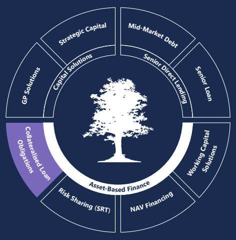


PEMBERTON

CLO Insights Series

CLOs for All Seasons

November 2025

Introduction

CLOs are typically designed for all seasons.

CLOs generally do well when there is a plentiful supply of good quality assets, minimal defaults and the arbitrage is strong. This characterised the long "summer" for CLOs from 2014 – 2019.

Looking back further, CLOs have proven their resilience through the "winter" of the global financial crisis and the Eurozone crisis.

More recently CLOs have survived the turbulence of negative interest rates, Covid lock downs and high inflation.

Throughout this period performance has been impressive with negligible defaults according to Standard & Poor's Rating Agency.

So, what makes CLOs so adaptable?

Matching

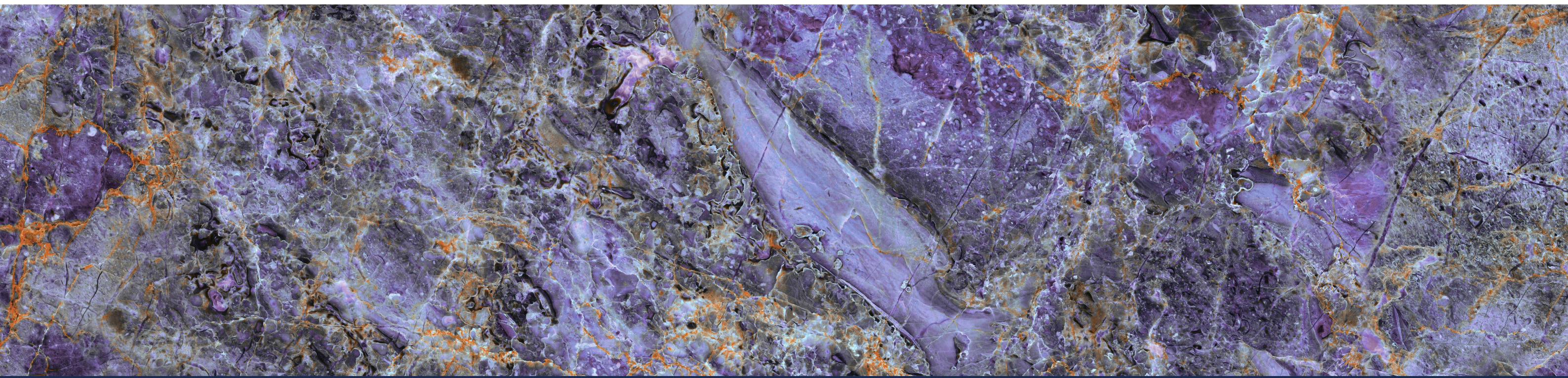
Firstly, CLOs are matching vehicles. They invest predominantly in Broadly Syndicated Leveraged loans (BSL) and seek to match the characteristics of the assets with the terms of the liabilities. This reduces some of the main investment risks associated with investing in credit assets.

Examples of matching include:

- Duration - as both assets and liabilities are linked to floating rates (or hedged).
- Currency risk – as assets and liabilities are in the same currency (or hedged).
- Maturity – as the note structure has a longer maturity date than the loans.

Structural Features (See Separate Papers)

- Eligibility Criteria and Portfolio Profile Tests
- Collateral Quality tests
- The Waterfall
- Lifecycle
- Role of Trustee and Collateral Administrator
- The CLO model has been built to withstand a level of stress
- CLOs incorporate "cure" provisions to protect investors



Investment Management Delegation, Expertise and Governance

CLOs delegate investment decisions to a CLO Manager with requisite expertise acting in accordance with an agreed Standard of Care (see separate paper).

Each asset is carefully analysed by the CLO Manager before being submitted for approval to an investment committee.

The Collateral Administrator is asked to run a "hypo" before acquisition of each asset to ensure that the portfolio requirements will be met.

