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CREDIT

Clarifying Misconceptions About the Arb

A Discussion on CLO Equity

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CLO strategies have grown in popularity in recent years but remain a less understood and niche part of the market today. We believe there are misconceptions about CLOs, particularly strategies that focus on CLO equity investing. In this paper, we delve into the topic of CLO equity return drivers and why the arbitrage (often referred to as the "arb"), or the spread between what a CLO earns on its asset portfolio versus the cost of its liabilities, is not always a strong predictor of ultimate CLO returns.[1]

1 Represents Bain Capital Credit's view as of the date of this publication and is subject to change.

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CLO Overview

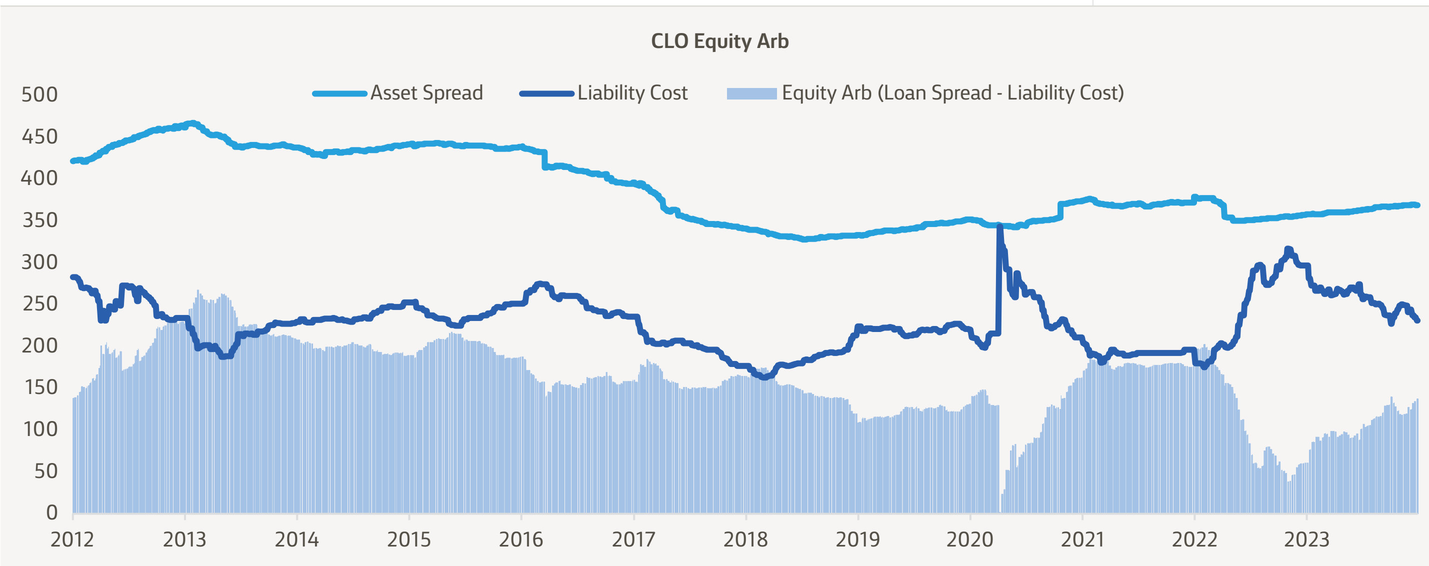
Collateralized loan obligations (CLOs) are securitizations which invest primarily in diversified pools of broadly syndicated loans (BSLs). CLOs finance these asset purchases with a capital structure, split into debt tranches rated AAA through single-B, and an unrated equity class. Higher rated tranches have seniority over lower rated tranches and equity, and therefore have priority on cash flows generated by the CLO. Due to the seniority and structural protections of the higher rated tranches, these investments offer lower yields than subordinated debt and equity tranches. For more information on CLOs, please see our *Introduction to CLOs* white paper.

CLO Arb

The arb, also known as the net interest margin, is an important consideration when issuing and managing CLOs, and generally moves around over time as both assets and liabilities react to market conditions (see Exhibit 1). Investors often articulate the best opportunities to issue CLOs are those when the net interest margin is wide relative to history.

EXHIBIT 1

Stated CLO Equity Arbitrage Over Time[2]



2 Data as of December 31, 2023. Exhibit 1: Liability cost calculated using JP Morgan Markets primary CLO spreads, assuming 36/24/18/12.5/9 par subs on the AAA-BB tranches. 26bps have been added to primary CLO spreads over Libor 3mo. Asset spreads from Pitchbook LCD.

