

CLOs

## Global CLO Relative Value Update

After the recent rally in mezz, CLO tranches down the capital stack look less attractive versus HY and loans. AAA tranches are cheap to IG and other structured credit, though, with Europe looking slightly cheaper than the US.

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### Top-line relative value

- **AAA CLO tranches** continue to look attractive in the US and Europe versus IG spreads, with European AAA spreads slightly more attractive compared to the US when considering hedging costs and the increased value of the embedded Euribor floor.
- **AA tranches** look *cheap* to IG in the US, while **single-A tranches** in both regions look relatively *rich* compared to both IG spreads and AAA spreads.
- Both US and European **BBB and BB tranches** still look cheap to HY (fairly valued versus single-B loans), but less so following the recent rally. On a swapped basis, US BB tranches look slightly more attractive versus European CLOs currently.
- **CLO equity** distributions were lower QoQ and could continue to be under pressure, especially for older vintage deals, as loan repricing activity remains high. NAVs have improved following the recent rally in loans, with potentially more upside for US CLO equity NAVs, but tail risk in the US is higher than in Europe.

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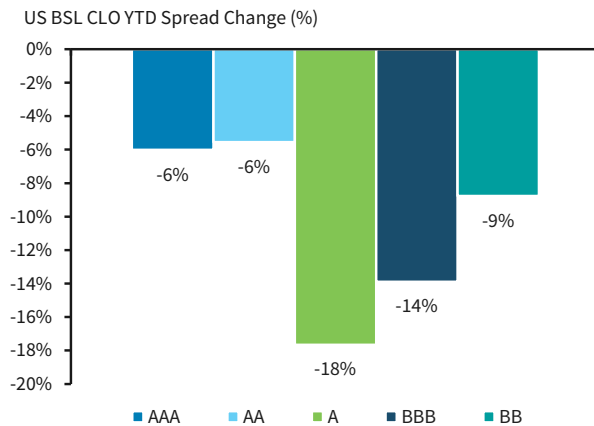
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## New year, more tightening

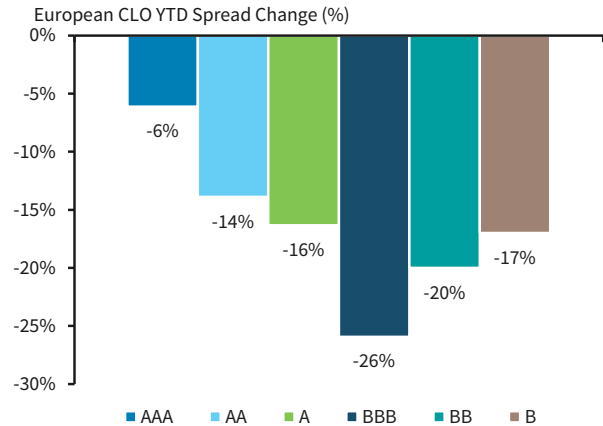
The year has started strongly for CLOs, following the improvement in the underlying loan markets that began last November. In addition to more supportive loan prices, the attractive relative value of CLOs and slower new issue supply have led to a sharp tightening across new issue CLO spreads in both the US (Figure 1) and Europe (Figure 2).

**FIGURE 1. The belly of the ratings stack has tightened most YTD for US BSL CLOs**



Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Barclays Research

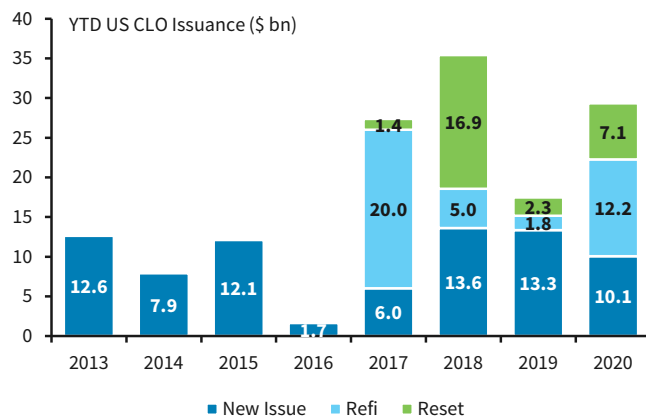
**FIGURE 2. Similarly, for European CLOs, BBB spreads have tightened most YTD**



Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Barclays Research

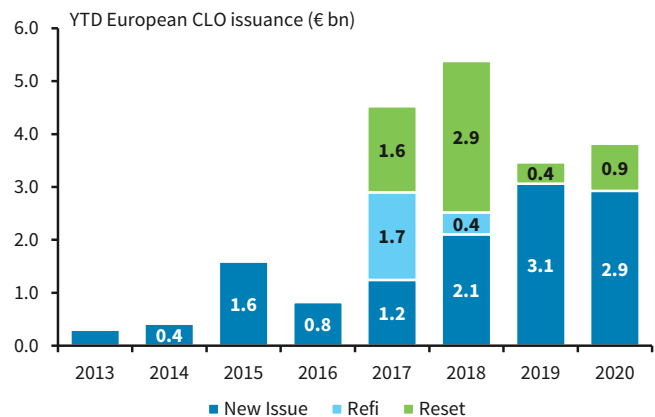
Tightening at the top of stack has been beneficial to greater refi and reset supply relative to last year, especially in the US as short duration spreads are nearly 20bp tighter since Q4 19 (Figure 3). While refi supply is still nil in Europe (same as 2019 YTD), reset supply has increased slightly relative to last year. Both refi and resets should increase should AAA spreads tighten more.

**FIGURE 3. US CLO refi and reset supply is more than 4x higher YTD than the same period in 2019**



Note: Re-issues counted as resets. As of 19 February 2020.  
Source: S&P LCD, Intex, Barclays Research

**FIGURE 4. Refi and reset supply in Europe has been low, but new issuance remains strong**

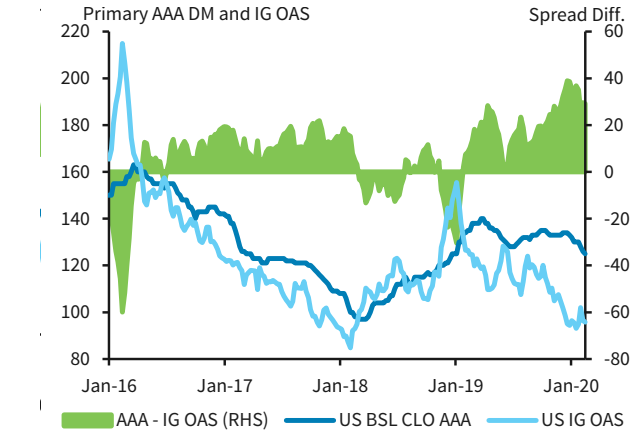


Note: Re-issues counted as resets. As of 19 February 2020.  
Source: S&P LCD, Intex, Barclays Research

## AAA Relative value

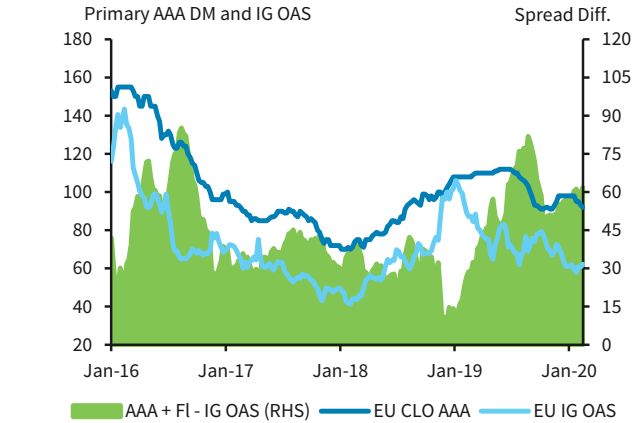
Longer duration new issue AAA spreads in the US have tightened from the low to mid-130bp range at the end of last year to the low 120bp range most recently for top tier managers. Despite the decline, though, AAA spreads remain wide to IG (Figure 5). European CLO AAA spreads have moved relatively less, from the 98bp range to 90-92bp most recently. Similar to US spreads, though, the gap between AAA spreads and IG still remains wide by historical standards (Figure 6).

