



# CLO Equity

## Dislocation Equals Opportunity

CLO equity, the junior-most segment of a collateralized loan obligation, has long offered investors the potential to earn attractive returns with modest risk, but opportunities to invest in the midst of a dislocation have been scarce in recent decades. During this period, the average price of leveraged loans (the underlying collateral of CLOs) typically remained near par. (See Figure 1.) That’s largely because interest rates were either low or declining in these years, and most borrowers therefore had little trouble servicing or refinancing their debt. However, this situation has changed as a result of the +500 basis point spike in the fed funds rate since the beginning of 2022. Many highly levered borrowers are now struggling to handle significantly higher borrowing costs. As a result, the average price in the U.S. leveraged loan market has fallen to roughly 95.5 cents on the dollar, with almost 10% of loans trading below 90.0 cents.<sup>1</sup>

**As a result, CLO equity investors now have a rare opportunity. They can potentially earn return in both the traditional fashion (i.e., through the CLO arbitrage) and through capital appreciation, which would be magnified by leverage. Moreover, CLO investors can expect to receive a healthy income stream while they wait for the market to correct.** But, of course, realizing these returns is only possible if CLO managers avoid losses – something that could become more challenging as distress builds in the loan market. Thus, more than ever, it’s critical to identify CLO managers who have extensive credit experience and the skill to take advantage of the types of opportunities that only dislocation can create.

Figure 1: Senior Loan Prices Have Historically Remained Near Par



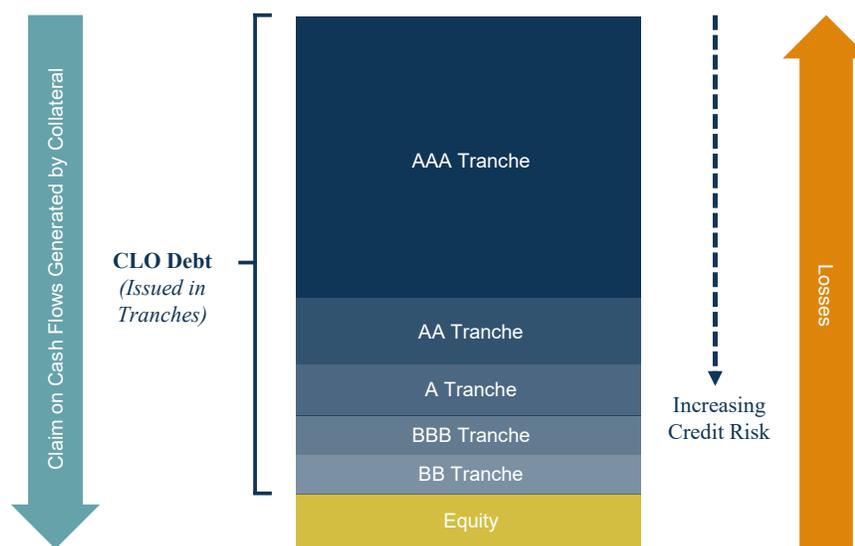
Source: Credit Suisse Leveraged Loan Index; weighted-average price of loans that were priced above 90 cents at the beginning of each month

## Looking at the Basics

In the last four decades, CLOs have evolved from an obscure balance sheet optimization tool used mostly by bankers to an actively traded alternative asset class with a sophisticated buyer base and a global market exceeding \$1 trillion.<sup>2</sup>

A CLO is best understood as a financial entity with assets – a highly diversified portfolio of leveraged loans – and liabilities – floating-rate bonds issued in tranches with varying levels of seniority and credit quality. The interest and principal payments of these bonds are made using cash flows from the underlying loans, and the debt tranches are always paid in order of seniority. The cash flows left over after the debt has been serviced go to the equity tranche, which offers the highest return potential but also the greatest risk, as it absorbs the initial losses if loans in the portfolio default.

Figure 2: How a CLO Is Structured



**However, CLO equity shouldn't be confused with a company's equity.** The latter is based on an individual company's earnings, which can be impacted by many factors and thus be highly volatile. CLO equity derives its value from **contractual** payments made on a diverse pool of leveraged loans. While the value of a loan at maturity is known in advance, the value of a company's equity is indeterminate. Finally, a company's equity has no value if the business becomes insolvent, but leveraged loans typically have the senior-most claim on a borrower's assets in the event of a bankruptcy. (This status has helped leveraged loans consistently record both lower default rates and higher recovery values than unsecured high yield bonds over the last decade.<sup>3</sup>)