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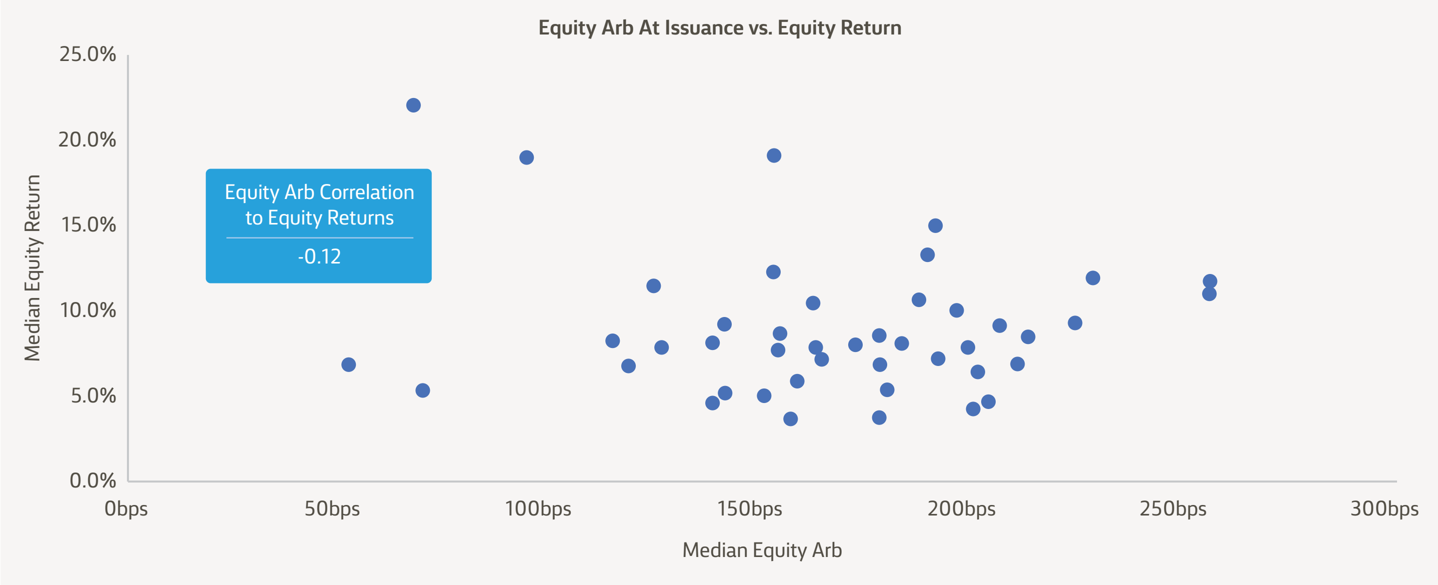
We believe this often leads to incorrect conclusions. In fact, while stated equity arbitrage at time of issuance is typically a strong predictor of new CLO origination, it has actually been *negatively* correlated to long-term returns (see Exhibit 2). We understand that this may be counterintuitive, so we offer an explanation on why we believe that is. Mainly, the widest arbs typically occur when markets are relatively stable following periods in which prices and liability spreads have rallied. This leaves less room for compression on both sides of the arb equation. In addition, as markets tend to cycle, these periods of stability have generally occurred prior to periods of volatility and spread widening. Thus, while there are CLOs that have performed well when issued in wide arb environments, history suggests it is a poor indicator of returns. Below we will explore other, perhaps more important, drivers of CLO equity performance.

EXHIBIT 2

CLO Equity Returns vs. the Arb at Issuance[3]



3 Equity returns calculated as of 1/31/24 using JP Morgan Pricing Service for any deals that are currently outstanding. Equity returns for any deals that have been redeemed are from Bank of America's Global Research's redeemed deal IRR calculation as of January 2024. Loan prices are the from the Morningstar LSTA price index

