Private Equity vs. CLO Equity Returns

Overview

I. Private Equity and CLO equity are linked in a common ecosystem, with different structural risks, but similar historical returns.

II. Today, private equity expected returns are lower than realized returns in the post-GFC era, whereas expected returns for CLO equity remain in the mid-teens.

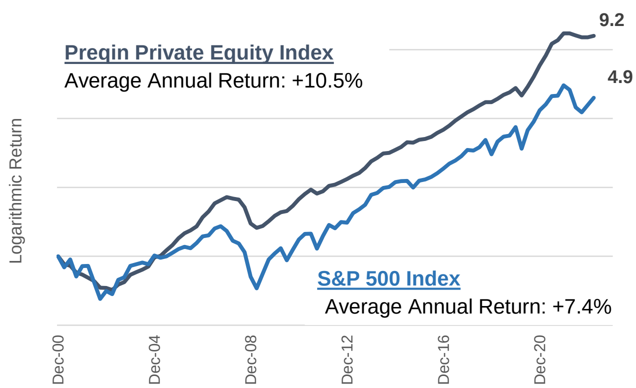
III. Many investors are heavily (or fully) allocated to Private Equity. Most have no allocation to CLO equity.

As investors search for high return alternatives, we suggest a serious look at CLO equity.

Private Equity Returns: 2001 to 2023

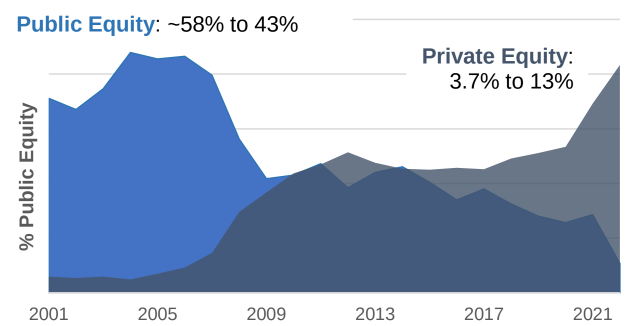
According to Preqin, an alternative asset data provider, private equity had an average annual return of +10.5% from January 2001 to March 2023. This reflected an average annual excess return of +3.1% relative to the S&P 500 index. Over the 22-year period, private equity outperformed the S&P 500 with an 87% higher cumulative return.

Private Equity vs. Public Equity Returns[1]
January 2001 to March 2023



The outperformance and (superficially) lower volatility drove a significant reallocation of capital in investor portfolios. Endowments, such as Yale and Harvard, were at the vanguard, and pension funds followed suit. According to the Center for Retirement Research at Boston College, the average U.S public pension plan reduced its allocation to public equities by ~15% from 2001 to 2022. Private equity absorbed the lion's share of the shift as the average allocation to the asset class grew by 350% over the same period.

US Public Pensions[2]: Change in Allocations%
Fiscal Year 2001 to Fiscal Year 2022



Private Equity Returns: Going Forward

Private equity performance was strongest in the post-GFC era: average annual returns were +14.4% from 2011 to March 2023. This was +2.1% higher than the S&P 500 during the longest bull market for public equities. Today, despite a considerably higher risk-free rate, the expected return for private equity is meaningfully lower.

The following compares private equity returns since 2011[1] to the expected returns of three representative investors: 1) University of Texas / Texas A&M Investment Management Company[3] ("UTIMCO", ~$70bn aum), 2) Meketa Investment Group[4] (~$1.7tn aua), and 3) NEPC[4] (~$1.3tn aua). All three expect significantly lower returns going forward, with NEPC expecting the return to be cut in half.

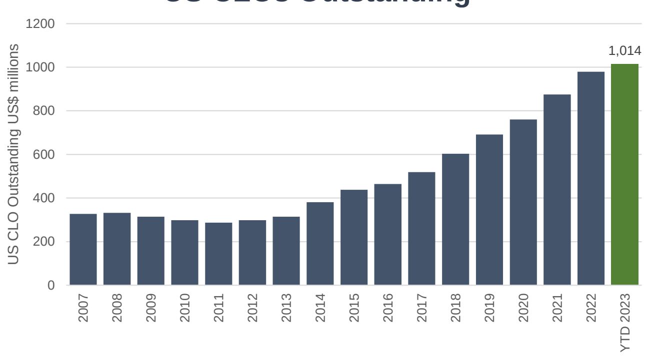
Preqin PE Index Realized Return Jan 2011 to Mar 2023	UTIMCO Expected Return as of Mar 2023	Meketa Expected Return as of Dec 2022	NEPC Expected Return as of Dec 2022
14.4%	10.1%	9.7%	7.7%

The lower expected returns coincide with the fact that many investors are heavily (or fully) allocated to private equity today. As investors search for other high-returning alternatives, we suggest CLO equity be given serious consideration.