CLOs reduce risk in multiple other ways. First, they're **highly diversified**: The portfolios normally feature 150–250 loans taken out by well-known companies in a wide variety of industries. CLOs also include many **structural features** designed to mitigate risk that must be tested regularly. Additionally, CLO portfolios are **actively managed**, so during dislocations, CLO managers can potentially protect the credit quality of their portfolio and generate trading gains that may offset any losses that occur in the underlying assets. Importantly, most CLOs have a five-year reinvestment period, so managers have time to improve credit quality, generate gains, and reinvest amortizations and prepayments. Finally, CLOs offer term financing, meaning **CLOs are never subject to margin calls, redemptions, or forced selling.**

All of the above help explain why default and loss rates for CLOs – including the junior tranches – have remained low historically, even during periods of market stress when loan defaults have increased.<sup>4</sup> For example, while CLOs experienced significant volatility during the Global Financial Crisis, this volatility didn't translate into widespread permanent losses. A mere 0.88% of the approximately \$500 billion of U.S. CLOs issued from 1994–2009 that were rated by S&P Global Ratings experienced defaults.<sup>5</sup> In fact, default rates among CLOs were lower than those of similarly rated corporate bonds, even though the former typically offered higher prospective returns.<sup>6</sup>

(For more information, please see [CLO Myth-Busting: The Top Three Misconceptions](#) and [CLOs: What You Need to Know.](#))

## Looking Beyond the Arbitrage

Over the last year, market chatter concerning CLOs has often highlighted the shrinking CLO arbitrage and the supposed negative implications for investors. But this conclusion misses the larger story: **the significant increase in total return potential and improved optionality CLO equity investors can access today.**

CLO arbitrage refers to the difference between a CLO’s financing costs and the income generated by its underlying loan portfolio. The potential profit for holders of CLO equity has historically been based almost entirely on this arbitrage, because CLO managers have typically purchased loans very close to par. **However, as we noted above, the loan market is currently trading at a discount to par, providing CLO equity investors with an additional avenue for profit, as managers can buy discounted loans that should appreciate toward par as they near maturity (i.e., “pull to par”), unless they default.**

**Moreover, two options that most CLO equity investors receive have become much more valuable in an environment where loan prices are low and interest rates are elevated.** First, after a two-year no-call period, CLO equity holders can exercise their option to liquidate the loan portfolio to capitalize on price increases. Second, they have the option to lower the CLO’s cost of debt by refinancing. These options were obviously far less valuable when interest rates were near zero and the loans market was trading above par.

## Looking to History

Many investors say “you make money on your buy” and this appears to be the case with CLO equity. We recently conducted back-testing using an approximation of an average new CLO portfolio. **It indicated that the strongest performance for equity investors is likely to occur when portfolios are created during periods of dislocation.**<sup>7</sup> (See Figure 3.)

If CLO managers have done their credit work properly and sought to limit the risk of default and, more importantly, the risk of loss, then the discounted portfolio should recover to par over time. And, as we noted earlier, this pull to par has the potential to generate a very attractive total return because of the leverage inherent in CLO equity.

While it may be more expensive to finance a CLO in a dislocated market – as credit spreads are likely to widen during these periods – managers can typically refinance their liabilities at much narrower spreads once the market strengthens. On the other hand, if spreads widen in the market, managers that bought loans at par don’t have the same opportunity to increase their coupons. Thus, there appears to be few better ways for managers to generate strong CLO equity returns than by buying the loans at a discount. **In short, market dislocations are opportunities for CLO equity investors.**

