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Maximising CLO returns post-reinvestment requires document flexibility and manager expertise

In our February column, we highlighted that many CLO triple A investors are facing accelerating paydowns on their triple A holdings as an increasing percentage of the CLO market moves beyond its reinvestment period. That said, as CLOs exit their reinvestment periods, the pace of debt paydowns varies significantly due to the CLO's structure, collateral manager behaviour and, perhaps most importantly, the provisions of its governing documents. Indeed, even for the most skilled collateral managers, if their documents aren't state-of-the-art, they may find themselves hamstrung when trying to maximise value.

Once a CLO exits its reinvestment period, some debt investors simply want to see their bonds repaid without giving due credit to the fact that some principal accumulating in the collection account was from unscheduled repayments of underlying loans in the CLO. While the terms of each deal vary, it is widely accepted that at least some unscheduled loan repayments can be reinvested in other loans with similar or shorter maturities than those that paid off unexpectedly early. This is not as simple as it sounds — it requires the right documents and the right CLO collateral manager.

Pairing asset extensions with purchases

Put simply — documents matter. Flexible language related to maturity amendments and post-reinvestment period trading can empower CLO collateral managers to take advantage of attractive opportunities. Often, it is as simple as having trading plan flexibility, which permits a collateral manager to pair asset extensions with other short-dated purchases so as to not adversely impact the loan portfolio weighted average life. Another option is an ability to contribute capital to the CLO in a way that is accretive to equity holders by allowing the deal to participate in potential upside, which benefits creditors and equity investors.

In many maturity extension opportunities, a borrower will require new capital contributions and some CLOs are precluded from participating due to indenture limitations. On the other hand, some indentures include language allowing equity to provide this capital without subordinating their entire return on this special new capital to the CLO liability waterfall, which can prevent the CLO from being diluted via the extension opportunity and provide a return to equity commensurate with the risk.

Recently, we have even seen CLO resets seek to add further flexibility, such as buying high yield bonds and other non-loan bucket items as part of a loan extension, in order to keep up with loan extension trends and potential outcomes. CLO documents should continue to adjust to market trends to give CLO collateral managers as many tools as reasonably possible.

Post-reinvestment period performance

As we have seen lately, in a period of a significant increase in the number of post-reinvestment CLOs, varying document terms and collateral manager skill can create a large divergence in performance outcomes for investors. This is further supported by our internal research, which maps amortisation speeds for each CLO collateral manager against equity distributions and collateral quality. Our data shows that collateral managers' performance varies to a large degree and a material amount of performance dispersion occurs after the end of reinvestment periods. This demonstrates the importance of working with a CLO collateral manager with the expertise and resources to navigate the complexities of the post-reinvestment period.

It is clear that CLO collateral managers take different approaches to managing their CLOs in the window leading up to the end of the reinvestment period and once the reinvestment period is over. Leveraging both internal and external automated optimisation tools have generated a great amount of value within CLOs. We have also seen some better-performing CLO collateral managers dedicate specific portfolio managers to optimising post-reinvestment CLOs.

The time near the end of a CLO's lifecycle is an exciting one in which proactive CLO collateral managers can seek new approaches in light of evolving technology and resource allocation tactics. Managing the dispersion of post-reinvestment period amortisation requires a nimble and holistic approach to negotiate the dynamic between stakeholders, capitalising on informational asymmetries and favourable document language. The effectiveness of each CLO's utilisation of the time after the reinvestment period will have a powerful effect on the ultimate results of a deal and deserves more attention from collateral managers.

> Managers need to be able to capitalise on favourable document language

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