CLO Insider Newsletter November 2021.

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

Loan prices are up 1.8 points in 2021.

In October, prices in the leveraged loan market ended the month higher by 0.03 points [1]. Year-to-date loan prices are now up 1.8 points.

Below is a recap of loan price performance since the end of 2020:

Three noteworthy items emerged in October

1: A CLO was the first to print with a SOFR tranche.
Nomura reset a CLO which had two pari passu AAA tranches. One tranche printed at 3M Libor + 109 basis points, while the other printed at 3M SOFR + 124 basis points. This CLO has a 3-year reinvestment period after the reset, while most new-issue CLOs have 5-year reinvestment periods, so we have not yet seen

if there is a larger spread differential between Libor and SOFR for longer-dated CLOs. The important point here is the 15-basis point difference in spread over 3M LIBOR vs spread over SOFR in a CLO that has a 3-year reinvestment period. This difference in spread is directly comparable because the two tranches were issued side-by-side in the same CLO and, therefore, at the same point in time. This is likely to serve as an indication of where the market will be pricing the differential between LIBOR and SOFR on CLO liabilities.

In the last ***CLO Insider*** newsletter, we mentioned that we have now seen several data points suggesting that for leveraged loans that pay monthly, the spread differential between 1M Libor and 1M SOFR was 10 basis points. The modest size of the spread over LIBOR coupled with the reasonable 1M vs 3M differential implies that as the floating rate market is moving from Libor to SOFR, the impact to CLOs and to CLO equity should not be significant [2].

2: The market continues to anticipate 'lower than typical' CLO issuance volumes in early 2022.

The CLO issuance market continues to originate, refinance and reset CLOs at a torrid pace. Market participants appear to believe that next year, when only SOFR indexed loans and CLOs can be created, the market will need time to adjust to the new benchmark. But what does that really mean?

For CLO managers, it means that they are concerned that they will not be able to issue new deals in early 2022 or perhaps even later. They are concerned that CLO equity investors will not be comfortable with new CLOs, which will have leveraged loans largely indexed to Libor [3], while the CLO liabilities will be indexed to SOFR. While this concern may be true for most CLO managers, it's likely that the largest CLO managers, which control significant amount of captive capital [4], will be the ones originating new CLOs in early 2022.

CLO investors, on the other hand, are concerned that lower issuance volumes in 2022 will bring fewer opportunities to deploy capital. The solution appears to be that investors are more than willing to put as much cash to work as possible in 2021.

As a result, the CLO market is witnessing months of record issuance without any sign of investor fatigue or spread widening on CLO liabilities. We believe this will continue until Thanksgiving. After that, it will become difficult to price and close Libor-indexed CLOs by the end of 2021[5].

There is some speculation in the CLO market that lower issuance volumes in 2022 will finally drive CLO liability spreads tighter. We likely will not know if this is the case until we get into the new year.

3: The value proposition between the new-issue and secondary markets is once again shifting, with the secondary market once again attracting our attention.

We have said in previous letters that, since we launched our fund in September 2015, CLO equity in the secondary market was more attractive [6] than CLO equity in the new-issue market. This changed in early 2021, when the value proposition reversed. At that time, we consistently saw greater opportunity in the new-issue market.

However, October saw the relative value in the secondary and new-issue market for CLO equity largely converge. While we continue to show interest in many of the new issue CLOs that are being originated, most of them appear to be clearing at prices that are higher than what we are willing to pay. We are, however, now beginning to again find value in the secondary market.

Spreads on CLO liabilities remained unchanged again in October

After CLO liabilities widened in March in response to the unprecedented supply of CLOs starting in February, spreads contracted in April. CLO spreads have remained largely unchanged since then with a slight tightening of AAA spreads in August.

We are not seeing a widening of spreads in CLO liabilities. Increased issuance volumes continue to be met with strong investor demand across the CLO capital structure. The CLO market is not witnessing ‘investor fatigue’, like what transpired in the early part of the year when over $90 billion of CLO issuance flooded the market. This is likely because investors are concerned that the possibility of lower CLO issuance volumes in early 2022 will create less opportunity for deployment of capital next year.

	March	**April - May**	**June - October**
CLO Tranche	*Spread Widening*	*Spread Contraction*	*Spread Widening*
AAA	5-10	5-10	3-5
AA	10-15	5-10	0
A	10-15	10-15	0
BBB	15-20	20-25	0
BB	25-50	25-50	0

Spread Widening or Contraction in basis points March – October 2021

October’s US CLO new-issue activity [7]

CLO issuance continues at a very rapid pace. The combined volume of new issue, refinancings and resets of CLOs added up to $43.3 billion in October and over 364 billion for the year 2021. October is the fifth month in 2021 in which combined monthly CLO activity exceeded $40 billion.

	October 2021 ($ billions)	YTD 2021 ($ billions)
New-Issue	19.8	150.0
Refinancing	8.6	97.5
Reset	14.9	117.2
TOTAL	**43.3**	**364.7**

Footnotes

[1] Based on our tracking of 907 CLOs

[2] As a reminder, we dedicated a significant portion of our July and August letters to a discussion regarding the transition from LIBOR to SOFR and the numerous implications thereof.

[3] As of October 29th, nearly the entire $1.2 trillion leveraged loan market was indexed to Libor and only a very small number of loans were indexed to SOFR.

[4] Captive capital is a reference to monies that CLO managers have raised to invest in the CLO equity tranches of the CLOs that these managers bring to market. This used to be referred to as risk-retention capital, when risk-retention was the law in the U.S.

[5] It typically takes five to six weeks between the pricing and closing of a CLO. It is very difficult to do so in 4 or fewer weeks. Therefore, the Thanksgiving holiday, at the end of November, will likely mark the end of Libor-indexed CLOs priced in 2021.

[6] By more attractive, we mean having higher risk-adjusted returns. Until 2021, almost 85% of our investments were sourced in the secondary market.

[7] All data are sourced from S&P Global Market Intelligence. Both Broadly Syndicated Loan (BSL) and Middle-Market (MM) CLOs are included. On average in 2021, BSL CLOs have represented approximately 90% of total US$ CLO new-issue volume.

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