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Why CLOs provide a unique access point to the US mid-market

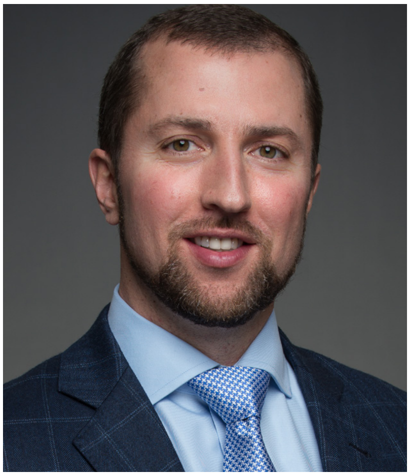
Protections and flexibility make CLOs an interesting way for investors to tap into the growth engine of the US economy, writes Jeremy VanDerMeid of **Monroe Capital**

Few areas within the US economy are as bullish as the middle market. The National Federation of Independent Business released its *Small Business Optimism Index* in June, showing record highs in earnings trends and describing expansion plans as the "most robust" in the survey's history. Beyond the mounting optimism, fuelled by December's tax cut, small- to mid-sized businesses are shielded to an extent from the potential threats facing larger domestic companies, be it a strengthening dollar or a global trade war.

While this makes for a compelling backdrop, the challenge for investors remains gaining access to the middle market in a way that captures the growth and underlying optimism, while addressing risks that become more pronounced near the top of a cycle.

Investors tend to think of the middle market as a niche within a larger asset allocation, but this segment actually represents one of the largest areas within the US economy. Domestic middle-market companies, for instance, generate over $10 trillion of revenue annually, and seven out of 10 have been in business two decades or longer. In fact, the size of the US middle market is equivalent to the world's third-largest economy on a GDP basis.

Still, the focus for many is on the risks. The biggest threat generally revolves around the lack of liquidity and whether companies can tap into the capital markets to fund growth. Ironically, the development of the private debt market has resolved this uncertainty following the commercial banks' retreat. At the same time, the industry's maturation creates an opening for investors seeking attractive middle-market exposures. As the market continues to evolve, the next challenge is to understand the range of strategies employed amid a growing universe of alternative lenders.



Jeremy VanDerMeid

"AMID THE GROWTH OF THE BROADER CLO UNIVERSE, THE MIDDLE MARKET REMAINS A SPECIALIZED SEGMENT WITH ONLY A HANDFUL OF TRUE MIDDLE MARKET CLO MANAGERS WHO CAN ORIGINATE AND SOURCE BESPOKE MIDDLE MARKET LOANS"

THE MIDDLE MARKET'S ALLURE

The benefits of middle-market loans are well documented, with less leverage, higher equity contributions, tighter legal documentation and stronger covenants as compared to the larger broadly syndicated loan (BSL) market. Middle-market loans are structured with a floating rate over LIBOR – creating a natural hedge against rising interest rates – while interest and fees provide current income. Middle market loans historically have generated yield premiums ranging from 50 to 150 basis points over BSL loans while also experiencing fewer defaults and higher recovery rates.

A common misconception is that there is less transparency in the middle market. The spotty coverage by the ratings agencies, for instance, can pose challenges for lenders lacking deep underwriting resources or monitoring capabilities. But experienced lenders enjoy a robust information flow that can include monthly financial statements, access to borrowers' management teams, and even customised financial reporting.

A nuance, which creates a barrier to entry, is that the middle market is very much relationship driven. To access the full scope of the middle-market opportunity set requires a significant investment to build origination capabilities. A capital markets presence is also critical

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to source club deals, and deep credit experience is compulsory to underwrite and manage loans.

These barriers are foundational to manage risk; the upshot is they prevent the middle market from becoming commoditised. While BSL loans are coping with price erosion and deteriorating protections, middle-market loans have only seen moderate pricing pressure and limited inclusion of covenant-lite structures. Middle-market loan issuance was also up 7 percent in the first half of 2018, providing a larger pool from which to select the best credits.

MIDDLE-MARKET CLO ENTRY POINT

Amid the growth of the broader CLO universe, the middle market remains a specialised segment with only a handful of true middle-market CLO managers which can originate and source bespoke middle-market loans.

Many institutional investors are attracted to the illiquidity premium and additional yield available across the capital stack. Middle-market CLOs are typically structured with AAA- to BB-rated debt in a tiered position at the top of the capital structure as well as unrated subordinated notes, or equity, at the bottom. AAA tranches typically offer a premium of between 40 to 50 bps versus BSL CLOs, with additional yield available up and down the middle-market CLO capital structure.

Middle-market CLOs include more equity in the capital structure, with overcollateralisation ratios that, again, well exceed BSL CLOs comprised of larger issuers. These protections, as well as the higher yield, offer investors a unique entry point to the US middle market and the ability to structure a specific risk/reward opportunity across numerous tranches of rated and unrated CLO securities.

Even as the middle market remains a specialised segment, certain attributes distinguish middle-market CLO managers.

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Some may tilt their portfolios toward private equity-backed credits, characterised by higher leverage and lower yields. Others may gravitate toward the upper end of the middle market, where the differences between broadly syndicated loans are less pronounced.

One of the biggest differentiators is the origination strategy or lack thereof for many of the newer entrants. While nearly all middle-market CLO managers participate in syndicated middle-market loans, those that directly originate and source proprietary club transactions have a unique competitive advantage. This reinforces the uncorrelated nature of private debt. Managers that originate their own loans can also better calibrate their portfolios for desired outcomes, such as diversity across sectors, deal sizes, coupons, weighted-average spreads, or weighted-average rating factor (WARF).

EXPERIENCE MATTERS

The conventional wisdom is that the required diversification in a CLO structure mutes the importance of manager selection. This could not be further from the truth. While it may be hard to recognise entering the 10th year of the credit cycle – particularly as new managers with limited origination capabilities enter the market – middle-market debt is indeed an actively managed strategy in which capabilities and track records matter.

At Monroe, our sourcing platform is comprised of 18 originators across the US, organised both geographically and by industry vertical, who source proprietary agented transactions. We also have a dedicated capital markets function that focuses on sourcing top-quartile club deals with high-quality partners. We will actively invest our remaining portfolio with syndicated middle-market loans that meet a specific need, such as diversification. Most importantly, our strategy adheres to a disciplined "buy-and-hold" philosophy, prioritising deep due diligence and strict underwriting standards consistent with our direct-lending strategy.

As a true originator, Monroe tailors its portfolios for attractive risk-adjusted returns across economic environments. In fact, its 2006 middle-market CLO generated cash-on-cash equity returns of 21.6 percent[1], highlighting the importance of underwriting discipline during both heady times and market dislocations.

As the market and opportunity evolve, experience and deep networks will enable firms to navigate an expansive and sometimes uncertain landscape. Investors with a discriminating eye will be rewarded with one of the few asset classes offering direct exposure to the middle-market growth engine that powers the US economy. ■

1. Past performance may not be indicative of future returns. No distributions have been made since December 2017.

__Jeremy VanDerMeid__ is a portfolio manager, CLO & loan trading, Monroe Capital, a private credit asset management firm founded in 2004 specializing in direct lending and opportunistic private credit investing. The firm has $5.6 billion of assets under management, including $2.0 billion of CLO assets across seven dedicated funds as of July 1, 2018.