



EUROPEAN CLO EQUITY: FRAMING THE INVESTMENT CASE

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EXECUTIVE SUMMARY

Recent headlines suggest scepticism around CLO equity is high. Some of it is justified. We do not dispute that the recent experience of higher losses, for example, will continue. But part of the negativity also reflects the asset class' transparency including daily pricing, liquidity, and granular reporting, especially when compared with private asset alternatives.

That visibility can make CLO equity appear uniquely vulnerable during periods of stress. In our view, however, the longer-term evidence tells a different story.

As we show later in this paper, CLO equity has delivered a strong and consistent performance track record across cycles. More importantly, we believe many of its structural advantages, particularly relative to private equity and private credit, are becoming more valuable in the current environment, not less. CLO equity does not rely on a market exit to generate returns, does not face redemption risk, and distributes cash early and regularly.

The current environment is challenging. However, historically, periods of dislocation have also produced some of the strongest CLO equity vintages on record. Wider spreads, volatility, and forced selling have repeatedly created attractive entry points for patient investors.

The catch is manager selection. Returns in CLO equity have never been evenly distributed, and we believe that dispersion is likely to widen materially from here. In a market defined increasingly by credit selection, trading expertise, and downside protection, manager quality will matter more than ever.

For investors able to navigate that dispersion, we believe today's environment may represent a compelling entry point.

KEY POINTS

- **Manager selection is everything.** Managers will increasingly be rewarded for NAV protection. Within any given vintage, the gap between the best- and worst-performing CLO equity managers can run to tens of percentage points of NAV. And over the last six years, managers with a total return discipline have outperformed those without, by a meaningful 3.8 percentage points (see Section I) of unrealised IRR.
- **Volatility rewards patient capital.** CLO equity has delivered a median realised IRR of approximately 10% for redeemed European deals, with nearly a quarter generating returns above 15% (See Section II). Historically, the strongest performance has come from vintages issued during periods of stress, not despite difficult conditions, but because of them.
- **Structurally superior to the alternatives.** CLO equity does not require a market exit to generate returns, does not face redemption risk, and is marked to market daily. These are becoming increasingly important advantages in an environment where private equity exits have stalled and private credit vehicles are facing increased scrutiny.
- **Europe has consistently outperformed the US.** Since the start of 2014, average distributions for European CLO equity investors have been 4.3%, versus 3.6% in the US (See Section IV). In our view, that outperformance reflects structural advantages within the European market, and the drivers behind it remain firmly in place to those with the expertise to capitalise.
- **Captive equity has stabilised formation and comes with attractive economics.** The growth of captive equity programmes has kept CLO issuance resilient even in a challenging arbitrage environment. For investors inside these structures, fee sharing and majority investor control can create enhanced return profiles unavailable to third-party equity participants.

I. MANAGER SELECTION IS EVERYTHING

As we emphasise throughout this paper, our view is that credit markets are evolving in ways that place far greater emphasis on a manager’s ability to underwrite risk. **Just as we expect wider dispersion across the loan market, we believe the same dynamic will drive greater divergence in manager returns and in managers’ ability to raise capital.**

One compelling way to think about this is through NAV protection. Dispersion across European CLO equity NAVs is already significant. Around 13% of European equity tranches had a negative NAV through April, extending to more than 20% of pre-2022 vintages¹.

We believe CLO investors will increasingly reward managers that protect NAVs through the cycle. That advantage translates into two outcomes on the liability side:

- Lower funding costs at origination
- Greater optionality to execute a reset

That divergence is already visible. As the chart below shows, the standard deviation in European CLO BB tranche pricing has widened materially in recent years, with a growing gap between the tightest and widest-priced tranches. We strongly believe that this trend has further to run.

Pricing differentiation between European CLO managers has increased for BB tranches

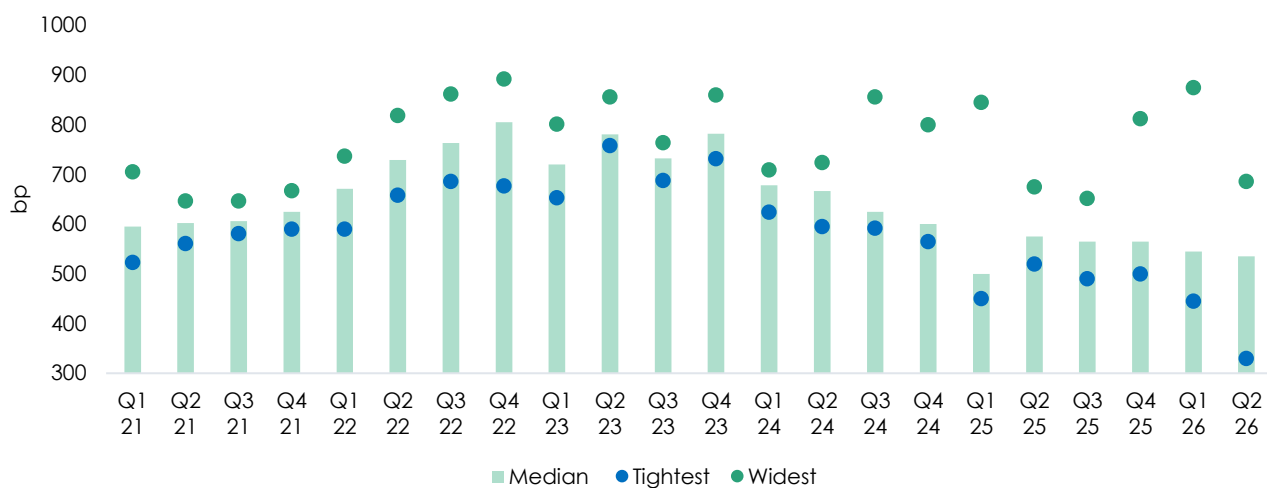


Figure 1: Range of European CLO BB Tranche Pricing Analysis by Manager Quarterly
Source: Sona Analysis, JP Morgan

BROADER CREDIT CAPABILITIES. BETTER RETURNS.

The current environment is a test, but not of portfolio size, diversity or AUM. **It is a test of who has built the research infrastructure, origination and execution capability, and credit cycle experience to navigate a more challenging environment.**

The software sector has been the clearest early fault line. The share of European CLO tech loans trading above par has fallen from 51% at year-end 2025 to just 25% today². Over the same period, the proportion trading below 90 cents has risen from 12% to 27%³. Managers who saw this coming, entering the selloff with lower software exposure,

¹ Source: Bank of America, Apr-26

² Source: Bloomberg, Apr-26

³ Source: Bloomberg, Apr-26

reinvestment flexibility, and the ability to buy discounted paper as others sold, have already opened a meaningful performance gap that will likely widen as the cycle develops.

The 2028 European loan maturity wall which is the steepest on record, with approximately €100bn of loans maturing in the next three years (equivalent to 25% of the market)⁴, will force active credit judgement at scale. The mechanism that absorbed some of the European loan stress in 2022 and 2023, namely the private credit market absorbing supply, is itself coming under pressure. The amend-and-extend option that rescued many issuers in prior cycles may not be as widely available this time around. Managers who can distinguish early on between a borrower that needs more time and one that needs a restructuring, and act on that distinction, are likely to benefit.