**FIGURE 5. US BSL CLO AAA spreads remain wide to IG**



Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Bloomberg, Barclays Research

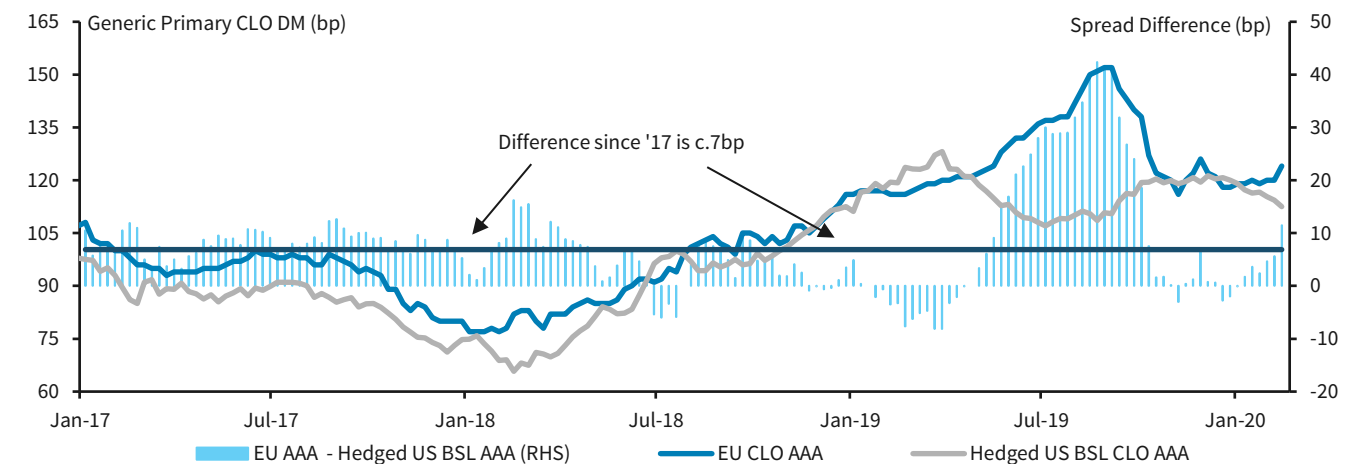
**FIGURE 6. Similar story for European CLO AAA spreads**



Note: Generic primary CLO spreads. Includes embedded Euribor floor value  
Source: S&P LCD, Intex, Bloomberg, Barclays Research

When comparing US BSL versus European CLO AAA spreads, we find that due to the lack of relative tightening in European CLO AAAs and the increase in the Euribor floor value (slightly above 30bp currently), European CLO AAA tranches are roughly 12bp wide to currency-hedged US BSL CLO AAA tranches (Figure 7). This is below the wides from Q3 last year - when the value of the embedded Euribor floor increased above 50bp (see [European CLO AAA relative value update](#)) - but is still 5bp more than the average difference since 2017.

**FIGURE 7. US BSL vs. European CLO AAA relative value**

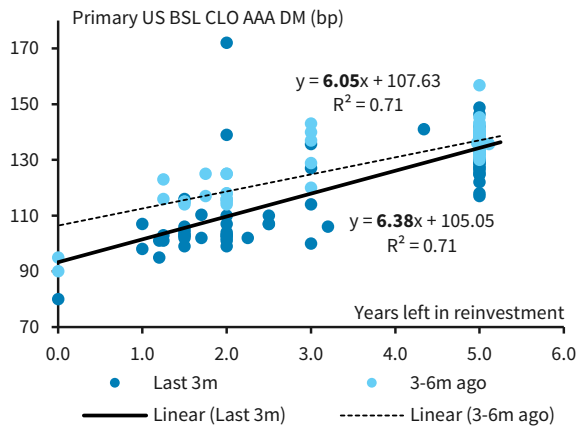


Note: US CLO spreads are currency adjusted using 5y cross currency basis swaps. EU CLO spreads include the Euribor floor value.  
Source: S&P LCD, Intex, Bloomberg, Barclays Research

In terms of short duration spreads, shorter deals in the US (whether through primary, refi or reset) have priced increasingly tighter compared to Q4 19. While longer duration AAA spreads have also tightened since then, shorter dated spreads have decreased more, leading to a

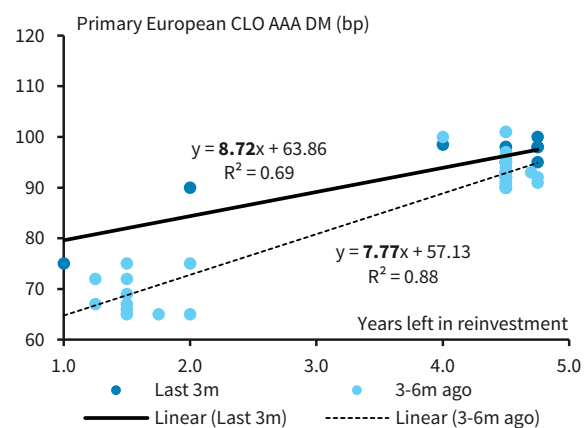
steeper AAA term curve in the US (Figure 8). In contrast, the AAA term curve in Europe has flattened as longer duration AAA spreads have tightened relatively less and demand for new short-duration tranches remains comparably lower than the US (Figure 9).

