S&P Global
Ratings

# CLO Insights

## New features in European CLOs for 2022

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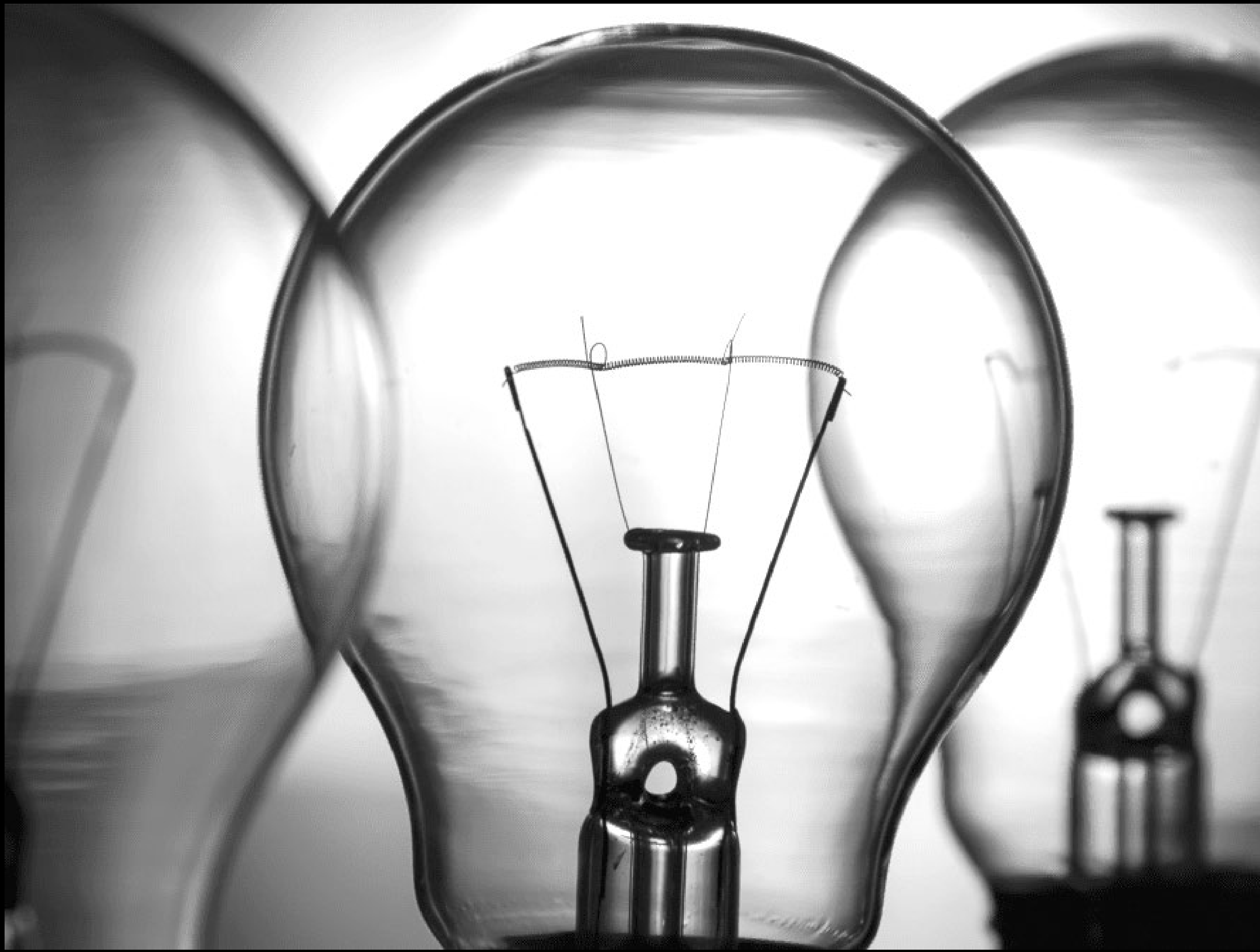


# Contents

# Key Takeaways

- CLO documentation continues to evolve, adding further flexibility for effective management of underlying portfolios.
- Among the new features, focus continues to be on the ability to manage scenarios where defaults and/or restructuring will become more frequent.
- At the same time, due to widening spreads, CLOs are adopting new liability management techniques.

