

Mind the gap

CLO equity price and NAV data examined

In this first of a new series of SCI CLO Case Studies, we examine how CLO equity prices have fared so far over this most tumultuous of years and their relationship to their underlying NAVs.

Unlike that for CLO equity, the path of CLO debt stack prices over the first three quarters of 2020 is a fairly clear one. New issue headline numbers provide a quick rule of thumb with primary triple-A spreads riding a rollercoaster from YTD tightness in January/February to major wides in March/April followed by a recovery back to around 10% shy of where we began by Q3 end.

Secondary levels provide a deeper and more consistent basis to ascertain the debt stack pattern. The following table provides a guide to what has happened so far:

| | October 2 close (CLOs mid-tier) | % Spread Recovery (Covid Crisis) | Change from Covid wides to current | Change from Feb 21st to COVID wides | Covid wides |
|--------------|------------------------------------|-------------------------------------|---------------------------------------|--|-------------|
| Euro CLO AAA | 148 | 86% | -228 | 265 | 375 |
| Euro CLO AA | 210 | 88% | -290 | 330 | 500 |
| Euro CLO A | 300 | 82% | -363 | 440 | 663 |
| Euro CLO BBB | 415 | 78% | -405 | 520 | 820 |
| Euro CLO BB | 730 | 82% | -620 | 760 | 1350 |
| Euro CLO B | 1125 | 83% | -1,125 | 1,350 | 2,250 |
| US CLO AAA | 134 | 90% | -266 | 294 | 400 |
| US CLO AA | 195 | 88% | -305 | 347 | 500 |
| US CLO A | 255 | 87% | -370 | 425 | 625 |
| US CLO BBB | 420 | 82% | -455 | 555 | 875 |
| US CLO BB | 840 | 87% | -835 | 960 | 1,675 |
| US CLO B | 1700 | 54% | -800 | 1,495 | 2,500 |

CLO spreads are mid-tier estimates but as bonds are trading on cash price spreads may be less meaningful. Data as of 2 October 2020 close. Based on US 3.0 Secondary CLO Spreads (from 2016-current) and European Secondary CLO spreads.

Source: JP Morgan

Unsurprisingly, CLO debt stack price movements reflect what was broadly seen in the leveraged loan market. The following chart gives some indication of the generalised trend there:

S&P Global Leveraged Loan Index



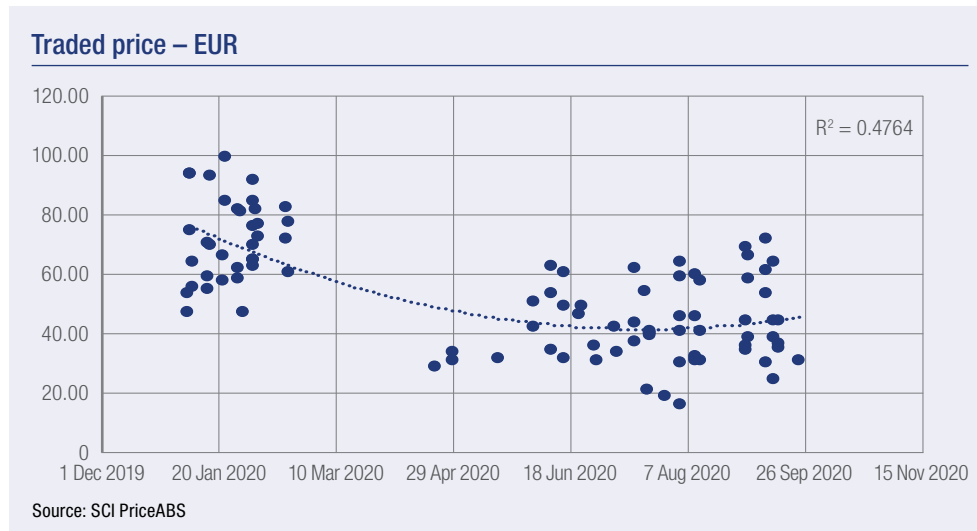
Source: S&P Dow Jones Indices

However, anecdotally and logically CLO equity did not see a similar significant rally in Q2 and Q3. So, let's drill down into the data from SCI's PriceABS service to look at the bottom of the stack more closely.

