The Carlyle Group

Carlyle Tweaks European CLO Payment Waterfall to Receive Subordinated Fees Before Performance Test

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Carlyle Group is marketing a new European CLO with an unusual structure that allows the manager to pay themselves fees before conducting a test that could force them to use interest to repay bondholders.

In a rating agency presale report for Carlyle Euro CLO 2025-2, the subordinated fee is shown as senior to the overcollateralisation test in the waterfall, a reversal of the typical order.

The switch also appeared in the reset of Carlyle Global Market Strategies Euro CLO 2014-1, priced in March, according to the offering circular. Several lawyers, investors and rating agency analysts said they could not remember seeing this feature in Europe in the past. A survey of other recently closed European deals and presale reports by Octus did not find it in CLOs by other managers.

In the United States, Carlyle has been printing deals with subordinated fees senior to the test since at least 2014.

“Tweaking the CLO waterfall this way is not something we are positive on,” said David Altenhofen, head of investments at Accunia Credit Management, “certainly not from a debt investor standpoint, nor really from an equity one either.”

While the overall impact on cashflow should be relatively small, moving the sub management fee up in the waterfall could be counterproductive for the equity as well as the debt in some scenarios, he added.

“Incentives should be fully aligned, and we feel the win-win is only for the manager here," Altenhofen said.

Managers usually receive fees twice in the interest waterfall - the senior fees and the subordinated fees - as well as an incentive fee tied to an equity IRR threshold. The senior manager fees (normally around 15 bps) sit near the top of the waterfall above triple-A tranche interest. Once it has been paid, the bondholders receive interest. The subordinated management fees (normally around 35 bps) are junior to the single-B tranche but senior to the equity.

Typically, between paying interest to the single-B investors and subordinated fees to the manager, sits the reinvestment overcollateralisation test, also known as the interest diversion test.

If it fails - which happens if the overcollateralisation drops too close to or below the liabilities - up to half of the available interest is diverted to the principal account. The remaining interest flows down the waterfall, to pay the subordinated fees and certain other subordinated amounts, followed by the equity distribution.

The diversion is meant to ensure at least the partial repayment of debt holders without leaving the manager and equity investors empty-handed.

"We like the CLO technology, among other things because it heals itself in times of trouble,” said Altenhofen. “Messing with the waterfall structure is a slippery slope."

A CLO senior tranche investor told Octus that the test provides a protective mechanism to senior noteholders in times of crisis, and the changed structure “undermines and attacks the alignment of interest.”

Switching the order of fee payment and test also weakens the deal from a ratings perspective.

Under S&P Global Ratings' modelling assumptions, fees are considered an almost uncapped payment due to the manager's flexibility around them. For example, the fees can be waived and subsequently be paid on a later payment date in addition to current payments; or there could be collateral manager advances.

"It's difficult to quantify the payment," said Sandeep Chana, director of CLOs at S&P Global Ratings. "If we can't quantify a payment in our models, then it's difficult to give credit to anything that ranks below in the CLO waterfall. Typically, we may consider switching the test off as a result, which may have an adverse impact on the results."

Such a deal will still be rated, however, and the presale report for the new Carlyle deal does not flag the changed waterfall as a specific concern. A manager could compensate for the negative impact on ratings, for example by increasing credit enhancement.

Carlyle's reset of the 2014 deal had triple-A par subordination of 38.25%, slightly higher than the typical 38%. The presale report for the planned new issue contains triple-A notes split into a more senior chunk with 39% par subordination and a smaller tranche with the same rating but 37% par subordination.

A spokesperson for Carlyle declined to comment.

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