CLO Outlook: Managers aim to pace issuance in an uneven recovery driven by Covid vaccine

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LevFin Insights
16/12/2020

The Covid vaccine is a game changer for CLO funds ready to deliver high yields for investors although issuer plans are vulnerable to a fragile arbitrage that could get tangled by ill-timed supply, sources said.

2021 Key Takeaways:

(1) **Issuance and Costs.** The market expects volume of $90 billion to $110 billion (~$80B net) and by year-end AAAs repricing between L+120 and 90 bps with a five-year reinvestment period and two-year non-call.

(2) **Bull Case.** Vaccines start beating back Covid-19 in the first half; then by mid-year, CLOs normalize to 2019/2018 spread levels and structures; e.g., larger deals ($500M), supported by heavy loan issuance, and equity returns rise to low 20% IRRs attracting new money.

(3) **Ownership Shift**. Global banks return to positive investment growth (catalysts: lower JPY swap costs, heavy pre-payments, AAA relative value and rating stability); insurers, asset managers and CLO platforms continue to increase exposure YOY.

U.S. CLO managers aim to buoy issuance 25% year-over-year to $100 billion. However, next years' growth is predicated on the chain reaction of vaccines fueling GDP targets hit targets in the low- to mid-single digits.

"We now have a light at the end of the tunnel," said Art Penn, founder of PennantPark, a $4B AUM upper-middle market asset manager and CLO issuer. "But we don't know if that light will come in the spring, summer or fall, next year, and we have to get past this winter."

Over a dozen muted CLO managers (flat issuance post-Covid) aim to get back past market share with a pace of two to three new transactions per annum. In addition, around five or more brand new CLO platforms aim to enter the market, sources said. At its peak in 2018, nearly 90 CLO managers issued a record $130 billion.

Even with a modest economic recovery of low-single-digit GDP growth, CLOs could return to spread and volume levels similar to the 2019/2018 vintages, sources said. A hurdle that market participants fear is substantial refinancing/reset waves of legacy deals that could spoil the arbitrage. On the other hand, large CCC buckets and distress loans have kept equity holders from starting a wave resets last seen in January and February. This limit on supply could disappear as upgrades and trading improve portfolios. Refinancing volume could spike quickly due to recent tightening, said sources.

U.S. BSL CLOs 2Y Trailing Spreads (min, max, average): AAA 121-300 (145), AA 160-450 (198), A 205-310 (274), BBB 310-900 (413), BB 625-1750 (777). (Barclays)

Intermittently, the CLO market chokes on its own success when oversupply and rising loan prices cause issuers to tap the breaks. Chief executives at the largest collateral managers said one of their top concerns next year is loan prices rising so high CLOs become uneconomical.

The second half should see a return to past market norms seen in 2019/2018, said sources. Volume should get absorbed to support economic expansion, CLO deal sizes and reinvestment periods should revert to pre-pandemic norms, writes Keyur Vyas, a CLO strategist at Deutsche Bank.

CLO Outlook 2021

Key factors	Base Case	Bull Case
*Equity IRR %	Mid-Teens	High-Teens to Low-20
Loan Defaults/GDP %	3.5/4	2/5.5
AAA (Tier 1/Other) (bps)	120/145	100/125
BB (Tier 1/Other) (bps)	700/800	600/725
US$ CLO Issuance	100B	130B
Refinancing /Reset ($)	20B/10B	30B/20B
WADM (bps)	< 200/250	< 150/200
HY Loan Issuance (net)	$160B	$200B

Note: *2% CADR, 70% Recovery, 20% CPR. Sources: LevFinInsights, Fitch Ratings, J.P Morgan, BofA Global Research, Deutsche Bank, Wells Fargo, Barclays, GSO.

Investors Narrow Risk

“The vaccine should lower investors’ fear of a prolonged global recession, making tail risk estimates more accurate by taking the most flawed worst-case scenarios off the table,” said Ed Reardon, head of structured finance research at Deutsche Bank.

Below are immediate risks that should be top of mind for CLO investors, sources said.