Figure 3: Modeled CLO Equity Returns Were Superior in Dislocated Markets

Subset of Loans	Weighted -Average Price Loan Index	Weighted -Average Price Subset of Loans	Hypothetical Equity Returns																	
			Total Loan Return (Annualized)			Coupon Loan Return (Annualized)			Price Loan Return (Annualized)			JPM CLOIE BB Index Return (Annualized)			Weighted-Average Cost of Debt: L+150			Weighted-Average Cost of Debt: L+250		
			1yr	2yr	5yr	1yr	2yr	5yr	1yr	2yr	5yr	1yr	2yr	5yr	1yr	2yr	5yr	1yr	2yr	5yr
All Loans	95.17	98.36	4.8%	4.6%	4.4%	5.2%	5.1%	4.9%	0.4%	0.6%	0.6%	9.0%	7.7%	7.3%	12.6%	11.0%	10.1%	5.7%	3.6%	2.6%
90 < Px < 99	92.24	97.12	5.4%	5.9%	5.3%	4.8%	4.6%	4.7%	0.6%	1.4%	0.7%	13.0%	11.3%	8.1%	21.9%	28.9%	20.4%	17.9%	27.1%	15.9%
90 < Px < 98.5	91.08	96.67	5.8%	6.3%	5.6%	4.7%	4.4%	4.6%	1.0%	1.9%	1.2%	15.2%	12.4%	8.7%	25.4%	32.9%	24.4%	19.5%	29.3%	18.2%
90 < Px < 98.5	89.01	95.75	6.6%	7.1%	6.1%	4.4%	4.1%	4.2%	2.2%	3.0%	2.2%	21.2%	13.6%	9.8%	36.5%	43.3%	32.5%	33.9%	42.9%	28.9%
90 < Px < 97.5	87.75	95.19	6.9%	7.5%	6.4%	4.4%	4.1%	4.0%	2.5%	3.5%	2.7%	26.2%	14.7%	10.9%	39.2%	47.3%	36.7%	37.5%	48.1%	34.3%
90 < Px < 97.5	86.52	94.76	7.4%	8.0%	6.7%	4.3%	3.9%	3.8%	3.1%	4.2%	3.2%	30.9%	15.7%	11.4%	44.5%	53.4%	40.7%	44.4%	56.1%	39.6%
91 < Px < 96	84.72	94	6.5%	8.7%	7.0%	4.4%	3.9%	3.7%	2.1%	4.9%	3.7%	24.0%	13.2%	9.5%	34.0%	59.9%	44.0%	30.7%	64.4%	43.9%
92 < Px < 95	81.5	92.89	8.0%	10.6%	7.6%	4.1%	3.6%	3.5%	3.9%	7.1%	4.6%	38.2%	21.2%	13.5%	51.2%	80.5%	52.4%	53.1%	91.4%	54.8%