**FIGURE 8. The US BSL CLO AAA term curve has steepened recently with the sharp tightening in refi spreads**



Note: Generic primary CLO spreads. As of 19 February 2020.  
Source: S&P LCD, Intex, Barclays Research

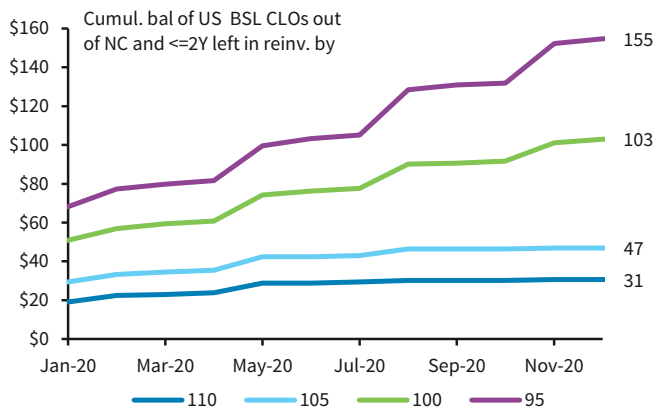
**FIGURE 9. In contrast, the European CLO AAA term curve has flattened with less demand for short-duration tranches**



Note: Generic primary CLO spreads. As of 19 February 2020.  
Source: S&P LCD, Intex, Barclays Research

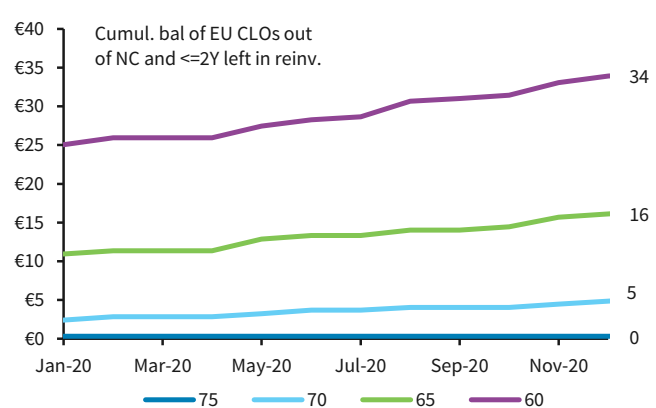
As refi spreads have come in quite dramatically in the US, the pool of 'eligible' refis (two years or less left in reinvestment with a AAA coupon of at least 25bp higher than the current AAA refi spread) has also quickly grown. Should refi spreads remain around 100bp, we think over \$100bn of US BSL CLOs could be 'eligible' for a refi by the end of 2020 (Figure 10). However, short duration AAA spreads will need to tighten more for an increase in refi supply in Europe (Figure 11).

**FIGURE 10. Over \$100bn in US CLOs could be refi 'eligible' by the end of 2020 if AAA refi spreads remain near 100bp**



Note: Assumes 25bp required AAA savings  
Source: Kaneraï, Intex, Barclays Research

**FIGURE 11. There is less potential refi supply in Europe until refi spreads tighten further**

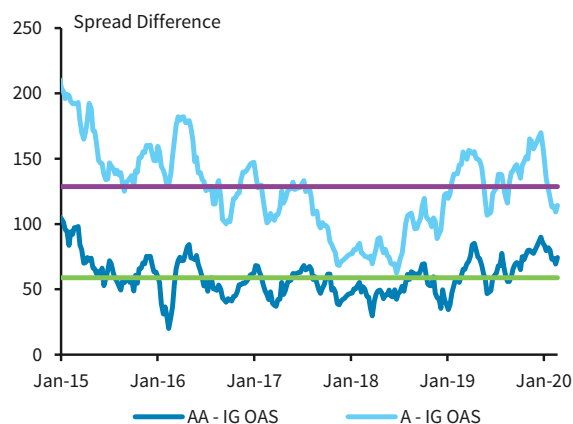


Note: Assumes 25bp required AAA savings  
Source: Kaneraï, Intex, Barclays Research