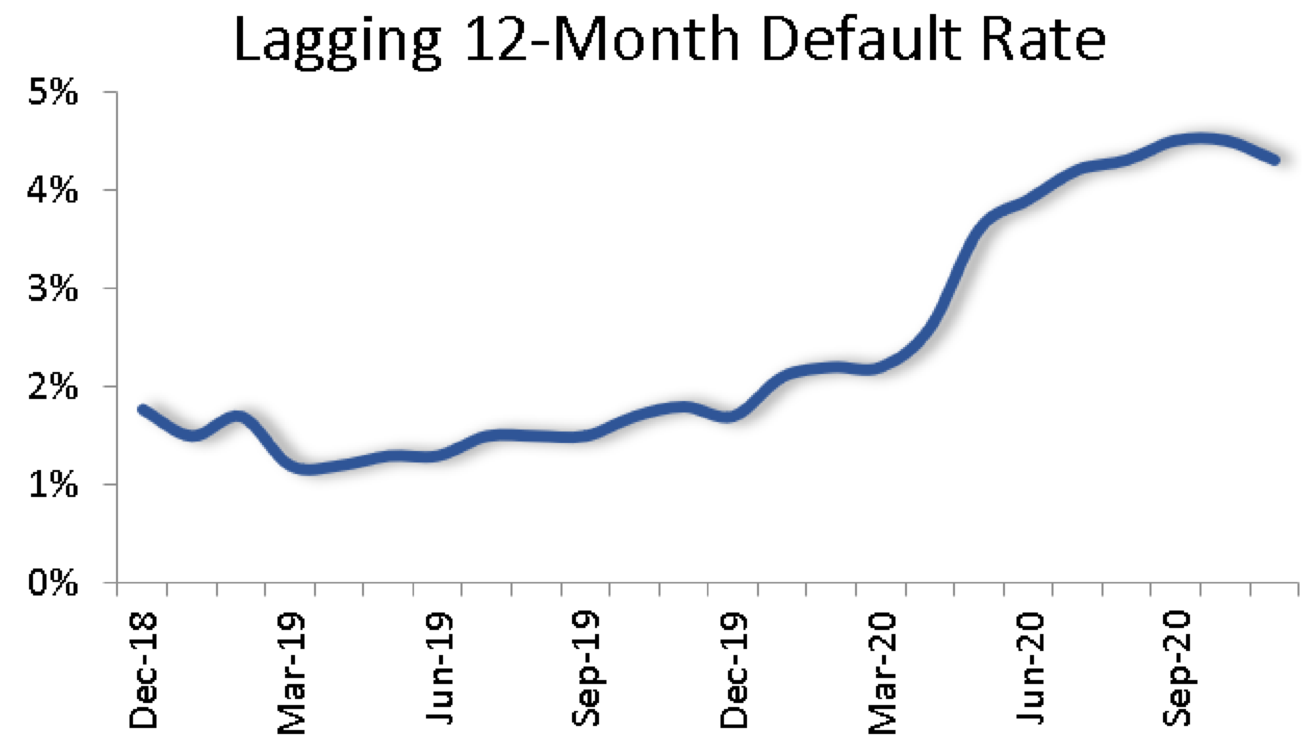
• The value destruction between the vaccines' "effectiveness" and containment of Covid-19.

• Dynamic consumer patterns that shift some borrowers up and others into bankruptcy.

• Recoveries could be lower before they go up next year.

Historically, structured products post-recession see credit enhancement levels lowered as demand rises. CLOs next year will likely follow this path too.

“CLOs that were issued in the spring and summer were structured with a bit more subordination at the lower tranches," said Gretchen Lam, senior portfolio manager at Octagon, which manages $26.6 billion in below-investment-grade corporate credit. "We are seeing this revert to more normal levels in the structures of more recently issued CLOs.”



Source: Fitch Ratings

Issuer Liquidity Views

Cinema company **Cineworld Group**'s raising a $450 million term loan in the fourth quarter from existing lenders, in addition to covenant waivers, avoiding a near term default, is a good example of improving liquidity for Covid-impacted firms, writes Pratik Gupta, head of CLO strategy at BofA Global Research.