The average software loan is down 6 points over the last year, and the maturity wall is the steepest in 10+ years

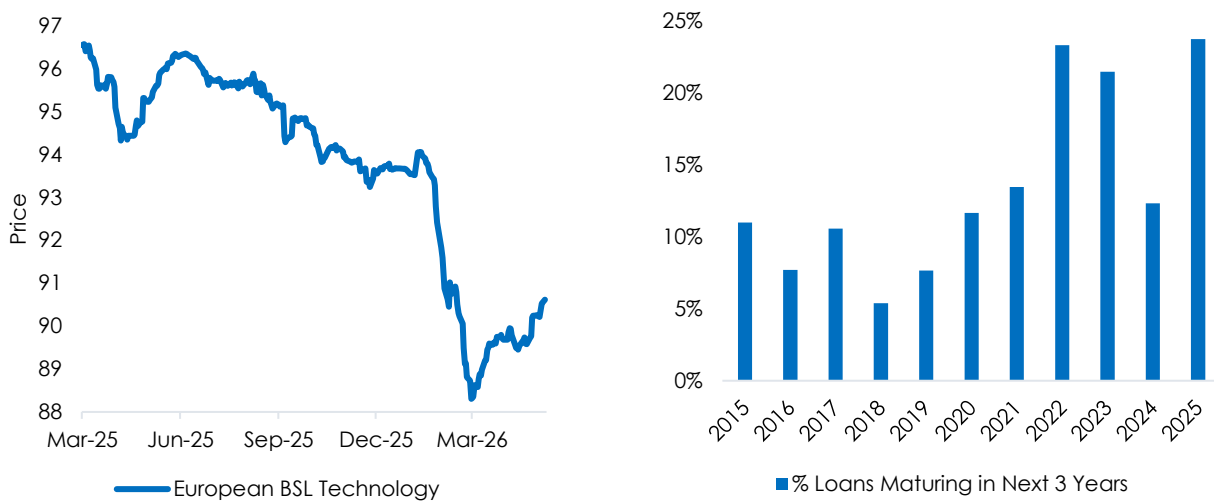


Figure 2: European BSL Technology Index Price vs. European BSL Maturity Wall

Source: Bloomberg, PitchBook

This is where manager credit capabilities matter. Managers that have built the expertise, either internally or through adjacent alternative credit strategies, to analyse recovery scenarios, navigate liability management exercises (LMEs), and engage constructively with borrowers through periods of stress hold a structural advantage in this environment that traditional performing-credit managers cannot easily replicate.

Specifically, we believe managers with a total return investing mindset are best positioned. Why? Because these managers inherently have mark-to-market connectivity. They also bring the discipline that comes from managing both long and short positions, experience that directly informs portfolio construction and sector weightings. Just as importantly, they are typically less constrained by the hold-to-maturity mentality that can define more traditional long-only strategies. The constant reassessment of relative value and the ability to walk away from a deteriorating credit is a genuine advantage.

That difference is already showing up in performance. We analysed unrealised IRRs across European CLO vintages for managers with broader investing capabilities that extend beyond traditional long-only strategies, including total return credit strategies, versus those without. Since 2018, managers with those capabilities have consistently outperformed. Since 2020, the average performance gap has been a meaningful 3.8 percentage points of unrealised IRR⁵.

⁴ Source: PitchBook, Mar-26

⁵ Source: Sona Analysis, Intex, Apr-26

European CLO managers with total return capabilities have consistently outperformed



Figure 3: Unrealised IRRs by Vintage for Managers With Total Return Credit Investing Capabilities vs. Without
Source: Sona Analysis, Intex

CREDIT MARKETS ARE CONVERGING – INFORMATION IS THE NEW MOAT

One of the defining structural shifts in credit markets over the past decade has been the progressive convergence of public and private lending. **The lines between broadly syndicated loans, direct lending, and structured credit are blurring, reshaping the information landscape for CLO managers and creating a new source of competitive advantage for those positioned to exploit it.**

The same borrower issuing into the BSL market today may have debt placed privately, bonds outstanding in the high yield market, and a revolving credit facility from a bank syndicate. Understanding that borrower's full capital structure, and how its different layers of debt interact, requires access to information flows that span multiple markets simultaneously. A CLO manager focused solely on the BSL market sees only one dimension of that picture. A manager operating across BSL, private credit, high yield, and structured credit sees the whole balance sheet.

We made this argument at length in our paper, [Private Credit: An Honest Assessment \(March 2026\)](#): **if you don't operate across both public and private credit, you should not be doing either.** The managers best positioned to succeed in the next phase of the cycle will combine the sourcing capabilities and structural creativity of leading private credit managers with the liquidity, price discovery, and real-time risk management available in public markets.

That integrated credit philosophy is not a hybrid strategy of simply owning both asset classes. It is a fundamentally different way of thinking about credit risk: one that continually asks where risk is most attractively priced, and where structure creates or destroys value.

Subsequently, the winners will be the managers best able to share and leverage this information internally.

SPONSOR AND ARRANGER RELATIONSHIPS: A DIFFICULT EDGE TO REPLICATE

Closely tied to the information convergence theme is the role of sponsor and arranger relationships and the degree to which those relationships will become more, not less, decisive in the next phase of the cycle.

Primary loan flow in the European leveraged loan market is highly concentrated. A relatively small group of private equity sponsors accounts for a disproportionate share of leveraged buyout (LBO) activity. The top five sponsors (CVC, PAI, KKR, CD&R and EQT) account for 27% of all deals, while the top ten represent 44%. In the US, the comparable figures are materially lower at 20% and 30%, respectively⁶.

There is a higher sponsor concentration in the European BSL market versus the US

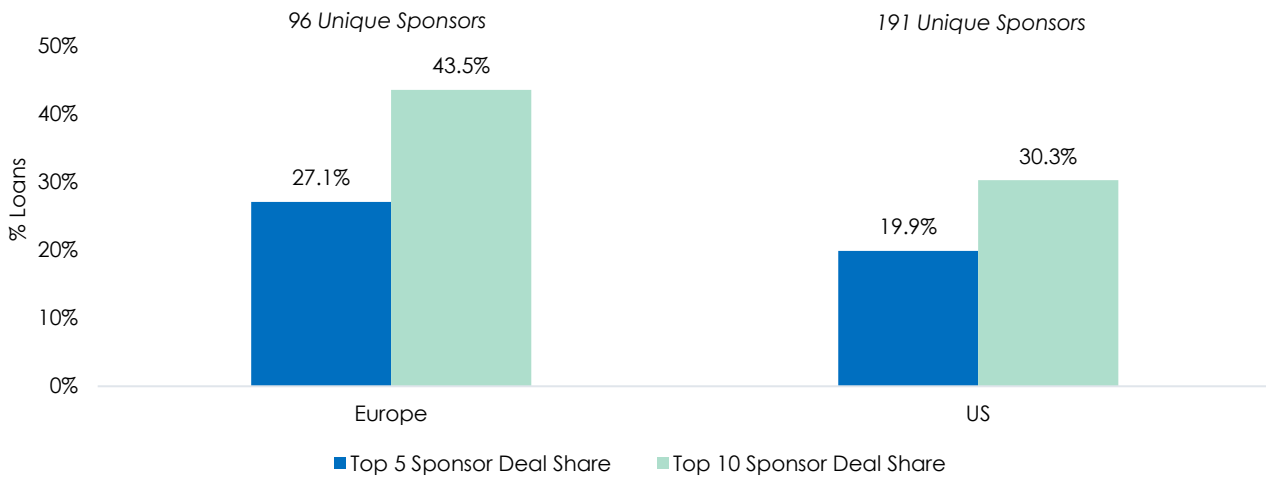


Figure 4: Concentration of Top Five & Ten Sponsors in European BSL Market vs. US
Source: Sona Analysis, PitchBook

