CLOs Explained

polen capital

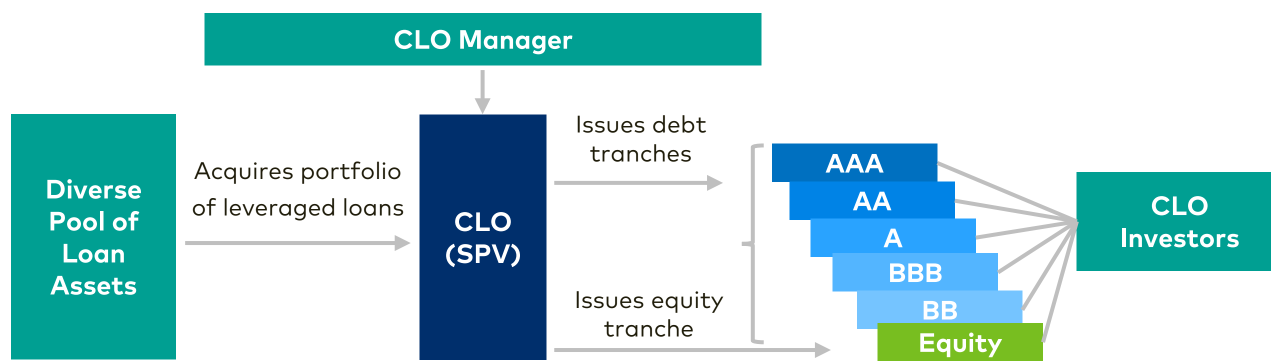
1. What is a CLO?

Collateralized Loan Obligations ("CLOs") are structured finance vehicles that raise money from investors by issuing various tranches of securities. The sale of these securities fund the purchase of a diverse pool of underlying corporate loans, which make up a CLO. The underlying loans in a CLO are actively managed by the CLO manager, like an investment fund.

2. How does a CLO work?

- Figure 1 illustrates how a CLO works. A CLO issues two types of tranches, debt and equity, to fund the purchase of underlying loans. Each tranche represents varying levels of risk and return to meet the needs of different investors.
- CLO tranches are formed through the securitization process, which is the creation of asset-backed securities. The process starts with the creation of a special purpose vehicle ("SPV"). The SPV serves two purposes: 1. Act as the "issuer" of CLO tranches to investors to finance the acquisition of loan assets, and 2. Provide a home for the acquired loans, which are held by the CLO and actively traded by the CLO manager. The CLO tranches issued to investors are asset-backed securities, which are secured by the underlying loans.
- Debt tranches are issued with ratings typically ranging from AAA to BB. These ratings depend on the amount of subordination or the hierarchy of repayment of each tranche. The higher-rated tranches are first in line to receive cash flows from the loans and, accordingly, are the least risky. The lower-rated tranches are last in line to receive cash flows and, accordingly, are the riskiest.
- The "equity" tranche is usually held by a combination of the CLO manager and third-party investors.