“We expect significant challenges for leveraged credits through the first half of the year, including rating downgrades and defaults, but the impact will be mitigated by optimism about the post-COVID future,” Alex Jackson, chief investment officer, at Nassau Corporate Credit.

“Distressed obligors will find liquidity bridge financing to be more readily available than in 2020 and restructuring outcomes will reflect more confidence in future prospects," Jackson also said. "CLO issuance should be robust, but is currently somewhat hampered by an imbalance between ever-tightening yields on loans, which have not been sufficiently reflected in the yields on CLO liabilities.”

Rating Stability

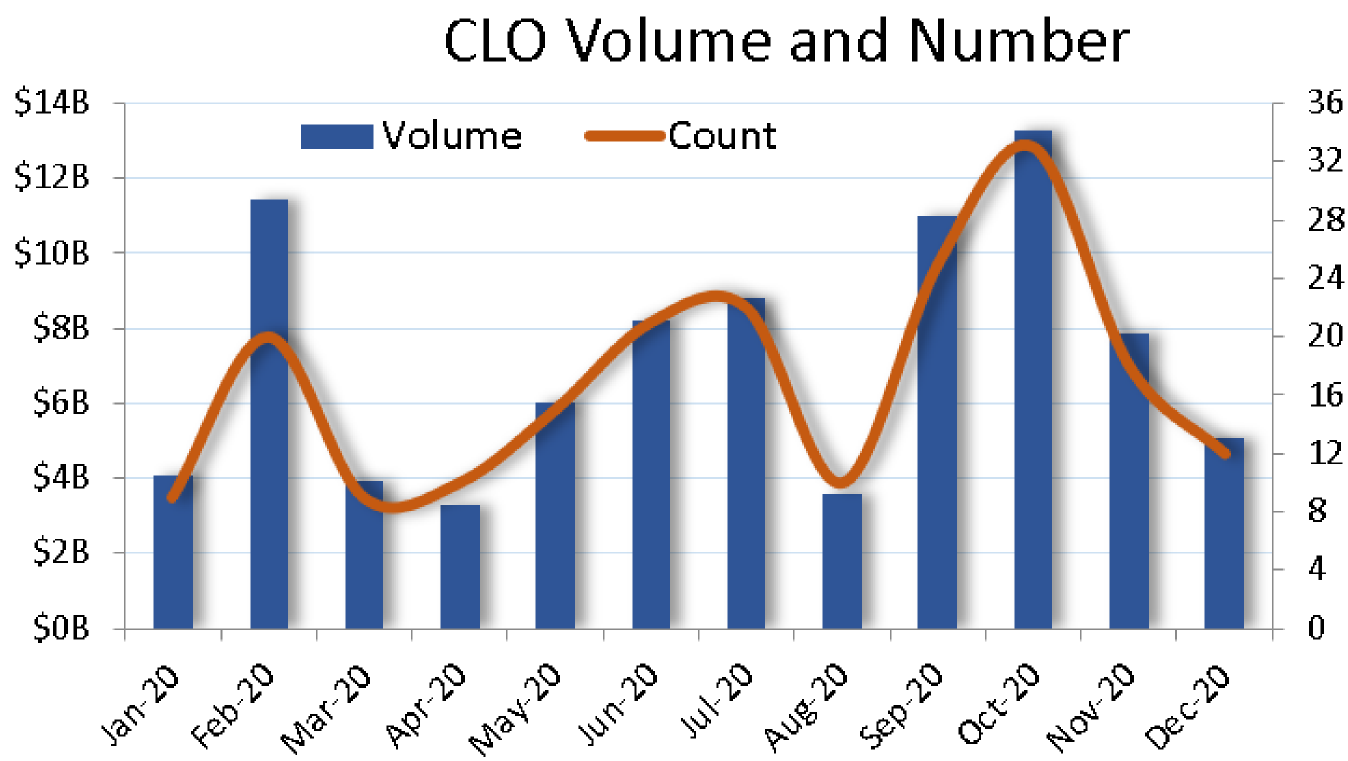
Rating agencies are rolling back pandemic-related downgrades as liquidity flows to stronger borrowers. CLO downgrades are not expected in the medium-term, based on the current market environment and vaccine developments, said sources.