For investors evaluating CLO equity managers, the quality of sponsor and arranger relationships should not be underestimated. Importantly, as credit markets converge, **the strength of those relationships is increasingly determined by the breadth of solutions a manager can provide**. CLO demand helps position managers as financing partners of choice for sponsors, opening access to opportunities that might not otherwise exist. And for banks, strong relationships can translate into more favourable warehousing terms and arranging support.

II. CLO EQUITY REWARDS PATIENT CAPITAL

The case for CLO equity is grounded in its long-run return profile. Not because past performance guarantees future outcomes, but because it tells us something important about the structure of the instrument and the conditions under which it performs.

For redeemed European CLO 2.0 deals, the median realised IRR stands at approximately 10%⁷, while around one-in-five deals have exceeded 15%⁸. These are not cherry-picked numbers from the best vintages. Rather, they represent the median outcome across the full history of the European CLO 2.0 market, through the region's sovereign debt crisis, Brexit, COVID, and the rate shock of 2022. Returns have proven resilient across cycles.

⁶ Source: Sona Analysis, PitchBook, Apr-26

⁷ Source: Intex, Apr-26

⁸ Source: Intex, Apr-26

European CLO equity IRRs have remained resilient through multiple market shocks

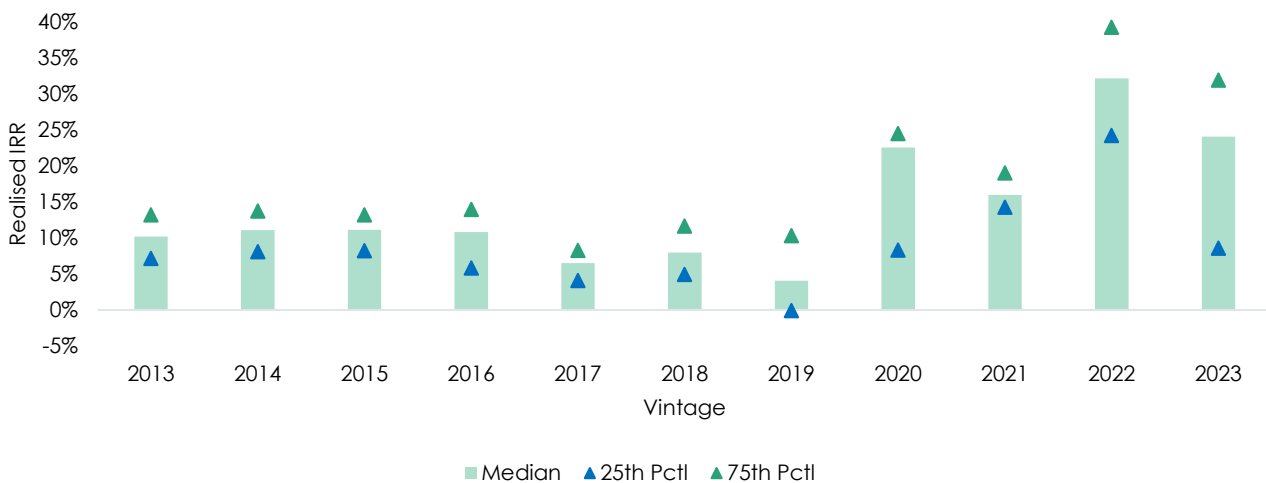


Figure 5: European CLO Equity Realised IRRs by Vintage

Source: Sona Analysis, Intex, Bank of America

The distribution of outcomes is equally important. Approximately 7% of redeemed European CLOs have generated negative IRRs⁹. That is a meaningful number, and we do not minimise it. But it also means that 93% of deals have delivered positive returns, while roughly 80% have generated IRRs above 5%.

For an asset class often described by critics as opaque, illiquid, and operationally complex, that return profile compares favourably with the current market narrative.

What is most striking, however, is where the strongest returns have come from. The 2022 and 2023 vintages — issued when CLO liabilities were expensive, loan spreads were wide, and investor sentiment was deeply negative — are generating the highest average IRRs of any vintage cohort in the history of the market¹⁰.

The deals that ramped quickly into dislocated loan markets, captured discounted assets, and refinanced or called at the right moment have delivered returns that more benign, par-priced vintages simply could not replicate.

The lesson is neither new nor especially subtle: **in CLO equity, periods of stress create opportunity**. The moments when the asset class feels hardest to own have often proven the best times to buy. Managers able to move quickly, and draw on expertise across different credit verticals, are often best positioned to take advantage of this dislocation.

CURRENT NUMBERS IN CONTEXT

Current unrealised IRRs are materially weaker: largely in the 5–8% range for older vintages¹¹, and flat to negative for 2023 and 2024 cohorts, reflecting mark-to-market pressure on NAVs. It is important to understand what these interim marks are, and what they are not. They are snapshots of temporary pricing, not terminal outcomes.

CLO equity does not require a market exit to realise value. It does not depend on a strategic buyer, an IPO window, or a private equity exit process to work. CLOs are not forced sellers, and the underlying loans continue to amortise and repay over time. The structure self-liquidates, and the equity receives the residual cash flows.

⁹ Source: Intex, Apr-26

¹⁰ Source: Intex, Apr-26

¹¹ Source: Bank of America, Apr-26

Patient capital is not penalised by the absence of an exit; it simply allows the structure to work as intended.

DISPERSION AND THE SELF-HEALING QUALITY OF ACTIVE MANAGEMENT

One of the most underappreciated features of CLO equity is the embedded ability of active managers to de-risk portfolios continuously throughout the reinvestment period. Paradoxically, the current market environment is demonstrating exactly how that mechanism works.

For much of the past two years, when most of the European leveraged loan market traded above par, reinvestment optionality was limited. Constant repricings compressed spreads, while managers seeking to rotate into stronger credits found little valuation dispersion and few opportunities to capture discounts.

That has now changed. The percentage of European loans trading below 95 averaged 12% in 2024 through to the middle of 2025. Since then, it has averaged 18% and was as high as 25% at the end of March this year.

