US Market Commentary: CLO Q&A with Sculptor's Josh Eisenberger, MD/Head of U.S. CLOs says BSL Triple As could tighten to 120s, rate cut impact, views on bond buckets and captive equity

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In an exclusive interview, *LFI* spoke with Josh Eisenberger, managing director and head of U.S. CLO Management at Sculptor Capital on high-level CLO trends affecting the US CLO market.

Where do you expect new-issue Triple-As to be in 4-6 weeks?

Recent volatility has put a bit of a damper on the tightening in CLO Triple As. J.P. Morgan has even recently called for CLO Triple As to pull back to S+150 and possibly S+175-200 in the case of a hard landing. Our recent conversations have led us to believe that Triple A spreads can tighten from the recent benchmark prints of S+134, though we see some resistance getting into the low S+120s.

How could the expected rate cuts impact the BSL CLO market?

As CLO liabilities are largely floating rate, any rate cut that would likely drive a drop in SOFR would reduce the running yield on CLO liabilities. As SOFR has risen, we have seen a number of CLO ETFs looking to capitalize on the retail investors' search for yield, and these might see some pressure should the floating component of CLO liabilities be reduced. This yield dynamic is, of course, not only limited to the retail investor base via traded ETFs, as there have certainly been a handful of CLO liability investors created or that have grown larger in the asset class just due to the absolute yield available (CLO Triple As current spot yield of about 7%).

On the collateral side of the equation, lower rates would certainly be a welcome gift for the myriad of highly leveraged companies that have largely funded themselves with floating-rate debt. Numerous companies are struggling under the burden of higher interest costs, and some have, or could still, run out of cash and need to restructure as a result. Other companies are waiting for rates to decline so that they may be able to show better free cash flow metrics to investors when they attempt to market their new debt facilities.

What's your view on the use of bond buckets?

At Sculptor, we have used our bond buckets for either (1) higher quality secured bonds where we likely swapped out of a pari-passu term loan in order to capture the discount afforded in the lower coupon bond, or (2) investment-grade bonds, which we have largely used as a risk-mitigation tool. We have attempted to leave ourselves roughly 200 basis points of buying capacity in our bond buckets so that we may be able to more easily sell a loan in the 70s or 80s that might be going through some amount of stress and replace it with an IG bond that trades in the low 80s. This enables us to mitigate much of the par lost due to the discount sale, while also materially improving the quality of the collateral with the corresponding investment-grade purchase.

Are CLO documentation changes still evolving to combat creditor-on-creditor violence and increase recoveries?

CLO documentation continues to evolve to enable CLOs to defend themselves better in this new age of creditor-on-creditor violence. Early iterations gave CLOs the ability to buy into restructurings to protect their positions only by diverting equity cash flow with the consent of CLO equity holders. That was certainly a start, but newer concepts adopted in recent CLO documentation allow for managers to more broadly participate in select uptier priming debt, which was previously more difficult to achieve. By giving some flexibility on rules for day one ratings, collateral managers can not only maximize recoveries for all investors, but also protect themselves from the significant downside recoveries that were likely should they not have been able to participate.

Some more welcome changes might be centered around the legacy language relating to PIK interest and the required coupon levels of restructuring obligations. In an environment where the single biggest cause of distress might be the inability of a company to shoulder the higher costs of financing, many restructurings require lenders to accept lower rates of cash interest in order to preserve the operating business. Currently, CLOs are very limited in the way they can structure these instruments, and, at times, may ultimately drive worse long-term outcomes by requiring companies to adhere to certain tests and qualifications. We would welcome the ability to engage with CLO liability investors and rating agencies to converse over why these changes might be valuable to all investors within a CLO structure.

Does the firm use captive equity funds?

As previously disclosed, earlier this year, the firm launched its debut captive CLO equity platform in partnership with our new parent, Rithm. The captive equity platform manages investments in the equity tranches of Sculptor managed CLOs and intends to hold majority equity in the firm's future issuances (and has done so in two of our deals YTD in CLO32 and ECLO11). We also have longstanding relationships with third-party equity investors and have partnered with several third-party equity accounts across our most recent new issue transactions in both the US and Europe.

Where is there room for more efficiency in the BSL CLO market?

There is definitely room for more efficiency in the BSL CLO market. One way that the market is looking to get more efficient is by investors having parity of information across all deals. We have been making our trustee reports available to market data providers with the belief that more information will allow for greater trading liquidity in the secondary market. Another way the market could become more efficient is by standardizing how we label or identify loans in CLO portfolios so that debt and equity investors might be able to more easily compare the collateral across multiple pools.

Have you seen any noticeable changes in ownerships for debt and/or equity this year?

With the traditional CLO equity arbitrage challenged for much of 2022 and 2023, we saw a change in the buyers of CLO equity from traditional excess I/O players to more opportunistic and retention fund buyers. As the equity arbitrage has normalized back to more traditional levels this year, we have certainly noticed a strong return of the more traditional CLO equity buyer.

In terms of the CLO debt side, there were definitely many investors that remained sidelined over the last couple of years, particularly at the Triple A level. The resurgence of issuance this year, coupled with the heightened prepayments that many Triple As investors have received, have brought many of these buyers back into the fold.

What factors are currently influencing the new-issue pace for CLOs?

Steep prepayments and high absolute yields have led to tremendous availability in the CLO Triple As market, which, in turn, has led to a frenzied issuance pace in the US CLO market YTD.

Another factor at play that we have not yet discussed is how the current rate environment is impacting the Japanese AAA buyer base. While high SOFR has been a boon to the domestic US buyer base, Japanese investors largely hedge out the SOFR component at a net cost of 50-80 basis points over SOFR. With the recent rate hikes in Japan, the JGB20 (a favorite comp for Japanese financial institutions) has become as attractive, or possibly even more attractive, than the swapped return of US CLO Triple As.

On the flip side, a stronger yen since June has led to an increase in demand on a dollar basis as well as decreased the swap Yen/SOFR costs. This all has led to some buyers favoring the outright wider sub-asset classes of MM CLO AAAs and Private Credit CLO Triple As, but we haven't seen a significant enough shift away from the BSL market to create any pause.

The primary item that has been holding back the CLO market from even greater issuance has been leveraged loan supply, which has continued to be hampered by the lack of true new issuance via M&A or LBO activity as high rates have stymied new deal creation. More recently, equity market volatility driven by the fear of an economic hard landing and emergency fed actions has dampened the CLO liability side of the equation, though this seems to have been only momentary.

How are technical factors like paydowns affecting the CLO market?

CLO amortization and refi/reset transactions had a very big part in the tightening on the AAA market earlier this year with the April and July payment periods resulting in ~$24B in amortization payments. AAA buyers that had locked in coupons of S+150 and higher were very suddenly presented with a heavy unexpected return of capital post CLO payment dates year to date.

While this should not have been a surprise, given that ~40% of all US BSL CLOs had exited their reinvestment periods by YE 2023, it nonetheless led to an immediate desire to reinvest that returned capital into CLO AAAs. With a limited number of immediate options in the primary market, this reinvesting capital drove AAA spreads meaningfully tighter. Many managers sought to capitalize on these tightening spreads and rushed into the market all at once, which drove a frenzied wave of new issue, reset and refi transactions.

As investors have adjusted expectation for future repayments on their AAA books, their buying patterns have become less cyclical and frenzied and more pre-planned. This has helped to keep AAA spreads in the low 130s, but the lack of “emergency” and unplanned buying on the heels of higher-than-expected prepayments, coupled with some of the recent macro events and headlines, has likely kept the market from gapping tighter.

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