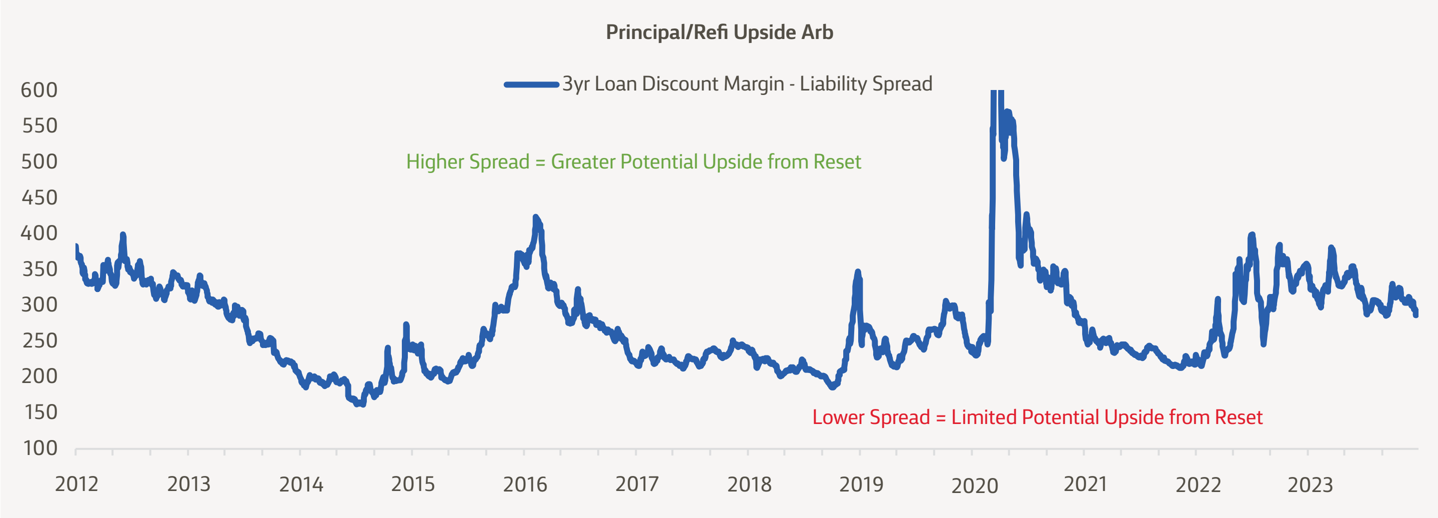
Drivers of CLO Equity Returns

Asset Prices: The greater the price discount in the loan portfolio, the more potential upside the CLO has from appreciation in loan prices. CLOs issued in 2020 and 2022, for example, had relatively poor stated arbitrage at issuance but since loans were discounted when many of these deals were issued, CLO portfolios benefited from the subsequent rally that took place. This value can be extracted by either redeeming the CLO or by refinancing the capital structure.

Refinancing Optionality: CLOs typically have a non-call period that ranges from 1 to 2 years. One half of the arb, the liability costs, can be changed following expiration of the non-call period. Because the arb is not static over the life of a CLO and deals can be refinanced, issuing a deal when liability costs are abnormally wide may still result in good returns. This was another reason 2020 vintage CLO equity has performed well. As liability costs compressed meaningfully in 2021 (see Exhibit 3), many of the 2020 deals were able to refinance and reduce their cost of debt. Throughout 2021, 525 deals totaling over $230 billion were either refinanced or reset.[4]

EXHIBIT 3

Potential Refinance Upside[5]



