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Big triple C buckets helped mid market CLO issuers in 2020 and the trend is for even bigger allowances this year

2020 could be described as a year of introspection. Due to lockdown restrictions, we remained closer to home. This provided time to focus on ourselves — be it through improving our fitness, binge-watching Netflix or exploring new hobbies.

The same conditions held true for CLO managers. With little to no new CLO issuance, investor presentations or industry conferences to occupy our time, we became focused on our portfolios and preserving the value of underlying collateral. There are two primary topics that occupied our time and thoughts: triple C buckets and their corresponding impact on over-collateralisation cushions.

As most assets in middle market CLOs are not publicly rated, CLO managers must obtain credit estimates from the agency that rated the CLO. These require annual refreshes (approximately 1,300 issuers have outstanding credit estimates).

As a result, mid market CLOs did not experience the massive wave of downgrades in April and May that were experienced by broadly syndicated loan (BSL) CLO managers. Instead, they saw a more gradual swing in ratings throughout 2020. In fact, ratings on some assets have recently been refreshed for the first time since the coronavirus pandemic began.

Mid market CLOs generally have more generous triple C buckets than BSL CLOs, as credit estimates tend to be more conservative than public ratings. But many mid market CLO managers exceeded their triple C buckets in 2020 and by early November average triple C exposure in mid market CLOs reached approximately 18.5%.

> Three CLOs issued in 2021 have included triple C baskets of 20%

Liability pricing benefits managers

2021 CLO issuance has so far met expectations, with managers eager to take advantage of favourable liability pricing. They are also requesting larger triple C buckets, and three CLOs issued in 2021 have included triple C baskets of 20% —a welcome enhancement from an issuer's perspective.

CLO managers are perpetually focused on their OC ratios, which are intended to measure the credit strength of the underlying collateral of their portfolio. But that preoccupation became even more intense during 2020, when the rating agencies were required to reassess companies through a covid lens.

As credit estimates were refreshed, CLO managers asked: "Will this get a triple hook?" What they wanted to know was whether the asset would be added to their growing triple C bucket and would potentially lower their OC cushion (once the triple C bucket is exceeded, the manager must carry the excess principal amount at the lower of 70 or market value).

Despite the impact of credit stress experienced in 2020, very few mid market CLOs reported junior OC test failures. Standard & Poor's calculated only 5% of middle market CLOs reporting a junior OC breach versus roughly 25% of BSL CLOs.

2020 performance was generally good

The good news was that, for the most part, mid market CLOs performed well during the pandemic. The structure of mid market loans (including financial maintenance covenants and monthly financial statement requirements) gives mid market lenders the chance to quickly spark dialogue with borrowers and sponsors when financial performance starts to weaken. This leads to timely measures being taken to address borrower concerns, often resulting in sponsor support in the form of enhanced liquidity or liquidity guarantees in exchange for lender concessions.

When Q4 brought a rebound in mid market leveraged loan issuance and an outlook of decreasing liability pricing, CLO managers were anxious to put 2020 behind them and focus on new opportunities. In fact, many projected a record year for mid market CLO issuance, with guestimates of $10-15 billion. While liability pricing has decreased as expected, competition for assets has intensified. As a result, the mid market space has seen pricing fall below pre-covid levels, with some borrowers even seeing reverse-inquiries from hungry lenders to provide structures with lower pricing and looser terms.

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