## AA-A

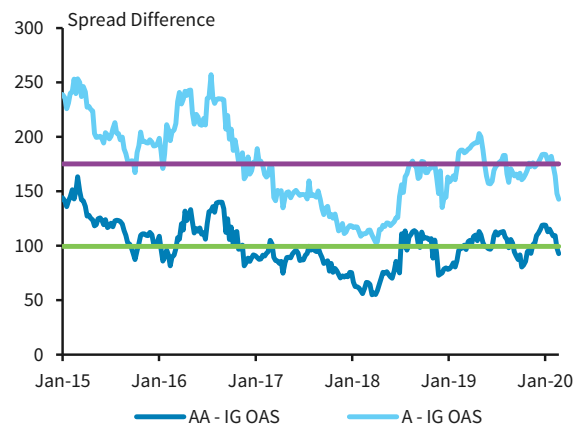
Both AA and single-A tranche spreads are tighter YTD, with single-A spreads moving in relatively more. As a result, AA US BSL spreads look relatively cheap versus IG (based on the historical difference since 2015), while single-A spreads appear rich (Figure 12). In Europe, however, AA spreads appear fairly valued versus IG, while single-A spreads also appear rich (Figure 13).

**FIGURE 12. US BSL CLO AA tranches are cheap to IG, while single-A tranches are relatively rich**



Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Bloomberg, Barclays Research

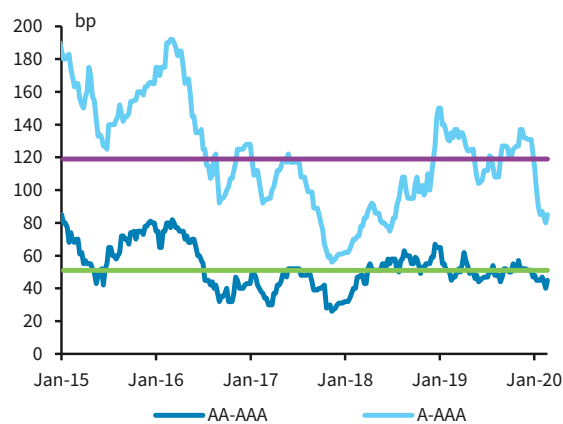
**FIGURE 13. European CLO AA tranches are close to fair value versus IG, while single-A tranches are also relatively rich**



Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Bloomberg, Barclays Research

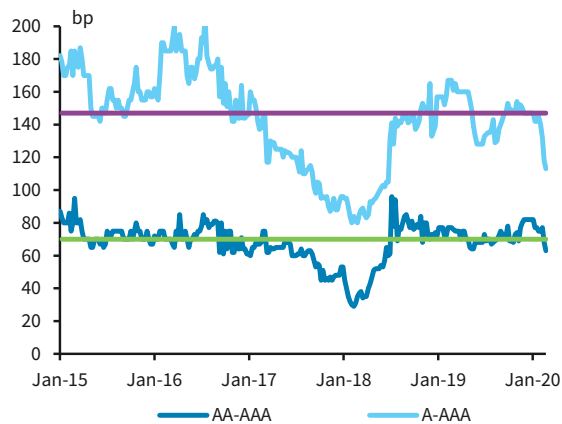
When we compare new issue AA and single-A spreads to AAA spreads, we find a similar story. US and European CLO AA tranches are close to the historical difference with AAA spreads, while single-A tranches are relatively rich.