For managers with the credit expertise to distinguish technical selling from genuine fundamental deterioration, and the discipline to act on that distinction, this repricing creates reinvestment opportunities. More than 180 CLO warehouses are currently open in Europe¹², close to the highest level on record, and well positioned to ramp into a discounted loan market. The dynamics are not identical to 2020, but the parallels are difficult to ignore: deals ramped during the COVID dislocation went on to generate median returns approaching 27%¹³ for the best-performing funds.

Dispersion in the European broadly syndicated loan market has increased

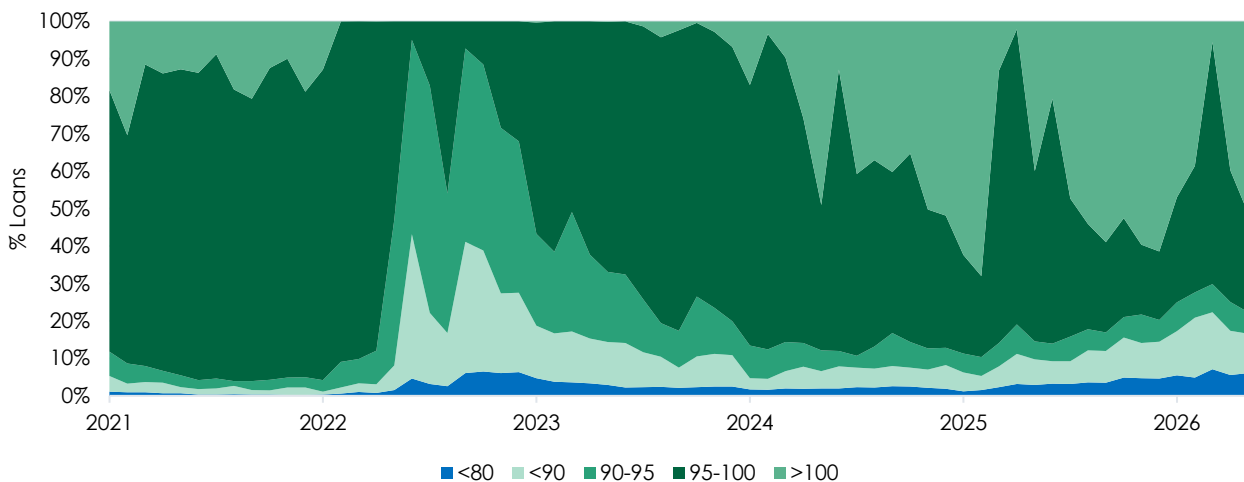


Figure 6: European BSL Market Split by Price Buckets

Source: PitchBook

III. STRUCTURAL ADVANTAGES OVER PRIVATE EQUITY & CREDIT

CLO equity is often compared to private equity and private credit based primarily on return targets. That comparison is, we believe, incomplete and, increasingly, flattering to the alternatives in ways the data no longer supports. The more important question is not simply what CLO equity has returned, but how those returns are generated, and what structural advantages the instrument offers that competitors cannot replicate.

¹² Source: Barclays, Apr-26

¹³ Source: Bank of America, Apr-26

The answer, in our view, is more compelling today than at any point in recent years. The structural vulnerabilities within both private equity and private credit have become increasingly visible. **CLO equity's advantages have become correspondingly more valuable.**

FRONT-LOADED RETURNS

CLO equity investors draw returns from two distinct sources: the ongoing excess spread generated by the underlying loan portfolio and a principal component of their return. What makes the instrument structurally distinctive is how quickly those returns can begin to flow.

In many cases, equity investors provide capital to the warehouse facility (the temporary structure used to assemble the loan portfolio before the CLO is formally issued) at attractive terms. This early involvement allows equity holders to begin accumulating returns before debt tranches have started receiving theirs. **The first return is crystallised the moment the warehouse closes.**

Once the CLO closes and enters its reinvestment period, **distributions begin almost immediately**, typically within six months of closing. The first one to two years of reinvestment generally fall within the non-call period, during which debt tranches cannot be refinanced or redeemed, creating a window of structural certainty during which managers can trade, cash flows accumulate, and equity investors continue earning without the liability structure being altered.

The data on this is striking. Across all European CLO 2.0 deals issued to date, the median transaction has returned 69% of cost to equity investors cumulatively within the first four years of closing¹⁴. We would argue these numbers are likely even higher once warehouse returns are included.

"The median European CLO 2.0 deal has returned 69% of cost within four years of closing. Private equity rarely distributes capital that quickly."

Private equity strategies are structurally back-ended. Capital is drawn early, deployed gradually, and meaningful returns typically only materialise when portfolio companies can be exited. Today, the proportion of PE-backed companies held for more than five years stands at 39%, the highest level since 2013¹⁵. Exit markets remain difficult. Capital is trapped.

For portfolio investors managing against liability benchmarks or return targets, this creates a compounding problem that CLO equity, with its front-loaded distribution profile, is structurally designed to offset.

¹⁴ Source: Bank of America, Apr-26

¹⁵ Source: Bain, "Global Private Equity Report", Feb-26

The front-loaded cash-flow profile of CLO equity complements private equity



Figure 7: Cash-Flow Profile of CLO Equity vs. Private Equity

Source: Sona Analysis

Illustrative Purposes Only

NO EXIT NEEDED. NO QUEUE. NO GATES

One of the most important structural advantages CLO equity holds over private equity and private credit in the current environment is that **it does not depend on a market exit to generate returns**. That distinction deserves to be stated plainly because it is not theoretical, it is the defining difference in the current market.

Parts of the private credit market are visibly under pressure. Nowhere is this clearer than the private/perpetual BDC market, where redemption requests totalled just under \$21bn¹⁶ in Q1 alone. Many funds imposed 5% gates. In our view, the risk of redemption queues building up over coming quarters remains high.

The CLO equity vehicle has no structural equivalent to these dynamics. There are no quarterly redemption windows to manage, no gate mechanisms to explain to investors, and no risk that a surge in withdrawal requests forces asset sales at the worst possible moment. The structure amortises naturally as underlying loans repay. Equity holders receive their principal return through the ordinary course of portfolio cash flows.

There is also an important second-order effect. In the current environment, majority equity holders sitting on compressed NAVs are, in practice, less inclined to call their deals prematurely, reducing the risk of forced loan BWICs that could place further pressure on already distressed names.

TRANSPARENCY PRIVATE CREDIT CANNOT MATCH

The opacity of private credit valuations has become one of the defining narratives of 2026, and for good reason. Without a public market to price against, marks on private credit portfolios are, at best, informed estimates and, at worst, a source of systematic optimism that delays the recognition of genuine deterioration.

¹⁶ Source: Financial Times, "Investors sought to pull \$20bn from private credit funds in first quarter", Apr-26

The divergence between public and private market marks has become increasingly difficult to ignore. At the end of 2025, the bottom quartile of private credit software loans was still marked at 99.0 cents¹⁷. The equivalent figure in the broadly syndicated loan market stood at 94.0 and by the end of May had fallen to 83.3.