Moody’s made a dramatic change to its CLO methodology roiling the loan market upward by putting 114 CLO transactions On Watch for upgrade.

Insurers are investing cautiously after getting burned in March due to the NAIC’s downgrade rules.

New-Issue Volume

Pushing up supply expectations is the belief that CLO investors will increase allocations because of more clarity around large macro events and CLOs’ value relative to other credit products, writes Deutsche Bank. "U.S. CLO supply next year is forecast at $76 billion net and $100 billion gross for new issue, split $85 billion BSL and $15 billion middle market." Deutsche's forecast shows an 18% uplift on the full 2020 gross expectation issuance of ~$75 billion and ~16% lower than 2019. The global (U.S. and Europe) outstanding CLO could grow by 11% from its current ~$713 billion next year.



Source: LevFin Insights

Refinancing Opportunities

CLOs' large, albeit shrinking, CCC holdings continue to slow down refinancing or resets despite falling liabilities, said sources. Nevertheless, Barclays expects up to $50 billion in CLO refinancing 2021.

The decision to reset rather than refinance will depend on the deal economics, performance of the underlying collateral, and the cost-benefit of extending the deal, said sources.

Refinancing case:

• AAA at +126 bps (3Y RP) could lead to $36 billion in supply.

Reset case:

• AAA at 132 bps (3Y RP) (170 bps WADM) would equate to $61 billion in supply**.**

(Deutsche excludes deals from the reset universe with BB OC cushions <1%, BB market value OC <90% and deal factor <50%).

The majority of post-Covid vintage-2020 CLOs could get called next year. Also, an increase in managers' executing partial refinancings or resets of AAA tranches is likely next year. In 2020, the majority of CLOs refinanced took place in the first two months – January $3.6 billion and February $11.1 billion. Managers mostly refinancing fixed rate tranches since April. Fixed-rate tranche partial refinancings are expected to continue.

CLO Yield Scenarios

U.S. AAA spreads could compress to high-double digits (e.g., 90 bps) with a successful vaccine implementation sometime in 2021, sources said. Supporting market participants' lower yield projections are factors, including low-interest rates, performance, a recovering economy and positive technicals, writes BofA.