Utilising all of the available BWIC cover prices from CLO equity auctions either side of the Atlantic in the first three quarters of this year alongside NAVs for the pieces involved should provide a clearer picture of what happened and if there were any discernible trends. To assist in the latter, a polynomial trendline has been included in the below graphs and the R^2 is shown – R^2 , or coefficient of determination, can range between 0 and 1 and the closer it is to 1 the better the fit of the regression line to the data.

Traded prices

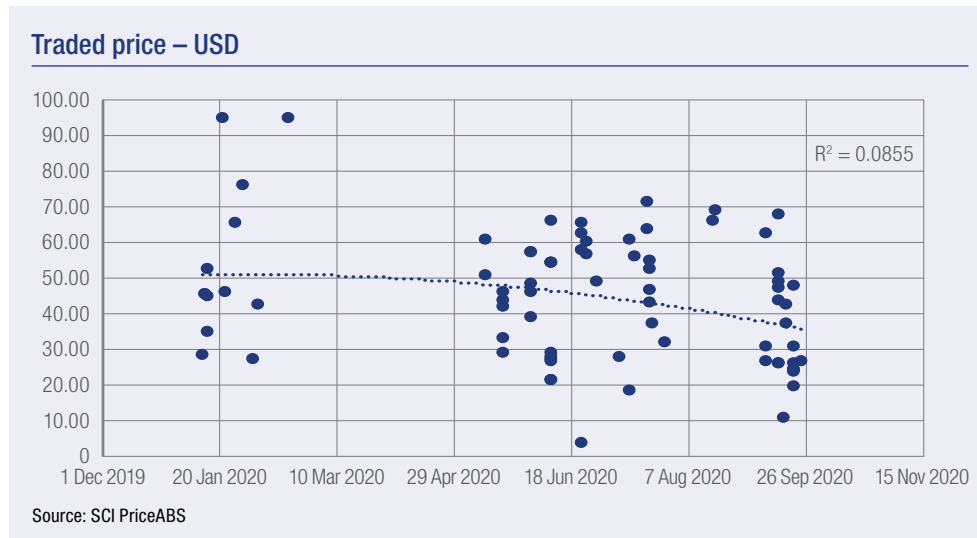
Europe



Looking at European cover prices, pre-Covid there is a decent cluster showing with the majority of prices mostly in the 60 to 80 area. There followed a hiatus in March and April where first BWIC activity halted altogether as the crisis unfolded and immediately after no cover prices were seen. As trading resumed afterwards and through to the end of Q3 there is greater dispersion in prices but with the majority of covers in the 30 to 55 range, clearly levels had dropped considerably.

The European prices present a strong enough trendline and are backed up with an R^2 of nearly 0.5. This reveals an element of recovery but is far from the strong return exhibited in leveraged loans and the CLO debt stack.

US



US cover prices present a different picture with a far greater disparity in the pre-Covid cluster. Overall, more manager tiering in the US than Europe and less overlap in underlying credits in the US versus Europe accounts for the delta in dispersion levels.

