

# The expanding middle

The small band of middle market CLO managers employ a growing range of strategies – from direct lending-style origination to dabbling in broadly syndicated loans – as they build out deals

by Tanvi Gupta

Asset sourcing is an important skill in the broadly syndicated loan (BSL) CLO market, but it's perhaps even more important for managers of middle market CLOs. They talk at length about having a differentiated approach, and this is validated by our analysis, which shows that the overlap between mid market US CLOs is approximately 5%.

There are two facets to investing in mid market loans: managers can either directly originate loans (to create unique exposures in their CLOs), or they can participate in club deals. Churchill Asset Management is active in both markets and Ken Kencel, the firm's chief executive officer, argues that strong relations are key.

"Churchill's origination strategy is centred on the direct coverage of the US middle market private equity community," he says. "Our strategy is augmented by direct coverage of our key co-lenders. This dual-sourcing approach ensures that Churchill can select its investments from the widest array of potential opportunities."

Churchill's head of product development

and capital raising David Heilbrunn says that an emphasis on direct origination can generate strong returns. "Middle market CLO managers originate a good portion of their deals relative to broadly syndicated loan managers, and there is significantly more opportunity for top managers to differentiate their portfolios."

Comparing 2017 CLOs launched by 14 managers, we found the highest portfolio overlap (as of April 2018) was between Midcap Financial's three deals (Woodmont 2017-1, Woodmont 2017-2 and Woodmont 2017-3) and two deals managed by Antares Capital (Antares CLO 2017-1 and Antares

CLO 2017-2). The managers have a portfolio overlap of 19.68%. (See matrix, below.)

According to CLO-i data, Antares's biggest position is Pegasus Transtech – Antares 2017-1 has an exposure of \$16.5 million to the company's loans, while Antares 2017-2 holds \$10 million. Pegasus Transtech is a software company focused on document management. The fact that it represents Antares's biggest CLO position should not come as a surprise – Antares was lead arranger on the company's \$145 million loan issue in November.

## Mid market and BSL overlap

Similarly, Antares was the lead arranger on a \$92 million add-on term loan issued by Nellson Nutraceutical (Knel Holdings) as part of the nutrition bar producer's \$292 million loan repricing in October. The loans have proven popular with mid market and BSL CLO managers alike, with several firms subscribing (see chart, page 17).

Other mid market CLO managers participate in less liquid loans. Cerberus Capital Management, for instance, has very little overlap with other managers, and with good

## Overlap methodology

To analyse CLO portfolio overlap, we look at loans held by 2017 middle market CLOs at April 2018. For each pair of managers, the overlap figure is generated from a comparison of the weighted average of the common loans across all CLOs of that vintage from those managers.