Figure 1: CLO Securitization

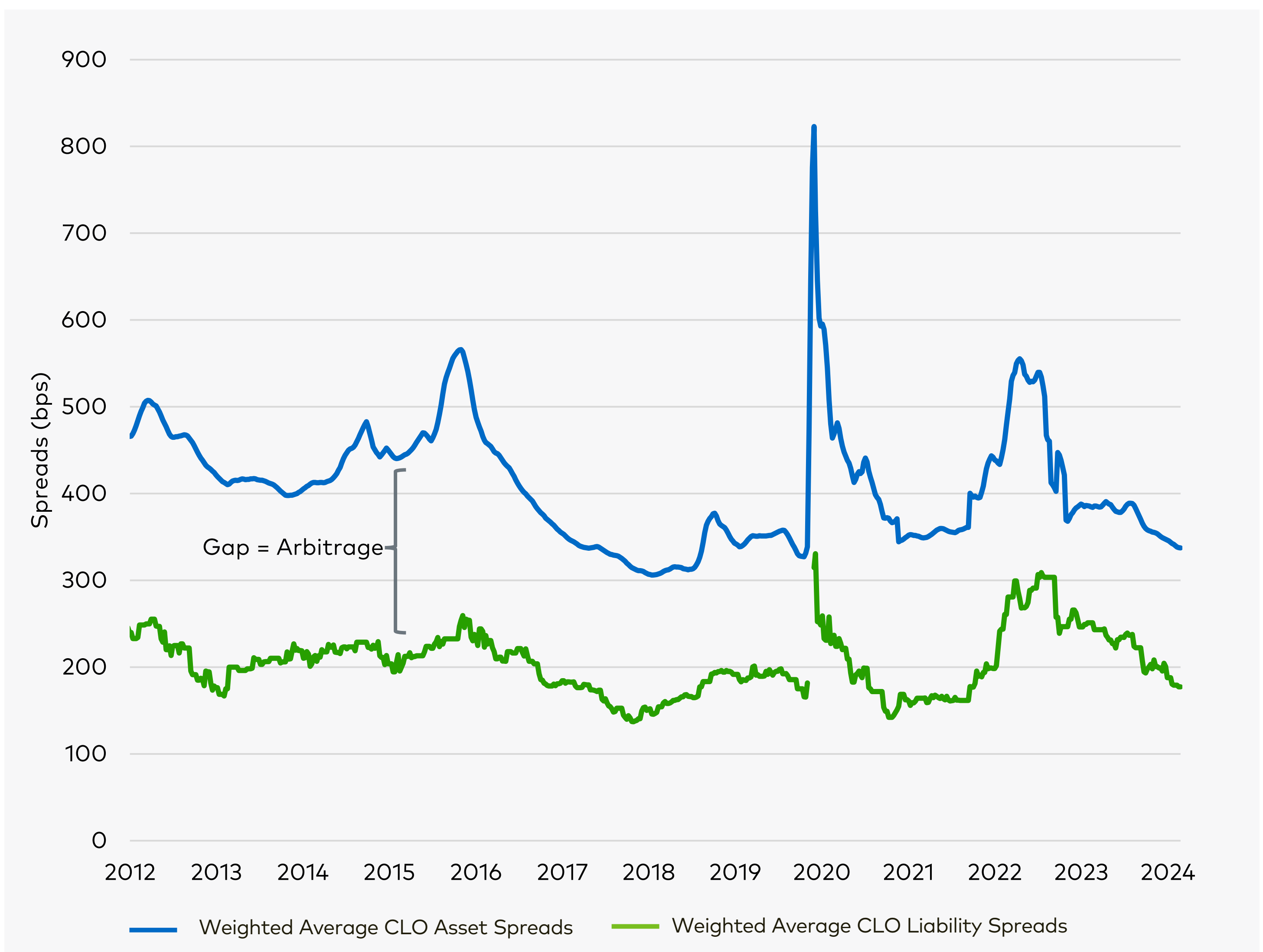


A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO), such as Moody's, S&P and Fitch, which evaluates the credit worthiness of an issuer with respect to debt obligations. Credit Ratings are measured using a scale that typically ranges from AAA (highest) to D (lowest) and are subject to change without notice.

3. How does a CLO generate returns for investors?

- CLOs aim to **capture cash flow arbitrage**, the excess spread between the interest and principal received on the loan portfolio (assets) held by the CLO and the payments due to the investors of the various CLO debt tranches (liabilities).
- Any excess cash after all CLO liabilities are paid belongs to the CLO Equity investors. This is known as the "Arb" or "Arbitrage" and represents the return to CLO Equity investors. CLO liabilities include all CLO expenses plus all coupon and principal payments on the debt tranches.

