

## The Counterintuitive Case for CLO Equity Late in a Credit Cycle

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What if I were to tell you that investing in the most subordinated tranche of a 10x levered three-letter acronym has the potential to produce out-sized returns in the instance of a near- or intermediate-term recession? Would you call me crazy to my face, or would you internalize it to save me from shame? What if I then showed you a graph that indicated that the leveraged loan market, which collateralized loan obligations (“CLOs”) invest in, returned *negative* 29.5% in 2008, yet the 2007 vintage of CLO equity (i.e., the CLO equity that was issued right before the financial crisis of 2008-2009) is the best performing vintage ever, with an average return of 18.4%, closely followed by the 2006 vintage, which returned 16.7%? Would I pique your interest? Such is the counter-intuitive nature of investing in CLO equity late in a credit cycle.

### CLOs Explained

CLOs are complex investment strategies. However, when explaining the strategy to investors, I find it helpful to use a banking analogy. The business model of a bank, in its simplest form, is to borrow money (i.e., deposits) and lend money at higher rates than it pays on the deposits. This arbitrage creates a net interest margin (or “NIM”), and there is embedded leverage in the banking model because of the deposit base. In straightforward math, leverage multiplied by NIM equals return on equity (or “ROE”). A CLO operates very similarly, but with a few structural nuances. Conceptually, owning CLO equity isn’t terribly different than owning equity in a bank. In today’s market, CLOs borrow money at a weighted average cost of roughly LIBOR plus 200 basis points and lend money to below-investment-grade companies on a senior secured basis at a weighted average spread of roughly LIBOR plus 350 basis points. That spread creates a NIM of 150 basis points, the leverage in the structure is 10x, and the ROE is in the mid-teens as a result. Also note that CLO equity is effectively rate agnostic as both assets and liabilities are linked to the same base rate, LIBOR. However, there are three structural nuances to CLOs that can add immense value to CLO equity investors vis-à-vis a traditional banking model:

1. *Active management* – When a bank makes a loan to a company, that loan typically sits on the bank’s balance sheet earning interest until it gets refinanced or matures. The loans in a CLO are initially made by an investment bank and then syndicated to a market of investors (including CLOs). Once the loan is syndicated, it trades on a secondary over-the-counter market. The loans in a CLO are liquid, and the portfolios of loans are actively managed. Thus, an experienced portfolio manager can (i) identify credit weakness and trade out of troubled situations, buying more credit-worthy loans in the secondary market to replace them and (ii) realize gains in the portfolio by actively trading to build par value. CLO equity investors thus

benefit from active management whereas buying equity in a bank is a more passive investment profile.<sup>1</sup>

2. *Retained earnings* – Typically, a portion of the NIM produced by a bank will be retained earnings to build a cushion to the bank’s balance sheet equity. There is no concept of retained earnings in a CLO. Every quarter, every cent of the NIM is distributed to CLO equity investors. This steady stream of payments creates a “dividend yield” for CLO equity that is typically in the mid-teens versus dividend yields for traditional bank equities that tend to be closer to low-to-mid single digits. On a comparative basis, CLO equity investors are getting more of their money off the table faster than owning equity in a traditional bank.
3. *Borrowing long to lend short* – Whereas traditional banks borrow short (deposits) to lend long to drive NIM, CLOs do the opposite – they borrow long to lend short. This positive duration mismatch is an incredibly important nuance that is the main driver of the outperformance of 2006 and 2007 CLO equity vintages. The loans in a CLO typically have 7-year maturities, but the weighted average life is closer to 3-3.5 years. The money that CLOs borrow typically has a 12-13-year maturity. Because a CLO is locking in its weighted average cost of capital for a 12-13-year period and investing money in a secondary market of traded loans, a CLO is *LONG volatility and SHORT credit risk* when it locks in its cost of financing. This structure exhibits the counter-intuitive nature of CLO equity that I will attempt to explain in the next section – being invested in the subordinated tranche of a 10x leveraged vehicle that invests in the leveraged loan market creates a *put option* on that very same leveraged loan market that can be extraordinarily valuable during periods of market dislocation as observed in 2008-2009.