Software loan marks diverged sharply between the BSL and BDC markets at the end of 2025

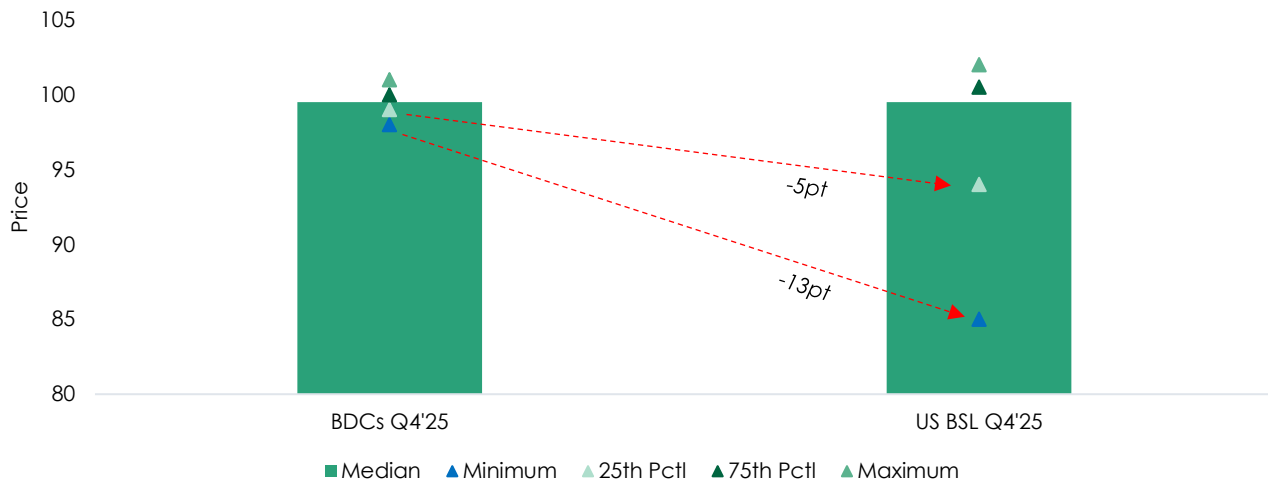


Figure 8: End-2025 BDC Software Marks vs. US BSL Software Prices

Source: Deutsche Bank

CLO equity is structurally incapable of this kind of mark management. Regular collateral pricing and monthly trustee reports provide granular visibility into portfolio composition, coverage ratios, and individual loan performance. **Investors know exactly what they own, where structural tests stand, and what the underlying loans are worth at current market prices.**

In a market where opacity is increasingly a source of anxiety rather than comfort, that transparency matters. Simply put, CLOs are traceable in ways that private assets are not. It also forces managers to react as conditions evolve. Constant price discovery encourages active trading, relative value reassessment, and quicker portfolio repositioning as the environment shifts.

MAJORITY INVESTOR OPTIONALITY

One of the most underappreciated structural features of CLO equity is the degree of control it gives investors holding a majority position. Unlike virtually every other fixed-income instrument, where investors are passive recipients of cash flows, a **majority CLO equity holder sits at the top of the decision-making hierarchy** and can actively shape the lifecycle of the deal at each stage.

That control manifests in three principal ways.

First, the majority equity holder can initiate a refinancing by replacing existing debt tranches with new notes at tighter spreads when market conditions are favourable, directly widening the excess spread flowing to equity without altering the underlying asset base. The impact is tangible: H2 2022 CLOs were originally issued with weighted

¹⁷ Source: Deutsche Bank, Apr-26

average funding costs of approximately 280bp¹⁸ and have since been refinanced close to 100bp tighter, materially increasing equity cash flows as a result. This excess cash flow is to the benefit of the equity.

Second, the majority equity holder can initiate a reset: extending the life of the deal by restarting the reinvestment period and repricing the liability stack. For investors sitting on well-constructed portfolios during periods of temporary spread widening, that embedded optionality allows skilled managers to preserve equity exposure to performing assets while improving the funding structure, without forcing liquidation and redeployment into a new vehicle.

Third, and most decisively, the majority equity holder can call the deal entirely, triggering an orderly liquidation, repaying debt tranches in order of seniority, and distributing residual proceeds to equity. Timing that decision correctly — calling when loans are at or near par rather than during periods of distress — is one of the most powerful drivers of ultimate IRR.

The key point is simple: the majority equity holder controls this timing entirely. No external buyer. No market window. No sponsor approval required. We are not aware of another credit instrument that offers investors that degree of control over the exit process.

IV. EUROPE VS. US

When institutional investors consider CLO equity allocations, they often default to the US market which is larger, more liquid, and more extensively researched. That instinct is understandable, but it is not reflected in realised returns.

In fact, Europe has consistently outperformed the US. This is evident in quarterly cash-on-cash (CoC) distributions, for example. Since the start of 2014, the average quarterly distribution for European CLO equity investors has been 4.3%, versus 3.6% in the US¹⁹.

More importantly, that outperformance has been remarkably persistent. As illustrated below, **over the last 49 quarters, European distributions have exceeded those in the US in 42 quarters**. Importantly, this has held true in both benign markets and periods of significant volatility.

European CLO equity cash distributions have consistently outpaced the US

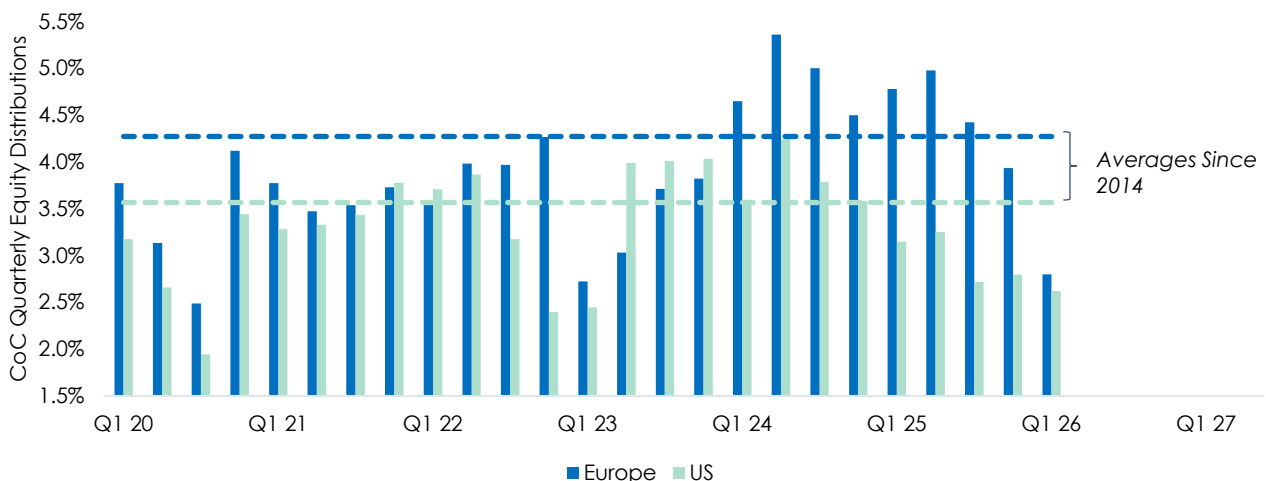


Figure 9: Quarterly CoC Equity CLO Distributions: Europe vs. US

Source: Bank of America, Intex

¹⁸ Source: Citi, Apr-26

¹⁹ Source: Bank of America, Intex, Apr-26

THE STRUCTURAL REASONS

European CLOs have historically operated with more conservative collateral quality tests and tighter overcollateralisation cushions than their US equivalents. That reduces the frequency of structural diversion events, where excess spread is redirected away from equity towards deleveraging senior tranches when coverage tests are breached. Fewer diversions mean more consistent equity distributions across the cycle, smoothing return profiles and reducing the risk of near-zero distribution periods during market stress.

