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CLO Insight: Q&A with LibreMax's Dominick Mazzitelli and Nirjhar Jain - inflows for distressed CLO trading to rise with dispersion

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In an exclusive interview, LFI spoke with Dominick Mazzitelli, CIO and head portfolio manager of LibreMax Capital's CLO management business at Trimaran Advisors, and Nirjhar Jain, sector head of CLOs at LibreMax Capital, about the state of the CLO market and opportunities. LibreMax Capital is a $9.4 billion asset management firm specializing in structured products across both public and private markets.

What's your outlook for triple-A spreads for mid-size CLO managers in June?
We believe triple-A spreads for mid-size managers look relatively wide compared to top-tier managers, and anticipate this widening will persist given the lack of sponsorship from domestic banks and money managers. We also expect that absent a tightening in AAA spreads, CLO issuance volumes will be lower as the CLO arbitrage does not appear economical.

In the absence of tightening in liabilities, will managers still liquidate CLOs?
Given where loan prices are currently, the only CLO liquidations we expect to come to fruition will be those from CLOs where portfolios have de-levered significantly, equity payments are de-minimis and there is excess NAV available for distribution to equity holders. We do not expect CLO liquidations to be a source of assets for new CLOs.

What have BSL CLO managers learned from the first quarter's heavy bankruptcies (e.g., creditor-on-creditor violence)?
One key observation from early 2023 was that median recovery rates for defaulted assets trended well below median rates observed in recent years and were more consistent with recoveries observed during recessionary periods. While creditor-on-creditor violence contributed to such outcomes in certain reorganizations, average recoveries were further pressured by a limited number of defaults where the rapid onset of unexpected business disruptions and/or financial distress led to unusually low recoveries to lenders. Looking ahead to the remainder of 2023, while there is some dispersion of thought across managers, average recoveries are commonly expected to remain close to current levels given the likelihood for the U.S. economy to contract during the back half of the year.

How is the large number of deals exiting their reinvestment period and virtually no repricings impacting the CLO secondary market?
As a large proportion of the CLO market exits the reinvestment period, these deals will become static and, over time, we anticipate that adverse selection will increase the tail risk in these pools as better-quality assets get repaid via normal course capital markets activity. As such, we expect to see more dispersion in pricing for these tranches as the credit story plays out over the next few years. We believe distressed CLO investing will become attractive and therefore bring in new capital as risk changes hands from insurance companies and money managers to distressed and private equity investors.

Where are you seeing value in the secondary market in equity or senior IG?
We are currently seeing value in short-duration IG tranches of CLOs and have been a buyer of deals out of re-invest that are highly de-levered with attractive risk-adjusted return profiles. Some of these original BBBs look similar to AA/A-type risk, with 2.5-3.5yr WALs as well as high-single-digit yields and upside to a call. In CLO equity, we have been extremely judicious as we look to invest in paper that derives a large portion of its value from interest distributions rather than ultimate NAV recovery. We also prefer cleaner deals with less tail risk, which we believe will be better suited to withstand the tough credit environment over the next couple of years.

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How does your firm tier CLOs managers in the secondary market, in general?
We tier managers based upon the part of the capital stack in which we are seeking to invest. In our view, manager tiering for a particular part of the stack is simply a function of credit performance, platform stability, liquidity, and relative value. We generally gravitate towards managers that provide good relative value for their credit performance.

When does the primary become more attractive than the secondary market for CLO?
Generally speaking, CLO equity aside, we believe that for the right portfolios, new issue debt is more attractive because we have found higher coupons, better structural protections, and cleaner portfolios available in that market. While secondary tranches are trading at discounted prices, we believe convexity is overpriced given that it is tough to see a catalyst for a strong rally or deal liquidations in the near-to-intermediate term.

When looking at CLO equity specifically, however, we believe secondary deals appear more attractive presently, as they have tighter cost of debt. However, as downgrades and defaults start gaining steam, credit and manager selection will be paramount and there will be dispersion in performance across deals.

New issue equity on the other hand, is a more conservative way to invest in the loan market (even though the arbitrage is not super enticing today) as current new issue structures have lower leverage and starting asset pools can be chosen more judiciously to better withstand credit turmoil. There is also convexity to refinance or reset scenarios once markets recover.

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