

## Primer on CLOs

**Collateralized Loan Obligations (CLOs) are a form of securitization where payments from multiple loans of non-investment grade corporates (leveraged loans) are pooled together and passed on to different classes of owners in various tranches. CLOs have led the expansion of credit for private equity-backed takeovers.**

In most cases, at least 90 per cent of CLOs' asset pools is made of first-lien senior-secured bank loans from a diverse range of borrowers, typically some 150–250 companies. Such loans rank first in priority of payment in a borrower's capital structure in the event of bankruptcy, ahead of unsecured debt. A CLO portfolio may also include a small allowance for second lien and unsecured debt. The average credit rating of a CLO's underlying collateral is typically around BB/B, with its loans usually floating rate, based on LIBOR. Further, in most cases there is also an allowance for leveraged bank loans with "Covenant Light" (cov-lite).

Usually, the term cov-lite refers to the reduction or elimination of maintenance covenants (e.g. periodical test metrics like interest cover or leverage). Most of negative covenants, however, remain in place, especially collateral protection (i.e. preventing a borrower from freely hiving off assets or redistributing cash).

In contrast to other ABS structures, CLO portfolios are actively managed over a fixed tenure known as reinvestment period (usually 3-5 years): During this period, a CLO's manager can buy and sell individual bank loans for the underlying collateral pool in an effort to create trading gains and mitigate losses from deteriorating credits.

From an economic point of view, the CLO equity investor owns the managed pool of bank loans, whilst the CLO debt investors term-finance that pool. - Structurally, CLOs are based on the cash flows from underlying loans: The payment order is fully sequential, whereby distributions begin with the most senior debt tranches and flow down to the bottom, the equity tranche (i.e. waterfall). Credit enhancement and structural protection provided to senior tranches means that these securities receive higher ratings (AAA/AA/A) by credit rating agencies than the average credit profile of the underlying collateral pool (BB/B). Hence, there are no mark-to-

market triggers: The main focus is on whether or not the cash flow can pay the senior tranches – and not whether the value of the assets have (temporarily) fallen.

For diversification purposes, CLOs are structured with specific investment limitations, such as issuer and industry concentrations. There are also limits to the total amount of CCC-rated investments that may be included in the underlying portfolio, which are typically limited to 5.0–7.5 per cent of the total portfolio.

During the financial crisis of 2008 CLOs proved to be resilient, with less than 1 per cent of rated loan tranches within CLOs having defaulted. The lowest-rated tranches of these issuers lost investors about 5 per cent (while US subprime residential mortgage-backed securities in the lowest-rated tranches lost investors some 90 per cent or more).

Prior to the 2008 crisis CLO structures were required to mark to market their assets: Since then so-called CLO 2.0 structures are not required to do so any longer. Neither are early redemptions by investors permissible. These features aim to make CLO 2.0 structures unsusceptible to "runs".