# Changes To CLOs | 2020

## Developing Trends In New CLOs: Back To The Drawing Board

| | | | |
|---|---|---|---|
| **Lower: Leverage**<br><br>**Higher: Par sub** | We are seeing a reduced prevalence of lower rates tranche issuances in CLOs and higher equity contributions.<br><br>Par subs have also increased (42%-44%) | Loan environment appears conducive to purchasing sound credits and avoiding rating transitions.<br><br>Accelerating CLO issuance by locking down liabilities and then building portfolio. | **Shorter effective date print and sprint CLOs** |
| **Shorter: Reinvestment**<br><br>**Shorter: Non-call** | Wider CLO liability spreads, investor sentiments—pushing deals with shorter reinvestment periods and non-call periods. | CLOs that purchase assets below 80% of par are considered discount.<br><br>Proposals to amend this definition to a lower percentage, for example 70%, or being index-based. | **Changes to definitions: Discount obligations, current pay** |
| **Covenants on: SDRS and recovery** | New structures requesting covenants into SDREs and recoveries at higher levels to accommodate further downgraded and maintain headroom to avoid rating volatility. | Fewer funds are required from the issuance proceeds to purchase assets.<br><br>If the economy rebounds, the return for equity investors can be substantial. | **Change in debt issuance relative to assets value** |
| **Concentration limits: 'CCC' bucket, single industry/obligor** | Widening of tradable allowance of 'CCC'-rated assets (15%-35%<br><br>Certain industries favored over others (20%-30%). | Corporate borrowers switch payment frequency to semi-annual (from quarterly).<br><br>ISAs should help smooth out interest cash flows to CLO noteholders. | **FSM and ISA: May finally be put to the test** |

FSM--Frequency switch mechanism. ISA--Interest smoothing amount. SDR--Scenario default rate. Par sub--Par subordination. Source: S&P Global Ratings.

## Redesigning The CLO Blueprint After COVID-19

- With market sentiment fluctuating as the COVID-19 effects evolve, CLO structures and their associated documents are being reassessed to adapt to the current market landscape.
- Whether it may be perceived as CLOs being reactive or just simply prepared, in this publication we highlighted some of the most observed developments in CLO documentation, structures, and the underlying loans that they are exposed to.
- CLO Spotlight: Redesigning The CLO Blueprint After COVID-19 S&P Global Ratings > Commentaries (capitaliq.com)

Source: S&P Global ratings research. Click here to read the full article.

# Changes To CLOs | 2021

## The European CLO Redesign Is Gathering Pace

| H1 2020 | | H2 2020-H1 2021 | | |
|---|---|---|---|---|
| Lower leverage, higher par sub | Short-term noncall reinvestments | Loss mitigation loans | Bankruptcy exchange | More reliance on manager |
| FSM and ISA may finally be put to the test | Changes to portfolio limits | Bigger bond buckets | Effective date hurdles relaxed | Check on negative cash |
| Print and sprint CLO: shorter effective date | Definition of discount and current pay | Innovation in ISA definitions | COVID-19 shields disappear | Market value risk |
| Covenants on SDRs and recovery | Changes to assets for debt issuance | ESG considerations | Looser definitions | Newer protections |
| | Structural changes → | Lower par sub | Longer reinvestment | Lower fees |