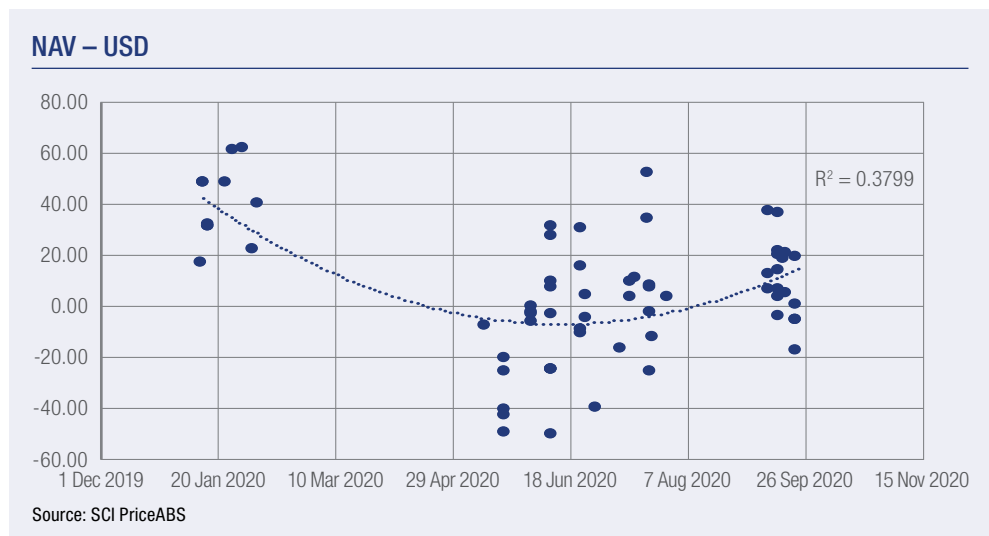
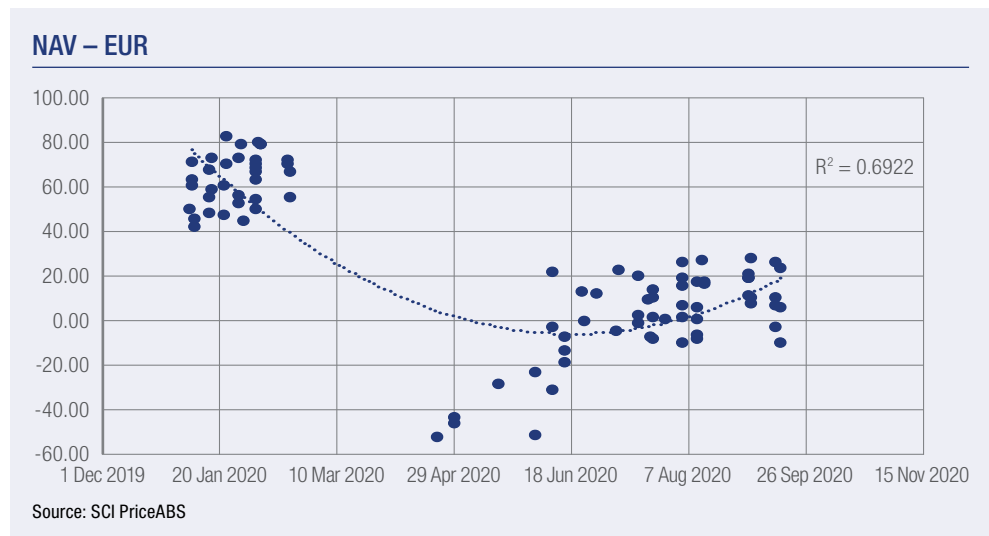
The relatively small number of pre-Covid cover prices was a result of US CLO Equity trading typically to 8-12% yield with cash prices 60+ and it was relatively rare to see equity change hands at those levels. While sub 50 cash prices pre-Covid were usually from weaker transactions, including from a bottom-up basis.

The US market then saw the same March and April hiatus. When it returned, the aforementioned weaker deals were hit the hardest given their fundamentals were already weak going into the crisis and a large percentage of trading has been in those names, which clustered in the 20-50 cash price range.

There were also more forced sellers post-Covid due to broad market volatility. As a result, more data points can be seen from May onwards.

The trendline here is weaker than in Europe and the R^2 is insignificant. All of which underscores that generalising US CLO equity is impossible – line by line credit analysis is needed especially post-Covid given that there are stressed default scenarios up to 12.5%.

