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CLOs and Late Cycle Credit Investing

Disruptive Forces in Investing

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Anu Rajakumar: Recent negative headlines surrounding the leveraged loan and collateralized loan obligation, or CLO markets, have fueled investor concerns around rising default rates and a turn in the credit cycle. As we begin the new decade, how should investors be thinking about investing in non-investment grade credit? My name is Anu Rajakumar, and on this episode of *Disruptive Forces*, I'm joined by Pim van Schie, senior portfolio manager of non-investment grade credit, focusing on collateralized loan obligation strategies. He will debunk some of the misconceptions lurking in the CLO and leveraged loan markets, and look at the opportunities he sees as a result of the disruptive press. Pim, thanks for being here for the first *Disruptive Forces* podcast of 2020.

Pim van Schie: Thank you for having me.

Anu: So maybe we can start by briefly discussing a bit of the evolution of the bank loan and CLO markets in recent years. How are these markets grown and really disrupted finance?

Pim: Absolutely. Leveraged loan markets really over the post-crisis period have grown tremendously. That growth has been fueled by two main factors. The first one, particularly in recent years prior to 2019, was a view on the part of investors that rates were likely to rise. And so that in turn fueled demand for floating rate assets. Loans are a floating rate asset class, and so that led to inflows into the asset class. The second factor has been a general search for yield in credit markets over the past four or five years, which has driven more and more investors into CLOs as an asset class. CLOs make up over 60 percent of demand for leveraged loans, and so the demand for CLOs indirectly drove more capital into loans as well.

Anu: All right. I think that that theme of expanding the toolkit in the search for yield is something we spoke about with Susan Kasser back in October on this podcast when we discussed the private debt market. So how is the CLO market different than private debt?

Pim: Yeah, absolutely. The similarity, obviously, is they're both debt. The difference is that loans in the broadly syndicated or leveraged loan market are typically much larger and issued by larger corporations than loans in the private debt market. Some examples would be names that everyone recognizes. So issuers in the leverage loan market would be a company like Hilton, American Airlines, Burger King, Dell Computer. As the name suggests, already broadly syndicated loans are also broadly syndicated, meaning they've got a large amount of investors typically. Whereas private debt is typically very narrowly syndicated or directly originated. The fact that broadly syndicated loans are widely held also makes that there are more liquid and actively traded in the secondary market. And so the other main difference between broadly syndicated loans and private debt is liquidity.

Anu: And so now where does CLOs fit on the risk spectrum, you know, maybe vis-a-vis high yield bonds, for example?

Pim: Yeah. Let's maybe to put things in perspective. Investors can really think of leveraged loans as a complement to high yield bonds in the sense that they're really sister markets. There is close to 50 percent overlap between companies issuing high yield bonds and companies issuing broadly syndicated loans. Most investors will be familiar with the fact that the size of the high yield bond market in U.S., today is about $1.2 trillion. The loan market as of last year is now about the same size as the high yield bond market. And so from a trading perspective, or an investment perspective, we like to think of loans as very similar to high yield bonds. The big difference between loans and bonds is the fact that loans are typically first lien and senior secured, whereas high yield bonds are typically subordinated and unsecured. And so the main difference between loans and bonds, from a performance perspective historically, has been not so much default rates given, again, many of the underlying companies are the same companies. The big difference from a historical performance perspective between loans and bonds has been recovery given default. For example, loans over the past 30 plus years have, on average, recovered more than 75 percent given default, whereas high yield bonds recovered closer to 40 percent.

Anu: Now, Pim collateralized loan obligations are often still painted with the negative brush of another instrument, beginning with “C” and ending with “O”. That still leaves some people with nightmares after the financial crisis. How are CLOs different to CDOs?

Pim: Yes, thank you for asking that question. A very critical question.

Anu: I'm sure you get that one a lot.

Pim: We get that question a lot, and we meet many investors that are still very wary of any three-letter product, really. In reality, CLOs and CDOs are fundamentally different, and the only similarity, really, is the fact that both started with a “C” and end with an “O”, and both apply securitization technology. CDOs, on the one hand, are backed by pools of subprime mortgages extended to individuals frequently on little or no data around the credit worthiness of that individual. Whereas CLOs are diversified portfolios of corporate loans issued by large corporations. I gave you some examples of that. The main issue with CDOs, and the main reason CDOs performed so poorly through the financial crisis, is that the correlation assumption, the diversification assumption that rating agencies made with respect to the subprime mortgage portfolio was drastically wrong. In other words, these subprime mortgage portfolios were much more correlated in a stressed credit environment than the rating agencies had assumed. CLOs, on the other hand, performed very well from a fundamental perspective through the financial crisis.

Anu: Okay. That's very helpful and I think important information for our listeners. Pim, can you give some more information on how a CLO actually works and how it's constructed?

