CLO Insider Newsletter
Our 2021 Review and 2022 Outlook

Welcome to **CLO Insider**, a monthly commentary on the CLO Equity Markets from **Mike Kurinets**, CIO of Capra Ibex Advisors and Capra Credit Management.

Year-In-Review: A Great Year for CLO Equity.

What significant global events impacted the CLO market during 2021?

2021 was a strong year for leveraged loans and CLOs. Loan prices were up 1.6 points. However, leveraged loans with lower credit ratings rallied much more than higher rated loans. BB and single-B rated loans rallied roughly 0.5 pts, while B- and CCC rated loans were nearly 1.4 points higher on the year. The largest rally was in defaulted loans, which rallied over 9 points in 2021.

During 2021, the performance of the leveraged loan and CLO market was linked more to developments related to Covid-19 than any other factor [1].

1. **Vaccines became available**. At the beginning of the year, there was a strong rally in loan prices because the market began to anticipate that the Biden administration would make vaccines broadly available in a short period of time. The vaccine rollout turned out to be faster than anticipated and, by the middle of May, the CDC removed the mask-mandate for indoor activities. It felt like pre-Covid life was resuming and everyone was talking about how soon we would all be back to regular office schedules.

  - Loan prices rose rapidly in January and February and continued to grind higher into early summer.
  - CLO new issuance, refinancing and reset volumes spiked higher early in 2021 and remained elevated.
  - CLO liability spreads contracted across the entire capital structure early in 2021.
2. **Delta variant appeared.** By the middle of summer, the new Delta variant appeared and threw the loan and CLO markets into brief turmoil.
  - For most people, plans to return to work in September stalled.
  - Loan prices were lower in July [2].
  - By August and September, the markets had stabilized, and evidence suggested that vaccines were effective against Delta.
3. **Omicron variant appeared**. Around Thanksgiving, a new variant caused concern. Medical experts were worried that this variant would not only be highly contagious, but also could be unresponsive to known vaccines/boosters. To make matters worse, in the early stages there was no evidence about the severity of symptoms, hospitalizations or mortality rates.
  - The loan markets went into a short-lived tailspin. The sell-off exceeded 0.4 points in the last 3 days of November.
  - Spreads on CLO mezzanine widened and CLO equity traded a little lower.
  - Trading volumes decreased considerably.

In early December, data began to emerge that vaccines were working better against Omicron than had been initially predicted and that this variant wasn't as harmful as was initially feared. In December, the initial dour sentiment began to fade. By the close of the year, the leveraged loan market recovered much of the sell-off from late November.

Why did CLO equity do so well in 2021?

1. **Loan market rallied.** Higher loan prices lifted the value of all CLO tranches. Since the bulk of the leveraged loan market rally came from B-, CCC and defaulted loans, CLO equity benefitted more than any other part of the CLO capital structure. Credit risk in the collateral pools of CLOs was significantly reduced [3]. Lower rated loans, for the most part, trade at lower prices and are considered to be riskier. Therefore, when they rally strongly, CLO equity increases in value faster than other CLO tranches.
2. **Default rate was low.** 2021's default rate was 0.3% [4], hovering close to an all-time low, and loss from defaults was only 0.1%. Additionally, there were no significant idiosyncratic defaults in 2021. This contrasts with the experience of 2018 and 2019 when overall default rates were also relatively low. However, several high-profile names that were held by many CLOs defaulted with low recoveries. Therefore, even though the loan market experienced a relatively benign default environment, CLO equity tranches experienced more market volatility than was implied by the default performance in the overall loan market.
3. **CLO spreads tightened**. In 2021, the overall spread on new-issue CLO liabilities was roughly 10 basis points [5] lower. The savings in the cost of CLO liabilities flowed through to CLO equity as additional cash flow, which made CLO equity more valuable.
4. **The CLO market was busy with corporate actions [6].** Of the 30 positions in our portfolio at the beginning of 2021, we took corporate action on 12 (40%).
   - 8 CLOs in our portfolio were refinanced, reducing the average spread on CLO debt. The benefit from the reduced cost of the CLO debt began to flow directly to the CLO equity.
   - 4 CLOs in our portfolio were reset. In all resets, the newly extended CLO increased the value of the CLO equity.

- Additionally, 1 CLO in our portfolio was sold because the CLO manager and a large investor delayed taking corporate action at the right time.

5. **Libor floors were in-the-money**. Libor floors produced roughly 3-4% of extra cash flows to CLO equity during 2021.
6. **Cash flows to CLO equity were largely uninterrupted.** In the CLO market, the vast majority of CLO equity deals paid in 2021. In our portfolio, every single position paid when it was expected to.

What significant events took place the CLO market in 2021?

