

# BARINGS

## STRUCTURED CREDIT

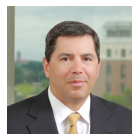
# Private Credit CLOs: 101

### INSIGHTS

A growing part of the broader \$1.3 trillion CLO market, private credit CLOs offer the potential for higher spreads relative to broadly syndicated CLOs—creating an interesting opportunity for long-term buy-and-hold investors.



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Private credit CLOs (also known as middle market CLOs) are generating a fair share of investor interest, and perhaps rightfully so given the market’s recent growth. At the end of last year, private credit CLOs made up roughly 11% of the broader \$1.3 trillion CLO market.<sup>1</sup> In 2023, \$27 billion of private credit CLOs were issued by twenty-eight managers, which represented over 20% of the total new issue CLO volume.<sup>2</sup> This trend is expected to continue, with private credit CLOs forecast to account for more than 30% of total issuance this year.<sup>3</sup> This is largely a reflection of the growth in private credit loans more broadly, a market that has increased in size to nearly \$1.7 trillion as companies have continued to seek non-bank financing as an alternative to the broadly syndicated market.<sup>4</sup>

Given the rapid expansion of this asset class and its projected growth ahead, a deeper analysis of the benefits of private credit CLOs, and how they compare to broadly syndicated CLOs, is essential for investors to understand.

**Figure 1: Private Credit CLOs vs. Broadly Syndicated CLOs**

	Middle Market CLOs	Private Large-cap CLOs	Broadly Syndicated CLOs
Market Size*	~\$110 B		~\$890 B
Avg. Tranche Subordination	AAA 42%, BBB 18%		AAA 37%, BBB 12%
Avg. AAA Coupon*	SOFR + 193 bps		SOFR + 143 bps
Deal Leverage	6–7x		10–11x
# of Obligor in the Portfolio	50–100	60–200	200+
Underlying Loan Borrower Size	EBITDA \$15–75M	EBITDA \$100M+	EBITDA \$100M+
Loan Weighted Avg. Spread	SOFR + 530–600 bps		SOFR + 350 bps
Loan Rating Type	Credit Estimates/ Opinions Assigned by NRSROs		Public Ratings Assigned by NRSROs
Weighted Average Loan Rating	B-		B/B-
Loans from 'B-' Companies**	74%		26%
CCC Bucket Limit	17.5%		7.50%
Loan Covenants**	The smaller the loan, the more likely it is to have maintenance covenants and more restrictive provisions		Covenant-lite loans are the norm (80% of the BSL loan market) along with looser provisions
# of Lenders per Loan	1–10		100+
# of Managers Who Issued in 2023	28		98

\*Source BofA. As of February 9, 2024. (AAA Coupon based on average from February 4, 2011–February 9, 2024)

\*\*Source S&P. As of January 22, 2024.

1. Source: BofA. As of January 5, 2024.
2. Source: BofA. As of January 5, 2024.
3. Source: JP Morgan. As of November 21, 2023.
4. Source: Citi. As of January 26, 2024.

## Defining the Market

### COLLATERALIZED LOAN OBLIGATIONS

A **collateralized loan obligation** (CLO) is an actively managed securitized product backed by a highly diversified pool of leveraged loans. CLOs provide an efficient, scalable way of investing in floating-rate senior secured loans while offering structural protection that has historically performed well through multiple credit cycles.

### BROADLY SYNDICATED LOAN CLOS

Broadly syndicated loan (BSL) CLOs are often created as an arbitrage trade to take advantage of the spread difference between the interest earned on a pool of loans (i.e., SOFR+350 bps) versus what a CLO has to pay its debt (i.e., SOFR+250 bps). This illustrative 100 bps of excess spread, i.e., the arbitrage, contributes to a possible double-digit return for the CLO equity tranche. Until recently, BSL CLOs accounted for more than 90% of the overall CLO market.<sup>5</sup> These traditional CLOs are backed by a highly diversified pool of over 200 leveraged loans from large (greater than \$100 million EBITDA), well-known borrowers—such as United Airlines, Virgin Media and Burger King—with robust financial reporting. The underlying loans typically have sub-investment grade credit ratings assigned by a Nationally Recognized Statistical Ratings Organization (NRSRO), such as S&P, Moody's or Fitch, with a typical weighted average rating between B and B-, and are distributed among a broad 100+ syndicated lender group. As a result, these loans are quite liquid and tradeable.

