E X P E R T Q & A

As the CLO market emerges from the covid-19 crisis in Europe, it is clear the asset class is positioned well to withstand volatility and respond to challenges, says Sharif Anbar-Colas, head of structured credit at Kartesia

The growing attractiveness of CLOs in Europe

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Q What are the attractions of CLOs to investors like Kartesia?

There are several things that we find particularly attractive about the CLO market. First, we like the fact that the underlying portfolios in CLOs were de-risked after the 2008 credit crisis and now focus on buying senior secured portfolios comprised of European loans and bonds for large European corporates and multinational companies.

The CLO structure has also been significantly improved since the credit crunch, with structural leverage being brought down by increasing the subordination level across all rating categories. That gives CLO tranches a larger capacity to weather market disruptions and makes it easier for CLO managers to address issues in underlying portfolio companies.

Another attraction is that because CLOs cover the entire capital structure, they allow different investor types with a variety of views and goals to build a portfolio that meets their particular need.

Other things that are interesting for us right now include the fact that, while rates are low or negative across Europe today, there is nevertheless a lot of inflationary pressure and talk of those rates going up. CLO rated tranches have EURIBOR floors, so even if rates stay negative or go further into negative territory, investors get the full contractual coupon. On the flipside, since CLO tranches are floating rate they also benefit if rates go up.

Here we have a product that has performed well by incorporating lessons learned across various economic cycles and is well positioned to keep performing.

Q How have European CLOs performed in the last few years?

If you look at the default and

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impairment ratios over the last several decades, European CLOs have outperformed similarly rated asset classes in Europe, whether that is looking at European loans or European bonds or European securitised assets. Meanwhile, in terms of returns, CLOs also offer incremental value compared to what you can achieve in similarly rated asset classes.

Q What has driven that performance?

When it comes to performance, there are several factors. First, being a complex product, CLOs are relatively illiquid compared to similarly rated asset classes, so investors demand an illiquidity premium that increases returns.

The second point is that the European loan and bond market has grown a lot over the past years and this has led to an increase in liquidity in these markets. This has provided downside protection because it enables managers to have more positions to choose from when investing and to more easily exit positions that they feel are at risk of deteriorating. Before the credit crunch, there wasn't that much variety or liquidity, so if something went south you typically had to buckle down and endure a lengthy and painful restructuring process.

There are also several structural protections that are built into CLOs, including the fact that the documentation allows the managers to focus on the quality of the underlying portfolio of assets. That helped them withstand the price volatility of 2008, 2016 and 2020 and take action when their views on assets changed.

Q How does Kartesia analyse CLOs?

Given the complexity of the product we analyse various facets from different angles with the goal of identifying sources of risk and value that may

Q How do you incorporate ESG factors into CLOs?

The ESG conversation in the broader market is in its infancy and everyone is approaching it differently, but in terms of how Kartesia does it, we like to look at the CLO management company and make sure it has cohesive ESG policies and a company-wide awareness of ESG risk. We then look at the CLO documentation to see how that reflects the ESG view of the manager; that is an evolving space because managers have different views on what is important at this point.

As a firm, we sit on the European Leveraged Finance Association's CLO Investor Committee and one of the things we are really keen on is to use that committee to push for more transparency and standardisation around ESG efforts. We think ESG is here to stay and is a positive development for CLOs and the credit markets as a whole. We also believe CLOs are now such an important constituent of the credit markets in Europe that they have a key role to play in the standardisation of the approach to ESG, and we want to help drive that process forward.

affect performance. Some of the facets we cover include performing a fundamental credit analysis on the underlying portfolio and a thorough review of the legal documentation governing the CLO. These deals are not standardised and you can have two different deals with the same manager within a short space of time and find they have very different documentation.

It is also really important to have a close working relationship with the CLO managers, because that enables a good exchange of views and enables better performance.

Finally, it's key to be up to speed on the structured credit market technicals. There are not that many market data points in structured credit due to its relative illiquidity and that can cause a less informed investor to make missteps.

Q What should investors take into consideration?

You really need to invest time in understanding the landscape. Kartesia has been investing in CLOs since its inception over a decade ago and I have been working in CLOs for close to 20 years, first in the US and then in Europe. This enabled Kartesia to build a holistic picture of the CLO market and its ecosystem which accretes a lot of value to our investment portfolio.

We don't subscribe to the view that CLOs are akin to a fund of funds investment; that is a superficial way of looking at the deals and likely to result in missing market opportunities or nuances in specific deals that could affect performance.

Q Are there any specific characteristics of the European market?

Some market participants tend to view the European CLO market as less mature and less diverse than the US market, but that's not an accurate representation. It is certainly true that the market is smaller, but it is very well diversified. When you look at the

performance of individual deals, instead of the average performance across the sector; you can see there is massive divergence. You wouldn't see that if there was no diversity in the market.

We are also seeing an increasing diversity among CLO managers, with each one bringing their own style and approach to the product.

When you compound the above with the growth we have seen in European credit markets over the past years, you are able to construct diverse portfolios that enable the manager and investor community to express their particular view on the current market.

Q How has the CLO market evolved, and where do you see it going in the next few years?

One thing we like about CLOs is that as an asset class they are extremely

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vibrant and agile. The European CLO market now has an AUM of about €160 billion and that has been growing at a rate of over 15 percent per annum for the past few years. That has made CLOs a very relevant part of both the European credit and securitised market.

People have learned lessons over the past economic cycles and translated those into CLO structures. For example, during covid we saw some loans in the US were going into restructuring processes and, because CLOs were restricted on the type of assets they could invest in, hedge funds would come in and try to issue restructured debt that would force CLO managers out. The CLO community reacted quickly to that trend by changing the language in documentation so that managers had a looser mandate in the event of a restructuring and avoid these situations.

CLOs have also stayed abreast of current topics like ESG, and have been part of that conversation as it has evolved and continues to move forward. CLOs have started including ESG language in deals and having ESG criteria at collateral level, which is clearly important.

The CLO is definitely a product of its time, which is why it has performed so well over the years. Every crisis we have had has been completely different and the CLO market has been able to respond. ■