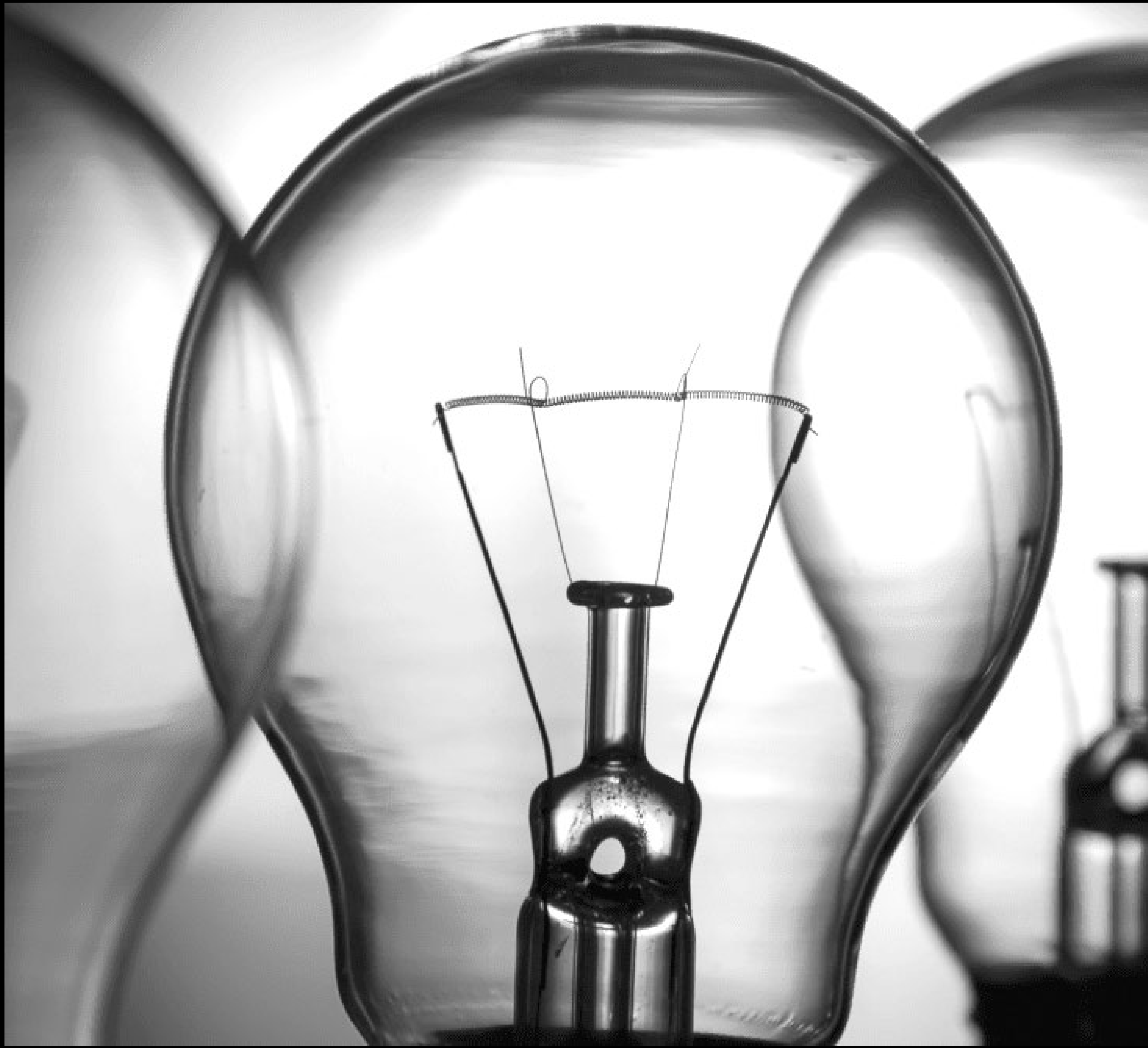
FSM--Frequency switch mechanism. ISA--Interest smoothing amount. SDR--Scenario default rate. Par sub--Par subordination. Source: S&P Global Ratings.

## New Features Continue To Appear In European CLOs

- CLOs issued in Europe in 2021 started to again resemble pre-pandemic transactions.
- Par subordination moved back to the 38%-40% range compared with 42%-44% for CLOs issued in 2020.
- We expect CLO documentation will continue to evolve to face new challenges.

