CIFC CLO Newsletter – July 2020

All,

I hope that this letter finds all of you healthy and in good spirits. Since my last update, the CLO markets have experienced significant spread tightening which has resulted in the reopening of the CLO primary market. Although we are certainly not out of the woods yet, I believe that the CLO asset class can add "pandemic proof" to its resume. While we have certainly seen a dramatic variation in performance amongst CLO managers, there have been no liquidations as CLOs have performed as expected during a period of higher CCC loan downgrades and defaults. Although the CLO asset class has performed as expected, there has been a notable re-tiering of CLO managers based on their performance year-to-date ("YTD"). As I was thinking about CLO manager performance throughout the pandemic, I recalled a lesson learned in my youth which I believe is still relevant today that I will share later in the update.

CLO Primary Market Activity:

YTD, 144 US CLOs have priced totaling $63.5bn (90/$39.5bn new issue and 54/$24.0bn refi/reset) and 35 Euro CLOs have priced totaling €11.8bn (33/€10.9bn new issue and 2/€0.9bn refi/reset/re-issue). CIFC's Capital Markets Team has also remained active during the past several weeks.[1]

- CIFC priced its 1st CLO of the year on June 12th. The transaction, which was underwritten by Barclays, is a $500mm CLO with a 3-year reinvestment period and a 1-year non-call
- On July 20th, CIFC priced its 2nd new issue CLO of the year with RBC acting as underwriter. The transaction, which upsized to $450mm, has a 3-year reinvestment period and a 1-year non-call

CLO Spreads:

During my most recent update, I highlighted that CLO debt had lagged the recovery experienced by other credit asset classes (IG, HY, Bank Loans). At the time (April 17th), JPM estimated that CLO BBBs and BBs were trading at a 750DM and 1500DM, respectively. At these levels, CLO BBBs had clawed back 23% of the 2020 wides while CLO BBs had clawed back only 18% [2]. Since, CLO BBBs have tightened to a 450DM and CLO BBs are now trading at a 935DM which equates to spread recovery of 77% for each from YTD wides.[1]

Higher loan prices have attributed to improved CLO metrics such as market value overcollateralization ("MVOC%"). The table below shows the 50th percentile CLO BB on 03/24/20 having a MVOC% of 83.2% compared with 99.2% as of 07/10/20. This translates to a CLO BB receiving 16% more of par back in a liquidation scenario. Tightening CLO spreads have also been attributed to a reduction in the pace of rating agency loan downgrades and improving CLO OC test levels.[3]

Historic Peak/Trough US BB MVOCs [3]

Time	Date	10th Percentile	25th Percentile	50th Percentile	75th Percentile	90th Percentile
Post-2008 Trough	1/2/2009	61.1%	64.0%	65.9%	69.0%	72.2%
2015/2016 Trough	2/24/2016	96.7%	98.5%	100.2%	101.9%	103.2%
2018 Peak	2/1/2018	106.0%	107.4%	108.3%	109.0%	109.4%
YE 2018 Trough	1/2/2019	101.8%	102.5%	103.1%	103.7%	104.1%
2020 Peak	1/22/2020	104.2%	105.4%	106.5%	107.5%	108.6%
2020 Trough	**3/24/2020**	81.1%	82.1%	**83.2%**	84.3%	85.5%
Current	**7/10/2020**	96.3%	97.7%	**99.2%**	100.7%	102.3%

1. Source: JPMorgan Research, "CLO Weekly" as of 07/20/20
2. Source: JPMorgan Research, "CLO Weekly" as of 04/20/20
3. Source: Morgan Stanley Research, "CLO Market Flash" as of 07/13/20

CLO Secondary Trading:

During June, US CLO bid wanted in competition ("BWIC") volumes increased to $5.7Bn which was a 50% increase from May. The average monthly BWIC volume over the past 2 years is $3.1Bn. Increased BWIC supply was driven by renewed interest in junior mezz. Trace volumes in IG CLOs rose by 27% to $14.6Bn compared to the trailing 2-year average of $7.5Bn.[(4)]

"The Importance of CLO Manager Selection – A Lesson from My Youth"

When I turned 16 years old, I had saved enough money to purchase a car to replace the 1979 Buick Regal my mother had so graciously provided me one year before. My grandfather really enjoyed cars, so I sought out his opinion since my expertise was limited to judging how well a car looked on the outside and how good the music sounded inside. When I began searching for the perfect car, I found a beautiful blue sports car with a twin turbo engine which I was certain would get me recognized by others (my ROI calculation at 16). My grandfather warned me that the turbo engine would be more trouble than it was worth and expensive repairs would certainly follow. He also reminded me that a car loses its appeal when it is overheated on the side of the road. Given that my balance sheet at the time was constrained, I took my grandfather's advice and found a different style car with a motor which would be easier to maintain. Ultimately, I had upgraded to a much better vehicle but not one which I would one day regret purchasing if conditions became more challenging. For those of you that may be curious or even nostalgic, I have included actual pictures of the two options I encountered below.