Middle market CLO managers portfolio overlap in 2017 CLOs (%)														
	AB Private Credit	Antares	ArrowMark	Barings	Cerberus	Churchill AM	Fortress	Golub	Ivy Hill (Ares)	Madison Capital	MM Credit Fund (Carlyle)	Midcap (Apollo)	Monroe	NewStar
AB Private Credit	-	1.74%	0.00%	1.45%	0.00%	0.00%	1.13%	0.00%	1.74%	1.99%	0.00%	2.92%	1.42%	1.36%
Antares	1.74%	-	3.73%	5.29%	0.00%	11.39%	2.07%	2.09%	12.29%	10.25%	11.03%	19.68%	6.81%	11.31%
ArrowMark	0.00%	3.73%	-	0.00%	2.82%	8.82%	9.48%	0.00%	5.08%	0.76%	7.73%	0.14%	9.08%	6.01%
Barings	1.45%	5.29%	0.00%	-	0.00%	6.09%	1.17%	2.19%	8.71%	1.42%	8.99%	1.94%	11.52%	6.54%
Cerberus	0.00%	0.00%	2.82%	0.00%	-	0.00%	5.36%	0.00%	0.00%	0.00%	0.00%	1.37%	1.63%	0.82%
Churchill AM	0.00%	11.39%	8.82%	6.09%	0.00%	-	1.30%	9.04%	1.88%	2.96%	9.77%	3.57%	15.27%	10.81%
Fortress	1.13%	2.07%	9.48%	1.17%	5.36%	1.30%	-	0.98%	2.07%	0.32%	1.47%	2.65%	1.77%	5.06%
Golub	0.00%	2.09%	0.00%	2.19%	0.00%	9.04%	0.98%	-	13.20%	3.18%	1.56%	2.93%	0.00%	1.28%
Ivy Hill (Ares)	1.74%	12.29%	5.08%	8.71%	0.00%	1.88%	2.07%	13.20%	-	6.54%	15.13%	5.52%	7.52%	7.39%
Madison Capital	1.99%	10.25%	0.76%	1.42%	0.00%	2.96%	0.32%	3.18%	6.54%	-	11.15%	11.27%	3.99%	10.88%
MM Credit Fund (Carlyle)	0.00%	11.03%	7.73%	8.99%	0.00%	9.77%	1.47%	1.56%	15.13%	11.15%	-	4.59%	16.49%	15.76%
Midcap (Apollo)	2.92%	19.68%	0.14%	1.94%	1.37%	3.57%	2.65%	2.93%	5.52%	11.27%	4.59%	-	3.71%	11.34%
Monroe	1.42%	6.81%	9.08%	11.52%	1.63%	15.27%	1.77%	0.00%	7.52%	3.99%	16.49%	3.71%	-	6.31%
NewStar	1.36%	11.31%	6.01%	6.54%	0.82%	10.81%	5.06%	1.28%	7.39%	10.88%	15.76%	11.34%	6.31%	-

Source: CLO-i

Middle market portfolios at a glance (Q2 2018)							
Deal	Manager	Deal size	Average loan size	Average Coupon	WAS	Warf	Largest holding (\$m)
ABPCI Direct Lending Fund CLO II	AB Private Credit	348.9	5.5	8.53	6.87%*	32.19*	Shopatron (9.26)
Antares CLO 2017-1	Antares	2,113.9	7.5	6.81	4.75%	3,573	Knel Holdings (16.70)
Antares CLO 2017-2		1,208.8	8.4	6.80	4.73%	3,335**	Carr Management, Pegasus Transtech, Plaskolite, Berry Plastics, Charkit Chemical, Stanton Carpet (each 10.0)
Peaks CLO 2	ArrowMark	159.4	0.9	7.20	5.12%	3,324	Extreme Reach (2.7)
Barings MM CLO 2017-1	Barings	503.2	6.2	6.83	4.89%	3,663	Port Townsend Paper Corp (15.0)
Cerberus Loan Funding XVIII		604.3	7.6	9.25	7.45%	3,868	Foundation Consumer Healthcare (17.96)
Cerberus Loan Funding XIX	Cerberus	300.4	3.3	9.01	7.42%	3,983	System1 (8.89)
Cerberus Loan Funding XXI		535.3	6.3	9.04	7.49%	3,790	Lionbridge Technologies (15.87)
TIAA Churchill Middle Market CLO II	Churchill AM	340.3	5.1	5.56	4.90%	-	Community Health Systems (9.88)
Fortress Credit Opportunities IX	Fortress	1,500.0	8.2	7.67	5.85%	3,528	Midcap financial holdings (74.80)
Golub Capital Partners CLO 34 (M)	Golub	411.4	3.9	7.81	5.78%	3,708	Diligent Corporation (10.34)
Ivy Hill Middle Market Credit Fund XII	Ivy Hill (Ares)	381.3	1.2	6.80	5.36%	3,533	Tronair (5.55)
MCFCLO VI	Madison Capital	324.9	4.6	7.13	5.04%**	3441**	Veritext Corp (10.48)
Woodmont 2017-1 Trust	Midcap (Apollo)	506.2	6.5	7.27	5.29%	3,416	Circustrix Holdings (14.81)
Woodmont 2017-2 Trust		1,212.2	10.1	7.17	5.39%	3,434	Golden Pear, Genesis Healthcare (35.00)
Woodmont 2017-3 Trust		353.3	2.9	7.10	5.20%	3,557	TG Midco (10.42)
MMCF CLO 2017-1	Middle Market Credit Fund (Carlyle)	399.9	6.5	7.30	4.87%	-	TurboCombuster Technology (15.97)
Monroe Capital MML CLO 2017-1	Monroe	405.0	3.6	6.62	4.90%	3,224	iPayment (5.47)
NewStar Commercial Loan Funding 2017-1	NewStar	397.3	2.7	6.98	4.96%	3,515	Berry Plastics Corporation (12.31)