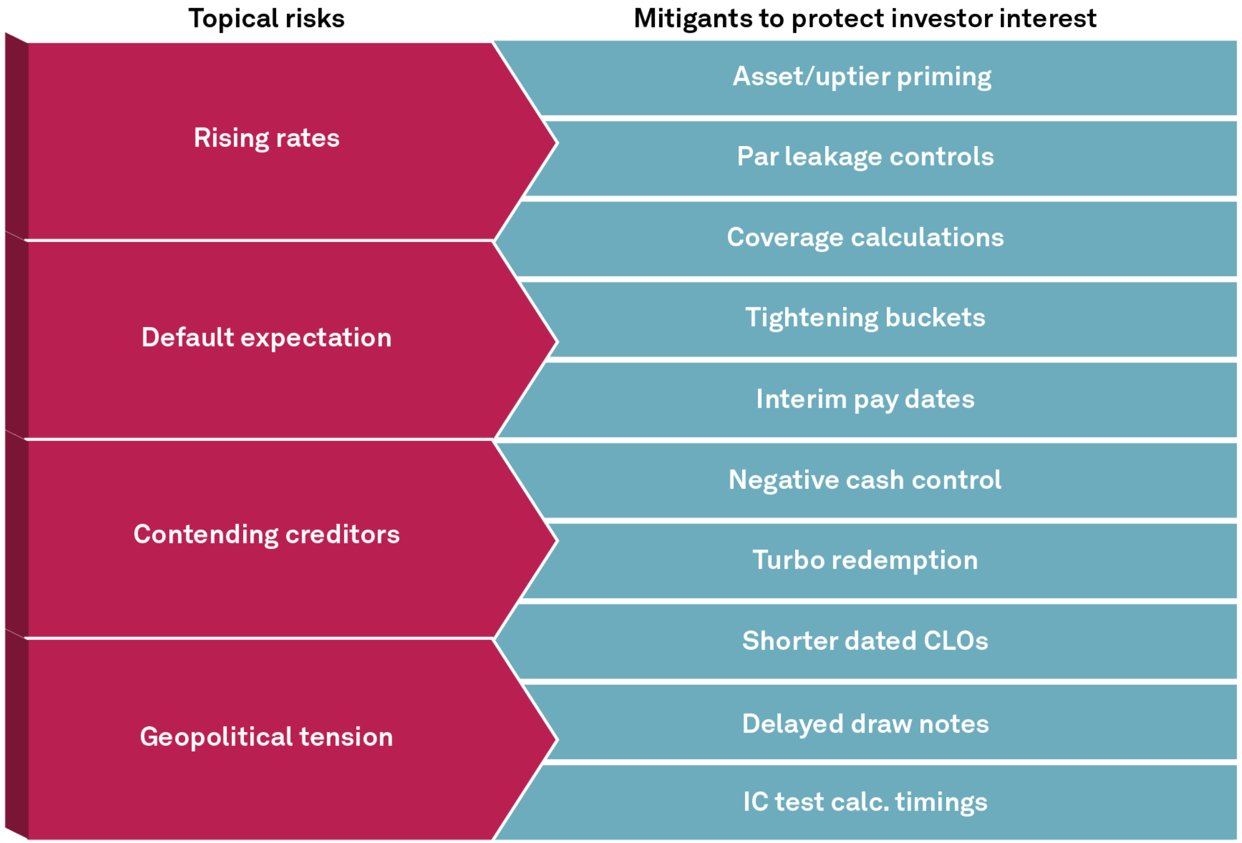
Source: S&P Global ratings research. Click here to read the full article.

# Fast Forward To 2022



# Fast Forward To 2022 | CLO Evolution

## As The Market Evolves, So Do European CLOs




Source: S&P Global Ratings.

## Redesigning The CLO Blueprint After COVID-19

- European CLO issuance is slower than in 2021.
- Various macroeconomic factors have dampened the CLO issuance engine without stalling it entirely.
- CLOs aim to re-engineer the asset class to shield themselves from various challenges they could face in the next few quarters.

Source: S&P Global ratings research. Click here to read the full article.

# Fast Forward To 2022 | Changes In CLO Language

## Features 2022

**Uptier priming loans**
**Asset drop down**

- To improve liquidity positions, several companies have used aggressive--and controversial--tactics to raise new capital in the past.
- These included collateral transfers (asset drop down transactions) that allowed companies to raise cash secured by first liens on the transferred assets, and uptiering priming loans, which allowed companies to secure new funds with super priority liens against all loan collateral.
- Although these transactions have slowed now, they are both likely to remain options for distressed corporate borrowers. They worked in the past, and most credit agreements have the flexibility to enable contractual priming transactions to be completed.

Source: S&P Global Ratings research. Click here to read the full article.

# Fast Forward To 2022 | Changes In CLO Language

## Asset Drop Down Transactions

- Companies moved collateral **outside the scope of existing creditors** and into newly created or pre-existing "unrestricted" subsidiaries.
- Updated language in CLO documents consider the minimum indebtedness eligibility criterion on an aggregate basis, allowing the CLO to participate in and hold the new debt.