**FIGURE 14. Versus AAA spreads, US AA tranches are fairly valued, while single-A spreads are rich**



Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Barclays Research

**FIGURE 15. Similar story for European CLO AA and single-A tranches**

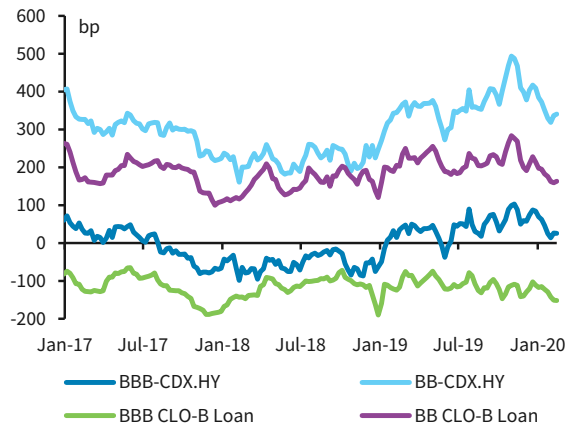


Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Barclays Research

## BBB-BB

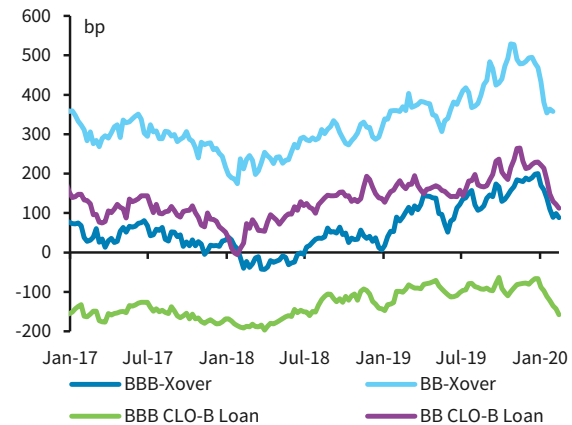
Following the loan market rally in Q4 last year, where market value metrics improved across portfolios (see [Santa Brings Uneven Rally to CLO Town](#)), CLO mezz tranche spreads have tightened sharply. New issue US BSL CLO mezz is still cheap to CDX.HY, but is close to the historical average versus single-B loan spreads ([Figure 16](#)). Similarly, European CLO mezz is less attractive than in Q4 2019, but is still attractive versus 2018 levels ([Figure 17](#)). On a currency hedged basis, US CLO BB tranches look slightly more attractive versus European CLOs currently.

**FIGURE 16. US CLO mezz is still cheap to CDX.HY, but fairly valued versus single-B loans**



Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Bloomberg, Barclays Research

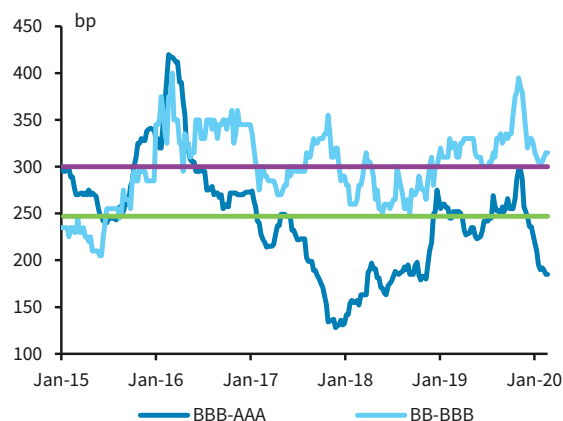
**FIGURE 17. European CLO mezz is less attractive than in Q4 2019, but still cheap versus 2018 levels**



Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Bloomberg, Barclays Research

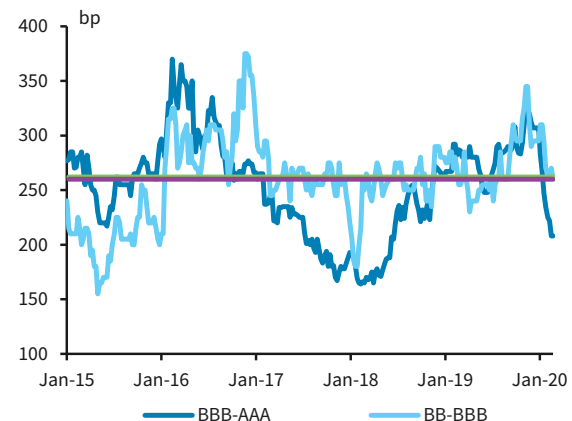
Versus the rest of the ratings stack, US BSL BBB tranches are tight to AAA spreads (based on the average difference since 2015), while the difference between BB spreads is in-line with the historical average ([Figure 18](#)). It is a similar story for European CLOs, where the BBBs are rich versus AAAs, while they are flat versus BBs ([Figure 19](#)).

