Chapter 24

Investing Issues: Collateralized Loan Obligations

What's in this chapter:

- CLO basics
- CLO structures
- how CLOs impact an analyst's job

CLOs ARE AN important part of the leveraged finance market. These structures make up a huge buying base in the leveraged loan markets. They have very specific structural aspects that impact how the investment portfolio is managed, and there are numerous rules that govern them. It is important for analysts to understand these structured credit products and the differences in their management versus that of other types of investment in a portfolio.

CLO Basics

CLOs are specially formed investment entities created for the purpose of owning a basket of corporate leveraged loans. To fund these purchases, a CLO issues debt in the form of bonds to investors. That debt makes up the liabilities of the CLO and the loans that it owns are the assets. The loans are the collateral that backs the value of the debt tranches that the CLO issues. Buyers of CLO

debt are attracted to the asset class for a number of reasons: 1) CLOs allow the acquisition of a higher-rated debt instrument while getting exposure to the leveraged loan asset class; 2) they can typically achieve a higher yield than debt instruments with similar credit ratings; and 3) they provide a means of getting diversified loan exposure by purchasing just one security.

The debt of a CLO is issued in several tranches, with the senior-most tranche rated AAA. The senior-most tranche gets such a high rating because of all of the excess value in the assets of the CLO. For example, if the assets and the liabilities of the CLO are worth $100 million and the AAA bond tranche of the CLO is 60% of the CLO's liabilities, it is over-collateralized by $40 million, so there are excess assets to support the debt by 40%. The AA rated debt issued by the CLO will still have excess collateral, but it will be somewhat less, thus the lower rating. The junior-most tranche is effectively the equity and receives any residual value after all of the other tranches are properly paid. This is not that different from many other asset-backed/securitized financing vehicles, such as mortgage-backed securities (MBSs).

CLOs fall into a category of investments called structured credit and also asset-backed securities (ABSs). CLOs are widely used, but there are other structures that may have different rules and structures but still invest in assets of the leveraged finance market. These could include collateralized debt obligations (CDOs) and collateralized bond obligations (CBOs). The basics of these products are similar to CLOs. The structured credit market is constantly evolving, adding nuance to existing structures and creating creating new structures.

As CLOs are both buyers and sellers of debt, credit analysis can be used to analyze whether a loan is a good fit for the CLO to buy. Analysts can also be used to analyze the debt that is issued by a CLO by analyzing the quality of the underlying investments (the assets) within that CLO relative to those of other CLO tranches.

Analysts examining investments in CLO tranches will use programs to stress-test the underlying collateral and the recoveries on the collateral in various default scenarios. The level of default loss rates can be critical to the success of a CLO and how CLO tranches trade. It will not just be the default rate but also the type of recovery expected on any defaulted loans. CLOs have structures that can help protect the most senior tranches of their debt should defaults or other risks spike in the market.

An extended period of very low default rates may lower default assumptions, and this could lead to a significant amount of CLO issuance coming to market and thus increasing demand for certain types of bank loan. But the reverse can also be true. Demand from investment-grade buyers for tranches of CLOs can be a factor in CLO formation, as the AAA tranches are usually the largest part of the capital raised by CLOs. Another key factor in CLO issuance is the spread at which they can be created. This refers to the difference in spread between the basket of leveraged loans and the spread that has to be paid out to the tranches of debt that are issued by the CLO. The CLO uses the income from the loans it owns to pay the interest on the debt it issued. The spread, or arbitrage, between what it gets paid and what it pays out is vital to the success of the CLO, particularly for the equity tranches. The size of this arbitrage will lead to increases or decreases in CLO formation. For example, if the spread demanded on AAA-rated CLO tranches widens too much relative to the rate on leveraged loans, it can be very difficult to attract equity investors and it can be difficult for new structures to work.

CLO Structures

CLO structures are typically actively managed. While there are static CLOs that do not actively manage the pool of collateral, the managed CLO structure is more common. In the managed structure, there is a collateral pool that changes as a manager decides to buy and sell assets during the life of the structure.

The debt tranches issued by the CLO will generally range from AAA to an unrated equity tranche. The coupons of each layer of debt issued by the CLO will go up as the ratings go down. In most structures the debt issued by the CLO will have floating-rate structures just as the majority of the underlying collateral does. This will help assure that cash flows from the assets used to pay the interest on the liabilities do not get mismatched if the interest rate environment changes.

The liabilities of a CLO could resemble the capital structure, as shown in Exhibit 24.1.

