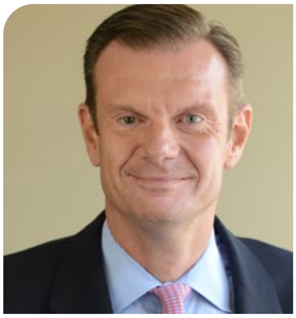

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The markets are supporting high reset and refi volumes — but sometimes calls are a better option

Broadly syndicated loans and CLOs kicked off 2024 with a nice rally. As a result, we are seeing a resurgence of majority CLO equity holders exercising their rights to refinance, reset, or even call their CLOs. Refinancing and reset volumes for January and February are already halfway to reaching the full-year volumes for both 2022 and 2023.

Following the more than USD 250bn of refinancing and reset transactions in 2021, volumes slowed to a trickle over the following two years. CLO triple A spreads widened to recent highs and the in-the-money nature of in-place CLO financing made refinancings and resets uneconomical. However, that changed at the tail-end of 2023, when the Fed-pivot rally lifted all credit markets, tightening CLO triple A spreads in the process.

Bank demand supports CLO triple As

While momentum from the rally has moderated in other credit asset classes, CLO triple A spreads have remained well supported, largely from bank demand. Many CLO triple A investors are facing paydowns on their existing holdings due to amortisation of certain post-reinvestment period CLOs. (We will cover why this affects some CLOs and not others in another column). CLO triple As being called, refinanced or reset are also a factor. With many investors expected to reinvest their repayments into CLO triple As, we believe spreads may tighten further, potentially pushing more CLO triple As into refinancing or reset eligibility.

By some estimates, recent spread tightening has created around USD 40bn of candidates for refinancing or reset. Third-party CLO equity investors will be motivated by the potential for economic gain from resets, since longer reinvestment period CLO equity typically trades at tighter yields than shorter reinvestment period CLO equity. Meanwhile, collateral managers will be incentivised by the lengthening of CLO management fee streams — especially if they manage captive funds.

Nevertheless, while often beneficial to CLO equity holders, refinancing and resets are not always the optimal decision. In some cases, calls are better. For instance, calling older-vintage CLOs with seasoned portfolios of stressed loans may be a better option than injecting more equity in hopes of a resurgence in a portfolio's performance. If the collateral manager has underperformed, why put additional equity dollars at risk?

Another scenario in which calls are a better option for CLO equity holders is if the CLO equity NAV has gained materially from original issuance. Here, the majority CLO equity holders could exercise a call to realise an attractive IRR (although under such circumstances many are likely to refinance or reset the CLO as a way to potentially flush out more gains over time). Either option can be accretive initially, but future increases in tail risk to a portfolio can quickly change the direction of an investment if it is not managed by a top CLO collateral manager.

If a CLO equity investor does call a deal, it should be prepared to closely monitor the process. Certain collateral managers do a good job of maximising value for equity investors. But in our experience, some focus on maintaining the portfolio and trying to shift it internally. Whose interests are they really looking after in those situations?

Understanding friction and technical drivers

Refinancing and reset activity is certainly back as a major driver in the CLO market, as spreads come off their highs from the past couple of years. The CLO market is well equipped to respond to the credit spread tightening from prior cycles of heavy refinancing and reset volume. But it is vital that majority CLO equity investors navigate these periods by understanding friction costs and technical drivers in order to maximise the value embedded in their CLO equity. These are times when CLO equity investors can create a lot of value by exercising their options.

> If the manager has underperformed, why put additional equity at risk?