1. **New-issue market offered better opportunities to invest in CLO equity than the secondary market**.
    - Since we launched our fund in September 2015, over 80% of our CLO equity investments were sourced in the secondary market. Most of the time, CLO equity in the new-issue market was simply too rich when compared to similar paper available in the secondary market. This difference was further exaggerated in 2018 and 2019 when most CLO managers successfully raised capital to satisfy risk retention requirements.
    - Many investors who invested in risk-retention funds learned that their interests may not always be aligned with those of CLO managers and that CLO managers may deploy that capital at elevated prices, particularly when markets become volatile. Today, only the largest CLO managers have readily available captive capital, while most CLO managers rely on 3rd party investors in CLO equity.

- From January through October 2021, we only made two purchases in the secondary CLO market, while our other 11 CLO purchases were in the new-issue market. This was a significant change in our behavior from the 5 previous years, but we adapted our trading according to where we saw better value.

2. **SOFR will replace Libor**. The most important event for the CLO market in 2021 was the announcement that SOFR will become the replacement benchmark to Libor. From August to November, the CLO market issued record volumes. Investors did not balk, and credit spreads did not widen in the face of relentless supply.
3. **CLO market exceeds $1 trillion dollars [7]**. In early July, the global CLO market reached a size that suggested it is no longer a niche space in structured credit, but an asset class that requires regular allocations in investment portfolios.
4. **Norinchukin Bank ("Nochu") has re-entered the CLO market**. Nochu had been the largest holder of CLO AAA paper when, in 2019, they announced that they would pause new purchases. At the time, there was concern that, without their market presence, the CLO AAA spreads would widen. However, US banks, money managers, and insurance companies stepped into the space and credit spreads tightened. Now that Nochu is coming back into the CLO market, they are an incremental source of capital. Credit spreads are more likely to grind tighter.

2022 Forecasting: Several Catalysts for Strong CLO Equity Cash Flow Ahead.

What do we expect for 2022?

1. **High new-issue forecasts.**
    - Most dealers anticipate that, in 2022, CLO new-issue volumes will not be as high as they were in 2021, but that they will still be significant by historical standards. Over $186 billion [8] in new CLOs were issued in 2021. Many dealers forecast this number to be in the $130 to $160 billion range in 2022 [9].
    - *Impact: Large issuance is a positive for investors in CLO equity as more paper will be available.*
2. **Refinancing and reset volumes will likely remain high.**
    - In 2021, refinancing and reset volumes for US CLOs were $112 and $137 billion respectively [10]. Morgan Stanley projects slightly lower volumes for 2022.
    - *Impact: Refinancings and resets typically increase the value of CLO equity. They take place only when a majority of CLO equity holders vote for them to occur.*
3. **CLO liability spreads are likely to tighten.**
    - Increased demand from Nochu for AAA CLO paper is likely to lower credit spreads on CLO AAAs. Additionally, as of 2022, NAIC lowered reserve requirements for insurance companies to hold investment grade CLO paper. Insurance companies have already been natural buyers of CLOs and the new, lower requirements should make it even easier for them to hold more investment grade CLO paper.

- *Impact: Lower CLO liability spreads are a positive for CLO equity, as they lead to larger cash flows to CLO equity.*

4. **Leveraged loan defaults are likely to stay low.**
   - Our August 2021 internal white paper (linked here) discussed several factors in today's leveraged loan market supporting our forecast for a low default rate in 2022. In a soon-to-be released update to that paper, we evaluate leveraged loan issuers in a rising rate environment and conclude that the increased debt servicing burden will not lead to a significant spike in defaults.
   - *Impact: Low defaults are generally a positive for CLO equity. However, some volatility in credit markets would benefit CLO equity since CLO managers would have more opportunity to source performing loans at lower prices.*
5. **Interest rate floors will be less important.**
   - With the anticipated rate hikes in 2022, the forward curves imply that most interest rate floors will be out-of-the-money by Q3:2022.
   - *Impact: The absence of activated interest rate floors is a negative for CLO equity since the cash flow that was generated by interest rate floors in 2021 is no longer freely flowing to the CLO equity.*

How will CLO equity perform in 2022?

Morgan Stanley picked CLO equity as their top securitized product of 2022 [11]. JP Morgan selected CLO equity as their "top pick" for CLO investing in 2022 [12]. We also believe that CLO equity will do well in 2022 because:

1. **Market conditions point to low defaults with possible spikes in volatility.** While we do not expect a spike in defaults this year, we do

think that there is room for general volatility in credit markets from Fed policy, new Covid variants, and anxiety about inflation. Volatility benefits CLO equity because it makes leveraged loans available at lower prices.

2. **Tighter CLO liabilities.** We expect CLO liabilities to grind tighter in 2022 as larger amounts of capital will be allocated to CLO debt, particularly in the investment grade part of the capital structure.
3. **Transitioning from Libor to SOFR.** As leveraged loans and CLOs liabilities transition from being Libor-based to being SOFR-based, market dislocations may arise. These dislocations are likely to be short lived, but might provide attractive entry points to investments in CLO equity.
4. **Libor floors vs. CLO management fees.** By Q3:2022, the anticipated Fed rate hikes may fully eliminate the Libor floor benefits that CLO equity enjoyed in H2:2020 and in all of 2021. The cash flows from Libor floors were approximately equivalent to the fees that CLOs paid to CLO managers [13]. As interest rate floor benefits go away and most CLO managers do not have access to captive capital to fund their new-issue CLO business, it is reasonable to expect that reduced CLO management fees may be required by 3rd party CLO equity investors to partially offset the loss of interest rate floor benefits that these investors have become accustomed to.

