LevFin Insights

CLO Insight: CIFC's head of structured credit investments Jay Huang says a bottom for mispriced BSL CLOs is near

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The pricing fundamentals of the BSL CLOs will improve and money will flow into the U.S. market next year, the head of structured credit investments at CIFC said in an exclusive interview with LFI.

“While there is fear in the market of a drawn-out downturn, we do not believe that the dislocation in CLO securities and related buying opportunity will persist.,” CIFC Managing Director Jay Huang said. "We expect additional capital allocations to the asset class throughout 2023.”

CIFC, a credit manager with $40 billion of assets under management, has an active CLO trading desk that evaluates and executes opportunities across the capital stack in both the primary and secondary markets.

“We believe BB rated CLO tranches, which are currently paying a stated yield of 12-15%, present an attractive investment opportunity," Huang said. "There have only been two other times since the Great Financial Crisis during which yields exceeded current levels. During times of uncertainty, we have observed that many downside scenarios are already baked into trading prices, therefore increasing the margin of safety of many CLO debt and equity securities. For instance, some models in the market may take a conservative stance and assume that 100% of loans priced below $80 will default over the next 12 months, which would imply a one-year loan default rate of 7%-8%, given where loans are priced today.”

The following are highlights from the interview:

How has the current downturn impacted the CLO market, how have such conditions affected buying and selling, and how long do you expect this dislocation to persist?
The broad market downturn has triggered liquidity needs from holders of CLO securities, and such liquidity needs have served as the predominant driver of increased selling of CLO securities. These holders may include asset managers receiving redemptions, financial institutions reducing capital consumption, or entities needing liquidity to fund other commitments. We have spoken to very few, if any, recent sellers of CLO securities who have sold due to an increased fear of credit impairment of CLO tranches.

The current downturn has undoubtedly had an impact on CLO yields, but we believe much of the selloff in the space has been driven by technicals rather than fundamentals. There are certainly headwinds due to macroeconomic concerns, which will likely result in an increase in leveraged loan default and downgrade rates. However, CLOs were designed to withstand periods of higher default rates and have proven their resiliency across many cycles, particularly in times of dislocation. In fact, CLO debt tranches have seen a fraction of the default rate of similarly rated corporate debt over time, due to the structural protections and active management of the product.

While there is fear in the market of a drawn-out downturn, we do not believe that the dislocation in CLO securities and related buying opportunities will persist. From our conversations with market participants, CLO debt securities that yield 10%-15% – which have historically defaulted at a fraction of the rate of investment-grade rated bonds – are becoming more commonly recognized as a low-hanging fruit investment opportunity in the fixed-income markets. As such, we expect additional capital allocations to the asset class throughout 2023.

Does CIFC have a CLO secondary trading desk, and if so, what opportunities are seen?
CIFC has a dedicated, active CLO trading desk that constantly evaluates and executes opportunities across the capital stack in both the primary and secondary markets. Throughout 2022, we have seen pricing dislocation opportunities from AAAs all the way down to equity. For instance, at one point in 2022, AAAs and AAs were yielding as high as 7%-10% with some bonds trading at dollar prices in the $80s. Since the inception of the CLO product, the cumulative default rate of AAA and AA CLOs has been 0%. Today, we see similar opportunities in BBB and BB rated CLO debt tranches in the 10-15% yield range that we believe have a remote chance of taking an impairment even under many draconian stress scenarios.

In what part of the capital stack are you finding the most opportunities?
We believe BB rated CLO tranches, which are currently paying a stated yield of 12%-15%, present an attractive investment opportunity. There have only been two other times since the Great Financial Crisis during which yields exceeded current levels. BB rated CLO tranches have demonstrated their fundamental resiliency in prior periods of stress, thanks to the structural protections inherent in CLO transactions. For a select subset of BB rated CLOs, we do not see that fundamental default performance changing materially, if at all.

As we potentially head into a recession, how you are positioning the portfolio?
During times of uncertainty, we have observed that many downside scenarios are already baked into trading prices, therefore increasing the margin of safety of many CLO debt and equity securities. For instance, some models in the market may take a conservative stance and assume that 100% of loans priced below $80 will default over the next 12 months, which would imply a one-year loan default rate of 7%-8%, given where loans are priced today. While we believe that default rates will rise over the next 12 months, we do not believe default rates will come close to that 7-8% range.

That said, the benefit of market conservatism during stressed market conditions is that we can invest in securities that already reflect further downside risk. We see this as an opportunity to capture total return upside over the next 12 months if, for instance, the default rate of a particular loan pool of a CLO does indeed fall short of 7%-8%. Every day, leveraging our in-house data analytics team and proprietary technology, we run millions of simulations across the entire CLO universe. These simulations provide insight into how fundamentally protected a given tranche is under various stress scenarios. We have rotated our portfolio into those positions that we believe are best equipped to withstand stress.

What questions are investors asking the most?
Many investors are focused on the impact of a potential recession and rising rates on the underlying loan asset class. We have stress-tested hundreds of loan issuers that we believe provide an indicative picture of the loan universe, and have found that rising rates and a recessionary environment would pressure free cash flow, with a disproportionate effect on highly-leveraged companies that also have high capex loads (i.e., companies that had skinny FCF to begin with). As a result, some companies will undoubtedly need to restructure if both high rates and a recessionary environment coincided for an extended period, or if they need to refinance their debt on the heels of a weak year. Overall, most loan issuers came out of Covid with relatively strong balance sheets, which should help insulate them from these issues. Our individual company projection models build in the SOFR and LIBOR forward curves as well as interest rate hedges, and assume a relatively hard landing, so we believe we have a strong grasp of where FCF/liquidity risk lies in our portfolio, which is also a barometer for the broader loan market.

Please share your view on 2023 supply dynamics.
The new-issue CLO market is experiencing a number of headwinds, including limited new-issue loan supply, an overhang of underwater warehouse facilities, and wide CLO liability spreads. These headwinds are compressing new-issue equity yields to historically low levels and will likely moderate CLO issuance volumes for at least the first or second quarter of 2023. While we expect full-year 2023 issuance volumes to be down vs. 2022, we believe there will continue to be a steady supply of deals throughout the year that are supported by equity from captive CLO manager funds, long-term programmatic third-party investors, and opportunistic investors via "print-and-sprint" transactions during periods of heightened volatility.

Current CLO spreads will continue to limit reset and refinancing activity, but, if spreads tighten, we may see a pickup in volume in the second half of the year from 2022-vintage deals exiting their non-call periods.