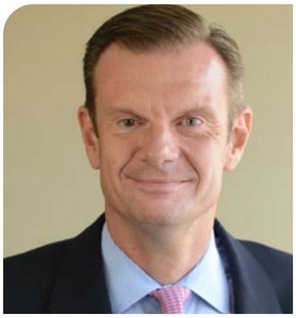
CLO naysayers have made arb and cov-lite into dirty words — that should now change



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Recent performance has shown that cov-lite loans and challenging arb don't spell doom for CLOs

Prior to the onset of covid-related market distress early last year, many market participants were complaining that CLO equity arbitrage (the difference between loan spreads and the cost of debt in a CLO) was not good and equity returns were being squeezed.

Indeed, the raw difference between these two debt measures had compressed by late 2019. But the arb is merely a point-in-time measurement, and in no way captures that CLOs are continuously changing.

In addition to a tight arb, some bemoaned that we were late in the cycle. Others cried about loan quality, fearing that when the cycle turned, covenant-lite loans made to highly leveraged companies would lead to large losses for lenders and, by extension, CLO investors.

Most CLOs paid throughout 2020

When loan prices fell precipitously in March 2020, the net asset value, or equity liquidation value, of nearly every CLO was zero. The number of CLOs that forcibly liquidated as a result was also zero. In fact, the vast majority of CLOs continued making equity distributions without interruption throughout 2020. By April, that purportedly expensive CLO debt issued just a few months ago, when the arb was bad, was looking cheap and could not be replicated.

Triple A spreads on five-year reinvestment period CLOs have tightened by nearly 20% this year and are inside where they were pre-covid. Similarly, CLO refinancings, including those with up to three-years remaining on reinvestment periods, can often achieve triple A spreads at or below 100 basis points, materially reducing the cost of funding for seasoned CLOs.

Syndicated loan spreads have also tightened, but at a much slower pace than CLO debt. While a sizeable portion of the loan market is trading at or above par, only a low single digit percentage of those loans are immediately callable without penalty. In addition, three-month Libor, the base rate for CLO debt, continues to hover around 0.20%, while Libor floors found in many (but not all) loans are generally around 0.50-0.75%, adding to CLO equity distributions.

Cov-lite has again proven its worth

Prior to the global financial crisis, cov-lite loans were generally afforded to only the highest-quality borrowers. They now comprise more than 80% of the overall syndicated loan market — compared to 17% in 2009. A loan with covenants is generally a red flag today.

The growth of cov-lite loans has often been portrayed as a downside accelerant in any negative economic shock. The exact opposite is true. Our view was reconfirmed by the events of 2020.

During the heights of covid-related stress, loan downgrades sky-rocketed as agencies hit over 1,500 issuers between March and August, and the rapid drop in GDP that came from government stay-at-home orders put an immense amount of pressure on corporate borrowers. But the lack of covenants allowed many companies to weather the difficult economic climate without the risk of technical default. And although the default rate did rise to an above average mid-4% range during the summer, that is far from the 10%-plus rates predicted by some, perhaps due to their incorrect understanding of cov-lite.

During this period, according to research from Goldman Sachs, cov-lite loans outperformed their covenanted peers by more than two points. Today, the loan default rate is approaching 3%. The lack of maintenance covenants represents more the maturation of the loan market than an additional risk. We are not blind to other weaknesses in loan terms today, but cov-lite has again proven to be a benefit for long-term investors.

Equity arbitrage and cov-lite have become dirty words for CLO naysayers as they express concerns about present or future CLO performance. With yet another storm now behind us, perhaps we can finally shake the dirt off these terms and start appreciating their more nuanced meanings.