CLOs: A Bounce, a Decline, the Math

Beyond the usual considerations.

Much of the recent research on CLOs has focused on portfolio dispersion, the disruptive potential of Artificial Intelligence, particularly for software and technology-related borrowers, and whether these risks are adequately reflected in CLO valuations, most notably in the mezzanine tranches. The IG tranches did not register so far any relevant impact from the credit spreads repricing and volatility. I set aside the equity component for the purposes of this analysis, given its specific characteristics and risk profile.

Having spent considerable time analysing the European CLO market, including existing portfolio compositions, resets, and warehouses, I believe the debate is overlooking a much more immediate and potentially consequential problem. The current focus is too narrow and, in my view, places disproportionate emphasis on the next potential source of disruption, despite the significant uncertainty surrounding its timing and magnitude. Greater attention should instead be paid to the credit deterioration already unfolding across parts of the leveraged finance market.

The most significant vulnerabilities in the high yield space remain concentrated in companies characterised by excessive leverage, approaching refinancing requirements that do not appear manageable with materially lower enterprise valuations than some years ago. The causes of deterioration may differ from one borrower to another, but the underlying consequences are remarkably consistent: weakening credit metrics, diminishing financial flexibility-terminating in rigidity-and capital structures that are becoming increasingly difficult to sustain amid revenues pressure, negative free cash flows and shrinking balance-sheet liquidity.

At this stage, the issue is no longer primarily an AI story, but rather a leveraged finance story, with implications that extend well beyond short-lived episodes of market volatility. In my view, the focus of the debate should therefore shift away from the performance of any single sector, such as software and technology—which remains particularly relevant for certain asset pools that may view current market conditions as an attractive opportunity to maintain or increase

their exposure—and towards the more fundamental dynamics of margins and cash flows.

One aspect that deserves considerably more attention is the behavior of Private Equity Sponsors. There is still limited visibility-in some cases evident divergence-on how Sponsors intend to approach their weakest portfolio companies, how much additional equity they are genuinely prepared to commit and, crucially, where they will eventually draw the line and hand the keys to creditors. Sponsor support is often implicitly incorporated into recovery assumptions, but willingness to provide additional capital should never be confused with the capacity or intention to do so. In an environment of lower enterprise valuations, high interest rates, and increasingly constrained exit opportunities, the distinction could prove decisive for eventual recoveries (I have expressed multiple times my negative view on the unsecured debt of many European companies).

Much as I highlighted the implications of declining portfolio WAS on the cash distributions to CLO equity investors more than 18 months ago, I continue to see mounting vulnerabilities in the single-B tranches, with the potential for deterioration to extend into other mezzanine paper. These developments should be considered alongside the evolution of portfolio par and MVOC, rather than in isolation. Here I deliberately bring together the two sentences concerning the low returns on equity positions and the sound condition of the capital structure. Indeed, at a certain point, the CLO PM may decide to cure the relevant tests by diverting cash flows and accelerating the amortisation of the AAAs. However, the extent to which management pursues such remedial action ultimately depends on the pressure exerted by equity holders and the extent to which their interests influence managerial decisions on asset pools and on other investors.

I am unconvinced that the current deterioration is merely cyclical or that the affected portfolios can be readily or easily repaired. There are several reasons for this, none of which can be considered in isolation. The real concern is that these "vulnerabilities" are interconnected, reinforcing one another and creating the conditions for stress to propagate further down the chain, with potentially much wider consequences.

First, in a number of CLO vehicles, we are no longer dealing with a mark-to-market issue. The deterioration is fundamental and has already occurred. The decline in collateral quality cannot simply be attributed to wider bid-offer spreads, temporary illiquidity or a general repricing of risk. Borrowers have experienced genuine deterioration in operating performance, leverage, cash generation and refinancing prospects. In these circumstances, lower market prices are not simply reflecting a decompression of credit spreads or a

temporary loss of investor confidence; the low marks are increasingly reflecting a deterioration in the underlying credit itself. A recovery in secondary-market sentiment will not necessarily translate into a recovery in credit quality or in prices for the weak names that remain, rightly, out of favor.

Second, the discrepancy between reported portfolio valuations and executable market prices remains in my opinion, a material concern. Across a number of CLO portfolios, underlying loans and bonds continue, when this is possible due to the CLO docs, to be carried at or close to par, despite trading at significantly lower levels in the secondary market. This creates a disconnect between reported portfolio metrics and the economic value of the collateral. More importantly, it risks overstating the resilience of the underlying asset pools and understating the extent of possible portfolio impairment. In a more stressed environment, the adjustment from reported valuations to executable market prices could be rapid, with direct implications for adjusted portfolio par, overcollateralisation tests and the protection afforded to junior liabilities. The question is not simply whether assets are marked conservatively enough, but whether the reported numbers adequately capture the credit/economic reality of the collateral.

Third, the assumption that managers can rebuild par through active portfolio management deserves much greater scrutiny. In theory, portfolio rotation, selective purchases and barbell strategies provide mechanisms to recover par. In practice, the current opportunity set is considerably less attractive. Purchasing discounted assets may help restore par, but often involves taking on additional fundamental credit risk. Meanwhile, genuinely resilient credit names continue to trade at prices that offer limited upside. Managers are therefore facing an increasingly difficult trade-off between buying quality at expensive levels and acquiring cheaper assets where the probability of further impairment remains substantial. Documentation constraints, portfolio eligibility criteria and other structural limitations further restrict the available options in certain names. The theoretical ability to rebuild par should not be mistaken for the practical ability to do so without compromising the total portfolio quality.

There is also a question of execution, and this is where I remain particularly sceptical about the assumptions embedded in some market analysis. Rebuilding par across 15–20 individual positions is not a straightforward exercise, particularly when exposures are relatively small, secondary-market liquidity is limited and the number of genuinely attractive opportunities is shrinking. It requires good credit selection and disciplined execution. I find it difficult to assume that managers will suddenly demonstrate the ability to execute complex portfolio-rebuilding strategies focused on convexity profiles, when some PMs have been unable or unwilling to reduce exposure to just four or six individual credits that have lost 25–30 figures in secondary over the past

8-12 months. The contrast between "smart pickers and big losers" is so unappealing that I would prefer to remain neutral; the potential upside compared with the past track record is unconvincing. There is a substantial difference between having the contractual flexibility to manage a portfolio and demonstrating the investment judgement and execution capacity to use that flexibility effectively. In stressed markets, the latter matters considerably more than the former.

Taken together, these factors suggest that the challenges facing parts of the European CLO market are more structural than cyclical. They also raise questions about the extent to which current valuations and market spreads of CLO notes adequately compensate investors for the risks embedded in the underlying collateral.

The debate should therefore move beyond whether CLO managers can navigate dispersion, whether AI-related risks are sufficiently priced into software exposures or whether mezzanine tranche levels offer adequate compensation for technological disruption or credit defaults. These are legitimate considerations, but they should not distract from the more fundamental questions: how much of the underlying collateral has already suffered permanent impairment and haircuts; how much additional deterioration can the portfolios absorb, and how realistic are the assumptions surrounding par preservation, par creation, and recovery?

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