The Private Equity and CLO Equity Ecosystem

Private equity managers often finance their acquisitions by borrowing in the $1.5 trillion Broadly Syndicated Loan market ("BSL"). Most of the loans are purchased by Collateralized Loan Obligations ("CLOs"), investment vehicles designed to earn an arbitrage between the income from the loans they purchase and their own cost of borrowing from banks, insurance companies, and other institutional investors. The CLO market has grown significantly since the first CLOs were issued in the early 1990's. Today, the U.S. CLO market is over $1 trillion in value.

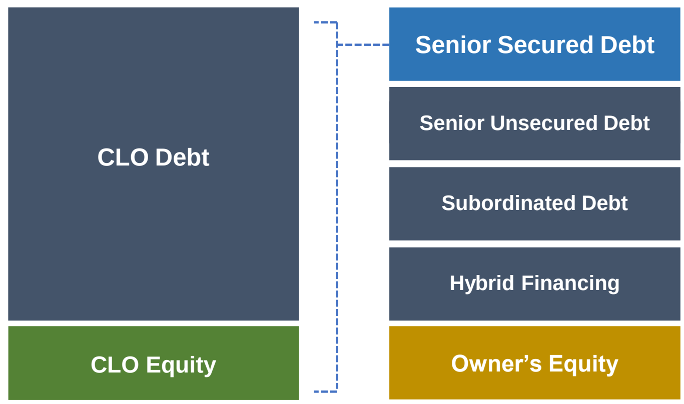
US CLOs Outstanding[5]



CLO equity sits at the bottom of a CLO's capital stack and receives residual income after paying interest to debt holders and after absorbing any losses in the CLO loan portfolio.

Essentially, CLO equity represents a levered exposure to BSL loan spreads. BSL loans are typically senior-secured, top-of-the-capital-stack debt that have first claim on a company's assets in the event of a bankruptcy. This is illustrated in the stylized capital structures that follow.

Capital Structure: CLO vs. Borrower[6]



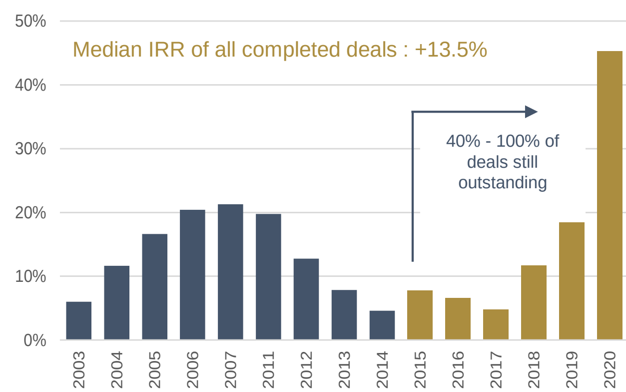
In contrast, private equity represents an exposure to the owner's equity of many of the levered borrowers in the BSL market. Owner's equity sits at the bottom of a company's capital stack and have last claim on assets in the event of a bankruptcy (yellow box in the graphic above).

In effect, private equity and CLO equity are linked in a common ecosystem, but they have fundamentally different structural positions and risk exposures. Notwithstanding their differences, they have similar historical returns.

Private Equity vs. CLO Equity Returns

According to Bank of America research, the median CLO equity IRR of completed CLO deals from 2003 to June 2023 was +13.5% net of fees. This represents the terminal performance of 958 CLOs.

