CONFERENCE
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Authors
Antonin Golman
Associate Director – Structured Finance Solutions

Domitille de Coincy
Sr Director – Structured Finance Solutions

Contact Us
Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

Moody's European CLO Conference 2024

Our inaugural European CLO Conference took place on 1 February 2024, in London, bringing together over 100 industry professionals. Arrangers, collateral managers, and investors gathered for an afternoon of insightful market-focused panels. Looking back on 2023, Annabel Schaafsma - Managing Director, Moody's Investors Service - outlined "*a year of low growth during which an economic recession was averted, defying our gloomier forecasts*". The outlook is cautiously optimistic with the CLO market's performance depending largely on the interest rate environment. The current economic environment has given collateral managers some encouraging signs with profitability returning to various sectors. Retail industries have managed to pass on inflation pressures gradually and successfully to their end consumers in recent months.

In the past year, arrangers have leveraged liability structural features to address investor demand and support steady issuance volumes. Regarding collateral pools, while defaults and Caa exposures increased in 2023, senior and junior OC cushions remained at comfortable levels insulating investors' cash flows. The WARF of amortizing CLOs rose towards the 3,000 level throughout the past year while the WARF of deals still in reinvestment period diverged down in the same time period.

The start of 2024 shows encouraging signs for the European CLO primary market with Aaa spreads tightening to 150 basis points for two transactions issued in January. Interest rates levels continue to be viewed as one of the key factors for the direction of CLO trading in 2024. Price distortions observed in the secondary market tend to produce attractive investment opportunities for senior and mezzanine tranche investors. In comparison, the primary market was more homogeneous although it benefits from the absence of execution risk associated with bid submission. As fixed income markets regain their appeal, Aaa spreads will need to widen this year to retain investors. Highly regulated banks facing acute internal and external scrutiny are particularly attentive to these movements.

It is expected that this year will see an increased number of refinancings, particularly from deals of the 2022 vintage due to spread tightening. In this context, managers who have built up par have the opportunity to push cash flows to equity tranche holders. High overcollateralization cushion levels should protect cash flows, but risks to equity holders remain. There are fears that recoveries will surprise to the downside. Hence, careful collateral pool selection and position sizing will be key for investors at the bottom of the capital structure. As Philippe Jodin – Partner, Alegra – puts it: "Credit quality remains our key focus for the year ahead - Credit, credit, credit". On the bright side, lender on lender violence in Europe is deemed unlikely due to the robust nature of business relationships in the sector. In this context, different collateral manager strategies are observed in fixed rate securities allocation within portfolios. Some use the bucket sparingly to ensure selectiveness, while others prefer a more extensive exposure ensuring diversification and returning higher yields.

The rise of technology and innovative approaches to the CLO market continue to transform the asset class generating interest. As Vitaliy Kozak – Chief Product Officer, Octaura – outlined, CLO traders have historically faced challenging and time-consuming processes. Octaura aims to address these pain points with the launch of an electronic trading platform for leveraged loans and CLOs.. Max Flugel – Portfolio Manager, LGT – indicated that for investors, "an efficient trading platform that significantly increases the speed of CLO trade execution would be a game changer for the space".

The start of European indices, such as the Total Return Index by PSL to launch later this month, was broadly perceived as a welcome development which will enhance transparency and help drive investments into the space. In addition, as this market matures, a standardized and simplified access to data will be pushed by investors vested interests. Concerning collateral managers, the development of a trade optimizer within Moody's Manager Module was mentioned as a considerable efficiency gain for the adjustment of CLO collateral pools. In addition, while the rise of machine learning in the space should improve the speed of documentation review, reporting and investment monitoring, the use of AI for decision-making appears further away. The conversation was illustrated by an extract of the following AI-generated CLO poem shared during a panel:

CLO Poem written by AI

In the world of finance, a unique creature
A CLO is born, with loans as its feature
A pool of loans bundled together in kind
Investors seeking performance, it's their hope,
But outcomes may vary, they must learn to cope.

But CLOs are complex, with loans that vary
So CLO managers come, diligent and wary
Selecting loans with care, analyzing risk and return
Fine-tuning the pool, ensuring a stable churn

Dividing them into tranches of seniority
Each with a different level of priority
Investors purchase the tranches they desire
With performance tied to the loans, they do aspire

But CLOs aren't always smooth sailing, we must note
Sometimes loans default, and investors may fear
The risk they took on, may now become clear.

Risk and reward, a tradeoff they must weigh
As CLO managers work, day by day
Ensuring the loans remain healthy and sound
So the CLOs performance stays stable and profound.

Some say CLOs are risky, with loans that may sour
But with CLO managers, risk they can devour
Investing in CLOs is unique, with complexities abounding
Thanks to CLO managers, in finance grounding.