NAVs



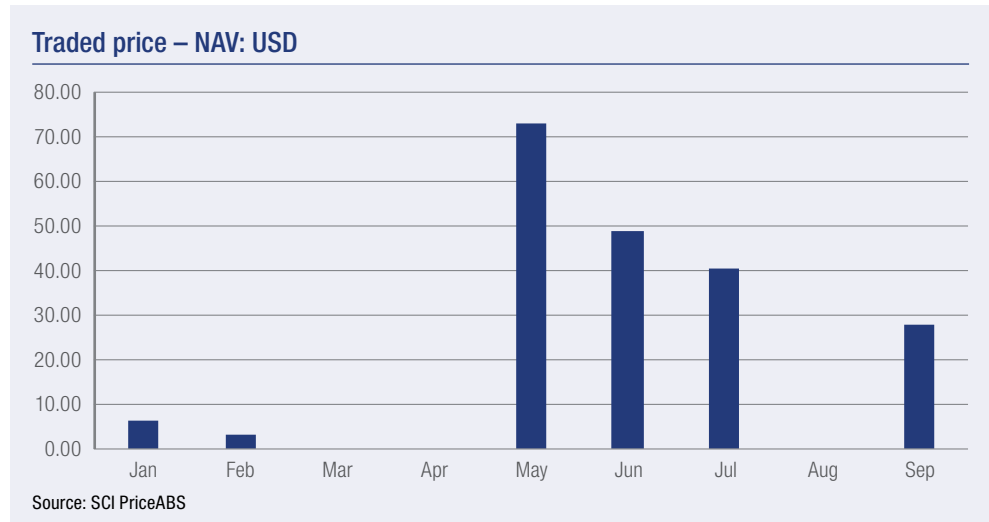
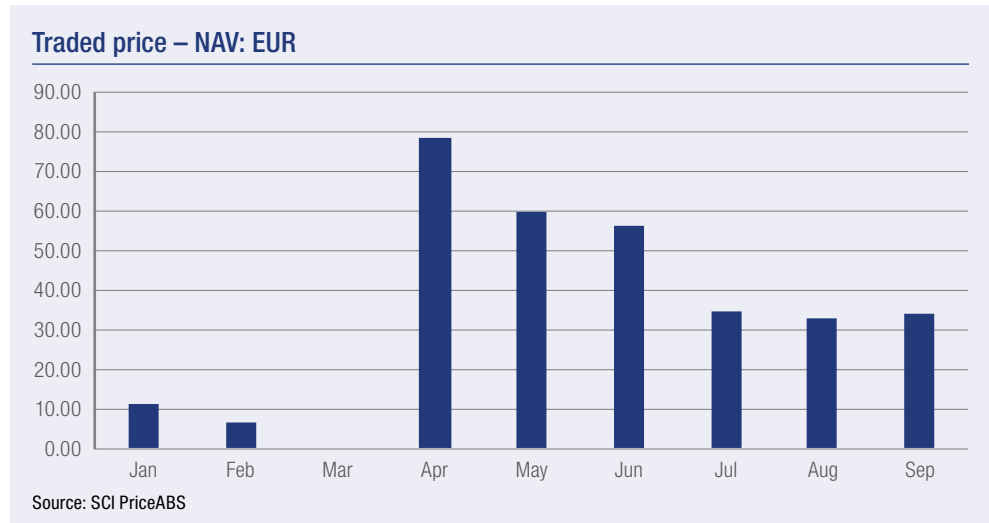
Here, the graphs show some elements of similarity notwithstanding the pre-Covid dispersion disparity, explained above. In both cases NAVs fall dramatically, far more so than prices, heading to zero and some down to the minus-50s.

Greater drops in NAV are to be expected given the effect of leverage. While leveraged loan prices dropped far less than NAVs, but once the loan price falls are carried over into the 10 times leveraged equity piece of CLO the NAV will fall by a far greater amount and result in the numbers seen in the graph.

However, traded values remained above NAV levels because traders understood that CLO equity is not just about the NAV – it is a cashflow product and the CLO structure protects itself. Fewer deals hit cashflow diversion triggers than initially anticipated at the start of the crisis making it incorrect for the majority of deals to value the equity in the same way as the NAV – particularly in Europe. However, the position is worse in the US with expectations for higher leveraged loan default rates in the US (6%+) than Europe (3-5%), more failing interest diversion tests and depleted NAVs.

In both case the trendlines in the graphs do at least show a path to recovery. However, it still looks to be lagging that of the CLO debt stack and the loan market.

Price versus NAV



Last, is a direct comparison of the difference between the traded price and the NAV, which accumulates the average traded price minus NAV on a monthly basis for all the trades in that given month.

For the two months prior to the Covid crisis, both Europe and the US exhibit around an under ten point gap. Then as post-crisis trading kicks in the spread balloons for the reasons explained above.

These charts go beyond the trendline of the earlier charts and provide a greater level of granularity. By isolating activity on a month-by-month basis, rather than incorporating the entire data set they illustrate a closer relationship between European and US equity than originally predicted. ■

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