CLOs purchase roughly 60% to 70% of the loans in the broadly syndicated market, leading to reasonably healthy demand and a liquid secondary loan market.<sup>6</sup> This liquidity allows for active portfolio management of a highly diverse pool of loans. As such, BSL CLOs can be managed to improve credit quality or trade risk. The documentation for broadly syndicated loans has evolved due to this increased demand for loans. Consequently, these loans are primarily viewed as “cov-lite,” meaning they have relatively few or less meaningful covenants. While this may give stressed companies more latitude to work through operating issues, it may also lead to lower long-term recovery values for the underlying problem loans. As a result, active management is key in BSL CLOs.

**From a CLO investor point of view, BSL CLO liabilities tend to have higher spreads relative to other similarly rated asset classes, while employing structural protections that provide investors with additional credit support compared to the underlying pool of loans.** For example, AAA CLOs currently earn around SOFR+1.50% and typically have structural subordination of around 37%.<sup>7</sup> This level of subordination means AAA tranches are extremely risk remote investments, assuming historical recovery rates, as they could theoretically withstand three-fourths of the underlying collateral pool defaulting and still pay out in full.<sup>8</sup> CLOs also have self-healing cash flow diversions built into the structure to divert distributions to waterfall debt repayments, further protecting senior tranches. Notably, BSL CLO tranches are quite liquid given the size of the market and can be easily traded.

5. Source: Morgan Stanley. As of September 13, 2023.

6. Source: BofA. As of January 11, 2024.

7. Source: Barings.

8. Source: Moody's Annual Default Study. As of March 2023.

## PRIVATE CREDIT CLOS

### Middle Market CLOs

Private credit CLOs have been in existence since the 1990s, longer than some may realize, but have more commonly been referred to as middle market (MM) CLOs. These CLOs are often created as a financing trade where asset managers who have directly originated loans look to the CLO market to move assets off their balance sheet to free up capacity. Core middle market CLOs are typically backed by more concentrated pools of loans to mid-sized companies with EBITDA values between \$15 and \$75 million.<sup>9</sup> These typically unrated or privately rated loans are syndicated to a smaller lending group. As a result, these pools of loans are often less liquid and rarely traded in the secondary market.

On the positive side, **middle market loans offer more control to the lender group through tightened credit agreements and more covenants.** These covenants allow lenders to work more directly with a company’s management team and step in earlier in the process when signs of distress occur—which can ultimately lead to improved recovery rates. Additionally, many of these loans are backed by private equity sponsors who offer added forms of support for borrowers in times of distress via documentation amendments and/or capital infusions that can provide further protection for lenders. Finally, because these loans are directly originated, regulations require the CLO manager to hold 5% of the deal notional to have “skin in the game” and align interests with investors.

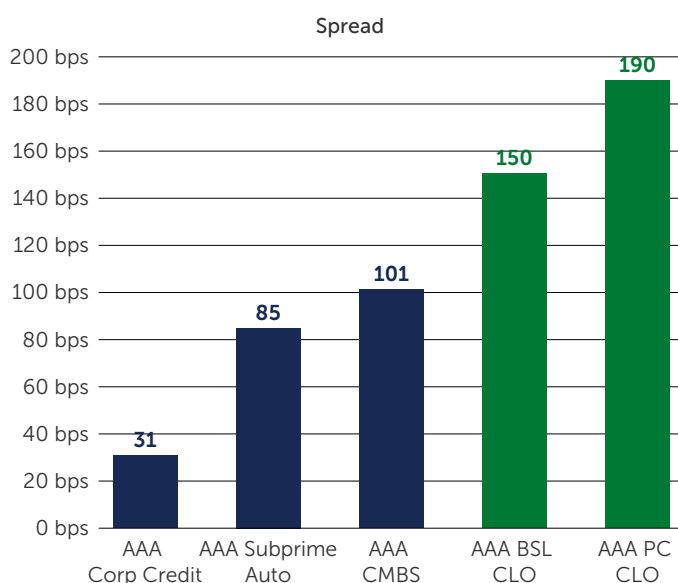
Just as middle market loans typically provide an illiquidity premium to broadly syndicated loans, middle market CLO tranches have also historically offered a significant spread pickup—of roughly 40 to 100+ bps—compared to their BSL counterparts (**Figure 2**). This premium is in addition to the increased subordination levels. That said, given the smaller size of the market and less liquid nature of the loans, a deep understanding of middle market CLO managers’ long-term investment style and risk profile is critical for CLO tranche investing.