Figure 2: U.S. New-Issue CLO Arbitrage

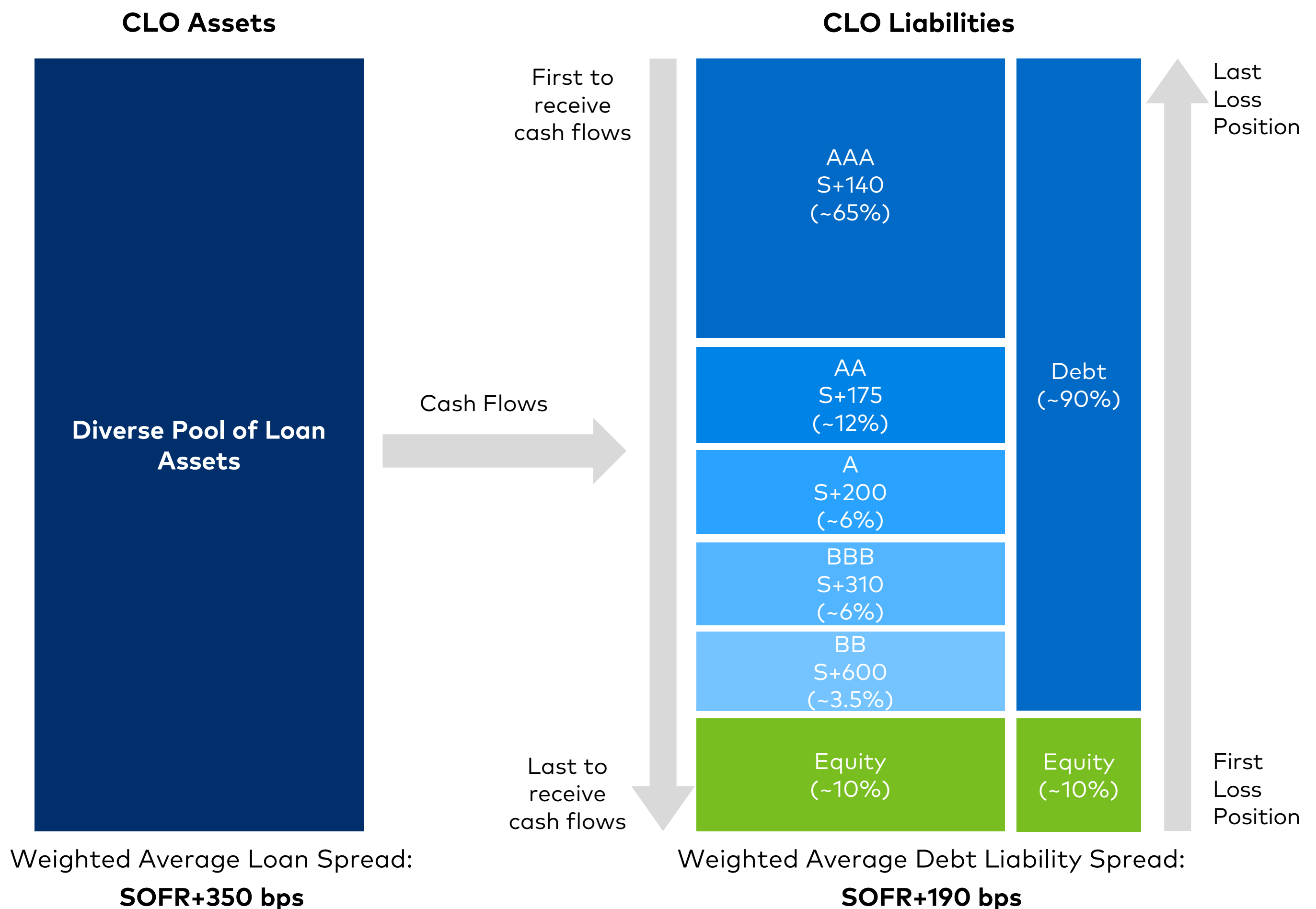


Source: BofA Global Research, LCD as of June 2024. There is a short break in reported data in late March 2020 due to the COVID-19 Pandemic.

4. How do CLOs capture this “Arb”?

- Figure 3 below illustrates how a CLO’s capital structure aims to capture the funding gap, or “arb,” between CLO assets and CLO liabilities, as shown in Figure 2.
- CLOs receive income from the diverse pool of loans held in the SPV (left hand side) and subsequently distribute income to CLO debt investors (right hand side) according to the cash flow waterfall. The cash flows through a waterfall, or priority of payments - the most senior tranches are paid first, followed by junior tranches.
- If, after fees and credit losses are accounted for, the income received by the CLO is greater than the income distributed to CLO debt investors, any leftover cash is then distributed to equity investors. It’s important to note that CLO Equity returns are typically magnified by the use of leverage, with CLO Loan-To-Values typically around 90%.
- In today’s market, our expected asset yield is ~SOFR + 350 and our expected liability/financing cost is ~SOFR + 190. The difference primarily flows through to the CLO Equity tranche on a quarterly basis, the result of which is intended to provide CLO Equity investors with consistent and durable income. Historically within the asset class, this income has generated on average an annual net rate of return in the mid-teens.