For CLO Insider - January 2022 (December Market Commentary), click here.

For all other white papers, click here.

Footnotes

[1] Low interest rates and $1.9 trillion stimulus package certainly helped all credit markets and CLOs in 2021, but major developments directly related to Covid-19 played a dominant role in the performance of CLOs and other credit products.

[2] Loan prices were also lower in March, but that was a technical correction due to a rapid rise in loan prices in December 2020 and January/February 2021.

[3] We estimate credit risk by modelling the sale of all loans trading below 85%. At the start of 2021, this implied that the average CLO would realize a 1.7% loss, while, by the end of 2021, this exercise only produced a 0.9% loss.

[4] Corporate default rates are according to LCD, a division of S&P, as of 12/31/2021. All-time low was 0.15% in June 2007 since LCD data started in January 1999. Average last-twelve-month default rate for the entire dataset from January 1999 through December 2021 is 2.83%, while the December 2021 last-twelve-month default rate was 0.29%.

[5] Based on Morgan Stanley's USD CLO Commentary.

[6] Corporations refer to refinancings, resets and liquidations of existing CLOs. Refinancings mainly reduce the spread on CLO debt tranches, while resets extend the reinvestment period and maturity and, in some cases, also reduces the spread on CLO debt tranches.

[7] JP Morgan Global Credit Research: "Crossing the $1 trillion Rubicon" by Rishad Ahluwalia. 11/23/2021.

[8] S&P Market Intelligence: Global CLO Databank.

[9] Morgan Stanley 2022: "Global Securitized Products Outlook: Credit Over Convexity" by Jay Bacow and James Egan. 11/16/21. S&P Global: "Barclays forecasts modest slowdown in CLO issuance in 2022" by Michael Rae. 11/12/21. JP Morgan Securitized Products Research: "The 2022 CLO Outlook: Fahrenheit 2.7" by Rishad Ahluwalia. 11/23/2021.

[10] S&P Market Intelligence: Global CLO Databank.

[11] Morgan Stanley Research: "2022 Global Securitized Products Outlook: Credit Over Convexity" by Jay Bacow and James Egan. 11/16/2021.

[12] JP Morgan Securitized Products Research: "The 2022 CLO Outlook: Fahrenheit 2.7" by Rishad Ahluwalia. 11/23/2021.

[13] Libor floor benefits to CLO equity varied from deal to deal but ranged roughly 30 to 40 basis points per annum.

Forward-Looking Statements

Some of the statements contained in this presentation constitute forward-looking statements within the meaning of the federal securities laws. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, you can identify forward-looking statements by the use of forward-looking terminology such as "may," "will," "should," "expects," "intends," "plans," "anticipates," "believes," "estimates," "predicts," or "potential" or the negative of these words and phrases or similar words or phrases which are predictions of or indicate future events or trends and which do not relate solely to historical matters. You can also identify forward-looking statements by discussions of strategy, plans or intentions.

The forward-looking statements contained in this presentation reflect our current views about future events and are subject to numerous known and unknown risks, uncertainties, assumptions and changes in circumstances, many of which are beyond our control, that may cause our actual results to differ significantly from those expressed in any forward-looking statement. Statements regarding the following subjects, among others, may be forward-looking: the use of proceeds from our public and private offerings (as the case may be); our business and investment strategy; our projected operating results; our ability to obtain financing arrangements; financing and advance rates for our target assets; our expected leverage; general volatility of the securities markets in which we invest; our expected investments; effects of hedging instruments on our target assets; rates of leasing and occupancy rates on our target assets; the degree to which our hedging strategies may or may not protect us from interest rate volatility; liquidity of our target assets; impact of changes in governmental regulations, tax law and rates, and similar matters; availability of investment opportunities; availability of qualified personnel; estimates relating to our ability to make distributions; our understanding of our competition; and market trends in our industry, interest rates, real estate values, the debt securities markets or the general economy.

While forward-looking statements reflect our good faith beliefs, assumptions and expectations, they are not guarantees of future performance. Furthermore, we disclaim any obligation to publicly update or revise any forward-looking statement to reflect changes in underlying assumptions or factors, new information, data or methods, future events or other changes.

This presentation contains statistics and other data that has been obtained from or compiled from information made available by third-party service providers. We have not independently verified such statistics or data.

Disclaimers

This confidential document is for informational purposes only and does not constitute an offer to sell or a solicitation of an offer to buy any securities or partnership interests described herein. Interests in Capra Credit Management, LLC ("Capra") partnerships may not be purchased except pursuant to the partnership's relevant subscription agreement and partnership agreement, each of which should be reviewed in its entirety prior to investment.