Source: CLO-i. Warf and WAS rated by Moody's (except \* rated by DBRS \*\* rated by S&P)

reason: the New York-based manager is known to invest in a high proportion of triple-C rated loans. Its overlap with the rest of the market is just 0.9%.

In theory, there should be a clear distinction between broadly syndicated loans (BSL) and mid market loans, but in practice the line is blurred. We highlight 10 loans that are widely held among mid market CLOs and find that several also appear in BSL CLOs.

CLO giants such as MJX Asset Management and Octagon Credit Investors are holding some mid market loans (admittedly this exposure is not particularly high), while Nassau Credit, a new CLO manager, has also dabbled in this space.

Loans from American Teleconferencing Service are widely held. LCM Asset Management and Neuberger Berman, which are considered to be among the most conservative CLO managers, hold \$19.3 million

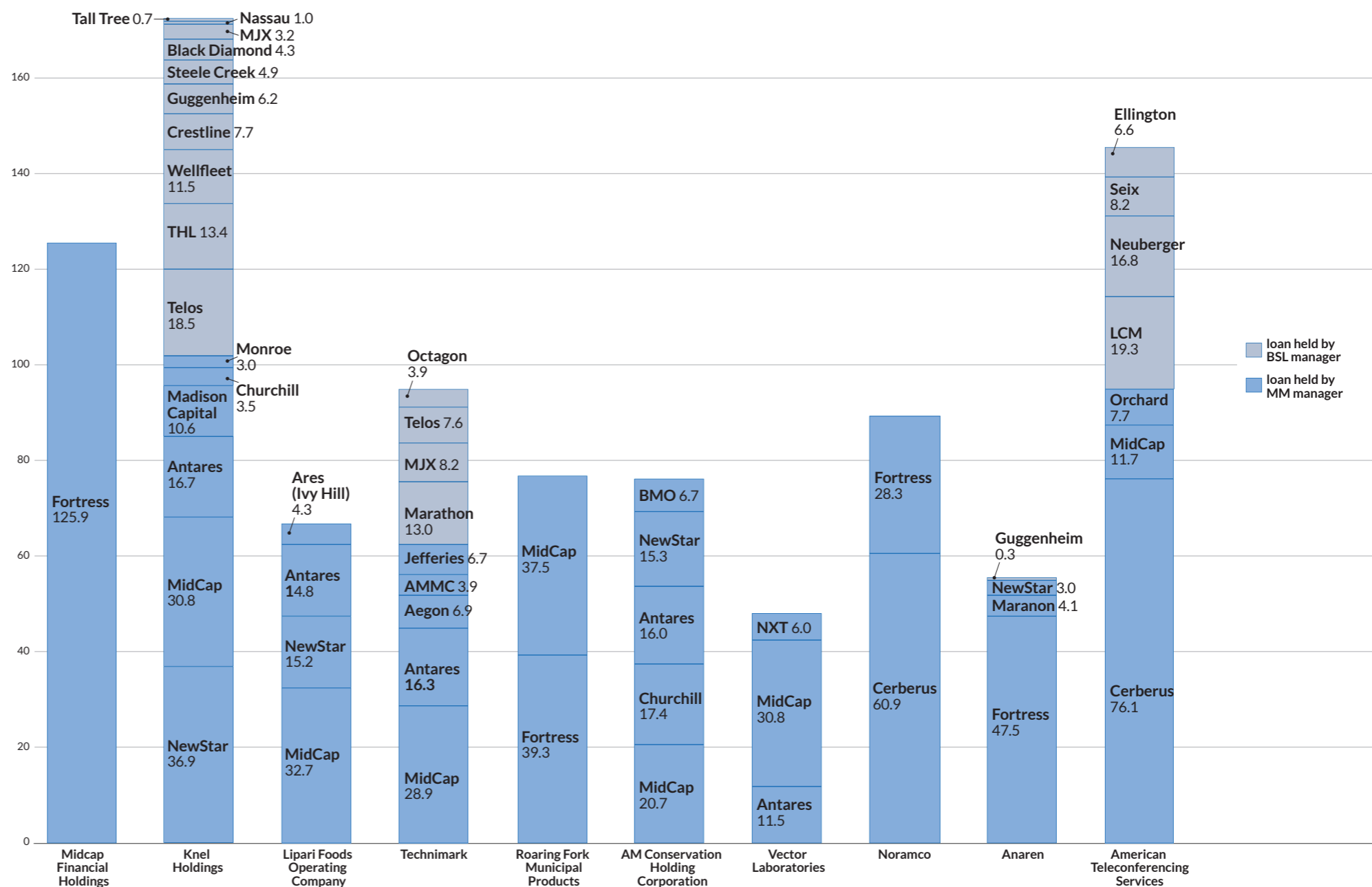
and \$16.8 million of the company's debt. In the middle market, Cerberus, Midcap and OFS Management are the biggest investors. American Teleconferencing Service issued \$165 million of debt in March 2017 via Deutsche Bank and co-lenders Barclays, Macquarie and SunTrust. A \$115 million tranche pays Libor plus 650bp

