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CLOs can survive defaults, but it could be death by triple Cs

by **Hugh Minch**

Covenant deterioration in the leveraged loan market has caused sleepless nights for CLO managers who worry that when defaults start to rise, recovery rates will be lower than in past downturns. But market participants are expressing concern that ratings, rather than defaults, pose a greater risk to the market.

"One of the questions we debate with investors is how quick will the ratings agencies be in this cycle given previous experience in the mortgage market," said Rebecca Dorrian, managing director at Morgan Stanley, speaking at the Creditflux CLO Investor Summit in November. "Could they be faster than they have been historically, in terms of moving on downgrades?"

The fear reflects the fact that the number of loans in CLO portfolios rated B3 or B- rose this year (see pages 26-27). These are loans that are only a one-notch downgrade away from becoming triple Cs — and when enough are downgraded, CLOs will quickly become forced sellers of these assets.

Loan investors fear that ratings agencies, stung by accusations that they were too slow to move during the last financial crisis, will move to downgrade too quickly.

Loans could be downgraded to triple C if the issuer is stressed but not at risk of default. "In a CLO you have to monitor the ratings of loans in the portfolio," says Thierry de Vergnes, head of acquisition debt funds at Amundi Asset Management. "There's less risk of default because of a covenant breach now, but where CLOs get hit is ratings: the ratings agencies are still watching."

According to a research paper published by Wells Fargo analysts on 1 November, loans rated B3 or B- make up 11 to 15% of CLO portfolios, in addition to 4 to 5% that are rated triple C (CLO triple C buckets typically constitute about 7.5% of the portfolio).

"If half of the B3 loans were to be downgraded tomorrow (and assuming all Caa1 rated loans were trading at 50 cents), the CLO would lose more than three points of OC cushion just due to Caa excess," wrote the authors, senior analyst Dave Preston and associate analysts Geoff Horton and Mackenzie Miller.

Could ratings agencies be faster than they have been in moving on downgrades?

Rebecca Dorrian
Managing director
Morgan Stanley

"Assuming the deal is also likely facing increased defaults and/or trading losses in this scenario, the CLO could easily fail its minimum OC cushion test — and begin diverting cash flows from the equity tranche." The analysts see downgrade risk as 'the biggest near-term fundamental risk to CLO investors".

CLOs could be forced to trade out of loans if they risk triggering their OC tests — multiple CLOs selling in unison would cause the market price of the loans to fall. In a typical period of volatility, prices only fall so far before loans are scooped up by investors looking for cheap assets. But with the CLO bid neutralised, and other investors deterred by weak loan documentation, it is unclear how the asset class would bounce back.

Some managers are positioning themselves to absorb these cheap assets after the sell-off. A new generation of opportunistic CLOs are emerging with an allowance of up to 50% assets rated triple C. Recently, HPS Investment Partners and Z Capital entered the space, which was established by Ellington Management Group in 2017. Other managers have told Creditflux that they're monitoring the performance of these vehicles with a view to jumping on the bandwagon.

"Credit risk is getting worse every day," says Tom Mansley, investment director at GAM Investments. "Recovery rates going forward will be much lower, around 50% to 60%, and if agencies model that then there will be downgrades."