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## CLOs can be disadvantaged in distressed situations, but there are ways they can adapt

It is becoming increasingly clear that CLO collateral managers need to improve their collaboration efforts in distressed situations. As corporate defaults — both coronavirus-related and otherwise — begin to increase in the worldwide recession, in too many cases we have observed distressed funds slowly but surely buying up pieces of loans from CLOs and other loan funds that are not oriented towards distressed investing.

Those distressed buyers, often acting in a small group, eventually accumulate control of a loan and push through a restructuring that is decidedly unfriendly to CLOs. Names like Acosta, Deluxe Entertainment and 4L Holdings are recent examples. In situations like these, value is transferred from the CLO community to the distressed community.

This topic was previewed in these pages back in March, in a column written in late February. The issues it covered seemed academic at the time, but today they are unambiguously real.

### A majority can quickly break apart

With CLOs controlling roughly 60% of the loan market, CLO collateral managers as a class clearly have the raw financial wherewithal to be able to have a major influence on the outcome of a restructuring. Yet with so many loan market participants, the law of large numbers seems to be in play. It takes just one or two CLO collateral managers (a small percentage of the total) selling into the distressed community for cracks to start forming. Then word gets around that people are selling. Momentum builds. Before we know it, distressed funds control the majority of a loan and restructurings are done in a manner unfriendly to CLOs. The CLO community would be well served to stop this trend.

In addition to changes in CLO collateral manager behaviour, the CLO community needs to better equip CLO collateral managers to navigate these situations. This is not a 'debt issue' or an 'equity issue' — it is a CLO issue. The behaviour of others in the loan market has changed, and CLOs need to evolve and adapt.

Some features that we believe would be helpful for CLO collateral managers include the following:

**Greater ease in buying DIP securities.** Some debtor-in-possession financings do not have final ratings when commitments are due. CLOs should be able to buy these, carrying them at par if they are already a lender. If a rating isn't published within 60 days, then the DIP would be carried with a triple C rating until such time as a rating is issued, since most DIP loans receive ratings above the triple C category.

**Swapped default obligations.** CLOs should be able to swap on a risk-neutral basis between different distressed situations, allowing CLO collateral managers to move into credits with the best recovery outlook.

**Loss mitigation loans.** CLOs should be able to use interest proceeds, or even some amount of principal proceeds, to participate in workout packages of existing obligors, even if the loan did not otherwise meet eligibility criteria.

Some of these suggestions may require changes in the Volcker rule before they can be implemented. Hopefully that relief will be adopted in the near term. As it stands, the Volcker regulations are adversely impacting many CLO investors, including banks and insurance companies. Ostensibly, these are the investors the regulations were seeking to protect.

### Making the call to equity investors

Until such relief is granted, if all else fails, CLO collateral managers should feel comfortable calling their equity investors to discuss these situations as they arise. We believe CLO equity investors with a long-term investing orientation would be willing to buy positions from a CLO and participate in the workout on their own if the CLO is not able to do so.

> It takes just a few CLO collateral managers selling into the distressed community to start cracks forming