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The case for CLO equity: complementing private equity

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HIGHLIGHTS

- The headwinds facing private equity
- A comparison of CLO equity to private equity
- The case for adding CLO equity to an alternatives allocation

*An environment of **higher-for-longer interest rates** is likely to tilt returns in favor of debt holders, and be a potential advantage to the current vintage of CLO equity.*

Traditional private equity funds – portfolios of privately-owned companies which have been acquired by specialized firms, or "sponsors" – are a mainstay allocation for many institutional investors. These funds account for a significant portion of the alternatives exposure in public pensions, endowments, family offices, and other sophisticated, long-horizon investors.

Private equity investors are primarily attracted to the private equity asset class because of historically robust returns in the mid-teens or higher. Private equity also tends to be far less volatile than publicly traded equity, due to lower liquidity and the generally longer-term horizon of private equity sponsors. A recent Nuveen survey found that roughly 55% of institutional investors planned to increase exposure to private equity over the next two years.[1]

THE HEADWINDS FACING PRIVATE EQUITY

Despite the many historical benefits of private equity, the asset class faces several headwinds in the current market environment.

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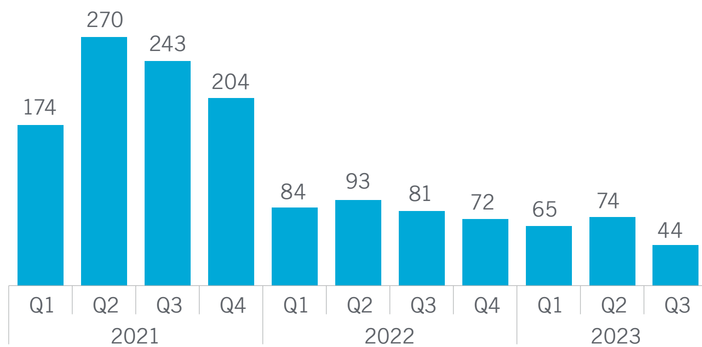
The most significant challenge for private equity returns in the current market is a meaningfully higher interest rate environment and the new "higher for longer" paradigm. In addition, the current market is presenting tighter financial conditions in the form of wider credit spreads for many borrowers leading to a sharp increase in financing costs for companies and diverting a greater proportion of investment returns to debt investors. As central banks draw the curtain on the era of cheap credit, the investment landscape is definitively tilted in favor of lenders.

Another issue facing private equity sponsors is general uncertainty in the capital markets. Traditional private equity sponsors often take publicly traded companies private with an eye to making strategic business changes (such as accretive acquisitions or spin-offs) and later re-introducing these companies to the public equity markets via IPOs. Unfortunately, IPO market conditions have recently been unpredictable, chilling the ambitions of private equity sponsors seeking to exit their investments in the public markets (Figure 1). Even if market conditions allow for a private company's successful IPO, potentially negative market swings may dampen the upside for private equity investors.

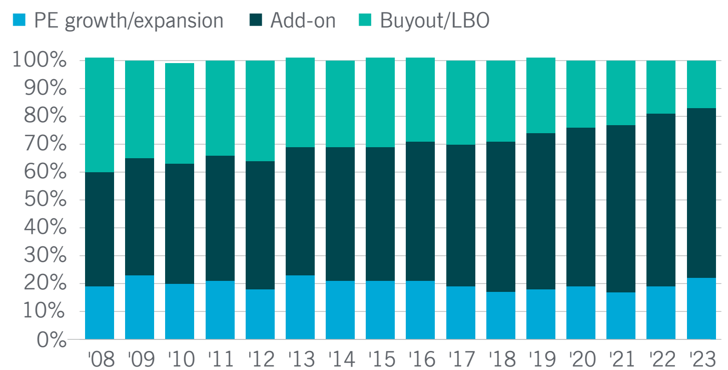
Figure 1: Private equity exits have slowed ($ billions)



Source: PitchBook as of 30 Sep 2023.

These weaker market conditions make it far more challenging for private equity sponsors to find opportunities capable of hitting the minimum return hurdle rate, leading to a steep drop in leveraged buyout (LBOs) activity (Figure 2). Instead, private equity sponsors appear to be placing greater focus on existing deals in their portfolio, deploying capital in the form of add-ons and similar transactions. All else equal, this increase in equity capital per deal may lead to weaker returns as these investments ultimately reach the exit stage.

Figure 2: LBOs now make up a smaller portion of private equity activity



Source: PitchBook as of 21 Jul 2023.

Many market watchers also point to high levels of private equity "dry powder" – uncalled and undeployed capital raised by private equity firms in recent years – yet another challenge for private equity returns (Figure 3). Indeed, the level of private equity dry powder currently exceeds the level of private debt (which is typically used to finance the take-private transactions of PE sponsors) by a factor of six to one.[2] Many market-watchers believe that there is an over-supply of private equity capital chasing a limited number of attractive deals, and there is a relatively shorter supply of private debt capital available to finance these deals. This places comparatively greater control in the hands of lenders, giving them greater negotiating power to extract returns at the expense of private equity investors.