CLO Equity Median IRRs[7]
Completed Deals by Year of Issuance, as of June 2023



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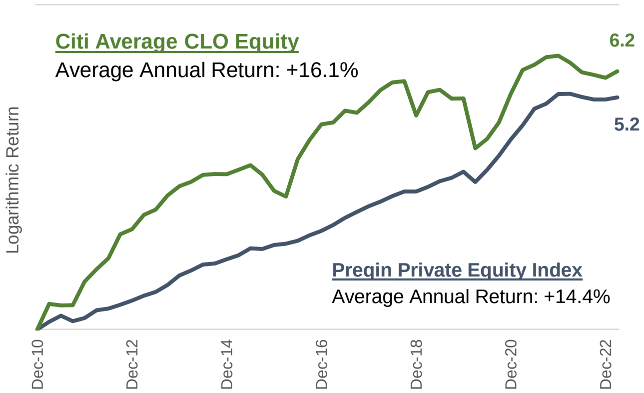
This compares favorably to the long-term return of private equity: +13.5% median IRR for CLO equity vs. +13.4% for the Preqin private equity index from January 2003 to March 2023. However, the data is incomplete and likely downwardly biased as most CLOs issued after 2015 are still outstanding (over 900 CLOs as of June 30).

Citigroup Research data on secondary market trading of CLO equity tranches offers another perspective. Though the data begins in 2008, we start the comparison below in 2011, when the trading volume in the secondary market began to be more meaningful (2008-2011 shows significantly higher average returns for CLO equity but are based on lower volumes of trading).

Private Equity[1] vs. CLO Equity[8]
January 2011 to March 2023



The analysis shows that the average CLO equity tranche had an average annual return of +16.1% from January 2011 to March 2023. This represents an annual excess return of +1.75% over the Preqin private equity index over the same period. Cumulatively, CLO equity had a 20% higher return than private equity over the 12-year span.

January 2011 to March 2023	Preqin Private Equity Index	Citi Average CLO Equity
Average Annual Return	14.4%	16.1%
Cumulative Return / MOIC	5.2	6.2

As we look forward today, we expect a diversified and actively managed portfolio of CLO equity to produce long-term returns in the mid-teens net of fees. Though times of greater volatility may offer opportunities for even higher returns, we suggest a strategic allocation to the asset class to take advantage of its attractive long-term features, while leaving flexibility for tactical repositioning.

Timing in CLO equity is as hard as timing in every other market; long-term investors are often better off with a strategic position.

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Disclosures

1. Source: Preqin Database: www.preqin.com
2. Source: Center for Retirement Research at Boston College; Public Plans Database: https://publicplansdata.org/quick-facts/national/
3. Source: UTIMCO Board of Directors meeting March 30, 2023 – 2023 SAA Review, page 65
4. Source: NEPC Presentation to Employee Retirement System of the State of Rhode Island, March 2023, Consultant Return Forecast Comparison, Page 7.
5. Source: JP. Morgan North American Credit Research, July 25, 2023
6. Stylized examples of CLO and typical borrower capital structure for illustration purposes only.
7. Source: BofA Global Research, Intex, CLO Equity Data as of 6/22/2023.
8. Source: Citigroup Average CLO Equity Tranche performance is published by Citigroup Research. Citigroup calculated actual CUSIP level CLO equity total returns, using month end prices from Citi's trading desk, and took the average total return after excluding the outliers (top and bottom 5 percentile.

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Investing involves risk, including the possible loss of principal.
perceived changes in the company's financial condition or prospects. An investment in a CLO involves substantial risks that should be carefully considered by any prospective investor before deciding to make such an investment. CLO securities present risks similar to those of other types of credit investments, including default (credit), interest rate, liquidity, prepayment, and reinvestment risks. CLO equity interests are not secured by any of the assets held by any underlying CLO and, while secured notes are outstanding, holders of CLO equity interests will not generally be entitled to exercise remedies under a CLO's indenture. The CLO issuer's ability to make distributions to the holders of CLO equity interests is limited by the terms of the relevant CLO indenture. If distributions on assets held by an underlying CLO are insufficient to make distributions on CLO equity interests issued by such CLO, no other assets will be available for distribution, which will adversely affect the value of the investment. The subordination of CLO equity interests to each class of secured notes makes CLO equity interests a leveraged investment in the assets of the CLO issuer. The occurrence of any of these risks could have a material adverse effect on an investment in CLO equity.

It should be noted, however, that there may be other risks applicable to such an investment that are not identified in this summary but that still may result in material losses to, or otherwise materially adversely affect, investments in CLOs.