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Investors undervalue CLOs by ignoring Euribor floor, Fair Oaks says

by **Hugh Minch**

Some investors are undervaluing European CLOs by ignoring the value of the Euribor floor, according to a note published by Fair Oaks Capital. Valuing the Euribor floor is tricky as it depends on the life of the CLO, which is calculated based on an estimate of when the equity is likely to refinance or call the deal, but ignoring the floor to focus only on the spread undervalues CLOs compared to alternative floating rate products, the note says.

Fair Oaks estimates the value of CLO Euribor floors to be 0.51% per annum for European CLOs with a two-year tenor, 0.48% for five years and 0.47% for six years. The value of the floor diminishes for longer duration CLOs as Euribor is likely to rise. The note argues that the value of Euribor floors has increased as projected Euribor rates have fallen – the expected three months Euribor rate fell from 0.6% in 2017, to 0.1% in 2018 and to -0.4% at the end of June

Typically set at 0%, Euribor floors protect CLO investors from negative rates while letting them benefit from rate rises above the floor level. This contrasts with other structured product asset classes such as ABS and RMBS, Fair Oaks says, where the floor is usually on the coupon rather than Euribor. Euribor has been negative since 2015.