Another explanation lies in the use of fixed bond buckets. **European CLOs typically have greater flexibility to allocate to fixed-rate assets**, often more than 10% of the portfolio, versus low single digits in the US. That gives skilled managers greater ability to capture attractive low-cash-price convexity opportunities, particularly in periods of declining interest rates.

The European leveraged loan market is also more relationship-driven and less commoditised than its US counterpart. European CLO managers with deep origination relationships across sponsors, arrangers, and loan agents built over multiple cycles, are, we believe, better positioned to access primary allocations at original economics, rather than buying already-priced paper in the secondary market at a premium.

FEWER DEFAULTS AND HIGHER RECOVERIES

The performance gap also reflects differences in the underlying loan markets. On a par-weighted basis, European leveraged loans have historically experienced lower default rates than their US equivalents. **Since 2017, the European par-weighted default rate has averaged 1.5%, versus 2.5% the US²⁰.**

The divergence becomes even more pronounced during periods of stress. Through the COVID cycle in 2020, the US default rate was 120bp higher than in Europe. In recent years, amid the growing use of LMEs, the US default rate has averaged 150bp above Europe on a rolling 12-month basis, as show in the chart below.

The same pattern is visible in recovery rates. Over the last decade, the average recovery rate for CLO assets has been 59.4% in Europe, versus 44.9% in the US²¹. The gap has widened further during periods of stress, driven in part, in our view, by the increased prevalence of LMEs in the US and their impact on recoveries.

For CLO equity investors, lower collateral losses sustained across cycles translate directly into stronger equity outcomes, reducing the likelihood of OC test breaches, preserving reinvestment flexibility, and protecting the excess spread flowing to the equity tranche.

²⁰ Source: PitchBook, Mar-26

²¹ Source: Bank of America, Feb-26

Default rates in the European broadly syndicated loan market have remained below the US

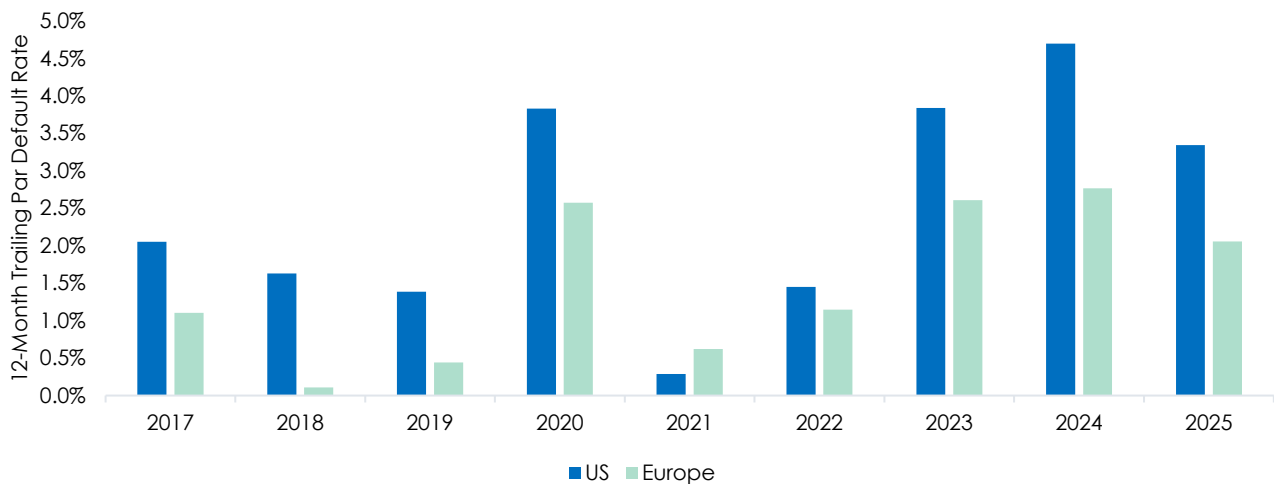


Figure 10: Trailing 12-Month BSL Default Rates: Europe vs. US (Par-Weighted). Default Rates from 2022 Include LMEs. Source: PitchBook

V. HOW CAPTIVE EQUITY HAS RESHAPED THE MARKET

One of the most consequential structural shifts in the European CLO market over recent years has been the rise of captive equity: the practice of CLO managers raising dedicated equity vehicles that provide committed, recurring capital to their own platforms. This trend has changed both the supply dynamics of the market and the return profile available to investors inside those structures.

A MARKET THAT KEEPS PRINTING – BY DESIGN

The stabilising effect of captive equity on CLO supply is now clearly visible in the data. Q1 2026 was the second busiest first quarter on record for European CLO gross new issuance²² despite an arbitrage environment that is demonstrably challenging. That resilience is not accidental.

We attribute this, in significant part, to the proliferation of captive equity funds. These structures give managers the flexibility to issue through periods when day-one arbitrage is unattractive because they are not reliant on sourcing third-party equity capital for every transaction. The value instead lies in the principal pull-to-par opportunity, rather than the interest-only component of the return. Captive equity also creates greater certainty of deal flow, while managers' own economic exposure to the equity provides a structural incentive to remain active even during periods of spread compression.

The consequences are increasingly visible in the loan market itself. **Persistent CLO formation has kept demand for higher-quality loans structurally elevated**, contributing to the bifurcation that now characterises the European leveraged loan market: 76% of loans still trade above 98 cents, while 17% trade below 95²³. That dynamic has tightened the reinvestment opportunity set for CLO managers — a by-product of the same market structure that has made CLO issuance so resilient.

²² Source: Bank of America, Apr-26

²³ Source: Bloomberg, May-26

THE RETURN ADVANTAGE OF CAPTIVE EQUITY

For equity investors inside captive structures, **the economics are often more attractive than traditional third-party minority equity participation**, and the advantages compound over the life of the deal.

The most immediate benefit is fee sharing. Where a CLO equity investor has a captive or affiliated relationship with the collateral manager, part of the senior management fee can be rebated back to the equity tranche, reducing fee drag without altering the underlying portfolio. The economics are far from trivial: on a €500mn CLO, even a 20bp senior fee represents €1mn annually. Returning even half of that materially improves the net yield on what is typically a €40–60mn equity tranche. Scaled across a portfolio of CLO equity positions managed through a captive programme, the cumulative impact of that fee compression becomes significant.