Source: Oaktree Capital, for illustrative purposes only; see endnote no. 7

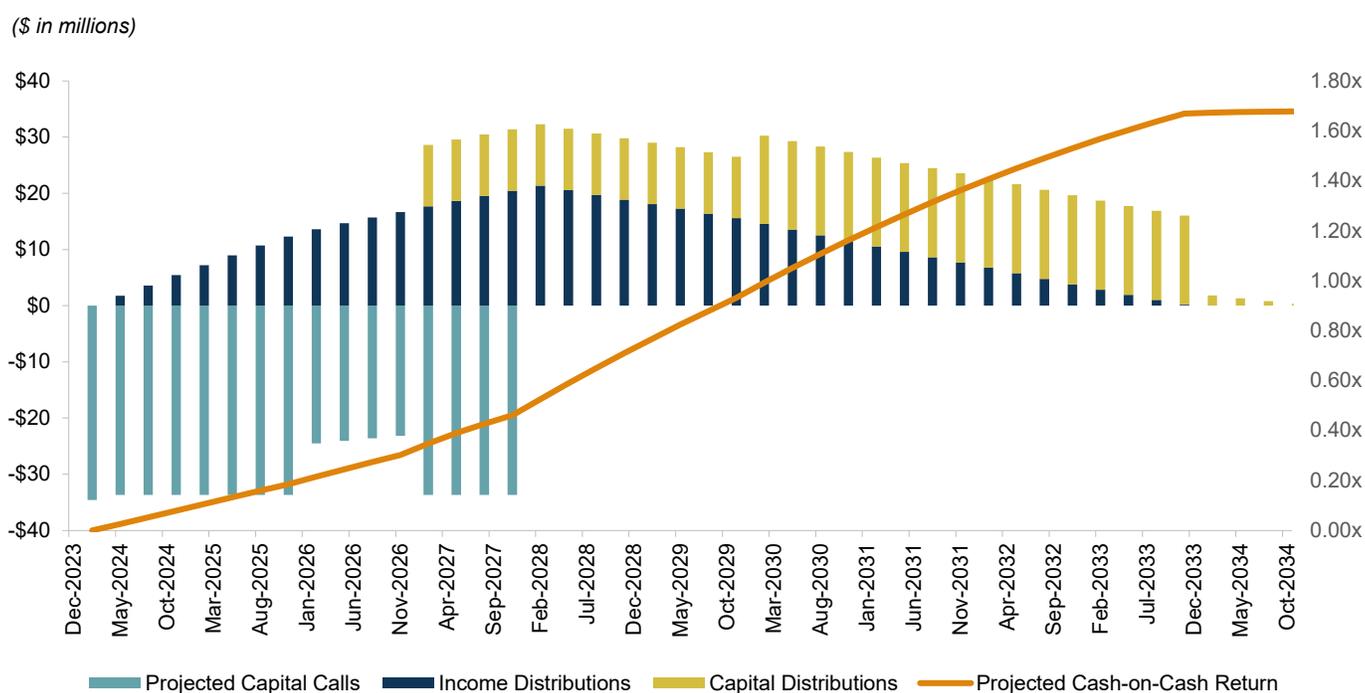
## Looking for Income

While the prospective returns for CLO equity are comparable to those of private equity or private debt, the liquidity profiles of these asset classes vary significantly. Investors in private instruments typically have to wait 5-7 years before receiving distributions, but CLO equity generates cash immediately and provides quarterly distributions. In Figure 4, we project expected cash flows for a typical CLO equity investor.<sup>8</sup> **The combination of almost immediate income distributions and timely capital distributions can potentially create a very attractive cash-on-cash return.**

This benefit may be especially valuable today. Many institutional investors with allocations to private equity are receiving fewer distributions than they expected, as restrictive capital markets have made it much more challenging for sponsors to exit at acceptable valuations. Given the increased probability of higher-for-longer interest rates and the dampening effect this will likely have on capital markets activity, we anticipate that CLO equity's income advantage will remain quite valuable for the foreseeable future.

True, CLO equity investors could see distributions decline if the CLO in question suffers significant losses or otherwise fails its structural tests and the manager fails to correct the issue. However, that's why we believe it's so critical to work with a CLO manager with extensive knowledge of the loan market and a long track record of limiting losses.

Figure 4: Projected Quarterly Cash Flows from CLO Equity



Source: Oaktree Capital estimates, as of March 31, 2023<sup>9</sup>

## Looking for Skilled Managers

**The role of the CLO manager has expanded in recent decades, as more sophisticated investor classes have entered the loan market.** In the period following the GFC, private equity firms increasingly began to use loans to finance leveraged buyouts, rather than high yield bonds. While these new entrants to the loan market provided liquidity and spurred growth, they also created additional layers of risk. This is because of (a) the leverage levels that were typically employed in LBOs – an average of 6x EBITDA in 2021<sup>10</sup> – and (b) the fact that sponsors' involvement has caused loan agreements to become far more complicated than they were in the past. Remember, CLO managers must scrutinize the agreements of hundreds of underlying loans, so this added complexity means the role demands far more credit expertise than it did previously.

Loans are trading at a discount today largely because many of these private-equity-owned companies are now facing a dramatic increase in borrowing costs. Many investment banks are currently predicting that defaults in the loan market will average 3-5% over the next two years, a significant rise from the sub 2.0% levels seen in recent years.<sup>11</sup> Moreover, because of the lax or non-existent creditor protections in many of these pre-2022 loan agreements, as well as the rise of loan-only borrowers, recovery values are likely to be well below average in the coming years. Consider that the average recovery rate in the U.S. loan market over the first 10 months of 2023 is around 40%, well below the long-term average of nearly 65%.<sup>12</sup>

**However, default forecasts for the entire loan market shouldn't be confused with the likelihood of defaults and losses in specific managers' portfolios.** Moreover, even if the default rate does reach 5%, this would mean that 95% of all leveraged loans would be performing, so managers would still have plenty of options when seeking to build a portfolio of performing assets – and, again, they'd likely to be able to do so at a discount. **But, ultimately, everything hinges on the CLO manager's ability to properly control risk – both through limiting exposure to credits with weak fundamentals and by actively managing the loan portfolio.**

Oaktree's Senior Loan and CLO teams have always prioritized risk control, in keeping with the first tenet of Oaktree's investment philosophy. This discipline has helped us minimize the incidence of credit problems, as evidenced by the fact that **our U.S. CLO portfolios' average annualized default rate since 2014 is only 0.9%, approximately 40% below the market average, and the annualized loss rate is a mere 0.4%, roughly 50% below the market average during this period.**<sup>13</sup> **The latter figure is driven both by the low incidence of losses in our portfolios and our higher-than-average recovery rates.** We believe loss rates are more illustrative of skill than default rates, as managers can artificially suppress their default rates by selling loans that are on the verge of defaulting – even though doing so typically means realizing significant losses. Importantly, Oaktree's risk management has been tested through multiple cycles, experience that we believe is especially key now, given that we're facing the increased likelihood of higher-for-longer interest rates, rising geopolitical tensions, and an uncertain global economic outlook.

