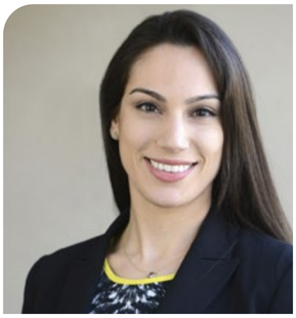

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Strong secondary loan prices are making CLO liquidations a compelling option

> The reset market is open, but it doesn't always make sense to extend the life of a CLO

To call, or not to call? That is the question in early 2022. On the back of record-breaking retail inflows into floating rate products and low expected loan default rates, the loan market is seeing solid support in secondary prices.

In direct correlation with this rise in loan market values, CLO equity NAVs have now fully rebounded from the covid-related volatility lows of 2020. For those with their hands on the call button — primarily third-party majority equity holders — is this the time to press it?

There are many factors a holder can incorporate into their call analysis. Some may be taking a macro view. Others may be making a specific credit play, such as unlocking the value of reorg equity. It may simply be a view on a CLO collateral manager's future performance, or a call on near term loan prices. However, two items almost always rise to the top in considerations: the reinvestment period remaining and the cash-on-cash equity return on NAV.

The first is simple: when a CLO has a shorter reinvestment period and has less trading flexibility, its ability to take advantage of asset optionality is limited. In other words, when loan prices are near all-time highs, there is limited upside and a lot of downside as the CLO equity is essentially a levered play on loan prices. If the CLO is not resettable, you can generally assume a shorter reinvestment period makes calling more likely.

The second is maths. When compared to the principal value which may be received in a CLO liquidation, are the CLO's interest payments enough to justify continuing? If CLO equity NAVs are low, this question becomes less challenging. However, a robust market for floating rate product can shift this thought process towards a call.

Riding the repricing wave

A strong loan market is often coupled with a repricing wave. As a CLO's portfolio spread gets compressed, quarterly cash-flows drop and it makes less sense for a CLO to remain outstanding. A holder might then consider a refinancing or reset, instead of calling.

While the reset market is active today, it doesn't always make sense to extend the life of a CLO. For example, a CLO collateral manager's par loss or asset restructurings might require additional capital injections at the reset. After including the costs to dealers, rating agencies, as well as additional expenses, it may be uneconomical. Timing in the busy primary market queue has also proven tricky, with investors and CLO collateral managers rushing to get refinancings or resets done with limited resources.

These limitations may also sway investors towards a call over a reset, which can be effected quickly and efficiently — well, sort of. A call is not always easy. For starters, execution levels may differ from the loan pricing observed on screens. Loan bid depth and timing of settlements must be considered with the CLO collateral manager.

Reorg equity can have hidden value

Reorg equity may provide value not captured in overcollateralisation tests, but often adds contractual complexities along with illiquidity. On the flip side, reorg equity securities may deliver hidden value if played correctly.

CLO calls are certainly more prevalent today than in recent memory on the back of strong loan demand. Generally, this activity is healthy for the CLO market as seasoned assets are jettisoned and replaced with new issue portfolios.

Although we believe the reset option will continue to be favoured, disciplined investors have learned to spot the right time to pull the plug and start anew versus engaging the recycling process.

In the right market conditions and with the right tools, majority equity holders may take advantage of these unique rights, and are now more frequently choosing the liquidation route.