### Private Large-Cap CLOs

Whereas middle market CLOs focus on smaller loan issuers, the broader private credit CLO universe also includes larger-cap private loans. Corporate issuers may choose the large-cap private credit market for ease and certainty of execution, and typically are willing to pay a higher spread with tighter covenants for this convenience. **Similar to middle market loans, these larger private loans typically provide tighter covenants and documentation relative to their BSL counterparts.** We saw corporate issuers choose this path over the past few years as rates rose, credit standards tightened, and BSL CLO formation contracted. Although these loans are larger and more liquid than typical middle market loans, they are not as actively traded as BSL loans in the secondary market given the lower transparency on ratings.

While large-cap private credit CLOs are essentially a variation on traditional smaller middle market CLOs, they typically still represent some form of a financing trade for managers. Again, a strong understanding of a manager’s risk tolerance and strategy are important criteria for large-cap private credit CLO tranche investing.

Figure 2: Spread Differential Across AAA Tranches



Sources: Barclays; Credit Suisse. As of January 31, 2023. BofA CLO spreads as of February 9, 2024.

9. Source: Barings.

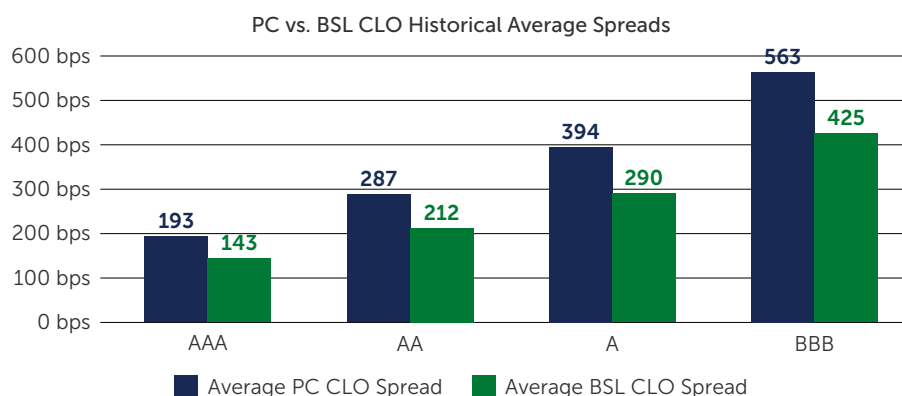
Further evolution of the CLO market may include bespoke hybrid CLO structures that blend portfolios of broadly syndicated loans with allowances for certain amounts of private credit or other lightly syndicated loans. These hybrid CLOs could benefit from diversity of assets across public and private markets while providing spread pickup and potentially higher returns compared to traditional BSL investing.

## Benefits of Private Credit CLOs

### SPREAD PICKUP AND ELEVATED CREDIT ENHANCEMENT

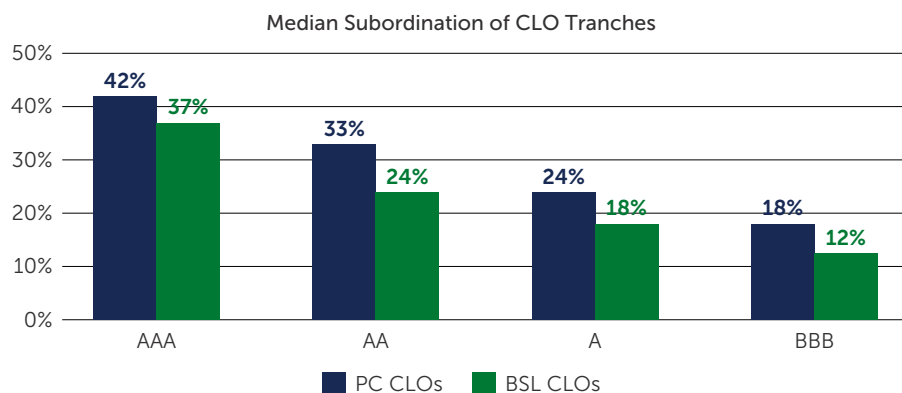
The combination of increased spreads (Figure 3), elevated subordination levels (Figure 4), and stricter underlying loan covenant protections present an interesting opportunity for buy-and-hold investors who can trade liquidity for yield pick-up. Further, while the liquidity of BSL CLO tranches is greater than that of PC CLO tranches, the latter has seen some uptick in secondary activity which could presumably continue to improve as this market matures.

