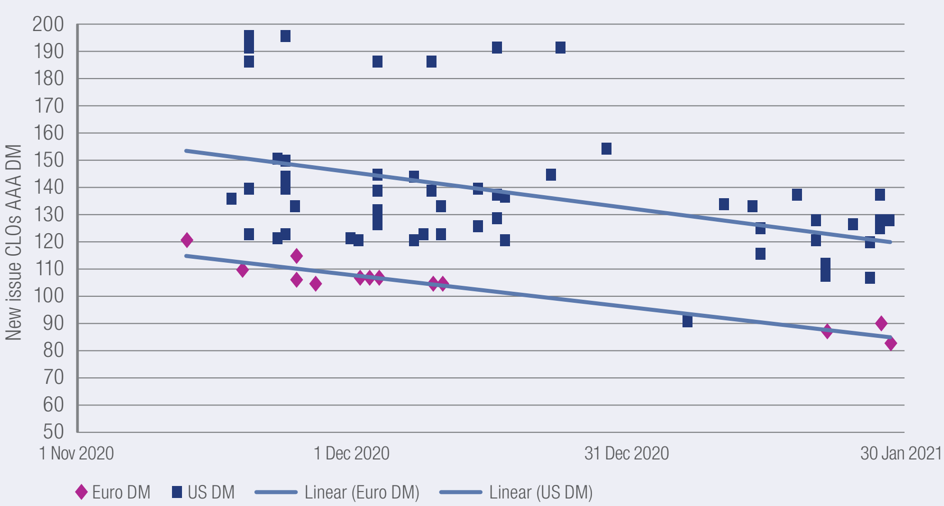
Pattern recognition?

New issue and secondary CLO double-B disparity discussed

In this latest in the series of SCI CLO Case Studies, we examine the double-B pricing patterns in CLO primary and secondary markets amid November to January's textbook new issue boom and rally.

Since November 2020, CLO new issuance has been on an upward trajectory, bolstered by an improving macro outlook and the ever-increasing demand for yield. Deals are being brought in growing numbers, regularly upsizing and prices tightening, as the following chart of new issue triple-A DMs shows:

Triple-A trends



Source: Bank/rating agency research and market sources

Such an environment historically causes some dislocation between primary and secondary pricing, particularly towards the bottom of the stack around the double-B level. So, we decided to take a look at comparative pricing levels in the new issue (for simplicity, excluding refinancings and resets) and BWIC markets in Europe and the US in the three months between November 2020 and January 2021.

New issue pricing is broadly driven by supply and demand and connected directly to secondary levels. However, a number of practical factors can impact relative pricing of double-B bonds, especially when the primary market is exceptionally busy.

Typically, market expectation is that in most cases new issue spreads are tighter on average than secondary spreads, thanks to such factors as: some double-B tranches being retained and traded later (see box); the extra work investors need to do on secondary paper can command a spread premium; and the higher level of demand in primary over secondary, due to the large number of investors who only participate in new issues. However, there is also an element that can push prices the other way – double-Bs typically only account for a small percentage of the debt stack, leaving it open to issuers to be flexible on pricing and offer wider than market spreads on the tranche to get the deal done.

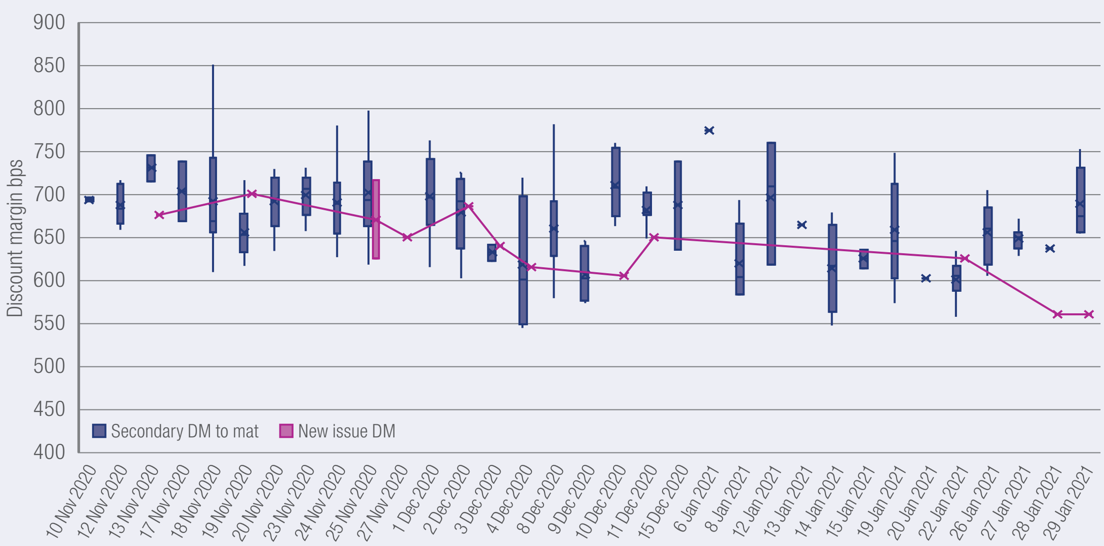
In any event, matters become more complex when moving down the stack and introducing secondary market prices. New issue does still retain an element of simplicity in that it only involves clean par bonds, but BWIC cover prices for lower mezz are typically seen in a wide range on any given day, reflecting manager tiering and whether the paper is trading at par or a big discount.

To compensate for this, we have used box and whisker charts to illustrate the data. These have the advantage of showing the full range of prices seen each day – the whiskers – so that outlying prices are not ignored, and a box illustrating the 25th percentile to the 75th percentile of prices to accentuate where the majority of the trades are printing.

Europe

First, let's look at Europe over the three-month period in question.

