STATE of the MARKET 2020
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Collateralised Loan Obligations: A Hidden Treasure

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INTRODUCTION
As investors continue to expand their allocations to credit, the European market for collateralised loan obligations (CLOs) presents an increasingly interesting investment opportunity. Historically, concerns over complexity, structural leverage, and a misguided perception that CLOs are partly responsible for the last financial crisis have caused many investors to overlook this asset class. Depending on your perspective, CLOs are either overly complex financial instruments or, alternatively, products that provide investors with attractive risk-adjusted returns. At PDM, we stand firmly in the latter camp.

COLLATERALISED LOAN OBLIGATIONS: THE BASICS
In very simple terms, a CLO is a vehicle that invests in corporate debt, predominantly in senior secured loans issued by large companies. Each CLO will typically invest in loans issued by around 100 large corporates, and the portfolio is actively managed by the CLO manager to boost yield and mitigate risk. The loans are floating-rate instruments that can be traded in the secondary market with transparent market prices.
The CLO vehicle is financed by a capital structure that includes both debt (c. 90% of the structure) and equity (c. 10%). CLOs therefore offer an investable proposition for investors with a range of risk–return appetites, from AAA-rated investment-grade debt all the way through to equity.

Investors in CLO debt benefit from a floating-rate coupon with an interest rate floor at 0%, representing an attractive proposition in today’s negative interest rate environment.

Meanwhile, CLO equity investors benefit from long-term, non-recourse leverage without mark-to-market triggers. That means that the CLO will not face liquidation or margin calls should the market value of the loans that it holds fall. This is one of the most attractive features of the CLO.

CLO equity returns are driven by the difference between the interest income generated by the portfolio of loans and the cost of the debt tranches; this difference is known as the arbitrage. In the current market, the portfolio of loans is generating an average coupon of Euribor + 380 bps, while the cost of the debt tranches is on average Euribor + 200 bps. The resultant arbitrage of c. 180 bps is received by the equity investor, and is amplified by the embedded leverage in the CLO structure. Given that both the liabilities and the assets are floating-rate instruments, there is a natural interest rate hedge.

**UNRAVELLING THE COMPLEXITY: WHAT ARE INVESTORS REALLY EXPOSED TO?**

The underlying assets of a CLO are predominantly senior secured leveraged loans. These loans are typically issued by large companies with an enterprise value in excess of €1 billion, some of which are publicly listed but most of which are owned by one or more private equity funds. The loans are typically used to finance a buy-out, recapitalisation, or a buy-and-build strategy. With each CLO portfolio comprising loans to around 100 companies, there is significant diversification by industry, geography, and vintage. The largest exposures of CLOs today are in companies such as Numericable, Stada, EuroGarages, Springer, Nets, Ineos, Verisure, Nord Anglia, Flora Food Group, and Eircom.

The key risk for CLO investors is the possibility that these large companies become unable to service their debt and default on their payments. As long as the companies continue to meet their interest payments, CLOs will continue to pay their investors.

Recently, there has been a lot of publicity around loan documentation, given that the majority of leveraged loans are now issued with no maintenance covenants. The growing prevalence of such ‘cov-lite’ loans is in some ways positive for the CLO market. It should result in short-term default rates remaining low, and has meant that companies are increasingly choosing to raise financing by issuing loans, growing the size of the loan market, which in turn increases liquidity and portfolio diversity. Conversely, recovery rates for cov-lite loans tend to be lower, and this can have an impact on returns.

**NOT A BLACK BOX: THE ROLE OF THE CLO MANAGER**

Every CLO is actively managed by a CLO manager. At the outset, the CLO manager’s role includes selecting and buying loans for the CLO portfolio. This requires good credit judgement, strong sourcing networks in order to access the most attractive opportunities, and the ability to construct a well-balanced and diversified portfolio of assets. Thereafter, the manager will actively...
monitor the portfolio, reinvest repayments and make buy/sell/hold decisions in order to maximise equity returns while remaining compliant with various tests and metrics. The quality and judgement of the CLO manager is therefore the key driver of returns.

Each CLO publishes a monthly report outlining every position in its portfolio, providing greater transparency and more regular reporting than for many closed-ended funds. Additionally, a growing number of CLO managers are considering ESG criteria in their credit analysis, with some (including PDM) building ESG screening criteria into the documentation governing the CLO.

THE EUROPEAN CLO MARKET: PAST AND PRESENT

The European CLO market has been in existence for more than 15 years. It has a very close and symbiotic relationship with the leveraged loan market. After a period of no issuance following the global financial crisis, the European CLO market restarted in 2013 and has grown at a CAGR of c.7.5% over the last five years. Over the same period, the European leveraged loan market has grown to €200 billion in size. In addition to new CLO issuance, there is a very active secondary market for all CLO tranches.

PROVEN PERFORMANCE THROUGH THE CYCLE

Pre-crisis vintage CLOs (known as ‘CLOs 1.0’) are one of few credit asset classes to have a proven track record through the cycle. Despite investor concerns about structured credit products during the period immediately after the collapse of Lehman Brothers, CLOs proved to be extremely resilient thanks to their robust structures and inherent portfolio diversification. Impairment rates for European CLOs were significantly lower than those experienced by other types of corporate credit and structured credit.

For long-term investors who could withstand (sometimes significant) mark-to-market moves, CLO equity also performed well during the crisis compared with other asset classes such as distressed debt and private equity.
Post-crisis vintage CLOs (‘CLOs 2.0’) benefit from even more robust structures. These include risk-retention rules which require CLO managers to be invested in at least 5% of the CLO directly or indirectly through a risk-retention fund. This has created stronger alignment between the CLO manager and the CLO investors, as well as improving the institutional quality of CLO managers across the market.

**THE CASE FOR CLO INVESTING IN TODAY’S MARKET**

There are a number of reasons for long-term investors to be optimistic about the prospects for the European CLO market, even as we potentially go into a period of increased macro-volatility.

- **CLOs do not require strong macro growth to perform well.** They simply require the underlying companies to continue to meet their financial obligations. We believe that the CLO market can continue to thrive even in a low-growth environment.
- **CLOs can benefit from periods of moderate volatility.** Market dislocations result in opportunities for CLO vehicles to buy loans below par, without the risk of being a forced seller if prices drop.
- **Private equity firms currently have very large amounts of dry powder, which is likely to continue to drive deal activity and demand for leveraged loans.**
- **Default rates in Europe remain at historic lows, although signs of stress are starting to emerge in some areas.** CLOs have the ability to withstand periods in which default rates rise significantly; moreover, the underlying assets are senior secured loans, which typically benefit from high recovery rates in the event of default.

**IN SUMMARY**

Many investors have historically shied away from CLOs, given the complexity of the asset class and lingering (unfounded) associations with the more obscure instruments which were one of the causes of the global financial crisis. Despite this, we at PDM have long believed that CLOs provide an attractive, risk-adjusted way for investors to invest in diversified corporate credit, and the PDM funds have been investing in the asset class for almost a decade across all tranches from AA to equity. For investors looking to take investment-grade risk, CLOs offer returns of 3%+, while for sub-investment-grade risk, CLOs can generate returns of 7%+ through to 15% for equity. CLOs therefore provide a compelling way to allocate capital across the risk–return spectrum for those investors with a long-term approach and a tolerance for complexity.

1. PDM view based on market intelligence; at November 2019.
2. LPC and Intex at November 2019; based on look-through exposure of PDM Sigma funds.
4. PDM view based on market intelligence; at November 2019.