CLO Performance: A comprehensive survey of equity returns in the European CLO market

Summary

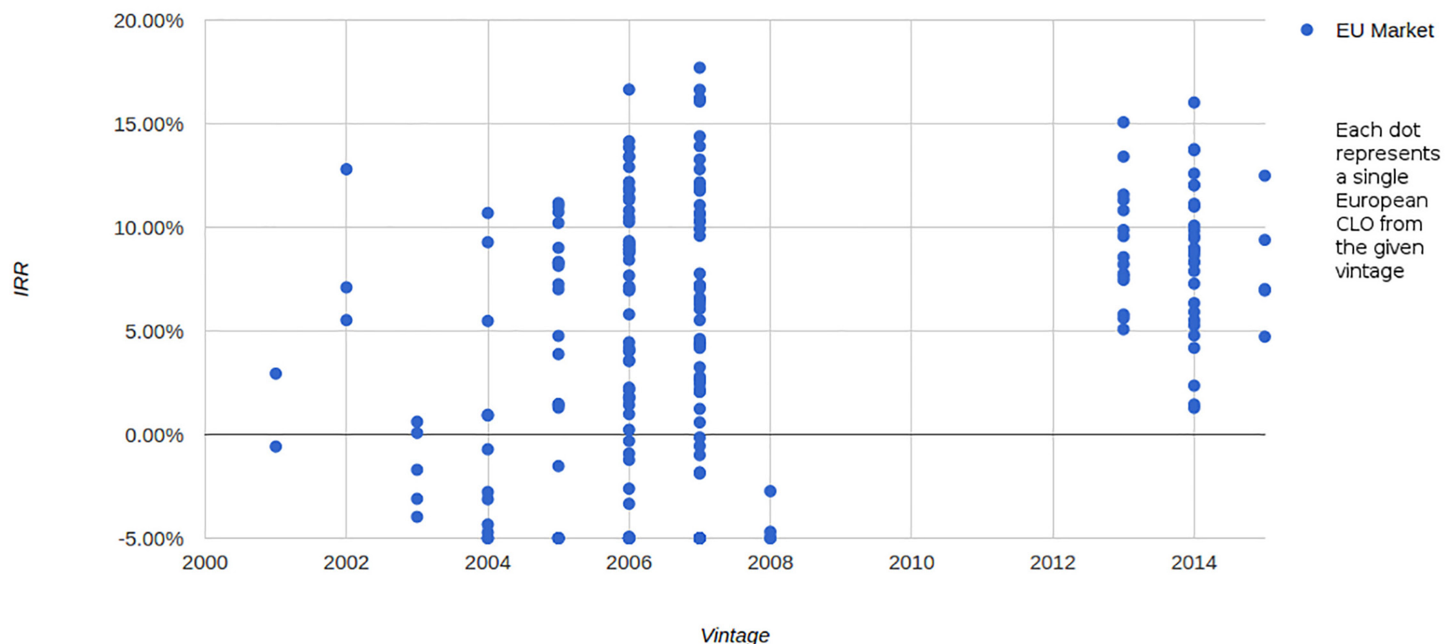
Overall equity returns in the European CLO market have been much as one would expect. All deals are sold on the basis that investors will make solid high returns, but not all can or will get there. Looking at the 2006 and 2007 vintages, a 30% chunk of deals hit their targets (above 10% IRR), a 45% middle rump returned investors money and some more (0 - 10% IRR) and only 25% of deals caused investor losses (IRR below 0%). The average return for the positive return deals in those vintages is 6.25% which is pretty impressive considering the financial crisis. European CLO equity has achieved what it "said on the tin."

Since H2 2013, annualised cash-on-cash returns in the European CLO market have been in the 14-16% range, ticking up to 15.70% in H2 2015. Now only 1 in 8 European CLOs is not paying its equity, compared to 4 in 7 at the height of the financial crisis in 2009.

Methodology

Traditionally equity returns have been hard to analyse because the cashflow profile is not uniform. First payments are typically low, due to ramp up to fully invested and also as interest on underlying loans only accrues from the closing date to determination date, whilst liabilities must be paid for through to the payment date. Subsequent payments are amongst the highest through the reinvestment period and then decline thereafter as the debt is paid down and the cost of capital increases and the leverage decreases. Then on the final payment date (generally

Figure 1. Historical and Projected IRR



when debt is called), equity will receive a lump sum, representing the remaining principal.

Equity is like a candle. The light burns brightly at

first (high cashflows) and then dims over time (lower cashflows post reinvestment period). But at every step, the candle remaining (the principal remaining) is less than originally. The remaining principal is usually only 70 - 80% of the original equity par amount out of the box at the closing date. This is due to the effect of deal fees. The remaining principal decreases for every default or trade loss.

In order to account for this candle effect, we measure equity return by adding realised returns to projected returns. We project returns to maturity based on a 2% CADR and 70% recovery. Alternative formulations are possible, including projecting to an optimal call date or using the current NAV on the assumption of an immediate call. However, these require additional assumptions and we believe projecting to maturity gives a good overview of deal performance.

Caveats

Some caveats are in order on our numbers.

Firstly, obtaining historical equity cashflows is hard work and our database is not complete. Where we had gaps, we use zero if the deal was failing OC tests on or around a given payment date and otherwise fill in using the market cash-on-cash return.

Secondly, we cannot tell whether equity was issued at par or all at a discount, as this is not typically disclosed at pricing. CLO 2.0 deals are said to often feature discounts or OID and this would boost returns versus our figures.

Thirdly, for cash-on-cash returns, we are mixing vintages and deals which are at different stages of their lifecycle.

Fourthly, we are projecting cashflows forward and this is always subject to uncertainty.

Nonetheless we believe this provides a remarkable insight into the generally opaque world of CLO equity returns.

Figure 2. Historical EUR CLO Cash-on-Cash returns