Option #1 Sports Car with Turbo Engine

Option #2 Less Sporty Car with Rotary Engine

This same lesson is relevant today as investors reflect upon their CLO manager selection process. Over the past several years, certain CLO managers have maintained higher weighted average spread (WAS) portfolios which have generated above-average CLO equity returns albeit with a higher level of risk (i.e. car w/turbo engine). Investors in these CLO managers likely celebrated their outperformance initially as default rates remained benign. Then 2020 happened and suddenly these riskier portfolios began to see significantly higher CCC downgrades and defaults. In certain cases, these CLOs failed their senior overcollateralization (OC) test which shuts off distributions to all subordinate debt and equity (i.e. turbo engine overheats and needs repair). It is during these more challenging times that a lower octane, less risky approach becomes more sustainable. This approach can be difficult to maintain during the "good times" as investors sometimes push managers to take more risk; however, the mood changes during periods where the credit markets face real fundamental challenges. In today's CLO market, investors with a more long-term cautious approach have been rewarded with continued distributions and a better outlook going forward.

4. Source: Morgan Stanley Research, "CLO Tracker" as of 07/10/20

CIFC CLO Manager Performance Update:
Having provided some context on CLO manager selection, I will take a moment to acknowledge the great work that CIFC's portfolio managers and research team have done navigating the current environment. As of June 30, 2020, CIFC manages 35 CLOs totaling $20.5Bn and is one of world's largest CLO managers.(5) CIFC managed CLOs did not violate overcollateralization tests during the Global Financial Crisis. During 2020, CIFC managed CLOs have not breached any overcollateralization tests or interest diversion tests. As a result, CIFC CLO equity investors have received 100% of their full distribution for each payment period during 2020 from all CLOs under management.(6)

To put some context around the level of outperformance achieved by the CIFC team, I have included the following summary from BofA research. BofA analyzed a sample of 900 CLOs with July payment dates that have reported thus far and found that 24% of all CLOs that paid in July are failing at least one ID/Jr OC test. A total of 16% of CLOs did not pay any interest to equity holders. In May reports, approximately 35% of all deals were failing their OC tests. (7)

CLO OC/ID Test Failures Across Deals (7)

OC Test Rating level	Failure Rate (%)	Current CCC (%)
AAA/AA breach	1%	17.2%
A breach	2%	15.9%
BBB breach	7%	15.4%
BB breach	**15%**	**13.6%**
B breach	**55%**	**14.3%**
Int Div Test breach	**20%**	**11.5%**
Not failing any test	76%	8.8%

CLOsing Thoughts

- Things we are watching closely during 2H20:
    - CLO downgrades – 95% of CLO tranches on Rating Watch are still under review. Thus far only 86 CLO tranches have been downgraded out of 1100 tranches placed on downgrade watch(8)
    - Impact of bank loan issuers migrating from CCC to default
    - The pace at which new issue CLO debt spreads tighten vs. bank loan spreads. The arb will remain challenged if CLO debt spreads remain wide compared with loan spreads
    - Impact and usefulness of CLOs with bond baskets and how these positions will trade vs. standard CLOs with only 1st and 2nd lien loans
- Be very wary when discussing CLOs with managers which say, "we do that too." Managing CLOs is not a side business that can be done effectively without proper focus and experience

5. Source: Kanerai, LCD, and CIFC data as of June 30, 2020.
6. Source: CIFC data, as of July 24, 2020.
7. Source: BofA Research, "CLO Weekly" as of 07/24/20.
8. Source: CITI Research, "US CLO 2020 Midyear Outlook" as of 07/07/20.

From CIFC

We welcome your comments and questions. Please feel free to contact me at jziegler@cifc.com or any member of our team at IR@cifc.com.

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