## Uptier Priming Transactions

- Allowed companies to amend the existing secured loan documents to permit **new "super-priority" secured debt** on the existing collateral.
- Participation can be limited to the existing lenders that consent to these amendments, further subordinating non-participating existing lenders.
- The new language would disregard certain requirements outlined in the eligibility criteria and concentration limits, allowing CLOs to participate.

Source: S&P Global Ratings research. Click here to read the full article.

# Fast Forward To 2022 | Liability Management Techniques

### Delayed drawn tranche

- Allows issuer to issue notes **at a later date**.
- Issuance proceeds **transferred to equity noteholders.**
- **Credit neutral** if the notes carry the same terms and conditions.

### Turbo redemption

- **Reduces the funding cost** by using excess interest proceeds.
- Typically benefits the junior notes and **decreases a CLO's cost of debt.**

### Interim payment dates

- Introduced **post reinvestment period**.
- Can be triggered only **once a month** on the pre-determined date.
- **Reduces the cost of debt** sooner.

### Additional compensation

- Additional **one-time amount** is paid as interest on the 1st IPD after the issue date.
- **Funded using the initial reserve** for transaction set-up costs.

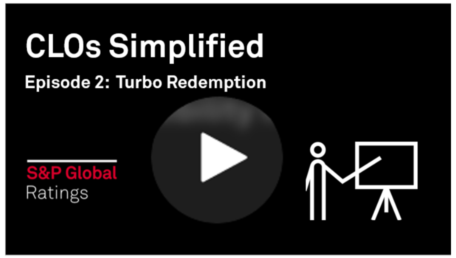
# Fast Forward To 2022 | Liability Management Techniques

## Turbo Redemption

### Turbo Amortization:
Cash flow analysis

| | | | | With turbo | | No turbo | |
|---|---|---|---|---|---|---|---|
| **Class** | **Balance** | **Rating** | **SDR** | **BDR** | **Cushion** | **BDR** | **Cushion** |
| F | €9.6 mil. | B (sf) | 27.08% | 31.08% | **4.00%** | 30.97% | **3.89%** |

For more information on how it works, click here:




### Transaction Performance
CLOs in our rated universe with turbo feature

| **Characteristics** | **S&P Global Ratings rated CLOs with turbo feature** | | |
|---|---|---|---|
| | **CLO 1** | **CLO 2** | **CLO 3** |
| Issue date | 14/11/2019 | 19/12/2019 | 18/12/2019 |
| Bal. in comparison to issue date | **80%** | **76%** | **80%** |
| Total int. available (avg.) | €3.6 mil. | €4.3 mil. | €3.1 mil. |
| Int. paid toward turbo (avg.) | 1.85% | 2.34% | 1.77% |
| Int. paid toward equity (avg.) | 22.16% | 9.28% | 20.52% |

BDR (break-even default rate) is the maximum default rate that can be applied to the collateral in each stress scenario while still ensuring the rated tranches receive interest and ultimate principal repayments. SDR (scenario default rate) estimates the level of defaults the CLO collateral pool.

# Fast Forward To 2022 | Liability Management Techniques

## Interim Payment Dates

### Cash Flow Analysis

Monthly and quarterly payment dates

| Class | Rating | Quarterly BDR | Monthly BDR | Difference |
|---|---|---|---|---|
| A | AAA | 86.93% | 87.59% | 0.66% |
| B | AA | 63.14% | 62.63% | **-0.50%** |
| C | A | 55.45% | 55.42% | **-0.02%** |
| D | BBB | 46.81% | 46.95% | 0.14% |
| E | BB | 33.84% | 34.11% | 0.27% |

Note: Cash flow results of an EMEA CLO in its amortizing phase.

Amortization Profile

| Month before IPD | IPD | Month after IPD |
|---|---|---|
| 33.23% | 39.29% | 27.48% |

### Monthly Amortization May Only Benefit Senior Notes

- As there is less excess spread in the CLO, we observe lower BDRs for some other classes.

BDR (break-even default rate) is the maximum default rate that can be applied to the collateral in each stress scenario while still ensuring the rated tranches receive interest and ultimate principal repayments. IPD--Interest payment date.