## The Value of the Option

There is one central concept that is at the core of the value of the put option that CLO equity investors hold on the leveraged loan market – that leveraged loans periodically repay lenders at par. Within the credit agreements of leveraged loan issuers are a few provisions that force periodic repayment of principal at *par*: (i) forced amortization that is typically 1% of face amount per year, (ii) mandatory prepayments associated with events like asset sales, equity issuance, debt issuance, etc., and (iii) excess cash flow sweeps where a percentage of the free cash flow generated by a company is required to pay down principal. So, while its perhaps obvious that loan repayment rates decline significantly during periods of market dislocation (i.e., why would a company ever repay a loan at par if it is trading at a meaningful discount to par?), it is equally important to note that loan market repayment rates cannot drop to zero due to the forced amortization mechanisms. On average, over the last 20 years, 33% of the leveraged loan market has repaid at

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<sup>1</sup> Research shows “that even the worst managers outperform the S&P/LSTA Leveraged Loan Index” indicating that active management is superior to passive implementation. See Liebscher, Roberto and Mahlmann, Thomas, “Choosing a Skilled CLO Manager,” Creditflux, February 2015.

par in a given year. That means that CLOs are getting a substantial amount of principal value back, at par, every year that they need to re-deploy into the market. *That is the effective definition of a put option – if the leveraged loan market declines, then that returned principal has more value and if the leveraged loan market appreciates, then that returned principal has less value.*

So did the leveraged loan market repayment rate drop off a cliff in 2008 when the leveraged loan market traded around 64 cents on the dollar on average? Of course it did. *However*, it did not decline to zero. Perhaps surprisingly, between 2008 and 2009, 24% of the leveraged loan market repaid at par<sup>2</sup>. What were CLOs doing with those par repayments? Buying loans in the secondary market that were trading at meaningful discounts. Not only were they buying loans on the cheap, but they were also doing so on a 10-15x leveraged basis (CLOs are now typically closer to 10x leveraged) thereby creating a tremendous amount of back-end principal upside for their CLO equity investors. *This optionality, in a nutshell, is why the 2006 and 2007 vintages of CLO equity performed so well and why CLO equity is a compelling late credit cycle investment.* So what allowed CLOs to be able to do this during 2008-2009? The non-mark-to-market nature of CLO leverage.

### **Non-Mark-to-Market Leverage**

How did the extreme loan market dislocation of 2008-2009 not trigger forced repayment of leverage in CLOs? Because the leverage in a CLO is what is known as *non-mark-to-market leverage*<sup>3</sup>. In explaining non-mark-to-market leverage, I find it useful to draw an analogy to the simple act of purchasing a home, which is a process that most investors are familiar with. When an individual purchases a home and takes out a mortgage from a bank to cover 75% of the cost of the home, that individual starts paying monthly mortgage payments to the bank. So long as the individual continues paying his/her mortgage payments on time, then there are no triggers in the mortgage agreement that bring the bank back to the table, so to speak, whether the value of the home underlying the mortgage has increased in value or decreased in value. If the individual defaults on their monthly mortgage payment, that is what allows the bank to force repayment of the mortgage loan and look through to the underlying value of the collateral securing the mortgage loan. This example highlights the value of non-mark-to-market leverage.

The tests and triggers in a CLO that would force repayment of the leverage are not directly linked to the underlying market value of the loans in the CLO – they are linked to the par value of the loans. There are three main ways for a CLO manager to erode par value in a CLO and thus tighten the cushion on leverage tests that could force repayment of the leverage:

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<sup>2</sup> Per LCD Global, S&P/LSTA Leveraged Loan Index data

<sup>3</sup> Note that there were some pre-crisis CLOs that had mark-to-market leverage, but unsurprisingly, those structures did not prove resilient in 2008-2009. As a result, all CLO leverage today is non-mark-to-market in nature.