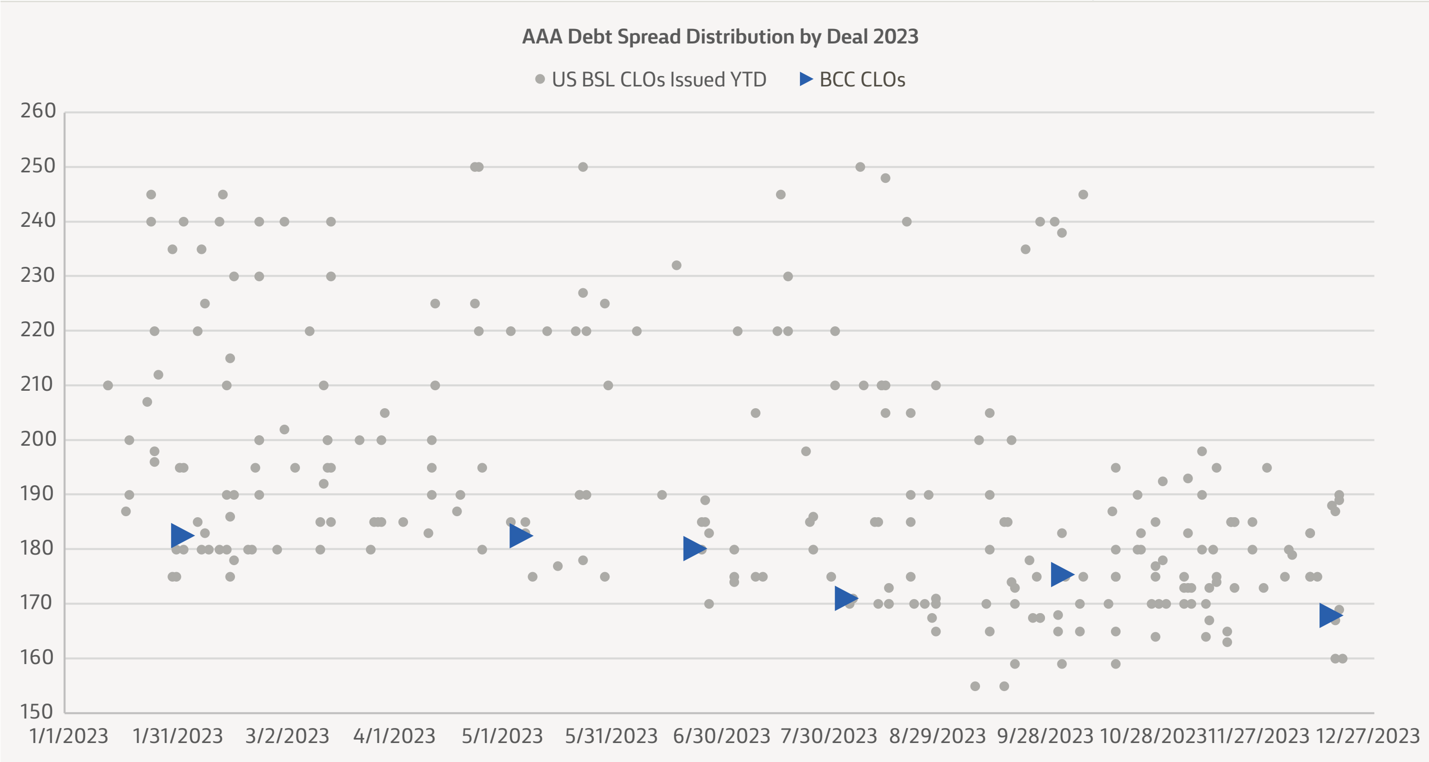
Manager Tiering & Performance: Finally, manager tiering, a term used to delineate manager quality, and manager performance can have large impacts on CLO equity returns. While the market-level arb does cycle between relatively attractive or not attractive over time, manager-level arbs can vary significantly over *all* time periods. Given CLOs are reinvesting vehicles and we now have more than a decade of manager performance data, there exists a relatively dramatic tiering in the market. As an example of this, in Exhibit 4 we plotted the AAA liability spreads of new issue deals priced in 2023.

4 Source: Pitchbook LCD. CLO vintage performance data referenced is as of December 31, 2023.

5 Data as of December 31, 2023. 3yr Loan DM from JP Morgan Markets. Liability cost calculated using JP Morgan Markets primary CLO spreads, assuming 36/24/18/12.5/9 par subs on the AAA-BB tranches. 26bps have been added to primary CLO spreads over Libor 3mo.

EXHIBIT 4

2023 New Issue AAA Prints[6]



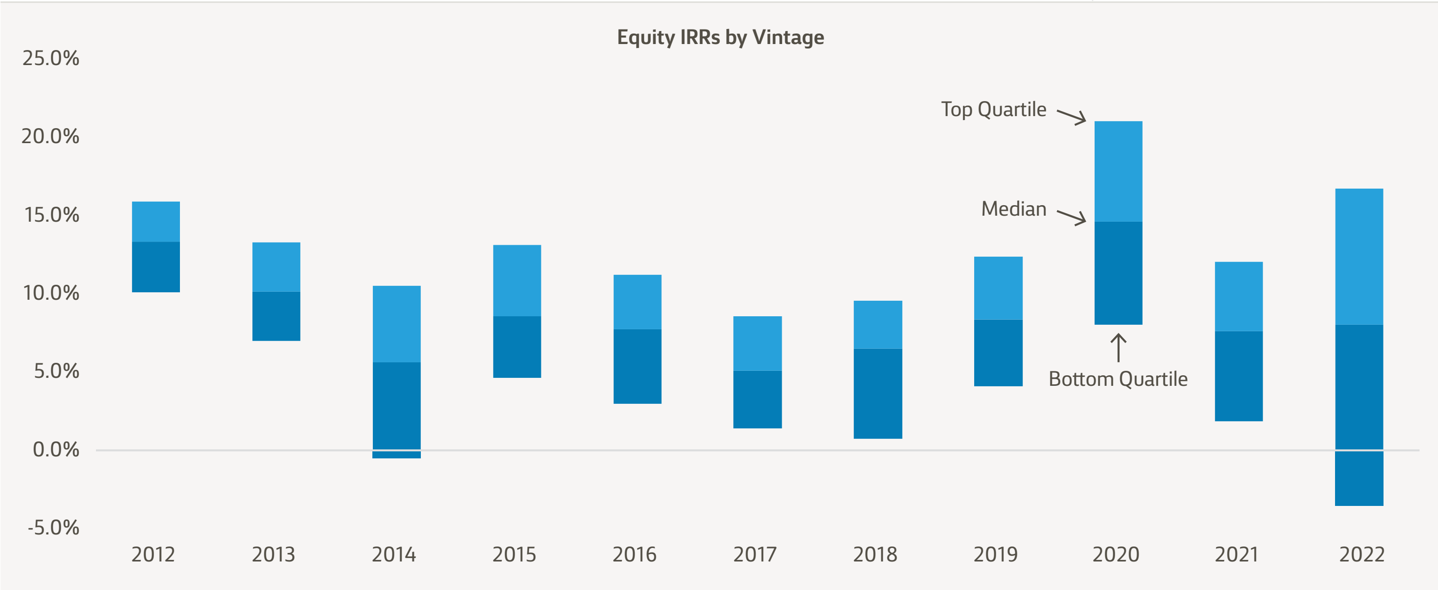
As shown above, there is a wide degree of dispersion in the CLO market and, given the leverage within the CLO structure, a wide or tight AAA print can make a significant difference in CLO equity performance. Beyond the CLO structure itself, underlying portfolio performance is a meaningful contributor to manager tiering. Factors such as credit expertise, loss avoidance, and trading acumen can be key components of portfolio returns. In addition, for managers that deliver strong CLO performance, there tends to be a positive feedback loop mechanism in the market – managers with better performance are generally able to issue deals with better arb, which in turn can drive better performance, all else equal. To further demonstrate dispersion in CLO performance, Exhibit 5 shows vintage year CLO performance percentiles. It is clear that, even within vintage years, there is a substantial difference between the top and bottom quartile performers.