**FIGURE 18. US BBB spreads are tight to AAA spreads, where the BBB to BB gap is in-line with the historical average**



Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Barclays Research

**FIGURE 19. Similar for European BBB and BB CLO spreads**



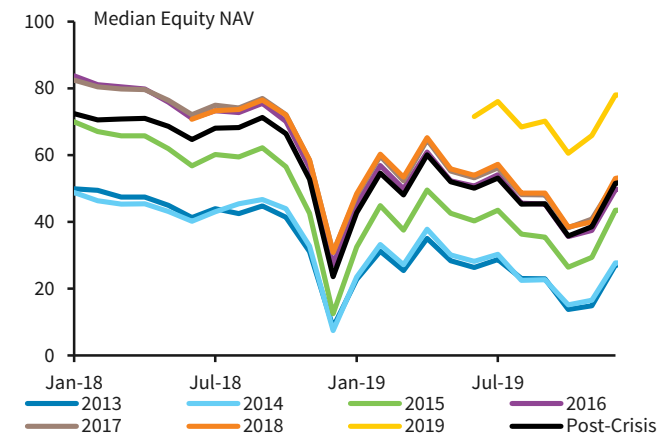
Note: Generic primary CLO spreads  
Source: S&P LCD, Intex, Barclays Research

## CLO Equity

Similar to CLO mezz, CLO equity market value metrics improved following the increase in loan prices. Specifically, US BSL CLO equity NAVs increased nearly 17 points, on average, from the lows in October 2019 (Figure 20). European CLO equity NAVs improved relatively less (8 points on average), but the European loan market has been more stable than the US (Figure 21).

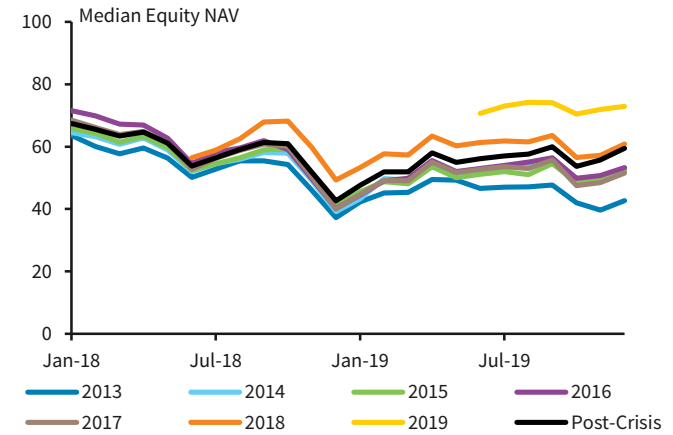
As the average bid price of the US loan market is roughly 1.8 points lower than the European market, US CLO equity NAVs could have more upside potential. However, as we note in [US vs. Europe: Some Love for Europe Prevails](#), elevated downgrade rates will weigh on US loans more as CCCs represent a greater portion of the market than they do in Europe.

**FIGURE 20. US BSL CLO equity NAVs have improved nearly 17 points, on average, since October 2019**



Source: Kanerai, Intex, Markit, Barclays Research

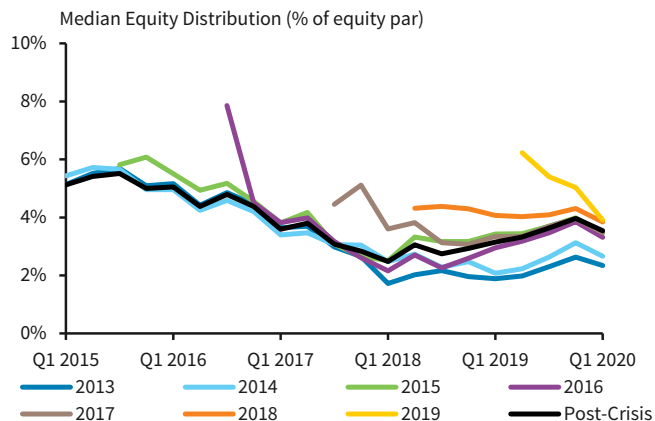
**FIGURE 21. European equity NAVs have only improved 8 points, though the EU loan market has been more stable**