Figure 3: Attractive Spread Pickup



Source: BofA. As of February 9, 2024. Historical averages from February 4, 2011 to January 26, 2024.

Figure 4: Elevated Credit Enhancement



Source: Barings. As of January 31, 2024.

### LESS VOLATILITY

Private credit loans have historically shown less volatility relative to broadly syndicated loans—which is to be expected given their less liquid nature.<sup>10</sup> This reduced pricing volatility translates into lower investor volatility as well, whether through direct investment or through CLO tranche investing.

### RATING STABILITY

PC CLOs have historically shown relative rating stability in periods of volatility. For example, during the pandemic, based on the universe of CLOs rated by S&P, only seven MM/PC CLO tranches (1.3%) experienced a downgrade compared to 568 downgrades (15.0%) experienced in BSL CLO tranches (Figure 5).

## The Importance of Fundamental Analysis in Evaluating Private Credit CLOs

Investing in private credit assets requires strong fundamental analysis of not only the overall credit market, but also the collateral manager, for a number of reasons. First, as the market for private credit loans is less liquid and transparent, it is important to work with an experienced team to evaluate current credit trends and metrics within the broader credit markets.

In addition, **as a PC CLO tranche investor, the importance of the CLO manager is further emphasized in private credit CLOs as the manager originates the loans**, in contrast to the BSL market where the manager is not the originator. Understanding the credit and

investing philosophy of the originating team is of utmost importance in grasping a manager’s portfolio profile and risk tolerance. Having a deep bench to compare and contrast these analytics and track trends over time will pay dividends when investing in private credit CLOs.

Finally, very few private credit loans are publicly rated. As a result, rating agency assigned ratings are not as easily available to investors. However, many private credit loans are assigned ‘credit estimates’ or ‘credit opinions’ by established rating agencies, which can mimic an actual BSL credit rating. These estimates are based on reviews of audited financial statements and provide a point-in-time credit opinion of the borrower. Credit estimates are denoted with a lowercase versus uppercase letter to distinguish them from public ratings (eg. b- versus B-).

Private credit estimates tend to skew lower, on average, relative to BSL loan ratings, again underscoring the importance of fundamental analysis in PC CLO investing. Roughly 74% of private credit loans in PC CLOs land in the b- category versus 26% in BSL CLOs.<sup>11</sup> Private credit CLOs can also accommodate a higher portion of CCCs and have a larger bucket available for CCC downgrades—typically 17.5%, compared to 7.5% in BSL CLOs. Structurally, the PC CLO accounts for all of this, and provides for additional levels of tranche subordination, which gives investors additional protection against collateral losses. As a result, **private credit loans have historically boasted a lower default and higher recovery rate compared to broadly syndicated loans.**<sup>12</sup>

Figure 5: S&P U.S. CLO Tranche Rating History (2020–Q4 2023)

CLO Type	Total Tranches	Downgrades	Upgrades	Comment
BSL CLOs	3,786	568 (15.0%)	422 (11.1%)	464 Downgrades in Q3 2020
MM CLOs	553	7 (1.3%)	34 (6.1%)	7 Downgrades in Q3 2020

Source: S&P. As of January 26, 2024.

10. Source: Barings. As of February 13, 2024.

11. Source: S&P. As of January 22, 2024.

12. Source: BofA. As of December 1, 2023.

## Key Takeaway

Private credit CLOs present an attractive investment opportunity in a growing market segment. Both the loans and CLO structures provide investors intriguing enhancements worthy of additional diligence. Understanding the nuances of each platform that originates private credit loans, as well as their CLO management capabilities, will be imperative for investors who want to enter the market.

Barings, as an issuer of more than \$3 billion of private credit CLOs—the first of which was completed in 2017—and as an investor in over \$2 billion PC CLO tranches since 1999 via our third-party Structured Credit investment team, is uniquely positioned to provide unparalleled experience and resources for investors who want to access and learn about this compelling asset class. Our CLO knowledge is bolstered by our \$48+ billion **Global CLO Platform**, which has managed and invested in the CLO market for over a quarter of a century through multiple market cycles—and this is combined with our 30+ year old Direct Lending platform, which showcases a strong proven history of investing in middle market companies across the globe.



Source: Barings. As of December 31, 2023.

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