Pim: Glad you asked that question. Investors frequently still think of a CLO as a pretty complex product. We like to suggest to investors that at its core it's actually quite simple in a sense that you can really think of a CLO as a mini bank. All a CLO does is it invests in a portfolio of loans, and it issues debt and equity to finance itself. The objective of the CLO, quite simply, is to take advantage to capture the excess spread between the yield on the loan portfolio and the cost of financing itself, just like a bank for the benefit of its equity investors. Now, I suggested to you that you could think of CLOs as a mini bank. I would argue that CLOs are actually much superior to a bank in one key aspect, which is the fact that contrary to popular belief, a CLO is not forced to sell loans into a bad market in order to de-lever or pay down debt. Unlike in a bank, in a CLO the assets and liabilities are maturity matched. This, again, is a critical point, because for example, in 2009, when many other types of loan investors were forced to sell loans in order to de-lever and pay down debt, CLOs were not forced sellers. In fact, CLOs were buying loans when everyone else was selling. The other critical aspect of CLOs is that the structure affords significant credit enhancement to CLO debt investors.

Anu: So now from a value proposition perspective, why should investors pay attention to CLOs?

Pim: CLOs can offer a significant yield premium over other corporate credit asset classes at the same rating level. So, for example, investors in CLO double B debt today can capture a yield premium of about five and a half percent over and above the yield on offer in double B high yield. And that is, again, a premium for an investment in a diversified portfolio with significant downside protection. And so the natural question typically then is, "Well, you're telling me that I get five and a half percent more yield for something that is better? So what am I missing? How does that make sense?" And we explain that premium as attributable to three main factors. The first one is as an investor and CLOs you're getting paid a complexity premium. Part of that you could also call reputational premium based on the comparison to CDOs that we talked about before. The second premium is a liquidity premium. While there is an active secondary market for CLO debt, CLO debt is a smaller market than, for example, high yield or loans. And so there's less liquidity. So you're getting paid for that. The largest part of the premium on offer in CLO debt markets, in our view, is a premium that investors demand for potential outsized mark to market volatility. And so if you were to ask me what's the biggest risk investing in CLO debt, in our view, I've just mentioned that we think from a credit perspective in CLO debt, as an investor, you're quite credit risk remote. The biggest risk to investors, in our view, investing in CLO debt is potential mark to market volatility. And so I think CLO debt can be an appropriate investment for investors that can take a medium to longer term investment horizon

Anu: Right. So, for example, seeing through the global financial crisis rather than sort of selling midway through?

Pim: Absolutely, and the same applies to other periods of volatility over the post-crisis years. Whether we're talking about early 2016 or even October, 2019.

Anu: Now, with that all said, Pim, there has been a stream of mostly negative press recently, but you've been able to find some pockets of opportunity. So talk us through how you've been able to take advantage of those entry points despite that negative press.

Pim: Yeah, you're absolutely right. There's been certainly a lot of negative press following the growth of the market that we discussed at the outset. A lot of that press focuses on a deterioration in credit quality of the loan market as a result of the strong demand for loans over the past number of years. And it really focuses in on two areas of potential weakness. The first one is one that's frequently referred to as covenant light, although that's technically a misnomer. What it really intends to refer to is three specific aspects of structural protections for loan investors where we've seen weakness, particularly in 2018, vintage issuance. Those are number one, the increased ability, for issuers to issue additional debt party pursued to our term loan at some future point, weakening our collateral package. The second is sponsors increased creativity around the definition of EBITDA in loan documents through a number of creative add backs and assumed synergies. And a third one is, in some cases, the ability for a company to take part of their assets and move them into a different entity where we no longer have recourse to them as the debt investor in case of a bankruptcy or restructuring. So that's category one, increased weakness in structural protection for loan investors. The other area that the press has been focused on, rightfully so in our view, is the proliferation, the increase of issuance from smaller, frequently loan-only issuers into the loan market. And so these are typically smaller companies that may issue a three, four, or $500 million bank loan. No bonds in the capital structure. And so as a loan investor, you may be first lein senior secured, but if there's really no one behind you, ultimately in a downturn, we expect recoveries to be more bond like. And so we generally agree with the two areas of concern that have been identified in the press. What's frequently not highlighted is that that's only a minority of the overall loan market. And so when we look at the majority of the loans in the market, we see those as being reasonably healthy from a fundamental perspective. And so where we see opportunity specifically is in the fact that sometimes this negative press will lead to overreactions on the part of investors with respect to both loans and particularly by extension CLOs and CLO mezzanine debt, for example, as we saw in October last year. And so, in our view, that's really where we see opportunities in the market. Ultimately, it still comes down to being able to pick the credits. So there is unfortunately no shortcut for doing fundamental credit work.

Anu: Absolutely. Well, Pim, thank you so much for joining me today. Perhaps a couple of takeaways for our listeners, just to summarize, CLOs are diversified pools of broadly syndicated loans to large corporations which are actively traded. And it sounds like going forward, you see that there might be some increased bifurcation in credit markets where the end of the day the ability to pick credits really is key.

Pim: Absolutely.

Anu: Thank you to our listeners for tuning in for this episode of *Disruptive Forces*, if you like what you heard, please subscribe via Apple Podcasts or Google Podcasts for previous episodes as well as more information about our firm and offerings, please visit www.nb.com/disruptiveforces.