

E X P E R T Q & A

CLO equity offers opportunities to enhance returns during periods of heightened volatility, says John Wright, partner and global head of credit at Bain Capital



Positioning to capture opportunities in CLO equity

Q Why does CLO equity present such an interesting investment opportunity in times of dislocation?

If you look at the history of collateralised loan obligation (CLO) equity as an asset class, it has performed very well through many different types of markets. One of the key advantages is that you do not need to assume a lot in order to generate an attractive return.

That said, during periods of dislocation, CLO equity offers a good opportunity to enhance what is already a good base case return. That is driven by your ability to acquire assets at a discount and refinance opportunistically. CLOs

issued during market downturns, such as in 2020 and 2022, exhibited significant upside, because despite weak initial arbitrage, or net interest margin, they benefited from subsequent market rallies and still delivered strong returns.

This is a market where generally managers can enhance returns by deploying during periods of dislocation and then actively managing through periods of volatility – that is what makes for an attractive return profile.

CLO equity is high-yielding but

also long volatility, which makes it particularly compelling.

We have issued and managed CLO equity since 1999, and I have personally been involved for 25 years. Our team is experienced in the CLO space, which is critical as we refine our capabilities and adapt to different market environments.

Q How important is a global perspective in CLO equity investing?

An investor could make a mistake in thinking that CLOs are just one thing. The technology may be one thing, but it is not just one market. Rather, you have broadly syndicated CLOs, private credit CLOs, US CLOs, European

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From an equity standpoint, base case yields today in the US and Europe are both compelling, so it is a relatively even field and we have advanced deals recently in both geographies. If you look at the pricing of CLO debt, Europe is a bit more compelling right now. For a risk-adjusted price, you get paid more for Europe than for the US, especially in the middle part of the capital structure.

Q What are the drivers of CLO equity performance?

Conceptually, the idea of managing a pool of assets that pays you a spread and ensuring that your losses do not consume that spread over a period of time generally works if you manage your risk.

On the asset side, sourcing levels, portfolio construction, minimising

default risk, issuing liability at an attractive spread and also actively refinancing at the right time are all key drivers of performance.

If you can acquire the loan portfolio at a price discount, there is more potential upside for the CLO with the appreciation in loan prices. That value can then be extracted by either redeeming the CLO or refinancing the capital structure.

The ability for CLOs to refinance liabilities after non-call periods adds flexibility and can substantially lower debt costs, as we saw in the refinancing wave of 2021. Bain Capital was the 10th largest issuer of CLO equity in the US last year but also the largest issuer of CLO refinancings, according to JPMorgan league tables. Two decades ago, before the global financial crisis, refinancing was not a big element of

CLOs, CLO equity and CLO debt. At any point in time, one of those may be more attractive than another.

It is important in our view to have the broadest reach and a global platform to get access to the opportunity. There are times where US CLOs are more attractive than European CLOs, and that is driven by relative value.

One of the key ways we give investors access to CLO equity is through our committed CLO equity programme. The pace at which we fill our US or European book can vary based on opportunity, but that global orientation is important for extracting maximum value.

Q How important is it for firms to remain opportunistic?

That is very important, so that you can take advantage of those windows when they exist. Your entire business cannot be to wait for that window, but you can generate additional returns when that window is open.

The other thing we have found about CLOs is that the more active you become, the more you find opportunities to add value on the margin. That can come down to how we trade the portfolio or how we structure the trades, drive warehousing returns and minimise the costs and expenses that come with managing, structuring and trading the CLO. Those elements might not sound like they will make a lot of difference in isolation, but when you start to aggregate them, they can materially impact efficiencies and drive returns for investors.

If you are going to be in the CLO business and invest in equity, it therefore makes sense to be with a manager that is a programmatic investor, that offers alignment, deep experience and a global footprint.



CLO value creation, but it is increasingly important today.

Q What does it take for managers to stand out as CLO equity investors?

Having a stable team with a lot of experience is really important in CLO equity, because even though today's market is different from yesterday's, you can really benefit from having lived through different markets and tracking risks in the medium and long term based on experience.

The second thing that is really important is alignment. At Bain, we invest heavily in everything we do, especially in our CLO business. That means that when we are speaking to our investors, they understand that we are an investor alongside them, and that creates alignment.

The last thing is that we have a consolidated CLO debt and equity investing presence within our CLO management team. That helps to inform our views on the liability side, gives us a sharper pencil as we think about how deep demand is for different parts of the capital structure, and enhances our visibility across the market. Being a CLO investor as well as a manager can really help to drive performance when it comes to CLO equity.

Q What are the challenges? More broadly, one of the biggest challenges facing the loan market today is the advent of liability management exercises, which have resulted in bankruptcy and restructuring processes becoming far more complex. That has led to lower recoveries, lengthier processes and an additional layer of uncertainty for investors.

We like to think we have seen the worst of that evolution, with lower recoveries now being incorporated into transactions more accurately. We now think differently about whether to work something out depending on the lender group, so that has been quite a shift.

“The ability for CLOs to refinance liabilities after non-call periods adds flexibility”

We have seen those processes presenting meaningful new risks to the loan market overall, and that has been more prevalent in the US than in Europe. Similar trends have been playing out on both sides of the Atlantic, but liability management is far more pervasive in the US than in Europe. That is another argument for global diversification when it comes to managing, structuring, trading and investing in CLOs.

Q Where are the most attractive deployment opportunities today?

As we look at CLO equity arbitrage and base case CLO equity yields, that arbitrage remains compelling. We still

see opportunities to generate really attractive base case yields, and when we think we can generate those returns, we tend to be more active in capital formation.

CLO equity really becomes valuable during periods of dislocation because you can step in to source assets at a discount when buyers are scarce and then benefit when prices recover. Because the arbitrage is not static over the life of the CLO and deals can be refinanced, issuing a deal when liability costs are abnormally wide can still result in strong returns.

We saw that in 2020, when CLOs had relatively poor arbitrage at issuance but benefited when the markets recovered, and those vintages performed well. We also saw the same during the global financial crisis, during the energy cycle and, to an extent, during the interest rate moves in 2022 and 2023.

That is why, historically, committed equity funds with a four-year life cycle are very likely to hit at least the 75th percentile for loan spreads at least once. Those are the real windows for opportunistic deployment.

Q Finally, how do you view the opportunity set moving forward?

We are at a point now where the markets are strong, there is a pipeline of repricings in the US and that is going to take some spread out of the portfolio. We are going to see opportunities both to create new deals and to refinance and reset existing deals to lower the costs of borrowing.

There is a lot of geopolitical risk right now, between tariffs and trade policy, war in Europe, volatility in the Middle East, inflation and energy price uncertainty. The CLO market seems benign to those, but it is just a matter of time before it reacts. Then we anticipate seeing a cheaper entry point for loans in both the US and Europe, and that will open up a new window of opportunity. ■