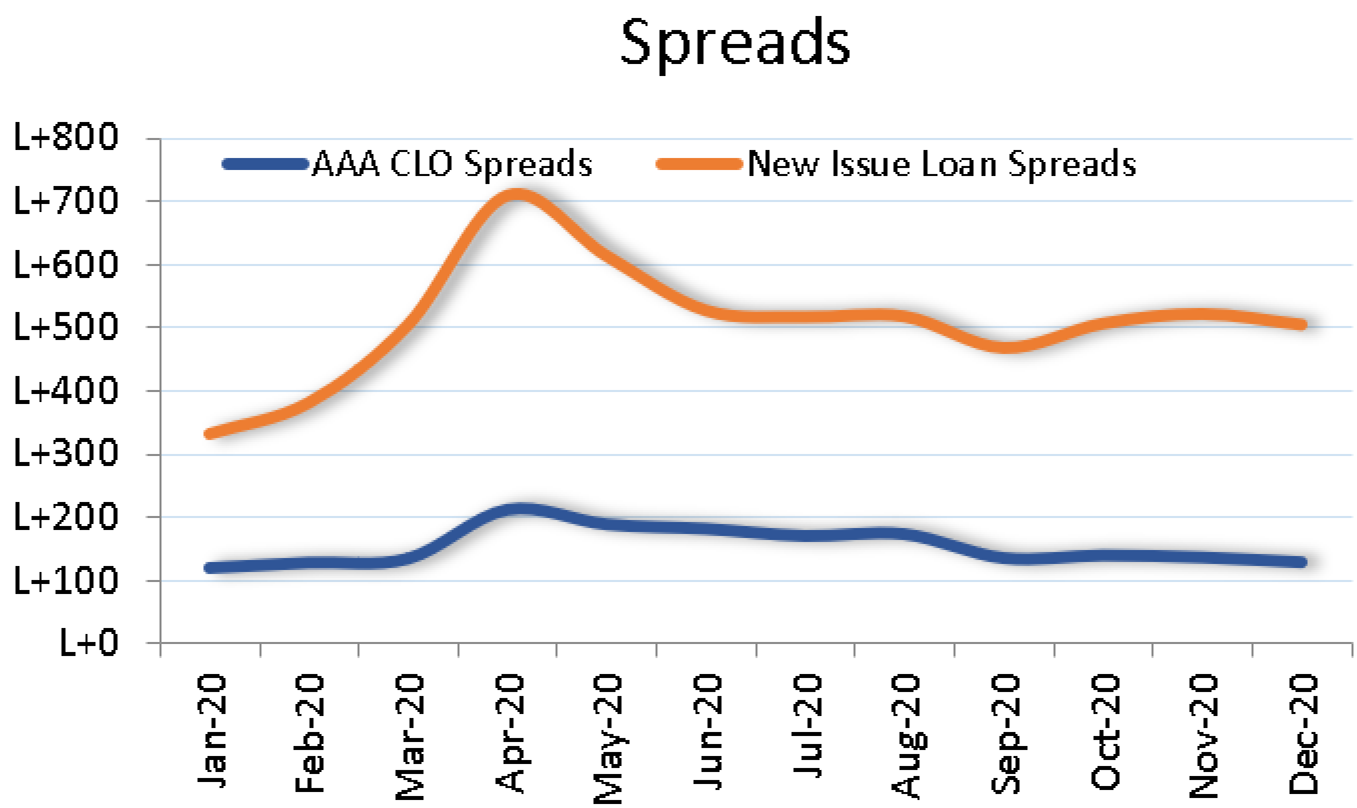
Manager ranking and spread discounting should narrow for top performers outside the large benchmark manager circle for AAAs, reverting to a discount inside 20-30 bps.

Spreads across the belly of the rating stack (AA through BBB) generally tightened YTD in the U.S., while the "wings" of the stack (AAA and BB) are slightly tighter, across manager types, writes Barclays.

Secondary spreads tightened close to J.P. Morgan's year-end 2020 targets: AAAs at 120 bps (135 bps target), BBBs at 360 bps (375 bps target).

JPMorgan expects modest new issue compression by YE 2021: AAA -10bp to 110bp, BBB -35bp to 325bp.

Like other market participants, JPMorgan views 2021 CLO spread compression as having a limit. Clearly, the deployment of vaccines is positive, but CLO spread tightening could stumble by the near-complete spread recovery, low Libor, near-par pricing, and ~$35 billion in refinancing activity taking away issuers pricing power.



Source: LevFin Insights

BSL vs. Middle Market Yields

Demand for higher return assets will likely flow through to the relative value of MM versus BSL CLO tranches. Both should compress back to their 2019 historical averages next year. This implies MM CLO AAA spreads decline to +165-175 bps by Y.E. 2021, or +20-30bp tighter from current levels. The basis between BSL/MM AAs already compressed to historical averages at +225-230 bps, writes Barclays.

Estimated U.S. CLO Ownership in 2020

• Banks 32% (-2%)

• Insurance companies 24.5% (+2%)

• Asset Managers 15.5% (+2%)

• Pension Funds 11% (-1%)

• Hedge Funds / CLO Mgrs 10% (Unch)

• Other 7.5% (Unch)

(Barclays)

Investor Trends

◦ **Global banks**. All eyes are on the return of Norinchukin, the world's largest AAA CLO holder, to buying CLOs robustly. The Barclays FX research team expects the decline of hedging costs to encourage Japanese banks to return as a major investor in CLOs, albeit buying at a slower pace than in the past. Barclays believes banks could again become major investors in the asset class next year, especially as pressures on net interest margins remain and hedging costs for JPY-based investors decrease further.