**In short, dislocation is an opportunity, but only for those with the skill to seize it.**



## **Megan Messina**

Managing Director and Head of CLO Capital Markets

Ms. Messina leads Oaktree's CLO capital markets efforts and is a managing director for the U.S. Senior Loans strategy. Prior to joining the firm in 2022, Ms. Messina was a director and senior portfolio strategist at Symphony Asset Management where she led the development and distribution of the structured credit platform both internally and externally. Prior thereto, Ms. Messina was a managing director and the Co-Head of Global Structured Credit Products at Bank of America Merrill Lynch and before that was a director at Citi for their global CLO business. In these roles, Ms. Messina oversaw primary issuance, secondary trading, and credit financing businesses in New York and London and was responsible for pitching, pricing and managing client relationships. Additional investment experience includes roles at Citi as a director in Credit Derivatives trading, Salomon Smith Barney in their Retail Credit Markets group and in retail sales within the Taxable Fixed Income department at Painewebber, Inc. Ms. Messina received a B.A. degree from Fordham University.



## **Ronnie Kaplan, CFA**

Managing Director and Portfolio Manager

Mr. Kaplan joined Oaktree in 2016 and is a managing director and portfolio manager for the U.S. Senior Loan strategy. Before joining Oaktree, he was a portfolio manager, managing director and analyst with Levine Leichtman Capital Partners. There, Mr. Kaplan managed a fixed income portfolio investing in leveraged loans and high yield securities. Prior thereto, he was an analyst for the credit opportunities strategy at Wolf Point Capital Management. Additional investment experience, in the distressed debt area, includes serving as vice president at PPM America, Inc.; Bank One, NA; and Renaissance Financial Restructuring. Mr. Kaplan began his career as a senior analyst with Bankers Trust Corporation. He received a B.S. degree *cum laude* in economics from The Wharton School at the University of Pennsylvania and is a CFA charterholder.



## **Brendan Beer**

Managing Director and Co-Portfolio Manager

Mr. Beer is a managing director and co-portfolio manager for Oaktree's Structured Credit strategy. In addition to his role within the Structured Credit strategy, Mr. Beer also assists with the arranging and optimization of Oaktree-managed CLOs. He joined Oaktree in 2017, having previously worked at Guggenheim Partners Investment Management, serving as a managing director and co-head of structured credit. At Guggenheim, he managed a team responsible for in excess of \$40 billion, which performed credit analysis, trading and risk management across private label RMBS, CMBS, ABS and CLOs, with Mr. Beer specializing in CLOs and Esoteric ABS. Prior thereto, he was a vice president at Citigroup Global Markets, as a secondary CDO trader and in securitized products distribution. Mr. Beer previously spent eight years in the Navy, as a division officer aboard a fast-attack nuclear submarine and as a classroom physics and chemistry instructor. He earned an M.B.A. from the University of Rhode Island, an M.S. in nuclear engineering from the Massachusetts Institute of Technology, and a B.S. in mathematics (honors track) with distinction from the United States Naval Academy.

# Endnotes

1. JP Morgan, as of November 21, 2023.
2. JP Morgan, as of November 21, 2023.
3. NYU Salomon Center/KBRA Altman, Credit Suisse.
4. S&P Global Ratings.
5. Pinebridge Investments.
6. Moody's Investors Service.
7. In this analysis, Oaktree excluded the worst-performing loans (i.e., those with prices below 90 cents on the dollar) when creating an approximate average new CLO portfolio, as CLOs are restricted from buying the riskiest loans. Dislocations were defined as periods in which the loan portfolio was trading below particular price thresholds (i.e., below 99 cents on the dollar). We calculated hypothetical equity returns for two sets of CLO liability structures: (a) one with a weighted-average cost of debt of the reference rate plus 150 bps, representative of "par loan" markets, and (b) one with a weighted-average cost of debt of the reference rate plus 225 bps, representative of "dislocated" markets. The percentage of periods (in months) in which the trigger was active is as follows:  $90 < P_x < 99$ , 56%;  $90 < P_x < 98.5$ , 43%;  $90 < P_x < 98$ , 28%;  $90 < P_x < 97.5$ , 22%;  $90 < P_x < 97$ , 18%;  $91 < P_x < 96$ , 13%;  $92 < P_x < 95$ , 7%.
8. Oaktree Capital estimates, as of March 31, 2023. Oaktree makes no representation, nor should it be assumed, that past performance is an indicator of future results.
9. Oaktree makes no representation, nor should it be assumed, that past performance is an indicator of future results.
10. Federal Reserve Bank of New York, as of July 14, 2023.
11. JP Morgan.
12. JP Morgan.
13. Oaktree Capital, as of December 31, 2022. Default rate defined as (the volume of defaults at par) divided by (average par value and cash outstanding for the period). Loss rate defined as default rate – (default rate multiplied by recovery rate). Source for market averages is JP Morgan.

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