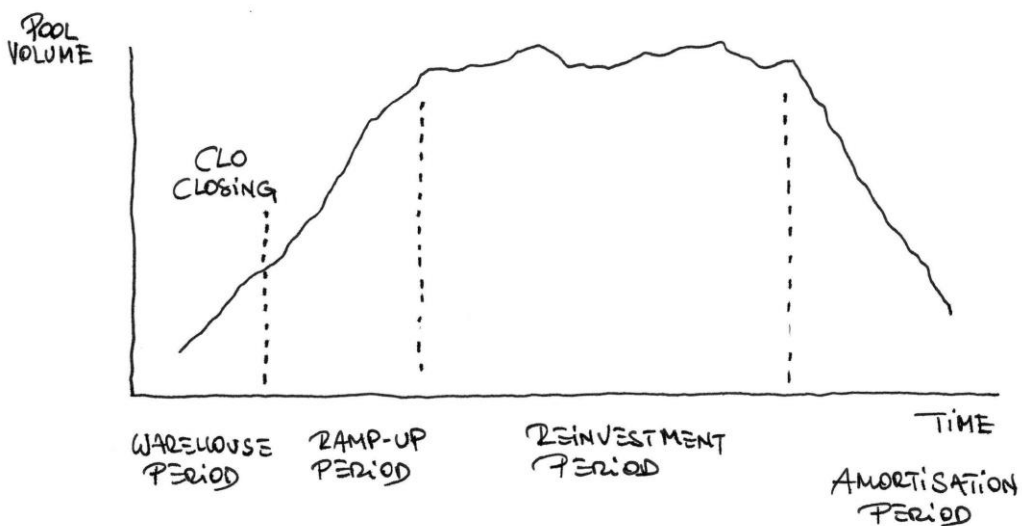
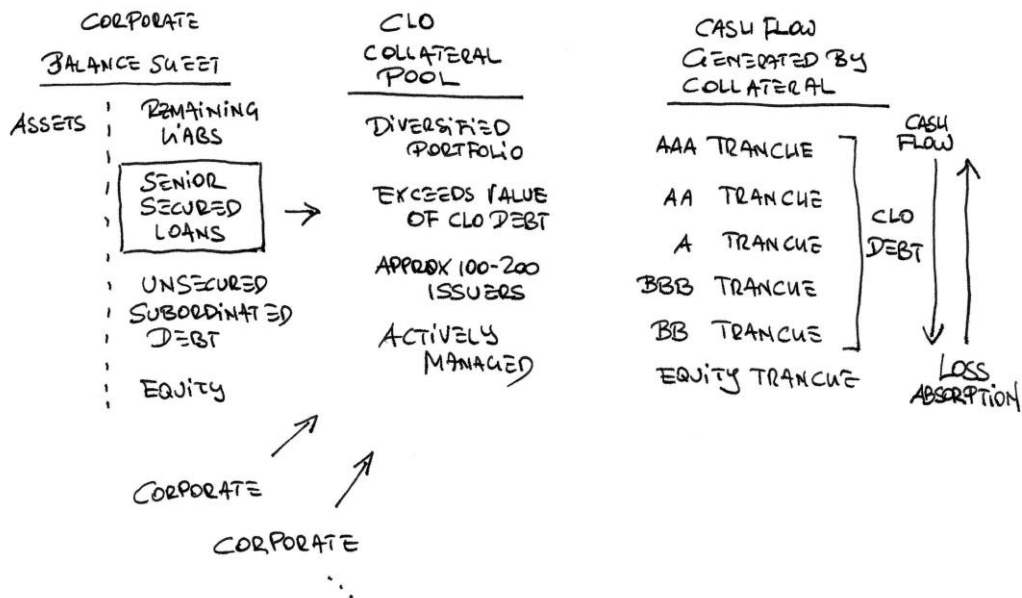
On a regular basis CLO structures face a series of tests, whereby over-collateralization (O/C) tests are most relevant, with each CLO tranche having its own targeted O/C ratio: To pass an O/C test, the principal value of the underlying collateral must exceed the principal value of the CLO tranche by a predetermined minimum ratio. Failure to meet such minimum results in redirecting the flow of funds to achieve this level, taking it away from making payment to lower-rated tranches: Hence, cash will be diverted from equity and junior CLO tranches towards senior debt tranche investors.

If the CCC basket exceeds a predetermined test level (normally 7.5 per cent of the value of a CLO), then - as an exception to CLOs marked at par - the excess CCC assets are held at market value: In this case O/C will be considered jeopardized and cash flow may be diverted away from junior classes to protect senior classes. To cure such breach, CLO managers will seek to sell these lower-rated loans, often even at some discount. (Also, when a default occurs, an asset is to be marked at the lower of market value or anticipated recovery value). – Interest coverage tests for each tranche measure the sufficiency of the

interest income of the underlying collateral to cover the scheduled interest payments to the note holders. Recent trends towards a low-default environment has given rise to borrower-friendly developments: Among others, cov-lite loans incorporate borrower-favourable terms such as Earnings Before Interest, Taxes, Depreciation, Amortization (EBITDA) add-backs and opportunities for collateral stripping. EBITDA add-backs add back one-time (extraneous) expenses to earnings, thereby improving a

borrower's perceived capacity to repay. - Collateral stripping occurs when borrowers move collateral out of reach for secured lenders, effectively harming the recovery value of secured loans in the event of a bankruptcy event.

Innovative structures, such as "enhanced CLOs" buy riskier loans than a typical CLO, by times backed with more than 20 per cent of highly speculative CCC-rated loans, nearly a triple of the standard portion.



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