**Mid market offers increased returns**

There is a growing interest in midcap loans, with managers of broadly syndicated loan CLOs frequently adding them to their portfolios in a bid to juice up equity returns. "Triple A investors by nature are very risk averse, but they're also moving into mid market CLOs for the first time," says one CLO structurer in New York.

2017 mid market CLO portfolios have a weighted average spread between 4.7% and 7.5%, while the deals on average had a cost of debt of 2.4%. Mid market loans

**Selected mid market loans by manager holding (\$m)**



Source: CLO-i

however, are judged to be riskier from a ratings perspective, with warf levels above 3,400 (on the Moody's warf scale).

According to Jeremy VanDerMeid, a Chicago-based portfolio manager at Monroe Capital, it's a two-way street when it comes to BSL managers and mid market managers investing in similar loans. "There are mid market CLO managers who, rather than directly originating, end up buying loans at the small end of the broadly syndicated loan spectrum," he says.

In 2017, 17 managers priced new mid

market deals, including Antares and Barings, who were both pricing their first 2.0 mid market deals. In 2018 there are expected to be more first-time issuers, with THL Credit Partners and Medley Management looking to print deals.

**Europe to see first deal since crisis**

In Europe the landscape has been barren, with zero issuance since the financial crisis. But that is set to change. BeSpoke Capital, a Dublin-based lender, is ramping up a new CLO via RBS. Founder Lars Schmidt-Ott

claims Spanish loans are most suited to a CLO structure. "German loans were a popular choice in the past but now, for similar levels of risk, German loans price lower than the comparable 690bp in Spain."

BeSpoke has made significant progress in ramping up its new CLO, according to Schmidt-Ott. "The warehouse is open and we have been ramped up €200 million," he says. "We aim to do €200 million more and expect to price by Q4."

Many US managers see potential in Europe. According to Monroe's VanDerMeid

several middle market managers are looking to establish a presence in Europe despite the logistical hurdles and need for originators in each country.

There are rumours of a couple of mid market CLOs being planned in Europe once BeSpoke issues its deal. But for now there is plenty of activity in the US. In the first six months of 2018 there has been \$8.5 billion of US mid market CLO issuance. Given the compact field of managers and the variation in deal sourcing methods, there seems to be plenty of space for new entrants.