1. *Loan defaults* – If a loan in a CLO portfolio experiences a payment default, that loan is required to be marked to the lower of market value or rating agency recovery value.
2. *Triple-C downgrades* – A CLO is typically allowed to own 7.5% of its portfolio in loans that are rated triple-C by Moody's and/or S&P. If a CLO owns more than 7.5% of its portfolio in assets rated triple-C, then it must mark its lowest dollar-priced loans to market in the amount of the overage. So by way of example, if a CLO contains 8.2% triple-C rated assets, then it must mark 70 basis points of exposure to market.
3. *Realized trading losses* – As previously mentioned, the loans in a CLO trade over-the-counter and the portfolios are actively managed. If a portfolio manager identifies a deteriorating credit situation and sells a loan at a discount to par, that represents a realized trading loss. As mentioned earlier, this is why historically even the worst managed CLOs have fared better than passive ownership of a leveraged loan index.

Note that the outright market value of the loans in a CLO portfolio cannot and will not trigger a forced repayment of the CLO leverage unless the portfolio has experienced a high level of defaults, triple-C downgrades, or trading losses. So, even though the loan market traded at an average price of 64 cents on the dollar in December 2008, that fact, in and of itself, did not trigger forced repayment of CLO leverage. This concept allowed CLO managers to create a tremendous amount of value in CLO structures with the aforementioned 24% of principal value that was repaid between 2008 and 2009.

There is one more attractive structural nuance of CLOs that is often overlooked but is of significant value to many investors – if and when a leverage test in a CLO is breached and there is forced repayment of CLO leverage, *there isn't an explicit capital call from CLO equity investors*. So even if a CLO experiences an extraordinary incidence of default, downgrade, or loss, CLO equity investors are not required to contribute additional capital over and above the principal already at risk in the structure. The test breach is cured by discontinuing the quarterly distributions to CLO equity investors and redirecting those interest dollars to either (i) purchase more collateral in the CLO or (ii) repay the leverage in the CLO. So, while it can be painful for CLO equity investors' cash flow to be temporarily disrupted, this "self-healing" mechanism does not require additional principal investment from the CLO equity investors.

### **Where CLO Equity Fits in a Portfolio**

For all of the reasons mentioned in this piece, I like to think of an investment in CLO equity as a long-term complementary hedge against a portfolio of generically long-risk assets, whether debt or equity, public or private. I view the high cash-on-cash return profile of a CLO equity investment, driven by the aforementioned NIM and leverage, as the effective compensation that a CLO equity investor is being paid to wait for volatility in the loan market. If that volatility never materializes, then CLO

equity investors will be reliant on the still-attractive quarterly cash-on-cash distributions to drive returns rather than realizing value on the loan market put option, but the investor has likely done quite well in their long-risk portfolio in that scenario. In the opposite scenario, where there is meaningful volatility in the loan market and likely other risk asset markets, then a CLO equity investor should realize value on the optionality embedded in the investment at a time when the rest of their long-risk portfolio isn't performing as well as it would in a benign market environment.

I am fully aware that it is easy for investors to look at a subordinated investment in a C-blank-O late in a credit cycle and eliminate it as an option on its face. The challenge is potentially twice as difficult for educating non-expert boards and investment committees. Even with this hurdle, I encourage sophisticated, independent-minded investors to embrace the complexity and optionality embedded in a CLO equity investment and consider CLO equity as a value-add component of a long-risk portfolio, either directly or through a CLO equity fund format. If an investor believes that we are late in a credit cycle, as I do, I would encourage that investor to consider the performance of CLO equity vintages between 2004-2007, where only 6% of CLOs lost money for the equity investor, and 71% of CLOs produced double-digit IRRs for the equity investor. Finally, I would encourage an investor to consider managers that are most experienced and best equipped to realize value on the loan market put option during periods of market dislocation.