◦ **Insurers and Asset Managers**. Insurers and asset managers likely increased their market share of CLO holdings this year, with these buyers finding the wider spread levels attractive versus other credit, especially given elevated levels of manager tiering. These investors are likely to continue to find high relative value in CLOs in 2021 and may even move lower in the rating stack in search of yield if spreads tighten.

◦ **Hedge Funds/Total Return.** Strong demand for CLO mezz and equity should also remain next year. Barclays believes that hedge funds and CLO managers maintained exposure to the asset class this year. The decline in mezz and equity performance may have driven some outflows for such funds, but there have also been a number of funds raised this year specifically to invest in stressed CLO special situations in both the U.S. and Europe and to invest in other managers CLOs; e.g., NCC, CSAM, GoldenTree and Palmer Square.

CLO BBs are the cheapest structured finance asset in the market, writes BofA. Mezz CLOs price recovery continues to lag the pace of the investment-grade retracement in the mid-high 90 cents to the dollar, not benefiting from the recovery. BBs have been a popular total return trade since the March Covid crash.

CLO Equity – In Line for the Vaccine

Deep discounts for mezz and CLO equity will continue next year. CLO equity lags the credit rally due to the high risk of cash-flow cut-offs on O.C. breaches and net asset value impairment (average NAV being ~30 currently for deals within reinvestment), sources said.

Third-party equity availability challenges even the largest managers; however, as equity returns move up with liability tightening, investors are returning to the market.

Equity distributions nearly doubled during the fourth quarter due to LIBOR levels reaching extreme lows in the third quarter impacting floors, lower liability costs, in addition to improving OC ratios. Source January CLO payments should be even better.

Lower Regulatory Headwinds

While a new rework of the Volcker Rule is possible under a Biden administration, it isn't expected, especially under a split U.S. Congress, sources said.

“We think there's a very low possibility of the re-introduction of risk retention for US BSL CLOs (risk retention for US MM and European CLOs likely to remain), with the new administration is likely to spend more time initially introducing non-financial related legislation (e.g., focusing on COVID-19 relief, the environment and healthcare),” writes Barclays.

The focus on including proper Libor fallback language in deals is likely to remain for the likes of banks, insurers and other investor types next year.

Bond Buckets

Many investors are skittish about CLO managers adding bond risk, which was cleared by amendments to the Volcker Rule in October. On the other hand, collateral managers counter with a compelling list of reasons for the value of bond buckets, such as diversification and spread gains.

Hybrid CLOs to Increase

Hybrid CLO issuance picked up to $2 billion YTD, surpassing total annual issuance in 2015-17. BofA Global Research expects issuance of Hybrid CLOs (CLOs that can hold both bonds/loans and have higher CCC limits) to increase due to (a) lower swap rates, (b) relatively cheap assets, and (c) increased investor base with the Volcker rule amendments.

Additionally, BofA believes hybrid CLOs outperformed BSL deals in specific metrics, including notional par build, market value change, and OC test failures. Hybrid CLO AAA spreads trade at around 240 bps, making it one of the cheapest bonds within securitized products. The AAA bonds have a make-whole clause until the end of a five-year reinvestment period, and the entire capital structure through BBB is around 100 bps wide versus primary BSL CLOs.