Exhibit 24.1: Hypothetical CLO Debt Structure

CLO Tranche Rating	% of Total CLO Capital
AAA	65%
AA	10%
A	7%
BBB	6%
BB	4%
Equity	9%

CLOs are not like mutual funds or a corporation; they have a defined life. The CLO structure typically starts when the CLO manager works with a provider that funds a warehouse to begin buying the assets that will be placed in the CLO. The provider of the funding expects to get paid back by the CLO when it sells its own tranches of debt and buys the collateral. The advantage of building up the assets in the warehouse is to better match the cash flows when the CLO's liabilities are placed, rather than scrambling in the market to try to buy all the collateral in one day. The CLO's life winds down as it goes into repayment and deleveraging mode, usually several years after the warehouse and the placement of the debt tranches issued by the CLO.

The typical phases of a CLO are as follows:

1. *Warehouse*: Assets are acquired over several months.
2. *Ramp-up*: The CLO closes on issuing all of its liabilities, receives cash, and purchases the warehoused assets and any additional shortfall.
3. *Reinvestment*: The manager can actively trade the asset holdings.
4. *Noncall*: Just as with other debt instruments, the CLO equity holders may want to call or refinance the liabilities because they believe they can get more attractive terms and there is a period when this is not permitted.
5. *Repayment*: The manager uses proceeds from repayment of the assets to pay down the CLO tranches in order of seniority, with excess proceeds going to the equity. Typically, after a period of time, the manager cannot reinvest or trade the assets and the CLO is static and in wind-down.

There are numerous aspects of the CLO structure that are covenanted in the debt instruments and they include the structure of the portfolio. These covenants are likely to require borrower diversification by industry and issuer. As a rule, they also define the types of asset they can buy, which are usually dominated by senior secured floating-rate loans. A significant number of tests are run on the collateral and the cash flows, and if those tests are violated, managers are required to try to cure them. All of these diversification rules and maintenance tests are also monitored by the credit rating agencies that rate the debt issued by the CLO. If the debt issued by the CLOs is downgraded, it will likely hurt the price of that debt and may hurt the manager's ability to create new CLOs. Some of the more important tests include the following:

1. *Weighted average rating factor (WARF)*: This is used to compare the average credit rating of a portfolio weighted for the size of each holding. Higher-rated investments get a lower score, but as the score increases for lower-rated holdings, the scale is not linear. A lower WARF implies a higher credit quality, as measured by the major rating agencies. Of course, the ratings agencies control both the ratings of the collateral and the CLO's liabilities.
2. *Overcollateralization test (O/C)*: The value of the collateral (the assets) needs to exceed the value of the debt that is issued by the CLO. The test measures the underlying collateral value at par versus each tranche of debt, including all classes senior to the tranche being examined. The test usually requires defaulted collateral be excluded and can also exclude from the collateral (haircut) loans with very low ratings (e.g., CCC ratings). This can make managers very sensitive to rating downgrades at the bottom of the credit rating spectrum.
3. *Interest coverage test (I/C)*: This examines whether the collateral pool generates enough interest income to service the payments on the debt tranches. It is similar to the collateralization test in that it is run for each tranche and usually has minimum acceptable levels stipulated in the documents.

When tests are not met, the manager has to try to cure them. Typically, the remedy is to cut off payments to the lowest tranches (e.g., equity, then single Bs, and so on) and use the excess cash flow that is generated to retire the most senior tranches of the CLO's debt structure until the violation is cured. This self-preservation mechanism can be a valuable tool during spikes in default or rating downgrade cycles.

How CLO Structures Impact an Analyst's Job

The structure of the CLO can make the goal of credit analysis different from that of other types of portfolios. The critical factors for the investments in a CLO portfolio are that the cash flows for the investment are not impaired and that the credit will not default or be rated so low it will not count as collateral. The CLO manager is less concerned about how a loan in the portfolio will trade and be marked to market. This is because the CLO is focused on the cash flow and meeting its maintenance tests. The maintenance tests are based on credit ratings and par value. Therefore, CLO portfolio managers are more likely than non-CLO managers to hold onto a position, even if they expect significant short-term downward price pressure, as long as it will not become insolvent or drop to the lowest credit ratings.

Because of this structure, where the collateral (e.g., loans) that the CLO owns gets treated as a par instrument for test purposes, CLO managers will sometimes try to build par during the reinvestment period of the CLO. In looking to build par, a manager may sell a loan that is trading at par or even slightly above and then look to acquire lower-priced assets that still get valued at par for collateralization tests and other risk measurements. Another reason CLO managers may be reluctant to sell assets if they have traded down to a discount is that the sale of assets at discounts can hurt the results of these tests.

Closing Comment

In undertaking credit analysis in the leveraged debt markets, it is important to understand the concepts behind CLO structures. If credit work is being done to support CLO portfolios or to help analyze investments in CLO-issued debt, it is important to understand how it is being used and realize that the market price vagaries are not as important to CLOs as they are to many other types of portfolio. Even if the credit work that is being undertaken is not directly involved with CLO structures, they are a large and important part of the market and can impact relative value, and supply and demand in the loan market, and affect companies' access to capital.