Figure 3: Capturing the “Arb”

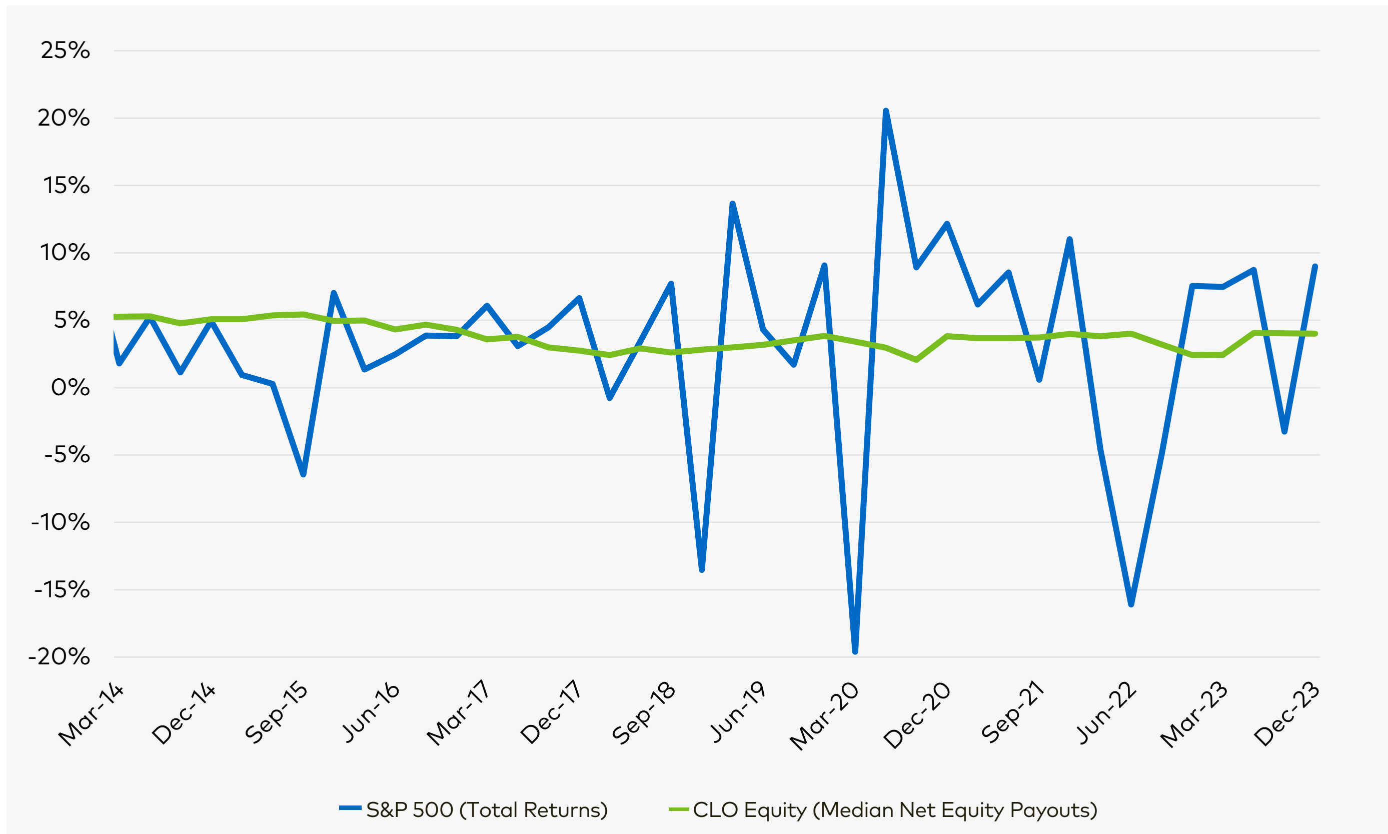


Past performance is not indicative of future results. Actual performance results for a CLO equity tranche, which may not achieve this level of return, will vary. The 3 month Secured Overnight Federal Rate (3M SOFR) is provided as of July 2024.

5. How has CLO Equity Performed Historically?

CLO Equity has typically provided double-digit annual returns, with less volatility vs. public equity markets.

