

LEVFIN INSIGHTS

US Market Commentary: CLO Q&A—Vibrant Capital Co-Chief CIO Kashyap Arora sees Triple As tightening further (especially short-end), exacerbated by negative net-supply, opportunities in secondary equity and BSL credit quality rising long term

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LFI spoke with Vibrant Capital Partners' Co-Chief CIO Kashyap Arora about high-level US BSL CLO trends. The firm has \$6.1bn of leveraged loan assets under management and 13 CLOs under management, according to Fitch Ratings.

What direction are spreads heading in the near-term primary AAA bull-case vs. base-case and why?

Directionally, we expect CLO AAA spreads to continue tightening in the near term, especially for the short end of the curve. Technicals in the CLO market have been positive. Despite the strong pace of new CLO issuance, CLO AAA net supply YTD has been negative due to amortizations and CLO liquidations. Further, CLO AAA ETFs have gained traction over the past few months, leading to additional demand. Fundamentals have been positive as well. The current environment is conducive for floating-rate credit, as the "higher for longer" monetary policy has kept base rates high without introducing significant stress in the credit market. CLOs benefit from higher rates, while loan defaults, although higher than historical levels, remain rangebound.

Where do you see opportunities in the CLO primary and secondary market?

We see significant opportunities in secondary CLO equity. The reset optionality is not appropriately priced in the current valuation of secondary CLO equity. Further, some of the stressed names in CLOs are priced to conservative scenarios and could offer meaningful upside. Additionally, due to variation in CLO documentation, specifically around CCCs and defaulted obligations, there could be differing impacts on test metrics for the same credit across different CLOs.

What metrics do you find most useful for tiering managers?

We evaluate CLO managers on a holistic basis. For manager performance, par build has always been one of the more important metrics to consider. However, it is more important to look at how a CLO manager built/lost par as opposed to whether they built/lost par. Taking too much risk to build par may not be the right thing to do especially in periods where loan prices are very high. In short, it's critical to examine the quality of the par build.

Any contrarian views on CLOs?

Over the next few years, we expect the composition of BSL loans to shift towards higher quality and better ratings. We have seen a similar phenomenon occur in the HY Bond market over the past decade, with an overall reduction in risk. Private credit has taken out some of the higher spread/riskier collateral in the broadly syndicated loan market, leaving the resulting market to be higher quality/better rating. We are seeing early signs of improved rating quality in new-issue loans, and we expect this to become more pronounced as private credit grows over time. A higher-for-longer rate environment also lends to a better quality of underwriting in the loan market.

Where is the CLO market most vulnerable?

In the near term, we see repricing as a key risk to the CLO market, with more than 60% of the loan market priced above par. The most obvious impact would be reduced excess interest that flows to CLO equity, given the tighter loan spreads. In an environment where loan repricing volumes are high, it is important that CLO managers remain disciplined and avoid taking unnecessary risks to reach for yield.

Is equity less compelling with the rise in loan prices?

With the rise in loan prices, the spot arbitrage may not look attractive; however, there is a lot of value to be extracted from being involved in the end-to-end creation of CLOs, starting from the warehouse stage. We do expect continued volatility in loans in the higher rate environment, and CLO warehouses offer a useful tool for capturing the potential volatility and securitizing those loans through the CLO structure at an opportune time.