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Why CLO's Matter (Part Three)

THE LEAD | July 1, 2014

Until recently, institutional investors have always had a love-hate relationship with the middle market – minus the love.

Compared to reassuringly large, liquid credits, companies with less than $50 million in Ebitda tend to be private, their debt unrated, their businesses niche-oriented, their access to public markets limited, and their management teams entrepreneurially lean.

Further, they issue few bonds to provide relative value guidance to cross-over buyers, their bank debt trades infrequently, if at all, providing little comfort to funds who demand instant liquidity. Finally their smaller scale often means more customer and vendor concentrations, and implies more vulnerability in cyclical downdrafts.

But in the wake of the credit crisis, funds are recognizing the virtues of the asset class. Middle market's limited access to capital markets also sheltered it when large cap prices swung wildly. More conservative structures with real covenants helped protect lenders. And when issuers' struggled, the smaller groups of like-minded, buy-and-hold lenders hung together. Hey, the kick-the-can-down-the-road strategy actually works!

So why, amid this year's surprising torrent of new issue broadly syndicated loan (BSL) CLOs, have we not seen the same volume for the securitization of middle market loans?

For one thing, as Wells Fargo's David Preston has told our readers, arrangers are concerned about the 'natural break of supply.' Managers who buy BSL's can be assured of a ready pipeline of paper for their vehicles. Middle market activity, by contrast, tends to come in chunks, with slow periods in between. That makes the ramp up less certain.

So far this quarter, seven middle market CLOs totaling almost $3 billion have been issued. For the year that makes ten vehicles for just under $4 billion. As a percent of total CLO volume, that's about 7%, up from 6.5% in 2013 and 4.5% in 2012.

That share is bound to grow. As frothiness in larger cap markets grows, investors will note the higher spreads and tighter structures offered in the middle market. While the "illiquidity premium" for smaller deals varies depending on technical factors (it was almost 200 bps a year ago, according to Thomson Reuters, and is now 84 bps), the extra yield averages 100 bps.

Combine that with the fact that, per Wells Fargo and LCD, middle market liabilities only cost 25-50 bps more than their BSL equivalents, middle market CLOs still offer 50-75 bps comparative spreads.

Finally, investors in single-A or better middle market CLO liabilities have (on average since 2012) over 28% of the capital structure below them, vs. 20% for BSL vehicles.

Next week, we wrap up our series on collateralized loan obligations with a look at how the next generation of vehicles will deal with regulatory and cyclical headwinds.