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Changes in Libor do not have a major impact on CLO equity cash flows or equity yields

Since the turn of the year, three-month Libor has dropped by roughly 50 basis points. With many market participants expecting imminent rate cuts from the Fed, which could continue into next year, what sort of impact could further drops in Libor have on CLO equity?

Many investors ask: "Aren't CLOs 10 times leveraged to loans — shouldn't a drop in Libor hurt the equity class?" It comes as a surprise for some to learn that, holding all else constant, changes in Libor have relatively little impact on CLO equity cash flows or equity yields.

Let's look at a generic US cash flow CLO with a five-year reinvestment period. In a base case scenario, assuming the current forward Libor curve, the expected loss-adjusted yield (or IRR) for the CLO's equity investor might be 16.1%. Holding all other assumptions constant, if Libor remained flat at its current level of around 2.3% for the life of the CLO, the CLO's equity IRR actually increases to 16.7%. (At present, the forward Libor curve is inverted.)

If we were to assume Libor sticks with the current forward curve for the balance of the year, then drops to 1% in 2020 and remains flat at 1% for the remaining life of the CLO, that CLO's equity IRR changes to 15.3%, a reduction of 0.8% from the original base case. As equity investors, we would rather not see our yield drop by this amount, but considering the myriad other variables that will play out over the life of a CLO, we consider the potential impact of a significant drop in Libor to be a relatively modest risk to CLO equity investing.

> Considering the variables over the life of a CLO, a drop in Libor is a relatively modest risk

Why are these changes so small? Broadly speaking, much of the change in Libor is cancelled out between a CLO's assets and liabilities. The vast majority of cash flow to CLO equity is driven by the difference in spreads on a CLO's assets and liabilities, not Libor itself.

Loan borrowers' interest expense reduced

Of course, these IRR comparisons are isolating just one variable — changes in Libor. Lower Libor, all else being equal, reduces loan borrowers' interest expense, which is a credit positive event. Reduced interest expense could increase the likelihood of lower future default rates.

The bigger question to be asking is, why are rates falling? If the Fed is cutting rates aggressively, is it making these cuts in the face of an increase in corporate defaults? Or is it taking action in advance of a spike in credit events, further extending the life of the current expansion?

Talk of the market grinding to a halt

Thinking further about interest rates, it is also worth revisiting a topic covered in this column about a year ago. At that time, one-month Libor was significantly less than three-month Libor (see the August 2018 issue of *Creditflux*). This difference in rates was a fairly controversial topic at the time.

We were of the view that the difference wouldn't have a material impact on long-term CLO equity returns. Others in the market had a more dour outlook, predicting that the difference in rates would have a significant negative effect on CLO equity returns and could even cause the market to seize up. Time has proven those naysayers inaccurate. The situation is now reversed, with one-month Libor modestly higher than three-month Libor.

After analysing both the potential impact of falling Libor and the basis between Libors of different tenors, the key takeaway is that holding all else constant, Libor itself has surprisingly little impact on CLO equity investing. Rather, in our view, moderate changes in Libor are more informative in what they say about the economic landscape.

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