Euro BB CLO spreads



Source: SCI PriceABS, bank/rating agency research and market sources

As can be seen, some of the blue secondary market entries either form as a cross – signifying a sole trade on a given day – or just a box with no whiskers, which is a result of only two or three trades on a given day meaning it's not possible to form quartiles. For the secondary data, there is no line connecting the entries, as connecting the median of such wide-ranging and complex data would not be meaningful.

Instead, the aim is to provide an intuitive visualisation of market activity and tone. From this, there is some indication of tightening and widening through the period. But overall prices are fairly flat, with a broad range throughout – typical of how the CLO secondary market behaves.

The pink entries showing DMs for new issues on their pricing dates are – with one exception – showing single issues on each day, as is usual in the European primary market. However, this cleaner data allows the ability to draw a connecting line between the entries throughout the period to provide an overall trend – though there are still notable fluctuations, driven by manager tiering, structure and asset quality.

RETAINING SKEW

One other aspect of new issuance double-B bonds that can slightly skew pricing is the tranche being retained. Eight US deals, but no European ones, did this during the period in question – Allegro CLO XII; CBAM 2020-13; GoldenTree Loan Management US CLO 9; Lucali CLO 2020-1; Maranon Loan Funding 2020-1; PennantPark CLO 2020-2; Sculptor CLO XXV; and Woodmont 2020-7.

Motivations can be various for retaining double-Bs – from the syndicate desk seeing immediately better relative value in secondary than the primary clearing levels on offer, to the issuer making a long-term economic decision. The last US deal to price in January with retained double-Bs, GoldenTree Loan Management US CLO 9, is believed to have taken the latter route.

The US$697.84m deal priced on 22 January 2021 as follows:

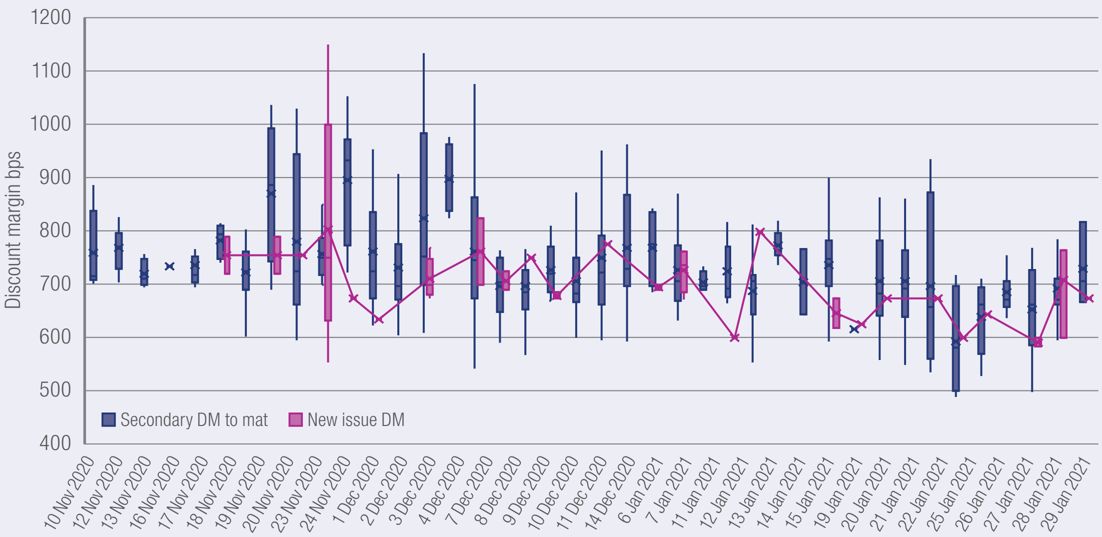
Class	Size	DM	S&P rtg
X	4.20	50	AAA
A	455.00	107	AAA
B	84.00	150	AA
C	45.50	180	A
D	40.60	290	BBB-
E	21.35	Retained	BB-
F	6.30	Retained	B-
SUB	40.89		NR

GoldenTree is understood to have held the double-Bs at par with a 7.7% coupon, with an option to sell them in secondary in the future when the market tightens sufficiently. Such a strategy is expected to increase in use as CLO managers continue to grow in size and have increasingly strong cash reserves to retain tranches for as long as is necessary.

US

Now, here are the US markets over the same period.

USD BB CLO spreads



Source: SCI PriceABS, bank/rating agency research and market sources

At first glance, the US primary connecting line – albeit with higher numbers of multiple deal days than Europe – doesn't appear to offer any clear message. However, a closer look reveals a pattern.

Starting from mid-November and the first deals of the month, the new issue level is slightly tighter than secondary on the same day. Then, it starts to tighten further by 20 November and still further by 23 November.

Then, on 24 November, new issue moves wider. But, notably, this is over a big range and – even then – the mean of the blue and pink boxes are still close.

Following this, there is a shift to where new issues are tighter again, even to the point of being tighter than the whole range of secondary prices. Certainly, on 1 December and 2 December – even on 4 December – new issue is clearly at the tight end of the trading range.

Overall, taking every entry one by one, the new issue level is usually around the middle of the secondary level or it is tighter. There are only a few incidents of new issue being wider, the most significant of which is 11 January, which was at the far wide end of the secondary trading level and that would be due to manager quality.

Conclusion

Counter to expectations, the data doesn't show a clear-cut picture. It has served to underscore the complexity and wide-ranging nature of secondary markets either side of the Atlantic. Equally, it has shown that new issue tightened more than secondary in the three months since November 2020, certainly in Europe but perhaps less so in the US.

Ultimately, we can see that over the period examined, double-B primary levels are not actually separated by an obvious gap from secondary levels. However, it is clear that the gap is within the range of secondary prices, but nearly always at the low end of that range.