

## European CLOs

Last week, I attended the Opal European Conference and had the opportunity to hear the perspectives of CLO managers and investors across several panel discussions.

The overall sentiment towards European CLOs was cautiously optimistic — hardly an unexpected outcome at a conference of this kind. Beneath this broadly constructive tone, however, increasingly differentiated dynamics are emerging across the capital structure. Relative value is being driven less by broad asset-class sentiment and more by tranche-specific credit characteristics, collateral composition, structural protections and investor demand.

Investment-grade tranches of CLOs continue to offer attractive value for institutional investors, supported by their position in the capital structure and the subordination available to absorb collateral losses. Potential demand catalysts include greater participation from insurers from 2027 onwards, subject to Regulatory developments, capital requirements and investment mandates, as well as broader retail access through CLO-focused ETFs. Whether these developments translate into sustained incremental demand will depend on implementation, product design and the relative attractiveness of CLO spreads versus other fixed-income opportunities. For insurers that have largely been absent from the asset class for an extended period, re-engagement will also involve a learning curve, as investment teams (and senior managers) rebuild their expertise in CLO structures, risk assessment and portfolio management.

The mezzanine segment of CLOs presents a more nuanced picture, with significant dispersion in discount margins reflecting differences in collateral quality, structural protection and the distribution of risk across transactions. This is particularly evident in B-rated tranches, where variations in market-value overcollateralisation (MVOC), collateral composition and underlying portfolio resilience can materially alter the risk-return profile of individual securities. Taking the analysis to the extreme, even vehicles of the same vintage can encompass materially different levels of downside risk, making tranche selection and transaction-level analysis increasingly important.

CLO equity continues to attract investor interest, although the high-double-digit returns historically associated with some of the strongest-performing transactions should no longer be considered a representative baseline. Expected returns are highly deal-specific and depend on the cost of liabilities, the spread differential between assets and liabilities, default and recovery assumptions, reinvestment opportunities and the timing of cash flows. The attraction of equity lies partly in its residual (from a capital stack perspective and waterfall view) cash-flow profile and its convexity and

optionality in response to changes in collateral spreads, financing costs and portfolio performance.

In my view, assessing the relative value of mezzanine tranches and equity pieces trading at discounts or premiums to the NAV of their underlying loan portfolios requires considerably more than a broad brush assessment or a comparison between market prices subject to stress analysis and current collateral marks. The key question is whether the observed discount margin at which a single-B CLO position trades (I am taking in this examination the lowest tranche but it can be expanded to other notes), adequately compensates investors for the risks embedded in the collateral pool, the transaction structure and the instrument itself. This requires a granular assessment of collateral tail risk, including single defaults or clustering, recovery uncertainty, sector and obligor concentrations, actual and projected rating migration, and the potential correlation of losses under stressed conditions. Portfolio diversification and composition are equally important. For example, a barbell portfolio combining stronger, more resilient credits with weaker, more vulnerable obligors, may exhibit a risk distribution that is not adequately captured by average ratings or headline portfolio metrics. The distinction between apparent diversification and genuine resilience under stress is particularly relevant when assessing downside scenarios. Structural protection also deserves close scrutiny, including current and projected OC/IC cushions, sensitivity to par erosion arising from trading activity (or real losses generated from collapsed names or aggressive LME), and the potential for coverage-test breaches to redirect cash flows away from junior liabilities and equity. Equally important is secondary-market liquidity, including market depth, executable bid levels and the ability to exit a position under adverse conditions. The quoted market price may not fully reflect the execution value of unwinding a position when liquidity deteriorates.

Another important dimension, raised during one of the conference panels, is transaction documentation and, more specifically, the manager's approach to interpreting and exercising the discretion it provides. The precise language governing investment criteria following the reinvestment period, trading flexibility, and the management decision of reinvestment and call periods can materially influence the allocation of value across the capital structure (this already happened in 2022). Documentation cannot be assessed independently of the manager responsible for implementing it. The manager's incentives, approach to liability management, refinancing decisions and trading strategy can all affect the timing and magnitude of cash flows ultimately realised by investors. In this respect, contractual flexibility is not simply a structural feature; its economic value also depends on how it is exercised in practice.

The ELLI index, CCC exposure and the proportion of collateral trading below 90 or 80 cents on the euro remain useful reference points, but none is sufficient on its own to establish the intrinsic value of a collateral pool or the relative value of a CLO tranche. These indicators must be considered alongside the severity and persistence of credit deterioration, the distinction between temporary market dislocation and fundamental impairment, expected recoveries (my view on some loans and SUNs have been clear

in my posts and in meetings with investors), default timing and the potential for correlated losses. The relevant question is therefore not simply how much distressed or lower-rated collateral a portfolio contains, but how those exposures are likely to evolve, how losses (even from trading activity as I said above) would propagate through the capital structure and whether the market price adequately compensates investors for those risks.

My view remains that European CLOs offer selective opportunities, but the current investment environment is challenging and demands rigorous, deal-by-deal analysis and discussions with CLO PMs. Underlying credit names today are behaving differently from those observed in previous stress episodes and market cycles, making historical precedents useful but potentially misleading reference points rather than reliable templates. In this environment, the ability to distinguish temporary price dislocations from structural credit deterioration, and genuine value from inadequately compensated risk, becomes important.

As you will have noticed, I have deliberately avoided considerations based on whether a platform is new or seasoned, the "perceived quality" of its people, or the availability of captive versus third-party equity. These characteristics do not, in themselves, explain the quality of a portfolio, the discipline behind its construction, or the ability to navigate the current challenges facing the CLO asset class. The evidence accumulated over the past two years challenges the prevailing narrative: some major platforms execute multiple deals annually and continue to attract capital without necessarily demonstrating superior portfolio quality or stronger performance in equity distributions.

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