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Getting the most out of reorg equity could be the difference between a good CLO and a great one

How CLO managers optimise the value of reorg equity is one of the most important unasked questions

The doomsday default scenarios talked about by some CLO gadflies last year never came to fruition. But dozens of companies did default on their credit obligations in the wake of covid-19, and were reorganised when creditors took over.

As some non-CLO investors sought to direct reorganisations in ways that prevented CLOs participating in recovery value, we saw many bouts of inter-creditor — and even intra-creditor — warfare. But thankfully, in many reorganisations, CLOs were able to prevail. And today, many have multiple line-items of 'reorg equity' in their portfolios.

Reorg equity can outshine loan value

While no one likes defaults in their CLOs, there may be a silver, or even golden, lining to some of last year's defaults. With the US economy growing at levels more commonly seen in developing markets, some of the reorg equity CLOs received last year has turned out to be quite valuable — perhaps even more than the original loan amount. In a few cases, we've seen CLOs where the value of the reorg equity they hold could be worth 10 points — or more — of NAV to the CLOs' equity tranches: examples commonly held by CLOs include Cirque du Soleil and Chuck E Cheese.

To frame this, think of CLO equity as roughly a three-year duration investment. Capturing 10 or more points of NAV could add 3%, or even more, to the final IRR of the CLO's equity. Getting this right could be the difference between a good CLO and a great one.

Despite the potential importance of reorg equity, when CLO investors conduct due diligence on CLO collateral managers, they focus their inquiries towards more basic measures, such as credits per analyst and default rates. From my banking days, I sat in many long meetings where CLO collateral managers pitched to prospective investors. I don't ever recall an investor asking a CLO collateral manager about their track record in optimising the value of reorg equity. Perhaps it was one of the most important unasked questions.

Most long-only loan managers, by nature, focus nearly exclusively on the downside possibilities in any investment. While perhaps appropriate when lending to a company, that's definitely not the way to evaluate owning it. Whereas holding a loan is analogous to writing a put option, owning reorg equity is more like owning a call option. Investors should be asking: "How do you decide to hold versus sell?", "What's your target price for the stock of company X?", "What's the catalyst to get there?" and "How long will it take?"

It's not clear how many loan managers possess the DNA to appropriately evaluate the upside potential in reorg equity. Frankly, I only recall one CLO collateral manager that proactively pitched its ability to capture value in reorganisations.

At the same time, reorganisations may also create conflict situations for some CLO collateral managers. If a workout is done in a way that's unfriendly to CLOs — basically, requiring creditors to put in new money to buy an 'in-the-money' security designed intentionally so that many CLOs can't purchase it — what does the CLO collateral manager do with the opportunity?

Did CLOs buy McDermott Industries stock?

A prime example of this situation was McDermott Industries. Creditors in McDermott were offered the right to buy stock trading at $0.75 for $0.50. This right was $0.25 in-the-money. Did they offer it to the holders of their CLOs' equity tranches? These investors, after all, are the ones who suffered the pain of the original credit loss. Or did they reallocate the opportunity to other funds they manage, which don't face the same constraints as CLOs? Or did they simply let the right to buy evaporate?

Everyone had at least a few surprise credit problems last year. If there isn't any workout equity in a pre-2020 vintage CLO, it might be worth asking the CLO collateral manager, why not?