PERSPECTIVES

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CLOs 2.0: Foreshadowing the Great Convergence

The ongoing revival of managed collateralized loan obligations (CLOs) epitomizes the rapid large-scale convergence between public and private markets and further shifts the boundaries of competitiveness for credit managers.

With potential changes to the European securitization framework afoot (following the "Draghi report"[1]), demand for securitized investments is poised to see a substantial increase – with CLOs expected to be a major beneficiary. Concurrently, as bank deleveraging accelerates, alternative credit solutions should continue to step in and fill the lending gap, leading to enhanced origination potential. These two trends position CLOs as an attractive new cog to the private credit machine which, after 10+ years of steady growth, appears nearly unstoppable.

Accessible revenue pool to increase by 2.0x by end of the decade

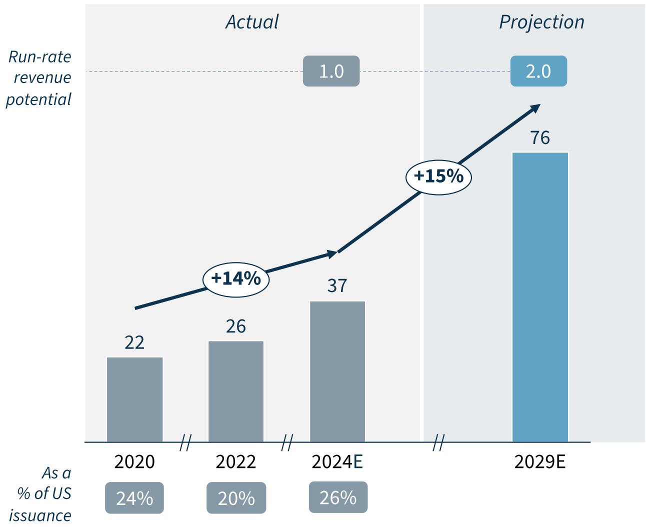
Several factors have hampered the European CLO industry, which currently represents approximately one-quarter of the US market, including:

- High capital charges under standard Solvency II frameworks;
- STS regulation ("simple and safe") discouraging complex products;
- The long shadow of the GFC; and an overall shallower credit market.

European demand is today limited to a focused target audience, including hedge funds, family offices, sophisticated pension funds, and leading insurers that operate internal models.

In a scenario where regulations change, disintermediation continues, and interest rates remain at current levels, we expect to see significant increases in annual issuance to ~€75bn p.a., translating into a €2bn revenue opportunity for European CLO managers.

Annual issuance of European CLOs (2020-2029E, €bn)



Sources: Deutsche Bank, Indefi analyses.

[1] Draghi, Mario. *The Future of European Competitiveness – A Competitiveness Strategy for Europe*. European Commission, September 9, 2024.

What it takes

The CLO market today presents attractive opportunities with relatively low barriers to entry. The European competitive landscape remains substantially fragmented (with 60+ active managers). The inherent alignment between CLO key success factors and traditional credit investing further facilitates organic market entry, and profitable expansion, even for traditional fixed income managers.

Key success factors include:

- **Sourcing & selection**: Access to loan markets, strong credit analysis capabilities, and an ESG investment process are all essential for effective selection.
- **Retention and equity tranche placement capabilities**: Ability to seed retention vehicles and place equity tranches efficiently is critical for stability.
- **CLO management expertise**: An experienced CLO management team with a strong track record to navigate specific loan management constraints and optimize portfolio performance.
- **Capital markets connectivity**: A recognized brand and connectivity with arrangers, structurers, and fixed-income investors enhance placement capabilities, supporting long-term growth and market positioning.

Beyond the attractive stand-alone opportunity that CLOs present for GPs and asset managers alike, the product's expected growth is also representative of what it will take to succeed as a credit manager in the near future.

CLOs at the intersection of the augmented credit platform model

Managers need to establish resilient 'all-weather' private credit platforms. In Europe, leveraged buyout-driven direct lending has been the mainstay of the private credit opportunity but is no longer the only game in town (e.g. fund-level financing, asset-based lending, SRT). CLOs will be a natural extension for many managers, and market leaders are thus embracing it as a core component of their platforms:

- **Creating integrated credit offerings:** As demand for credit becomes more sophisticated, market leaders will seize opportunities at the convergence of diverse capabilities. CLOs warrant particular attention, benefiting from growing demand as a standalone offering and as satellite allocations within liquid, illiquid, and hybrid products.
- **Maximizing fundraising opportunities**: While institutional investors remain core, appetite for private credit is rapidly spreading to wealth and retirement channels. It is critical for managers to actively position themselves within these key segments to capitalize on growth opportunities and ensure sustained market relevance.
- **Securing long-term growth via strategic partnerships with deep-pocket institutions:** Strategic deployment of seed funding enables managers to leverage emerging institutional demand for CLOs and structured credit while supporting broader platform expansion.
- **Industrializing origination**: Beyond proprietary sourcing channels, bank partnerships are proving attractive for CLO managers.

As the line between public and private markets becomes increasingly blurred, CLOs can offer a blueprint for reshaping credit platforms to best strategically gear up to the opportunities of a converging investment universe.

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