Thomas Majewski

Founder & managing partner

Eagle Point Credit Management

High triple C CLOs sound like a good idea on paper. But in practice, they have not fared well

As we sit on the edge of what could become the next global recession, it's a great time to highlight how traditional CLOs are designed to hold and acquire discounted assets in times of volatility.

All CLOs benefit from multi-year reinvestment periods and term financing without the burden of margin-style mark-to-market triggers. This ability to reinvest through cycles proved one of the best features of CLOs during the last credit downturn.

Contrary to what is misleadingly contained in the marketing materials of many distressed credit funds, CLOs can hold triple Cs and defaulted assets without being forced sellers. The holding periods for low-rated assets typically aren't limited, but most traditional CLOs do face limitations regarding the purchase of new triple C assets above a certain threshold, as well as punitive haircuts for defaulted assets as time passes. These adverse incentives keep traditional cash-flow CLOs light on these sorts of assets.

Enter "enhanced" CLOs in 2017

High triple C CLOs gained popularity in 2019. They had the ability to buy far larger amounts of triple C-rated assets compared to traditional CLOs. Further, these so-called enhanced CLOs offer more cushion in terms of the amount of triple Cs that can be held prior to a failure of the CLO's over-collateralisation test causing equity payment interruptions. The pitch sounded attractive — at least on the surface.

Then came covid. Russia invaded Ukraine. And inflation soared to 10%. Quality loans began trading in the low-90s. But environments like these should be perfect for enhanced CLOs, right?

Our expectations that enhanced CLOs would fail to live up to their promise have proven correct. There is no free lunch in the CLO market and a three-course meal of challenges for enhanced CLOs — higher debt costs, less leverage and shorter tenors — took a massive bite out of their advertised equity returns.

Some enhanced CLO collateral managers added triple C and second-lien exposures too early, wanting to generate early returns. Others pushed down the pedal too dramatically at the first sign of cracks, as they began to feel the pressure of their mounting underperformance.

When the market did turn, these structures were left holding too much risk. They suffered higher defaults than traditional CLOs and faced payment interruptions despite being underlevered. Though these investments are structured to hold additional risk assets, rating agency overlays and rapid market movements left the collateral managers of enhanced CLOs unable to rotate.

Our view was that, unless the credit cycle turns immediately after pricing, the higher debt costs and lower leverage of an enhanced CLO would translate to lower equity returns. And stacking them up today versus traditional CLOs of comparable vintages, the equity IRRs of enhanced CLOs are nearly all in the bottom decile of the market.

In addition, when issued, enhanced CLOs were only able to secure two- to four-year reinvestment periods (compared to the typical five-year reinvestment periods in regular CLOs at the same time). Their bespoke structuring and potential for added risk also left them without the ability to refinance or extend in their last few years. Many will soon be going static, so their equity underperformance is all but locked in.

In order to be able to take advantage of an excess of out-of-favour assets, the portfolios of enhanced CLOs needed to be defensive before the credit downturn. But this doesn't seem to have been the case for most enhanced CLO portfolios we've seen. And defensive positioning comes at a cost. If a credit cycle doesn't occur quickly enough, the premium paid to debt financiers of enhanced CLOs will be analogous to an option expiring worthless. In such a scenario, equity investors in enhanced CLOs face potential returns below what is available as an investor in the mezzanine tranches of the same CLOs.

Even when timed well, the CLO collateral manager must navigate artfully to overcome high debt costs and low leverage. To that end, so far it seems debt investors in enhanced CLOs will come out ahead — so long as their investments pay off at par at maturity.

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