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The ability to refinance or reset a CLO is valuable, but there are friction costs to consider

Last year's headlines — of record-breaking new issuance and the size of the global CLO market crossing the $1 trillion threshold — have been well documented. Meanwhile, refinancing and reset volumes of over $250 billion also smashed records in 2021.

Although it is less in-the-money today, the ability to direct a refinancing or a reset is still a valuable option to the majority equity holder. However, the friction costs in execution can be material.

An equity investor's price yield table may factor in the attractiveness of the CLO equity optionality, but it fails to capture the nuances of when to refi, reset or call a CLO. For example, a majority equity investor needs to navigate securing a spot on a CLO collateral manager's pipeline and obtain a rating agency slot. This may be critical the next time the refi and reset window opens.

It's no good just chasing the action

The CLO market can sometimes resemble a primary school soccer game at recess. Everyone on the field is crowded around the ball in chaos, when a properly thought-out game plan, with the right personnel strategically positioned around the field, could keep the ball moving efficiently towards the goal.

During a record-breaking year of issuance, like 2021, majority equity investors looking to exercise their right to refinance or reset had to communicate with CLO collateral managers well in advance to manage deal pipelines and compete with other deals the CLO collateral manager might be preparing. After all, some CLO collateral managers didn't have a day in the year when a new issue, refinancing or reset wasn't in the market.

Then there's the challenge of selecting a dealer. Equity investors need to be cognisant of which dealers have the bandwidth to structure and market a transaction. This is greatly aided by relationships and experience. And even with the perfect dealer lined up, there are still other parties to consider, such as rating agencies. Due to the record-breaking volume last year, rating agencies were backed up, and deals needed to have a slot in the queue to receive a rating. It would be great if there was a tradeable market for rating agency slots. This is another form of friction cost that doesn't show up on price yield tables.

Another consideration is if there isn't a single majority equity holder. If the majority is held by a consortium of investors, then forming a consensus on which right to exercise — and when — can present another hurdle.

With many CLOs out of their non-call periods, there is still significant value to be unlocked, whether via refinancing or resetting when the market returns to pre-invasion levels. Another right, which is more common today, is liquidation.

There could be myriad reasons to call a deal, and some require the consent of a CLO collateral manager, which may stand to lose its management fee stream. This is where relationships and documentation can make a difference. Liquidating or transferring a portfolio can take weeks — and the loan market will move while legal notices are drafted and posted. These slippage costs, too, can be minimised by experienced equity investors.

Timing is all, but it is never perfect

As the CLO market continues to mature and investors are drawn to the asset class, they must be aware of the slippage costs associated with the headline returns. Refis and resets are not as easy as exercising a stock call or put option.

CLO equity is a great investment, ripe with optionality, but not everyone has the resources or bandwidth to realise it effectively. The market is inefficient, as evidenced by some CLOs that have missed their window of opportunity. And nobody can always time things perfectly — because even the best managers won't be able to execute on their entire portfolio at once.

Given these timing issues and hidden costs, it is wise for managers to prepare now for the next action, even if it seems less imminent today. There are many levers to utilise — and with the right game plan, an experienced equity investor and a deep team, options can be turned into valuable opportunities.

> The CLO market can resemble a primary school soccer game, with everyone crowded around the ball