Beyond the fee economics, captive structures also provide the full suite of majority holder rights described in Section II of this paper, including the ability to refinance, reset, and call deals at the most advantageous point in the cycle. A scaled captive equity investor does not simply own a portfolio of CLO equity tranches. They manage it actively: rotating across the capital structure as conditions change, recycling proceeds from called deals into new warehouses, and responding to market dislocations with a level of tactical flexibility that static allocations cannot provide. Additionally, equity investors inside captive structures benefit from any excess spread generated during the warehouse period itself. At certain points in the cycle, those returns can be particularly meaningful.

CONCLUSION

Despite the challenges facing leveraged finance markets, we believe there is a credible investment case for CLO equity today. The comparison with the alternatives is particularly favourable. Private equity exits have stalled. Private credit vehicles are gating redemptions. Marks in direct lending are disconnecting visibly from public market reality. CLO equity's transparency, its front-loaded cash distributions, its absence of redemption risk, and the control majority holders retain over deal lifecycle decisions are not merely theoretical advantages. They are live, observable differentiators at a moment when the alternatives are under genuine and increasing pressure.

The leveraged finance market in Europe is operating in a higher loss environment relative to the pre-2022 regime. Higher funding costs are the primary reason for this and something we expect to persist. This will continue to drive high dispersion and pricing dislocations, both of which we view as genuine opportunities for investors. The historical record is clear on this point: the moments that have felt hardest to own the asset class have repeatedly proven the most rewarding entry points. The 2022 and 2023 vintages, issued into a rate shock and challenging investor sentiment, are now generating the highest average IRRs of any cohort in the market's history. Similar conditions exist today.

But the opportunity will not be evenly distributed. We believe it will accrue disproportionately to managers with genuine total return investing capabilities — those with the credit infrastructure to navigate restructurings and liability management exercises, the cross-market information flows to identify deterioration before it becomes consensus, and the discipline to act decisively when others cannot. Manager selection has always mattered in CLO equity. We believe it has never mattered more than it does today.

APPENDIX – CLO PRIMER

WHAT IS A CLO?

A Collateralised Loan Obligation (CLO) is an actively managed securitisation vehicle backed primarily by a diversified pool of 150–300 senior secured broadly syndicated loans (BSLs), typically rated BB or single-B. CLOs are floating-rate products engineered to exploit the 'arbitrage': the gap between the spread generated by the underlying loan portfolio and the cost of the rated liabilities issued to fund it.

The CLO vehicle is structured as a bankruptcy-remote Special Purpose Vehicle (SPV). It raises capital by issuing debt tranches rated AAA through BB (or single-B) and an unrated equity piece. Interest and principal generated by the loan pool flow through the vehicle and are distributed to investors according to a strict priority of payments (the 'waterfall') with senior noteholders paid first and equity holders receiving the residual.

A CLO manager, typically a credit fund, asset manager or insurance firm, is appointed to actively manage the portfolio. The manager may buy and sell loans during a defined Reinvestment Period (usually 4–5 years), subject to portfolio concentration tests and coverage constraints. The manager earns senior and subordinated management fees; crucially, subordinated fees rank junior to noteholder payments, aligning manager incentives with note performance.

CLOs are the single largest buyer in the global leveraged loan market, holding well over half of all outstanding BSL volume.

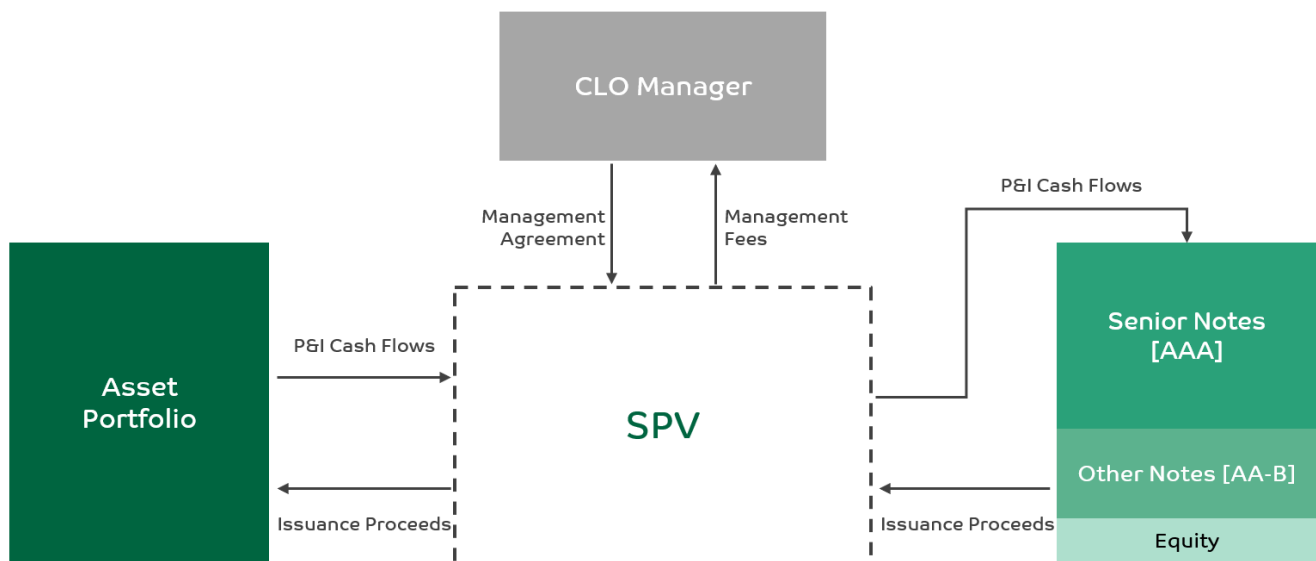


Figure 11: Basic CLO Structure Overview
Source: Barclays

CAPITAL STRUCTURE & TRANCHE TYPES

The CLO liability stack is divided into rated debt tranches and unrated equity. Each tranche is differentiated by its seniority, coupon, weighted average life (WAL), credit enhancement, and discount margin.

The AAA tranche (typically 60–65% of the capital structure) carries the highest credit enhancement and the lowest spread, funded by the most liquid investor base (banks, insurers, pension funds). The equity tranche, typically 9–10% of total notional (implying ~9–10x leverage), receives all residual cash flow after debt service and fees. Equity holders are the primary beneficiaries of strong portfolio performance and the primary risk bearers of credit deterioration.

Tranches are further differentiated by call and reset optionality. After the Non-Call Period (~2 years), equity holders can direct the manager to refinance (refi) individual tranches at tighter spreads, or execute a full reset, extending the reinvestment period and repricing the entire liability stack, provided market conditions are favourable.

STRUCTURAL ENHANCEMENTS

For CLO tranches to carry ratings materially higher than the underlying BB/B-rated loan collateral, the structure incorporates multiple overlapping investor protections. These mechanisms work both to absorb losses before they reach senior noteholders and to divert cash flows away from junior tranches when deal performance deteriorates.