Figure 4: Quarterly Returns - S&P 500 vs. Median CLO Equity Tranche



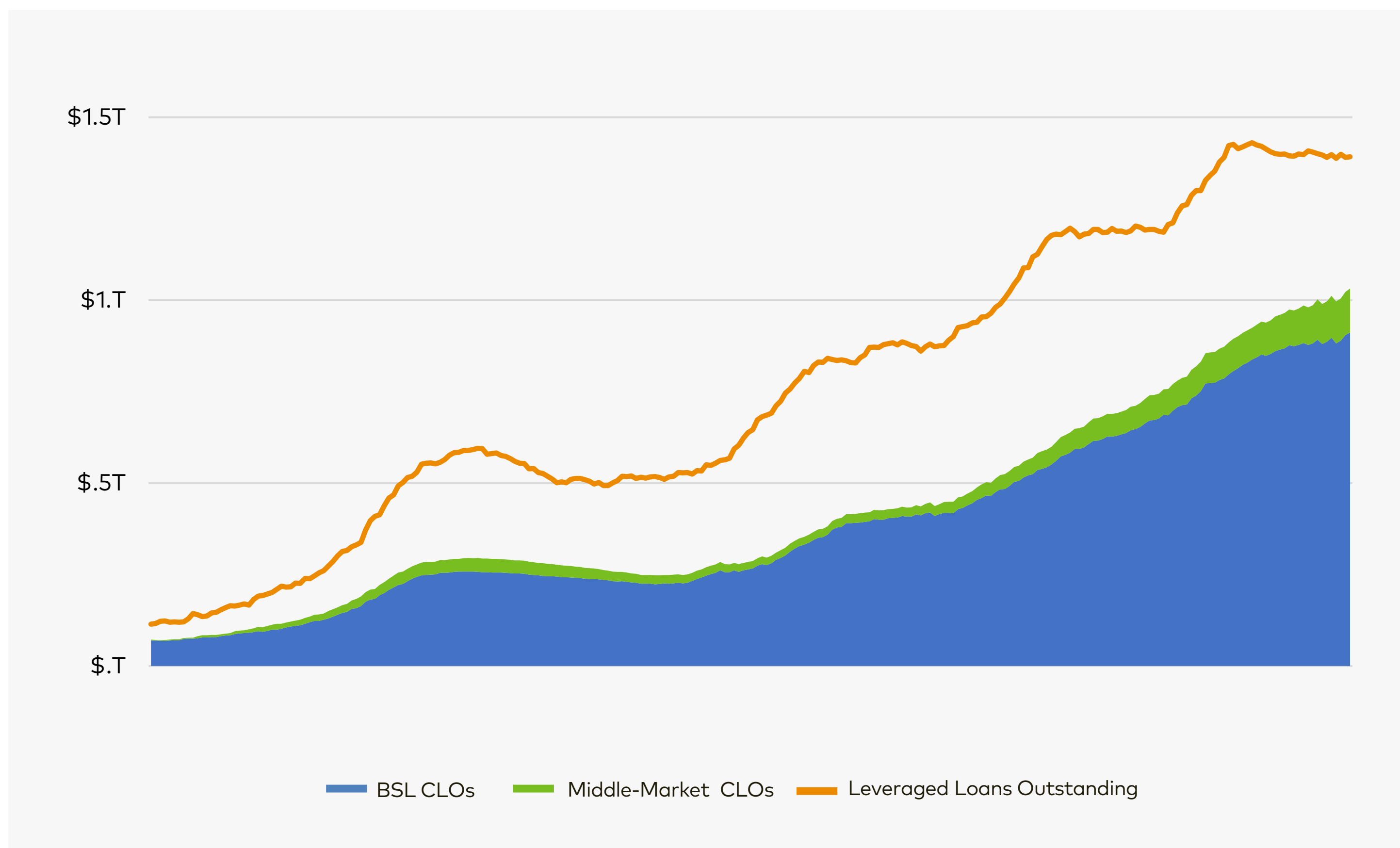
Year	S&P 500	CLO Equity	+ / - CLO Equity
2023	26%	14%	-12%
2022	-18%	13%	31%
2021	29%	15%	-14%
2020	18%	12%	-7%
2019	31%	13%	-19%
2018	-4%	10%	15%
2017	22%	12%	-10%
2016	12%	17%	5%
2015	1%	19%	17%
2014	14%	18%	4%
2013	32%	17%	-16%

Source: Bloomberg Finance LP, Intex, Markit, Deutsche Bank as of December 31 , 2023. CLO universe represented by all outstanding CLOs. The S&P 500 Index, which is maintained by S&P Dow Jones Indices, is a market capitalization weighted index that measures 500 common equities that are generally representative of the U.S. stock market. Past performance is not indicative of future results.