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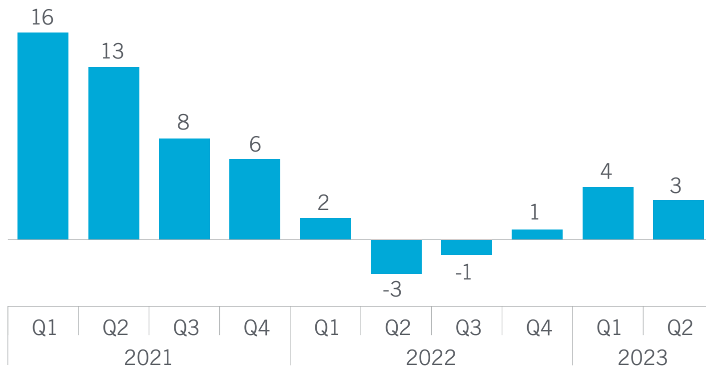
Figure 3: Recent PE returns have been hampered by multiple headwinds

Quarterly IRRs (%)



Source: PitchBook as of 30 Jun 2023. Q2 2023 includes preliminary returns.

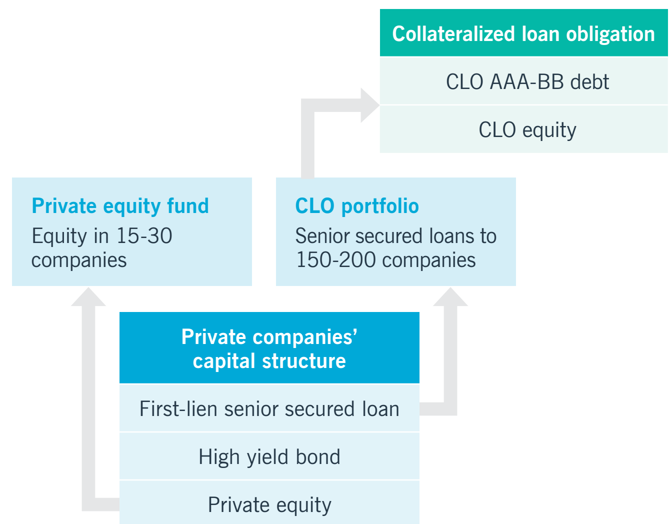
A COMPARISON OF CLO EQUITY TO PRIVATE EQUITY

At first blush, the equity tranche in a collateralized loan obligation ("CLO") appears to have little in common with a private equity fund (Figure 4). A CLO is a highly diversified portfolio of debt instruments, while a private equity fund consists of investments in the equity of private companies. CLO returns are driven primarily by ongoing coupon payments from the underlying debt obligations of these companies, while PE fund returns are tied to the performance of company equity, leading to starkly different return outcomes for these vehicles.

However, a CLO investor's return experience varies depending on their position in the CLO capital stack. Investors holding the higher-rated tranches in a CLO earn consistent, coupon-driven income over the life of the CLO, with principal repaid as the CLO approaches maturity. Investors in the equity tranche of a CLO earn less predictable – but generally far higher – quarterly income payments and may also benefit from total return opportunities in the underlying loan portfolio (as well as greater downside risk associated with potential defaults and other losses in the CLO portfolio).

The return experience of CLO equity investors is driven by the embedded leverage in a CLO's capital structure, which magnifies returns (as well as losses). This leverage drives a key similarity shared by CLO equity and private equity: both investments use leverage to magnify returns which are ultimately tied to the performance of companies. In the case of private equity investments, the leverage comes from the debt capital markets, typically in the form of floating-rate debt which is generally acquired by CLOs. In the case of CLO equity, the leverage comes from the rated tranches of CLO debt which finance the purchase of the floating-rate debt portfolio.

Figure 4: Harnessing private companies' returns using different parts of the capital structure



For illustrative purposes only.

Viewed from this perspective, CLO equity re-creates many of the risk and return characteristics of private equity. The underlying "beta" of these two investments – the performance of private companies – is effectively equivalent, with varying modalities of leverage applied to transmute this performance into comparable return outcomes.

Returns experience

Despite this similarity, CLO equity has an important distinction which fundamentally alters the return experience for these investors: returns are driven by debt instruments, rather than equities. CLO equity benefits from the ongoing income stream generated by coupon payments from these debt instruments, which generally leads to a more front-ended return profile relative to

private equity investing. In addition, the underlying collateral for CLO portfolios is highly diversified and almost entirely senior secured debt, which provides an important measure of protection if any position defaults. Because of this, standard CLO equity models usually require a 6% constant annual default rate with a 64% recovery rate to hit their breakeven point at which expected returns turn negative.[3] This contrasts with private equity, when a portfolio company defaults, recovery rates to private equity are generally zero. This is a key reason why over 95% of CLO equity tranches have generated positive IRRs when held from inception to maturity.[4]

Liquidity differences

There is another important distinction separating CLO equity from private equity. While a private equity manager can add value directly to portfolio companies, the equity positions in these companies are typically highly illiquid. In situations where the investment thesis does not come to fruition, the private equity manager has limited options to dispose of the investment – often, restructuring is the only viable option. Even well-performing private equity investments require favorable market conditions upon exit, either in the form of strong M&A appetite or a robust IPO environment.

