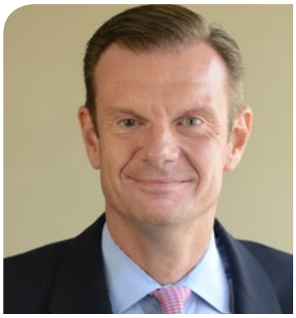

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No one ever says the CLO equity arb looks great. But even in particularly challenging periods there are ways for equity investors to generate strong returns

Throughout 2019, many market participants have noted that the 'CLO equity arbitrage' (i.e. the difference between loan spreads and the weighted average cost of debt in the CLO market) looks less favourable than it has in recent history. Indeed, the raw difference between these two debt measures is tighter than it has been in some time.

However, the IRR on any given CLO equity security is driven, in our view, by many more factors than just these two simplistic inputs to a financial model. Indeed, some 1.0 CLOs that generated high equity IRRs were created when the arbitrage at pricing was considered to be challenging.

While the loan market recovered in the first quarter this year from the losses suffered at the end of 2018, the CLO debt market has generally lagged. In fact, CLO triple A spreads have actually widened since year-end, while loan prices rallied.

It is periods like this, where CLO debt spreads have not yet fully tightened in concert with loan spreads, that the arbitrage may look challenging on a point-in-time basis.

Reducing fees offsets financing costs

Upfront and ongoing fees and expenses can be meaningful factors in determining ultimate CLO equity IRRs. Well-positioned investors can drive down the costs of CLO creation to make new CLOs more attractive. Due to the challenging CLO equity arbitrage, many leading service providers are lowering their upfront and/or ongoing fees in order to help offset the widening in CLO debt financing costs. The alternative is equivalent to an airline having an aircraft take off with empty seats.

Portfolio turnover can drive returns

Even with these savings, what else isn't being considered in the models? In our view, there can be too much focus on the default and recovery assumptions when evaluating a CLO equity investment opportunity. We believe relatively few investors give adequate attention to loan prepayment rates, potential reinvestment spreads and discretionary trading by CLO collateral managers. Average annual loan prepayments have been 34% over the past 15 years. These prepayment rates also don't account for discretionary (and credit risk/credit improved) sales by CLO collateral managers. Put more simply, a CLO's portfolio two years from now will likely be very different than what it is today. If loan spreads widen and the CLO collateral manager can rotate into these wider spread loans, a given CLO's arbitrage will certainly improve.

> The IRR of CLO equity is driven by far more than just initial spreads

Long reinvestment periods increase

Most new CLOs benefit from five-year reinvestment periods, which in our view create very valuable options for managers. Of course, in a new CLO, the equity is typically precluded from refinancing the CLO's debt for the first two years, which could be a drawback.

There are two immediate differences between secondary purchases of CLO equity and primary purchases. First, if a CLO is two years seasoned, its debt is now freely callable or, if market conditions permit, can be refinanced or reset (whereas a primary investment is typically subject to a two-year non-call period). This is unambiguously a benefit, though the seller of the CLO equity likely factored in any potential refi upside when setting the secondary sale price.

In addition, using the same example, the secondary investment would only have three years left in its reinvestment period. This is two years (40%!) less than a primary investment. What is two years of additional reinvestment optionality worth? While a longer tenor certainly has value, we believe different market participants have very different perspectives on that value. These divergent views create a potential opportunity for experienced market participants.

We believe that there are attractive opportunities in both the primary and secondary markets. Indeed, some (but not all) secondary opportunities pencil out to a higher IRR than a typical new-issue transaction today.

With any investment decision, finding the best opportunities requires significant time, resources and experience. Most of all, investors must remain highly selective because the variables impacting CLO equity are many and are constantly shifting. The manager's ability to understand all of them, to access optionality and provide adequate reinvestment runway for future volatility can ultimately drive the performance of CLO equity far beyond the day one arbitrage.