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If the current credit cycle doesn't end within two years, triple C-heavy CLOs will not see a return on their high financing costs

Depending on your view on where we are in the credit cycle, CLOs designed and structured to hold — and even proactively acquire — out-of-favour assets could be an attractive investment opportunity.

Contrary to the marketing materials of many of today's distressed credit funds, cash flow CLOs today can hold triple Cs and defaulted assets for as long as they like, and will not be forced sellers. Unfortunately, while the holding periods for low-rated assets typically aren't limited, most regular CLOs do face stringent limitations regarding the purchase of new triple C assets above a certain threshold, and receive punitive haircuts for defaulted assets as time passes.

Enter today's 'enhanced' CLOs, as they've been dubbed. They offer something potentially very attractive — the ability to proactively buy larger amounts of triple C-rated loans than conventional cash flow CLOs. During periods when there are few other buyers of these loans, and particularly under the stewardship of skilled CLO collateral managers backed by experienced equity investors, this option could prove to be a tremendous asset when the credit cycle next turns.

No such thing as a free lunch

Most enhanced CLOs offer great latitude in terms of the amount of triple Cs that can be held prior to haircuts being taken under the CLO's overcollateralisation test numerator. As a CLO equity investor or CLO collateral manager, this sounds just about as good as it gets.

For enhanced CLOs to outperform, investors need the credit cycle to turn — and quickly

Sadly, there is no free lunch. In the case of enhanced CLOs, the tab for the proverbial lunch reflects the cost of a three-course meal — higher debt costs, reduced leverage and shorter tenor (in terms of reinvestment period). Our analysis of several recent enhanced CLOs showed that they faced financing costs typically between 72 and 127 basis points higher than a regular CLO. Making matters worse, they are usually far less leveraged, often with equity classes double the size of a regular CLO, which means lower ongoing cash-on-cash returns.

The last piece of the equation is tenor. In today's benign default environment, the ability to bulk up on triple Cs might not be that attractive, but in the future, it certainly could be. When exactly that future comes, however, remains an open question. Bears may say it is right around the corner. According to my recollection, many called the seventh or eighth inning of the credit cycle in December 2014. Others may look at the covenant-lite aspect of loans and consider the default cycle to be multiple years away.

Some pundits simply focus on age. But while the US expansion has lasted 10 years — which ranks as the longest on record — no one knows for sure when the cycle will turn, or what exactly will cause it to turn.

Credit cycle urgently required

With many recent enhanced CLOs offering three or four-year reinvestment periods (compared to the typical five-year periods in regular CLOs), in order to make equity investments in enhanced CLOs outperform today's opportunity in standard CLOs, equity investors not only need the credit cycle to turn, they need that turn relatively quickly.

Furthermore, the portfolios in the enhanced CLOs need to be in a defensive position (which doesn't seem to be the case) and need to suffer only limited losses during the initial stages of the credit downturn in order to be able to buy out-of-favour assets. If the CLO collateral manager is taking material losses in the enhanced CLO portfolio, it will likely prove difficult to rotate into triple C-rated loans. However, positioning defensively in a benign credit market, like today's, certainly comes at a cost. Put simply, if the credit cycle doesn't turn in the next two years, we believe the premium paid to debt financiers of enhanced CLOs will be analogous to options expiring worthless. In such a scenario, equity investors in these triple C-heavy CLOs face potential returns below what are available as an investor in double B-rated CLO tranches in regular CLOs today (and perhaps even to investors in triple Bs).

However, if markets turn more quickly and the CLO collateral managers of these enhanced CLOs are able to rotate into out-of-favour assets, the optionality they have purchased could provide the cheapest lunch ever.

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