Active Management

During the Reinvestment Period, the CLO Manager can reinvest repayments and trade assets to manage risk and optimise the portfolio. This means that CLO Managers can reposition the portfolio to reflect their views on individual sectors as well as to manage other risks. Typical reasons to trade include:

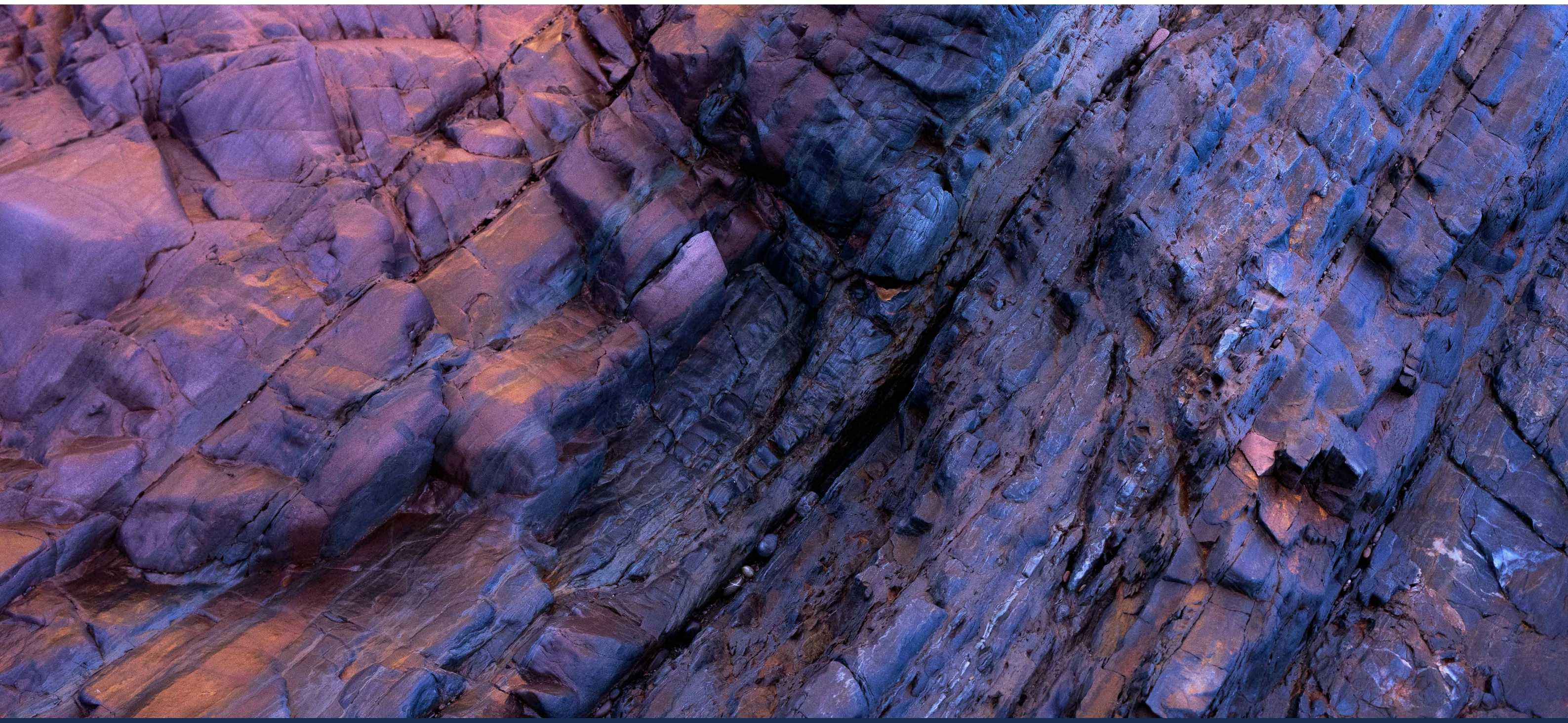
- Borrower performance
- Relative value
- Rating changes
- Maturity changes
- Spread changes
- Realising gains or reducing losses

Risk Retention (See Separate Paper)

EU and UK regulation requires the originator, sponsor or original lender of a "securitisation" (which includes CLOs) to retain a net economic interest of at least 5%. Risk retention (commonly known as "skin in the game") therefore aligns the interest of the Retention Holder with Investors.

