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Mezz opportunities

Pretium structured credit and CLO liabilities MD Ian Wolkoff and Director Marty Young argue that mezzanine CLO bonds should be on the radar screens of most asset allocators with long investment horizons

US CLO mezzanine debt offers high expected return rates, with yields maintained under a default scenario more extreme than the GFC credit cycle and with upside potential in a market recovery scenario.

CLO debt offers strong long-run expected returns with bounded downside

In the current market context, macro uncertainty and the potential for a growth downturn loom large while valuations across many sectors still screen as relatively expensive. Given this set-up, asset allocators are searching even more actively than usual for investment opportunities which offer high potential yields but with contained downside protection in bearish scenarios. CLO mezzanine debt is a sector which appears to offer this combination.

The US CLO market has grown to over US$950bn in outstanding balance, with over US$160bn of balance in mezzanine (single-A through single-B) tranches. As a result, a CLO mezzanine debt strategy addresses a market large enough to allow investors to allocate selectively while still targeting high yields with contained risks.

Yields on CLO mezzanine debt securities have moved up sharply over the past two years; double-B CLO bonds purchased in the secondary market offer average lifetime quoted yields of 14.4% as of June 2023 versus 7.7% in mid-2021. The current baseline yields for double-B CLOs compare quite favourably to the yields available from other similarly rated fixed income assets: double-B leveraged loans and double-B corporate bonds, for example, currently yield just 7.6% and 7.2% respectively.

The extra yield earned by double-B CLOs versus double-B corporate bonds does not appear to reflect added default risk as the comparison holds debt ratings constant; indeed, during the 2008 financial crisis episode, CLO bonds had significantly lower default rates than similarly rated corporate bonds. CLO transactions are designed so that the bond classes can withstand elevated default rates on the underlying loan portfolios without taking principal losses; the double-B CLO bonds benefit from multiple structural protections, including overcollateralisation and excess spread that absorb losses before they can be passed to the double-B bonds.

A price-yield analysis of a double-B tranche from a sample 2021 vintage CLO transaction indicates that the double-B bond yield remains in double-digits under a scenario in which 28% of the underlying loan assets default over the next five years with a 60% recovery rate – a default intensity over 1.6 times the five-year cumulative default rate experienced following the global financial crisis. Indeed, the double-B tranche yield remains positive, even if the assumed five-year cumulative loan default rate rises to 35%, more than 2x the level seen during 2007-2013. CLO double-B bond yields remain positive in this high default rate scenario, despite the fact that much of the bond principal would be projected to be written down in such an event, as the high projected coupon payments over the lifetime of the bond would compensate for the principal loss.

CLO debt offers upside potential in a market recovery scenario

Per above, double-B CLOs can offer around 14% yields under a moderate recession baseline scenario. The bonds can maintain these double-digit yields in a loss scenario comparable to that experienced during the global financial crisis and can continue to earn positive yields in scenarios significantly more extreme than in 2008. Thus, the long-run downside risk for the majority of bonds in the double-B CLO sector, while not zero, appears bounded.

At the same time, the bonds provide meaningful potential return upside in a scenario in which double-B CLO spreads partially normalise relative to their current wide levels. Double-B CLO spreads are currently trading 250bp above the level that would be predicted, given their historical relationship to high yield corporate bond spreads. If 60% of this pricing anomaly were to be slowly corrected over a two-year period, the double-B CLO horizon yields would be expected to reach around 18%, with 14% of the yield coming from coupon income and 4% from price appreciation.

Summary

Mezzanine CLO yields are currently elevated relative to the yields available on comparably rated corporate bonds. While CLO bonds may experience short-term mark-to-market price volatility, over a longer-term horizon, yields would be expected to remain in double-digits across a wide range of loss scenarios - including scenarios featuring default rates more extreme than those that were realised during the challenging 2007-2013 period.

At the same time, mezzanine CLO bonds offer realistic chances of return upside if bond spreads partially revert back to more historically typical levels. Given this favourable risk/return profile for mezzanine CLO debt, Pretium believes the sector should be on the radar screens of most asset allocators with long investment horizons.

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