Recovery Risks

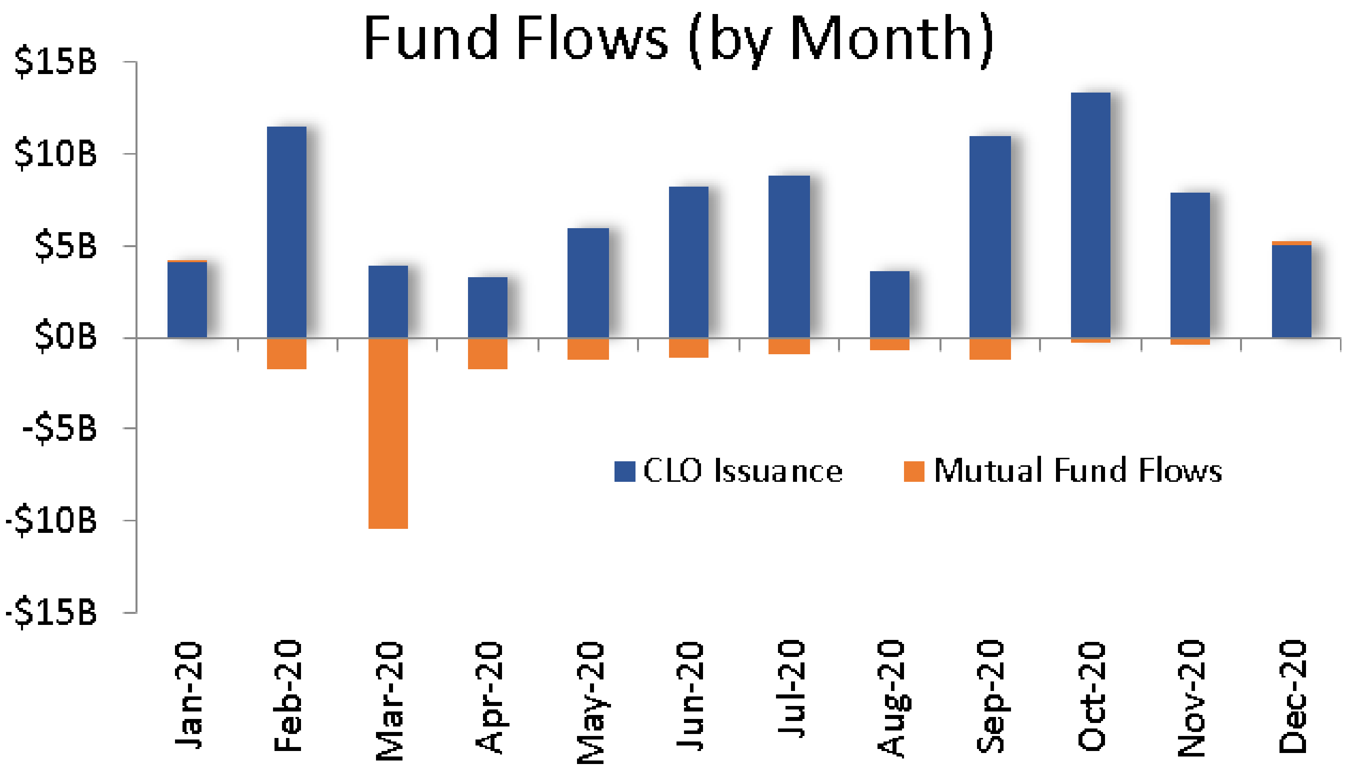
1) If fiscal stimulus is insufficient, collateral performance could decline as unemployment remains elevated. The single biggest move that has contained the financial chaos is the timely and robust fiscal and monetary policy response seen at the onset of the Covid pandemic. If the current Covid gets significantly worse, will Congress act as swiftly and effectively as earlier in the year?

2) Delays in vaccine availability, or discovery of significant side effects issues could slow the timeline to herd immunity and economic recovery. The baseline expectation to herd immunity is at midyear; longer than that, expectations for issuance and performance might be too optimistic.

3) About half of the global population would refuse to take the vaccine, according to a recent survey by Deutsche Bank.

(Source: Deutsche Bank)

Charts:



Source: LevFin Insights

U.S. CLOs Marketing Dec. 14th		
Aegon	Cedar Funding XI	JPM
FSIM		JPM
Golub	Golub Capital Partners 52(B)	JPM
GSO	Tallman Park	Barclays
King Street	Rockford Tower 2020-1	JPM
LCM	LCM 31	Natixis
Marble Point		Barclays
Nassau Re	Nassau 2020	MS
Octagon	Octagon Investment Partners 49	Goldman
Redding Ridge	Redding Ridge 12	BNP
Sound Point	Sound Point XXVIII	Barc

(Market Sources)

–David Graubard