6. Where do the Loans come from that are held in CLOs?

- The underlying collateral held in a CLO typically includes 200-250 individual leveraged loans across various sectors and borrowers in the United States.
- The leveraged loan market consists mostly of loans issued by non-investment-grade corporate companies that are typically senior secured, floating rate, and callable. These loans are known as Broadly Syndicated Loans ("BSL") and get their name from the way they are issued and sold to investors, through a bank syndication desk. BSL loans typically have a deep and liquid secondary market.
- There is a growing area of the leveraged loan market, known as the "middle-market" or "private credit," in which loans are issued to smaller companies and often directly from a lender to a company (i.e., as a direct loan with no broad syndication). These types of loans, which are used to collateralize "middle market" CLOs, in the aggregate, are approximately 10% the size of the BSL market.
- The leveraged loan market currently has ~US$1.4 trillion loan outstanding, with over 50% of issuances exceeding US$1.0 billion in size, primarily coming from larger corporations.

Figure 5: US BSL CLOs hold ~65% of the total leveraged loan market



Source: BofA Global Research, Intex, LCD, as of June 2024.

7. How does a CLO mitigate risk?

CLOs have embedded structural protections to promote diversity and risk management.

Diversification	• Exposure to various industry sectors and borrowers via 200-250 underlying loans
Locked-Up Capital	• Non-mark-to-market vehicle; when loan prices decline, CLOs are not forced sellers • Buy when others are selling • Ability to refi/reset liabilities, which provides optionality for the equity tranche
Active Management	• Managers have the ability to sell distressed credits to mitigate losses and purchase assets to take advantage of relative value opportunities • Any gains from secondary trading of the loan collateral can increase credit support • Constant focus on maintaining sufficient risk mitigation
Risk Measurements	• Trigger-based **collateral** and **performance** tests force redirected cashflows • Interest Coverage Tests, Overcollateralization Tests, Weighted Average Risk Factor (WARF), Weighted Average Spread (WAS), 2nd Lien Limits, and CCC Limits • Debt repayment may be required using cash interest

Enhanced Structural Protections: CLOs 2.0 emerged from the Great Financial Crisis of 2008 (GFC) and offer even more structural advantages, which can help preserve capital and generate attractive returns.

	Pre-GFC CLOs (CLOs 1.0)	**Post-GFC CLOs (CLOs 2.0)**
Leverage	12.0x	10.0x
AAA Par Subordination	25.0%	36.0%
BB Par Subordination	5.6%	8.4%
Permitted Collateral	15-20% Non-Senior Secured Loans (Structured Finance, Synthetic etc.)	5-10% Non-Senior Secured Loans
Refinancing Capabilities	None	Permitted
Weighted Average Default Rate (Across All Debt Tranches)	0.9%	0.1%

Source: Wells Fargo Research, JPMorgan, Guggenheim Investments, S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro®. CLO tranche default rate as of April 1, 2024. The Global Financial Crisis (GFC) was a severe worldwide economic crisis. The National Bureau of Economic Research dates the recession around this crisis from Dec-2007 through Jun-2009. The economic environment that brought the Global Financial Crisis differs from today's economic environment.

8. CLOs vs. CDOs: What's the difference? Are they the same?

- CLOs are not CDOs. CDO stands for Collateralized Debt Obligation. The key word is "debt," which is a catch-all term for various types of debt. The primary difference between CDOs and CLOs is the underlying collateral. CDOs can contain various forms of debt like, consumer credit card loans, auto loans, mortgage-backed securities, and even other CDOs ("CDOs Squared"). CLO collateral is made up of broadly syndicated loans from varying corporate sectors and issuers.

- One misconception is that CLOs are highly risky and played a significant role in the 2008 Global Financial Crisis. This confusion stems from similar names and structural features. However, the CDOs that contributed to the 2008 financial crisis were almost entirely backed by a single industry, sub-prime mortgages. This led to a high correlation of underlying collateral which, ultimately, turned out to be bad loans when the housing bubble burst. This is very different than the collateral (BSL corporate loans) underlying CLOs during the financial crisis and today.

- AAA CLO tranches have yet to default, shown in Figure 6. Furthermore, the weighted average default rate of all CLO tranches issued is below 1%, and CLOs issued post-GFC fall well below that level.

