A decisive inflection point for CLOs

When official Default Rates understate the real credit risk.

Leveraged loans in Europe have come under renewed pressure since the beginning of second week of September, reflecting a combination of macroeconomic headwinds and increasingly pronounced sector-specific concerns. The macroeconomic drivers are known: renewed uncertainty surrounding France(from my CLO analysis performed on portfolios I received from interested parties, I have yet to come across a comprehensive, transparent list of credits, prepared by the managers, issued under French jurisdiction or borrowers with a good percentage of earnings generated in France), rising oil and gas prices and their inflationary implications, alongside the resulting interest rate volatility across European government markets. While sectors with greater exposure to energy costs and inflation are naturally bearing the brunt of these developments, individual issuers have also experienced outsized price movements driven by deteriorating fundamentals (carried forward over multiple quarters) and sector-specific concerns (recent and long standing). The telecom sector is a case in point in October, with the latest developments surrounding Virgin Media and VodafoneZiggo highlighting the vulnerability of individual credits (actual or just perceived, but both amplified by prevailing negative market sentiment). Year to date, European leveraged loan prices are on average, as measured by the ELLI, are approximately 3–4 figures below their levels at the beginning of the year, although certain weak issuers and sectors have significantly underperformed the broader market.

HY bonds followed a similar trajectory.

More concerningly, the prospect of rating migration among weaker B-rated names into the CCC category, combined with a growing proportion of loans trading below 90 and 80, is creating an increasingly challenging environment for CLO equity and mezzanine investors. The breadth and severity of the current market deterioration inevitably bring back memories of 2022, when Central Banks embarked on an aggressive monetary tightening cycle and leveraged loans together with equity valuations came under pressure.

While CLO equity has its own distinctive risk-return profile, and is typically held by specialised investors accustomed to absorbing substantial volatility and principal risk (are we sure the captive equity funds understand this? Are third party investors better prepared?), the current loan environment represents a particularly demanding test for mezzanine investors. The combination of rating migration, stressed-distressed asset valuations and deteriorating collateral quality is exposing structural vulnerabilities that have rarely been tested throughout the CLO 2.0 era, apart from short periods of market dislocation such as Q1 2016, Q4 2018, COVID, and the final months of 2022.

The implications for CLO mezzanine are becoming increasingly tangible. In several transactions, the additional default capacity available before principal impairment reaches the mezzanine tranches has fallen to low levels, with breakeven default rates around 2% in certain structures for single Bs. Elsewhere, collateral pools have already experienced substantial deterioration in underlying credit quality. Where, based on "valuation and mark to market", B-rated tranches have already suffered principal impairment (judging from MVOC levels), further deterioration in the underlying loan portfolios could accelerate the transmission of losses up the CLO capital structure, eventually bringing BB-rated tranches into the firing line. What initially appears to be an idiosyncratic problem confined to the B notes could therefore evolve into a broader capital structure issue, particularly if defaults, debt haircuts in LMEs, rating migration and weaker recovery prospects begin to reinforce one another.

Against this backdrop, investors should pay particular attention to the growing dispersion in performance across CLO managers, reflecting differences in portfolio construction, underwriting discipline, credit selection and active portfolio management (I stress the importance of talking with the portfolio manager). Equally important is the flexibility embedded in individual CLO documentation, particularly the mechanisms available to cure deteriorating overcollateralisation and interest coverage tests, and the ability to redirect cash flows following a potential breach. Regarding vintages, the distinction between transactions still within their reinvestment period and those that have entered their amortisation phase will also become increasingly relevant, given the different degrees of flexibility available to managers to trade, rotate and actively manage their portfolios. The proximity of call dates, together with the feasibility of refinancing or resetting individual transactions, adds another layer of complexity to the analysis. At the asset level, particular attention should be paid to exposure to CCC-rated borrowers, the prices, distressed credits and sectors facing structural disruption, as well as portfolio concentration, correlation, rating migration, and the underlying resilience of obligors. Finally, the assumptions underpinning portfolio stress tests—particularly default rates, recovery values—will be critical in assessing the capacity of individual

structures to absorb further collateral deterioration without triggering principal losses across the capital structure.

Ultimately, the next phase for the CLO market may be less about the absolute direction of loan prices and more about the resilience of individual CLO structures. I wrote in this text about the decisive differentiating factors; for mezzanine investors in particular, the margin for error in their investments is narrowing. Bottom-up CLO analysis and transaction-specific stress testing are essential for navigating the next phase of the credit cycle.

One point I often repeat: CLO structures with greater flexibility are better positioned to withstand extended periods of market stress. The timing of portfolio adjustments is therefore critical. By contrast, rigid structures, particularly those with constrained asset pools and depressed NAVs, risk becoming increasingly difficult to manage. Once trapped in those positions, the ability to rebalance and restore "portfolio health" becomes more limited, potentially prolonging both the cure process and the subsequent recovery.

With the elements and numbers under our control, I invite therefore to review the discount margins (DMs) of the Single-B and Double-BB tranches today, comparing them against 2022 levels. Assess the potential upside and downside, including spread movements, current valuations, credit quality and relative investment attractiveness.

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