In Exhibit 4, we have highlighted AAA liability spreads of Bain Capital Credit ("BCC") deals priced in 2023. Pricing tight AAA levels can drive attractive CLO equity returns.

6 Data as of December 31, 2023. Issuance data from JP Morgan Markets. Bain Capital Credit analysis. Showing US CLOs for Bain Capital Credit.

EXHIBIT 5

CLO Performance Dispersion[7]



Conclusion

As with many aspects of investing, there is more than meets the eye when assessing the CLO space in our view. We believe one cannot simply look at one or two metrics to determine whether a CLO will perform better or worse relative to history or other CLOs. The arb, and its weak correlation to ultimate CLO equity returns, is a prime example of this. Rather, there are a multitude of factors driving CLO equity returns, some market driven, and others influenced by manager performance and deal structuring. We believe it is important for investors to understand all of these factors when evaluating CLOs and CLO managers.

Accessing CLO Equity Through Committed Equity Vehicles

There are two primary ways to invest in CLO equity: third-party equity investments in a fund or managed account, or through committed equity vehicles - strategies targeting programmatic investments into the equity tranches of a manager's own CLOs and warehouses. Both of these approaches can yield positive results for investors, but we believe committed equity vehicles, when deployed well and structured with strong alignment between investor and manager, offer the most efficient way to access CLO equity. Among other benefits, committed equity vehicles can provide diversification across vintages, opportunistic deployment in reaction to market volatility, and attractive terms. Of course, as discussed in this paper, not all managers and structures are created equal. We believe it is important to partner with experienced managers with scale and expertise in the CLO sector, as well as deep fundamental credit knowledge.

7 Equity returns calculated as of December 31, 2023, using JP Morgan Pricing Service for any deals that are currently outstanding. Excluded 2023 vintage deals. Equity returns for any deals that have been redeemed are from Bank of America's Global Research's redeemed deal IRR calculation as of January 2024.

About Bain Capital Credit[8]

Bain Capital Credit ("BCC") is a $47B alternative asset manager with expertise across the credit spectrum, including CLOs, bank loans, high-yield bonds, and private credit. BCC has a successful 23+ year track record of managing, structuring, trading, and investing in the CLO asset class and today manages $23B across its structured credit platform. We strongly believe scale, experience, and expertise are imperative in driving value in the CLO market, especially during times of heightened uncertainty. As an issuer and investor in CLO debt and equity, we are vertically integrated in this market and, as such, we believe can offer differentiated knowledge to a variety of investor types that choose to invest in CLOs. Our strong performance results are accentuated by the fact that we have managed 70 CLOs through multiple cycles and have successfully launched multiple dedicated vehicles exclusively focused on CLO investing.

8 Bain Capital Credit AUM data as of December 31, 2023. CLO AUM and investing statistics as of December 31, 2023.

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