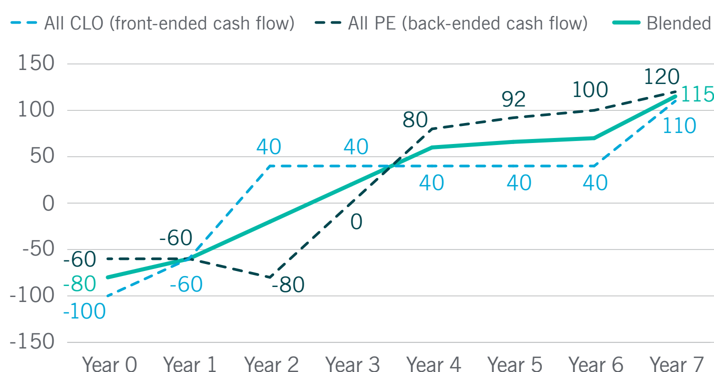
CLO portfolios, on the other hand, typically consist of relatively liquid debt instruments which can be sold into active secondary markets. CLOs are never forced sellers; the term structure of CLO debt enables managers to wait for the opportune moment to trade out of names that have experienced credit deterioration, or which have become fully valued. This advantage is especially critical when major macro shifts – such as pandemics, geopolitical upheaval, or drastic changes in interest rates – call for significant portfolio re-positioning. As an added advantage, CLO managers are not dependent on the unpredictability of the capital markets when hunting for opportunities. Even if new issuance markets come to a complete halt, CLO managers can turn to secondary markets to find investment opportunities, often at substantial discounts to where the deals priced in the new-issue market.

THE CASE FOR ADDING CLO EQUITY TO AN ALTERNATIVES ALLOCATION

The relative benefits of CLO equity do not diminish the many positive attributes of private equity, which has delivered impressive performance through multiple economic cycles and served as an important engine of returns for institutional investors. Talented private equity managers can pull many levers to add value to portfolio companies. Private equity also offers meaningfully greater upside than CLO equity, since CLO performance is ultimately linked to debt instruments which have capped upside.

In a portfolio context, there are compelling arguments in favor of utilizing CLO equity as a complement to private equity. While both of these investments derive their value from exposure to companies, the fundamentally different return drivers of debt versus equity instruments enables an investor to harness dual engines of alpha. The front-ended, cashflow-driven return of CLO equity pairs well with the back-ended, total-return upside of private equity, potentially creating a smoother blended return profile within an alternatives allocation (Figure 5).

Figure 5: Combining cashflows from CLO equity and private equity may provide a smoother returns experience



For illustrative purposes only to show the impact of combining front-ended cashflows with back-ended cashflows.

Market cycle differences between CLO equity and private equity returns

The performance of CLO equity and private equity is often quite different depending on the market environment, with markedly different return outcomes depending on the economic cycle (expansion versus contraction), interest rates (low versus high), and animal spirits (ebullient IPO markets versus risk-off). We believe rising interest rates and potentially oncoming recessionary environments may lead to outperformance for CLO equity vs. respective PE vintages, as CLO managers can take advantage of volatility in the markets, while PE managers may struggle to monetize their investments. CLO-equity vintages from the years prior to the GFC (e.g., 2004 to 2009) outperformed the PE vintages from the same time period primarily for these reasons.[5] Going forward, we see a lot of similarities in the current environment with the pre-GFC environment and believe that CLO equity may again outperform PE. This makes intuitive sense given the impact of higher financing costs on portfolio companies during high interest rate environments.

An environment of higher-for-longer interest rates is likely to tilt returns in favor of debt holders, and be a potential advantage to the current vintage of CLO equity. Regardless of an investor's macro outlook, the benefits of CLO-driven cashflows are obvious; robust ongoing income provides liquidity as well as the flexibility to pivot portfolios as conditions change over time.

CONCLUSION

We believe investments in CLOs can bring multiple benefits to a diversified portfolio. Adding CLO equity to private-equity alternatives allocations may be worth considering. Overall, this unique asset class provides benefits for institutional investors seeking increased potential for diversification, liquidity and historically favorable outcomes in higher interest rate environments.

For more information, please visit nuveen.com.

Endnotes

Sources

1 Nuveen Equilibrium: 2023 Global Institutional Investor Survey
2 Preqin as of 31 Dec 2021
3 The 24 year average was 64.3%. Source: JP Morgan Default Monitor as of 01 Nov 2023
4 BofA Securities Research CLO equity data as of 30 Sep 2023.
5 Pitchbook as of 31 Mar 2023

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