# Fast Forward To 2022 | Liability Management Techniques

## Delayed Draw Tranche

### Scenario Analysis

Class F notes issued later with a lower margin

**Fully drawn- class F notes day 1 margin 10.5%**

**BDR cushions -100% floating scenario**

| Class/margin | 10.50% | 10.00% | 9.50% | 9.00% | 8.50% | 8.00% | 7.50% |
|---|---|---|---|---|---|---|---|
| A (AAA) | 1.06% | 1.06% | 1.06% | 1.06% | 1.06% | 1.06% | 1.06% |
| B (AA) | 5.03% | 5.03% | 5.03% | 5.03% | 5.03% | 5.03% | 5.03% |
| C (A) | 6.32% | 6.32% | 6.32% | 6.32% | 6.32% | 6.32% | 6.32% |
| D (BBB-) | 6.71% | 6.71% | 6.72% | 6.73% | 6.73% | 6.74% | 6.75% |
| E (BB-) | 7.01% | 7.02% | 7.02% | 7.03% | 7.03% | 7.04% | 7.04% |
| F (B-) | 0.78% | 1.07% | 1.35% | 1.62% | 1.87% | 2.13% | 2.40% |

| Defaults applied at 3.1% for 5.25 years (WAL) | Base case -10.50% | 10.00% | 9.50% | 9.00% | 8.50% | 8.00% | 7.50% |
|---|---|---|---|---|---|---|---|
| Class fully redeemed at end of the transaction's life | N | N | Y | Y | Y | Y | Y |
| Total Interest deferred unpaid at end of the transaction's life | 7.54% | 7.54% | - | - | - | - | - |
| Total notional unpaid at end of the transaction's life | 7.30% | 7.30% | - | - | - | - | - |
| Comments | Deferred interest is fully paid when class becomes senior most tranche, but starts deferring timely interest again two periods later | | Deferred interest is fully paid when class becomes senior most tranche | | | | |
| Deferred interest before becoming senior tranche | €7.2 mil. | €6.8 mil. | €6.4 mil. | €6.0 mil. | €5.6 mil. | €5.2 mil. | €4.8 mil. |

Note: Results based on a single cash flow run. BDR (break-even default rate) is the maximum default rate that can be applied to the collateral in each stress scenario while still ensuring the rated tranches receive interest and ultimate principal repayments. WAL--Weighted-average life.

# Fast Forward To 2022 | Other Techniques To Tackle Rising Cost

### Longer time to calculate interest coverage

- I/C test calculation to **begin from the 3rd interest payment date.**
- Adapts to the long 1st interest payment in some of the new corporate assets.

### Cost reduction techniques

- **Lower senior fees.**
- **Fewer CLOs** now have form approved **swaps.**

### Focus on negative cash

- The trade date cash balance test ensures that the amount standing in **the principal account is not a negative** amount over a certain threshold.

### Par leakage controls

- **Reduction** in the percentage of **principal leaked to equity**.
- **Higher hurdles** for trading gains to go to equity investors.

# Preparing For The Next Downturn

## Rising geopolitical tensions + High inflation + Rising interest rates = Slower economic expansion

CLOs have faced many challenges in the past 20 years. However, we note the strong credit performance of European CLO 1.0s, higher credit enhancement in CLO 2.0 tranches, cleaner portfolios, and the presence of risk retention.

Managers and investor have learned from previous experiences, and we believe CLO transaction structures and documents will continue to evolve in response to market developments and meet equity and debt investors' expectations.

Depending on investor appetite, macroeconomic conditions, and default expectations on the underlying assets, we could see more managers seeking to broaden their options in terms of what they could be allowed to do under the CLO documents in preparing their CLOs for the next downturn.

### Default Summary By Original Rating For European CLOs

As of Dec. 31, 2021

| | **CLO 1.0** | | | **CLO 2.0** | | |
|---|---|---|---|---|---|---|
| | No. of original ratings | No. of defaults | Currently rated | No. of original ratings | No. of defaults | Currently rated |
| **AAA** | 472 | 0 | 0 | 645 | 0 | 394 |
| **AA** | 222 | 0 | 0 | 693 | 0 | 466 |
| **A** | 239 | 0 | 0 | 452 | 0 | 294 |
| **BBB** | 288 | 4 | 0 | 419 | 0 | 272 |
| **BB** | 205 | 17 | 1 | 393 | 0 | 269 |

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