The Beat of the CLO Market

With more than $350bn in assets under administration, Virtus Partners is the premier provider of front, middle and back-office solutions for alternative asset managers and banks in the Structured CLO and Leveraged Loan market. Paul Livanos is a Director at Virtus Partners responsible for leading business development efforts across multiple business verticals including Credit Portfolio Management, Middle Office Managed Services, Fund Administration, CLO Trustee Services, and Loan Agency & Settlements. Mr. Livanos has over 12 years of experience in Structured Finance. Outside of work he is a classical guitarist and avidly appreciates music. To learn more about Virtus Partners, please visit us at www.virtusllc.com or email Paul.Livanos@virtusllc.com

—Paul Livanos, Director, Business Development, Virtus Partners, LLC

What explains the upsurge in investor interest in CLOs?

Virtus Partners provides key services and technology to our clients in the structured credit and leveraged loan space. We have very close relationships with our clients and we often share our views on the market. There are a few forces behind increased demand for CLOs. First, rising interest rates are driving demand as CLO assets and liabilities are floating rate instruments. Second, CLO returns are more attractive compared to other assets at the same entry point. Investors are getting around 3.5% on AAA rated CLO debt compared to the 10-year Treasury, which is now 3%. Finally, CLOs are a proven and successful asset class. We're seeing more investors and managers coming into the CLO market.

Where are interest rates headed?

Broadly speaking the expectation is that there will be more rate hikes and LIBOR will continue to rise. Rising rates are good for debt investors because CLO liabilities are floating rate. The debt is overcollateralized and equity gets the residual, so an increase in LIBOR is good for equity investors as well. One headwind to CLO equity is the spread differential between 90-day and 30-day LIBOR. The underlying loan issuers are able to choose the reference rate for their debt. Almost two-thirds of loans held by CLOs are now referencing 30-day or 60-day LIBOR. The spread differential between to two rates is about 45 bps. On a CLO that is 10 times levered that will have a material impact on equity cash flow. The hope is that rates will normalize over time but this could be a problem that lingers for a while.

Where are some of the best opportunities in the CLO market right now?

According to the structured credit investors we work with there has been demand for all tranches recently. With debt there is no arbitrage risk and the assets are more liquid since they're rated. Towards the beginning of the year, the spread on AAA's tightened to LIBOR+90's. Then in April they widened to L+110-L+115. This is mostly due to the surge in supply that resulted from a wave of refinancing. Many investors are expressing interest in shorter dated paper. Also, investors who are looking for exposure to CLOs will invest in the warehouse equity.

What are the recent regulatory changes impacting CLOs in terms of risk retention?

The repeal of Risk Retention made it easier for managers to refinance and reset deals since they don't need to comply with the regulation. CLO platforms are less capital intensive and manager can focus on running the business and credit selection. Another byproduct is the CLO market is more competitive with more deals coming to market. On the down side, there's already been a lot of inflow to loans and the supply-demand imbalance is slightly worse. One positive result of Risk Retention is that it brought long-term capital into the asset class. Top-tier managers successfully raised awareness of the CLO story and the economics of these vehicles.

What should investors focus on when considering a CLO management platform?

Investors should understand how managers make buy and sell decisions. Credit selection is going to be key to the performance of a CLO. It's also important to understand the depth of a manager's resources. They need to ask 'Who will maintain the necessary resources to properly manage their deals during the next downturn?' Lastly, a big factor is alignment of interests between the manager and the investor.

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