that can mislead investors

manager's default performance. This slide will often quote a defaulted percentage materially below a common loan index. In our experience, the average CLO collateral manager performs far better than average — at least according to their stats. (This is, of course, statistically impossible.) The slide may even include loans sold before a default, boasting of early exits.

What these default slides fail to mention is the value potentially missed through an early exit. In order to pad the default statistics, a CLO collateral manager may sell a loan just prior to default to keep their default track record clean.

To judge credit performance, investors should scrutinise par gain or loss numbers and trade success statistics against loan recovery values across portfolios. This is complex — especially

and in previous cycles. In a phrase this is: "lower quarterly cashflows, similar price volatility".

For CLO equity investors, in choppy markets, it is great to be 'short' CLO debt, which all equity is effectively. Why would you want to have less of a good thing? We would challenge any CLO collateral manager to show us where an intentionally underlevered CLO delivered outperformance in choppy markets.