Under pressure?

Credit deterioration affecting 2.0 CLOs

The percentage of US CLO 2.0 loans trading below 90 continues to rise, reaching a year-to-date peak of more than 8% last month. Credit quality erosion is limiting origination and impacting pricing, with manager performance coming under greater scrutiny as a result.

"Certainly the market value overcollateralisation deterioration is apparent across the CLO 2.0 space. We are seeing dispersion among 2.0 deals based on portfolio quality," says Christopher Long, president, Palmer Square Capital Management.

He continues: "There are a lot more loans trading below 90 dollar prices. There are more loans in the oil and gas and contagion sectors which are stressed, and finally, there is greater manager tiering now on the part of investors. However, that of course also brings plenty of interesting opportunities."

Morgan Stanley figures suggest that the US$5.6bn of US CLO issuance last month was the lowest monthly total since January. Macro concerns stemming from China and declining confidence in sectors such as energy, as well as metals and mining have taken a toll.

Among the 77 loan issuers with price drops last month of larger than five points, 17 issuers were in oil and gas. Morgan Stanley notes that 610 CLO 2.0 transactions have exposure to these 77 issuers.

"There has been a major sell-off in commodity- and energy-focused high yield credit. As CLOs have diversified portfolios, inevitably they are going to have exposure," says Matt Natcharian, head of structured credit, Babson Capital.

He continues: "Most CLOs will have low exposure, but we have seen some CLOs with weighting to these sectors as high as 13%. Junior tranches have traded off as a result."

However, a CLO could be highly overweight to oil and gas, metals and mining or another compromised sector and still only see very limited losses. As these sectors typically account for only a small part of a portfolio, Natcharian notes that if a deal with high exposure was to suffer 2% losses, double-B tranches would still be unaffected as they can typically handle losses of up to 10%.

Long agrees that the deterioration in credit should not have investors too worried just yet. He says: "If you were to stress test a CLO, then from a fundamental credit perspective it would still hold up. There are cases where the market is being unfairly penalised and that means there are opportunities, not least in the 2.0 double-B space."

Commodity market concerns make credit picking even more important than normal. While managers have to choose the right loans, investors have to choose the right managers. Experience through credit cycles is highly valued.

"Managers have to be very discerning in this environment and, as an investor, you absolutely cannot cut corners. You need to do your research to get the right manger, with the right structure and the right loan pool. You need to do your homework loan by loan," says Long.

He continues: "If you do your homework, there are great opportunities. A lot of double-B paper has traded down to very low dollar prices, but comes with tremendous convexity and very low remaining life. The perception of distress in creating a lot of opportunity."

Investors will increasingly be looking for opportunities in the secondary market, as the primary pipeline continues to dry up. While a summer slowdown is not unusual, the fact that issuance did not pick back up over September – and that the month saw the second lowest volumes of the year as the market dealt with Fed nervousness, market volatility, credit weakness and deteriorating liquidity – is more concerning.

"Bank loan prices over this period mean things can still get done, albeit at a slower pace than the market initially expected. Until macro conditions look more positive, I do not think people will jump back in," says Natcharian.

JPMorgan CLO analysts note that their previous prediction of total yearly issuance in the US$100bn-US$110bn range now looks less likely. Issuance to the end of September was just under US$80bn, with near-term issuance expected to be slow.

"The equity arb is very tough right now. It also appears to be the case that the market has hit an inflection point, whereby people need to see some definite plans around risk retention. That is causing some issuers to go back to the drawing board and reconsider issuances," says Long.

He continues: "There is typically a catalyst that allows assets to widen or liabilities to tighten, but we do not see anything like that in the near term. In that case, investors need to be patient and discerning and do their homework, because the action is going to be in the secondary market."

Any primary issuance should be of good quality, however. The ability to construct cleaner portfolios has meant that the 2015 vintage has significantly lower exposure to loans trading below 90 than the 2013 or 2014 vintages.

"We are trying to take advantage of buying good deals from good managers. New issue CLOs are offering a wide spread with a newly selected portfolio, which should have only limited exposure to sectors such as oil and gas. The ability to ramp up with cleaner loans in this environment is positive," says Natcharian.

He concludes: "Total yearly issuance of US$100bn-US$120bn is still possible, but things would need to pick up again for that target to be reached. Without a change in the market, issuance will continue to be limited."

JL

This article was published in Structured Credit Investor on 7 October 2015.