Figure 6: Default % Pre- and Post GFC

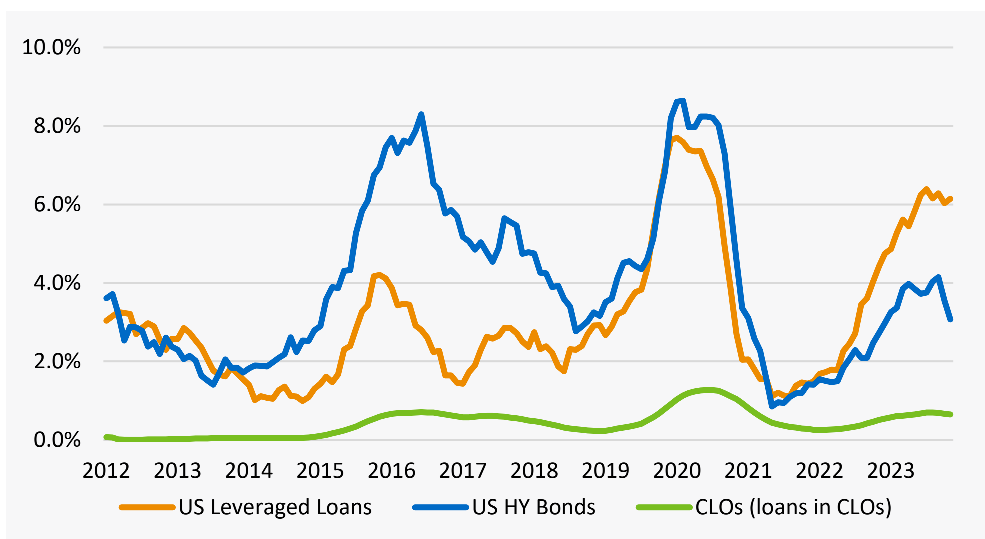
Orig. Rating Category	Pre-GFC CLOs (CLO 1.0)	Post-GFC CLOs (CLO 2.0)
AAA	0.0	0.0
AA	0.2	0.0
A	0.6	0.0
BBB	1.2	0.0
BB	3.9	0.5
B	10.7	2.8
Total	**0.9**	**0.1**

Original rating counts as of Dec. 31, 2023. CLO tranche default counts as of April 1, 2024. Source: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro®.

- CLO default rates are a direct result of the underlying loans held in the CLO, which have remained lower than other high yield credit markets.

- Low historical CLO default rates have been primarily due to the active management, diversification, and structural protections offered by CLOs.

Figure 7: 12 Month Trailing Default Rate



Sources: PitchBook LCD, Moody's, Intex, Deutsche Bank as of June 2024.

9. Why do investors overlook the asset class?

- **New:** CLOs are a relatively new asset class with only 20+ years of history. They are mainly tailored to major institutional investors such as insurance companies, pension funds, banks, and hedge funds. While CLOs were smaller and more opaque pre-Great Financial Crisis, today's CLO market has grown into a healthy, thriving and transparent market.
- **Misunderstood**: The perceived complexity and often misunderstood risks and rewards associated with investing in CLOs have deterred investors.
- **Access:** As CLO tranches are private securities, average investors typically do not have easy access to them. Investing in CLO debt tranches oftentimes requires partnering with sophisticated institutions that have structuring and trading expertise coupled with analytical resources.

10. What makes CLOs particularly attractive to investors?

Structural Protections

Diversified Underlying First Lien Loan Collateral

Active Management

11. Why CLO Equity?

Exposure to Senior Secured Loans	CLOs' underlying loans are senior and secured instruments, which have historically experienced low defaults and relatively high recovery rates.
Insulated from Interest Rate Volatility	CLOs' underlying loans are floating rate, mitigating adverse impact from increases in interest rates.
Highly Diversified Portfolios in Large Established Corporates	CLO portfolios typically consist of over 200 BSLs across varied sectors, offering diversification benefits.
Attractive Return Potential	CLOs offer attractive return potential given the spread between the underlying loans and the cost of senior tranches in the CLO. Active management offers ongoing risk mitigation and the ability to capture attractive returns during periods of market volatility.
Transparency	CLO investments offer detailed transparency to investors, including underlying exposures and portfolio-level metrics
Locked-In Financing	CLOs can capture market dislocations. Also, CLO Equity owns call rights after a short non-call period, which creates the option to reduce overall financing costs via "refinancing" and "resetting" the outstanding liabilities in whole or in part.

Disclosures:

Investing in CLOs is not without risk, including the possible loss of principal. As with other securities, CLOs are subject to credit, liquidity, and mark-to-market risk, and the basic architecture of CLOs requires that investors must understand the waterfall mechanisms and protections as well as the terms, conditions, and credit profile of the underlying loan collateral.

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