Amortisation

Loans have scheduled repayment dates so that investors can expect to get their money back from repayment rather than sale of assets. Following the Reinvestment Period, the CLO Manager's ability to reinvest is limited to unscheduled principal receipts and sale proceeds of credit improved or credit impaired assets and the Reinvestment Criteria also becomes more restrictive. This tilts the CLO Manager towards amortisation of the CLO notes.



Self Defence

CLOs contain a variety of techniques to limit what the CLO Manager can do whilst allowing the CLO Manager flexibility to manage the portfolio including assets that default or become distressed. The following table highlights these provisions.

Topic	Actions and Controls
Eligibility Criteria	These are criteria that must be satisfied for each asset at the time of acquisition (or binding commitment) as determined by the CM in its reasonable discretion. For instance, assets cannot be in defaulted assets and must have minimum ratings. Typically, no structured credit instruments are permitted.
Portfolio Profile Test	There are limits imposed on concentration within the portfolio (by obligor, sector and country) as well as on holdings of HY bonds, mezzanine, second lien, PIK, zero coupon, project finance, infrastructure and unsecured loans. There are also limits on extent of permitted super senior debt above the senior lenders. Typically, at least 90% of the portfolio must consist of senior secured loans and bonds.
Credit Amendments	The CLO Manager can generally agree changes to the assets including agreeing pricing and maturity amendments, subject to certain conditions.
CCC Bucket	There is usually a limit of 7.5% CCC assets carried at par with the excess carried at market value or recovery rate.
Recovery	Senior secured lenders may be able to negotiate with shareholders for additional equity. Senior secured lenders may be able to accelerate the loans and take possession of key assets to facilitate a sale.
Distressed assets	A prescribed minimum purchase price allows the CLO Manager to build par but makes buying distressed assets less attractive.
Defaulted assets	There is a range of tools to manage defaulted or distressed assets: • Bankruptcy exchanges are useful if eventual recovery potential is improved. • Current pay loans are loans to bankrupt companies that are still paying interest. • Restructured loans give borrowers extra flexibility • Loss mitigation loans help preserve value for existing creditors • Corporate Rescue loans provide additional funds to viable businesses • Up-tier priming debt allows CLOs to participate in Liability Management Exercises to protect existing exposure.
Collateral enhancement account	This account opens the possibility of increasing potential recoveries by acquiring warrants or equities received in exchange or in connection with any collateral asset.

The "Weather" Forecast

Credit analysts are prudent people. They think about the downside rather than the upside.

They want the borrower to succeed because this means timely payment of interest and principal to the investors. Base case and downside sensitivities are run to gauge the risk of default.

Lenders don't make multiples of invested capital, so the integrity of every asset is important.

Similarly, CLO Managers want everything to go well but they are realists and recognise that sometimes things can go wrong.

This pragmatic mindset means that CLO Managers keep a close eye on macro and market developments that could affect the portfolio.

Some of the clouds on the horizon include:

- Geopolitical events
- Impact of technology (particularly AI)
- Trade tariffs
- Resurgent inflation and interest rates
- Availability of assets
- Lower spreads
- Increased defaults and lower recoveries

Conclusion

This article looked at the long-term performance of CLOs describing how they have weathered historic crises and upheavals before explaining some of the tools available to CLO Managers to navigate change.

The CLO sector remains a relevant financing option for borrowers to access funding on competitive market terms and for CLO investors in all seasons.[1]

Produced in association with Weil, Gotshal & Manges (London) LLP.

[1]Past performance is not a reliable indicator of future results.

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