Source: Kanerai, Intex, Markit, Barclays Research

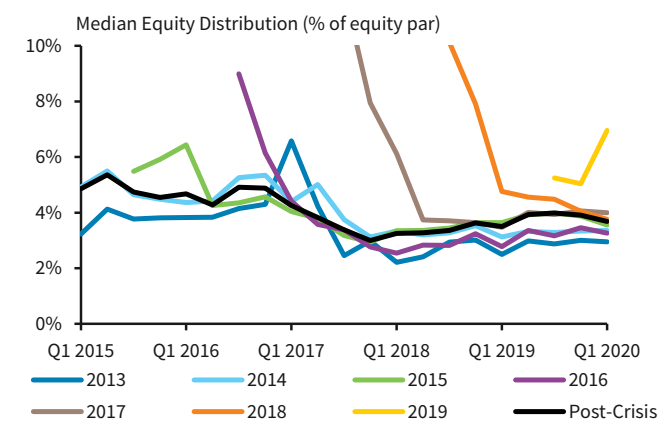
In contrast to NAVs, CLO equity distributions declined QoQ, with median US BSL CLO equity distributions falling roughly 40bp to 3.5% per quarter (Figure 22). European CLO equity distributions declined relatively less QoQ, falling approximately 20bp to 3.7% per quarter (Figure 23). Despite the declines, average US quarterly equity distributions are still nearly 40bp higher than Q1 2019, and European distributions almost 20bp higher. This is largely due to asset spreads remaining relatively wide to debt costs in 2019, but repricings could put pressure on distributions going forward, requiring CLOs to refi/reset to keep equity yields in tact (see [The Tail of CQTs: Return of the Repricings](#)).

**FIGURE 22. US BSL equity distributions are lower QoQ, though distributions did improve slightly in 2019**



Note: In-reinvestment interest distributions only  
Source: Kanerai, Intex, Barclays Research

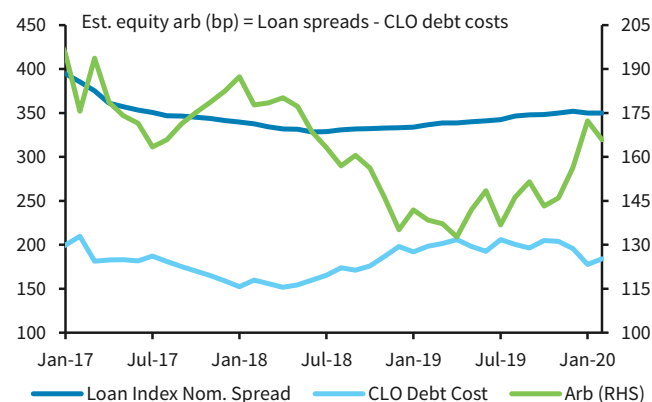
**FIGURE 23. Median equity distributions in Europe have been slightly higher relative to the US**



Note: In-reinvestment interest distributions only  
Source: Kanerai, Intex, Barclays Research

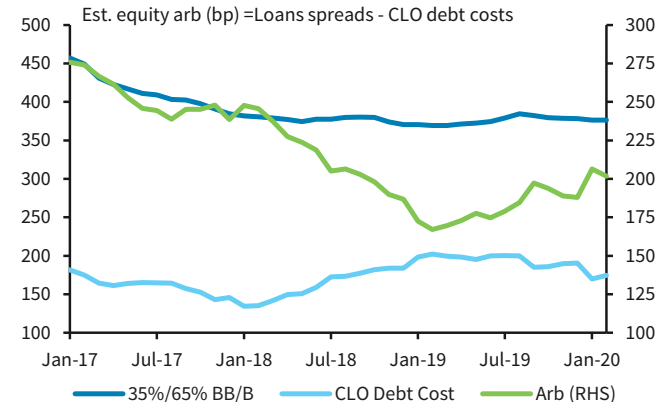
Not only did distributions see a boost because of the lack of repricings through most of 2019, both the US BSL (Figure 24) and European (Figure 25) CLO new issue equity arb also improved. As repricing supply has increased, though, and dispersion in underlying loan quality persists, the equity arb could decline in the short-term. However, CLO managers have different avenues to improve the new issue arb, whether by pricing shorter-duration deals, increasing structural equity leverage or cutting management fees (see [Dissecting and Forecasting the CLO Equity Arb](#)).

**FIGURE 24. The US BSL CLO new issue equity arb improved in H2 19, but could be pressured due to more repricings**



Note: Arb is ex-deal fees  
Source: S&P LCD, Intex, Barclays Research

**FIGURE 25. The European CLO new issue arb also improved throughout 2019, but still faces similar repricing pressures**



Note: Arb is ex-deal fees  
Source: S&P LCD, Intex, Barclays Research



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