ENHANCEMENT	DESCRIPTION
Credit Enhancement (C/E)	How much portfolio par value can decline before a tranche incurs a principal loss. Senior tranches carry higher C/E (e.g. 36% for AAA), providing a large buffer before losses reach them.
Overcollateralisation (OC) Tests	Compare par value of assets to par value of liabilities. Failing an OC test diverts cash flows from junior tranches to redeem senior notes, protecting senior holders.
Interest Coverage (IC) Tests	Compare interest income from assets to interest due on liabilities. A breach triggers cash diversion up the waterfall, typically before the OC breach.
Excess Spread	The margin between asset yields and liability costs (the 'arb'). Acts as a first-loss buffer, absorbing credit losses before any tranche is impaired.
Portfolio Diversification	CLOs typically hold 150–300 loans across issuers and industries. Concentration limits prevent overexposure to any single sector or borrower.
No Mark-to-Market Triggers	Unlike pre-GFC CDOs, CLOs contain no market-value triggers. Managers cannot be forced to sell assets at distressed prices, preserving the portfolio for the long term.

Figure 12: Examples of CLO Structural Enhancements

Source: Sona

THE WATERFALL

On each quarterly payment date, the CLO distributes cash through two separate waterfalls, an interest waterfall and a principal waterfall, in strict sequential order. Coverage tests embedded in the waterfall act as circuit breakers: if OC or IC tests are failing, cash that would otherwise flow to junior tranches is redirected upwards to redeem senior notes, accelerating deleveraging and protecting senior holders.

The Reinvestment Diversion Test in the interest waterfall is particularly important for equity investors: if failing, 50% of residual cash is redirected to purchase additional collateral rather than being distributed to equity. This mechanism links equity distribution levels directly to deal health and portfolio performance.

CLO Life Cycle

A CLO typically has a total legal maturity of 10–13 years from closing, though the economically active life is considerably shorter. The diagram below illustrates the characteristic portfolio par build-up and amortization across the five distinct phases of a CLO's life:

PHASE	DURATION	DESCRIPTION
Warehouse	~3–9 mo	An arranger/underwriter (typically an investment bank) provides financing to the collateral manager to start purchasing assets several months before the Pricing Date. The CLO is not yet legally formed.
Ramp-Up	~3–6 mo	Following the Closing Date (when deal documents become legally binding and the warehouse is closed), the manager purchases the remainder of the portfolio. Assets are transferred into the SPV.
Reinvestment	~4–5 yr	Commences on the Effective Date or when Target Par is reached. The manager may reinvest asset repayments and sale proceeds into new collateral, subject to coverage tests and portfolio constraints.
Non-Call	~2 yr	After the Non-Call Period, equity holders can direct the issuer to redeem the notes at any time via optional redemption, execute a refinancing (refi) or reset of the deal terms.
Post-Reinvestment	~2–3 yr	Collateral proceeds must be used to sequentially redeem CLO tranches, starting with the most senior. CLOs are typically called 2–3 years after reinvestment ends. A clean-up call option becomes available once the portfolio falls below ~15% of original balance.

Figure 13: Typical CLO Life Cycle
Source: Sona

In practice, most CLOs are called well before legal maturity. The economic incentive to call arises because as the portfolio amortises post-reinvestment, the AAA tranche, the largest and cheapest funding source, is repaid first. Removing the cheapest liabilities whilst retaining riskier assets causes the weighted average cost of funding to rise sharply, eroding the arb and compressing equity distributions. A clean-up call option — available once the portfolio falls below ~15% of original par — provides a final mechanism for orderly wind-down.

THE ROLE OF CLO EQUITY

Overview

CLO equity is a non-recourse, leveraged position on a pool of actively managed senior secured loans. Equity holders sit last in the waterfall - they receive all residual cash after debt service, management fees and deal expenses have been paid. That subordinated position is also the source of the instrument's return potential: in a well-performing deal, equity investors benefit from the full spread of the loan portfolio over and above the cost of the rated liabilities.

Structurally, CLO equity combines two distinct cash-flow streams. The Interest-Only (IO) stream comprises quarterly distributions generated by the excess spread between asset yields and liability costs: the 'arb'. The Principal-Only (PO) stream represents the return of the equity notional at deal call or maturity, where equity NAV (tracked via the reinvestment waterfall and trading activity) serves as the best proxy. Together these streams produce a return profile

that is front-loaded with IO distributions and back-loaded with a large principal pay-out when the deal is called - typically 2–3 years after the reinvestment period ends.

Risk retention regulation (applicable to US middle market and European CLOs) requires managers to retain a minimum 5% economic interest in each CLO they manage. This has steadily shifted equity ownership away from third-party investors toward the CLO managers themselves and dedicated retention vehicles, aligning manager and investor incentives more directly than at any point in the asset class's history.

Investor Landscape

Each part of the CLO capital stack attracts a different investor type, with distinct return objectives and risk tolerances. The table below summarises the investor base, priorities, and primary concerns across the liability structure.

RATING	INVESTOR TYPES	INVESTOR PRIORITIES	INVESTOR CONCERNS
AAA-AA	Banks Asset Managers Insurers Pensions	<ul style="list-style-type: none"> Safety of principal Predictability of amortization speed 	<ul style="list-style-type: none"> Reinvestment risk — uncertainty over timing of principal repayment Strength of indenture language limiting manager latitude post-reinvestment period
A-BBB	Asset Managers Insurers Pensions Credit Funds	<ul style="list-style-type: none"> Safety of principal Predictability of amortization speed Secondary market liquidity 	<ul style="list-style-type: none"> Reinvestment risk — uncertainty over timing of principal repayment Strength of indenture language limiting manager latitude post-reinvestment period
BB-B	Asset Managers Pensions Credit Funds	<ul style="list-style-type: none"> Credit loss avoidance Acceleration of discount amortization Secondary market liquidity 	<ul style="list-style-type: none"> Collateral portfolio composition and potential tail risks Manager track record for uninterrupted payments to all liability tranche holders
Equity	Asset Managers CLO Managers Credit Funds BDCs Insurers (combo notes) Risk Retention Vehicles	<ul style="list-style-type: none"> Credit loss avoidance Residual cash flow maximization Maintaining leverage & low cost of debt 	<ul style="list-style-type: none"> Collateral portfolio composition and growing tail risks Manager track record for maintaining equity distributions Manager risk retention

Figure 14: CLO Tranche Investor Comparisons
Source: Sona

Return Profile

CLO equity distributions are driven primarily by the CLO equity arb: the gap between portfolio asset spreads and the weighted average cost of the CLO's liabilities. However, initial arb at new issue has shown limited correlation with final realized equity IRR. Rather, there are a multiplicity of variables that influence final returns:

- **Portfolio performance:** CDRs, recovery rates, and the pace and severity of defaults have the largest single impact on equity IRR, particularly at the tail of the distribution.
- **Manager trading activity:** A manager who builds par through secondary purchases at discount and realises gains at par can materially enhance equity NAV over the reinvestment period.
- **Refi / Reset activity:** Refinancing tranches at tighter liability spreads or resetting the deal extends the window of attractive arb, directly lifting the IO stream.
- **Reinvestment dynamics:** Reinvesting principal proceeds at lower prices can paradoxically increase long-run IRR by widening the effective arb — a counterintuitive feature of CLO equity mechanics.
- **Call timing:** The decision to call is driven by equity holders. An early call may truncate IO distributions; a late call risks deteriorating arb as cheap AAA funding is repaid first.

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