MID-MARKET CLOs

Sizing up the middle

CLOs offer attractive alternatives for investors looking to gain exposure to mid-market debt. **David Heilbrunn**, Churchill Asset Management's head of product development and capital raising, and **Shai Vichness**, the company's chief financial officer, give us their insights

When David Heilbrunn started talking about mid-market CLOs at conferences several years ago, hardly anyone showed up. At a recent conference, he faced a ballroom filled with over 500 attendees eager to hear what he and other panellists had to say, evidence of surging interest.

Churchill provides senior and unitranche debt financing to the mid-market, securitising those loans into CLOs alongside private funds and separate accounts that it manages on behalf of a diverse group of investors. Churchill is a majority-owned affiliate of Nuveen, a TIAA subsidiary which has $967 billion in assets under management, including $209 billion in alternatives. Heilbrunn and Shai Vichness discuss the current state of mid-market CLOs with *PDI*.

Q How has the US CLO opportunity evolved since you first started making these investments?

David Heilbrunn: Over the past two decades, the CLO market has grown substantially and today accounts for a significant portion of overall leveraged loan issuance. Strong historical performance, including throughout the financial crisis, has validated and helped to transition the asset class to a mainstream marketplace that offers global credit investors a wide array of attractive risk/return investment opportunities.

Middle market CLOs today represent a growing but still relatively small portion of the overall CLO marketplace. As investors continue their search for yield, the historical performance of middle market loans has led to increased investor comfort, which

David Heilbrunn

is expected to fuel the continued growth in middle market CLO issuance over the foreseeable future.

Q What do you see as the factors behind the recent growth of the CLO market?

DH: Investor focus on sourcing attractive investment opportunities continues to be a significant growth driver for the CLO market, as these transactions offer a clear yield premium over similarly rated alternatives. Additionally, CLOs have been tested through a challenging period, demonstrating the durability of the asset class. This performance has improved overall investor comfort with the space which, in turn, has helped to drive overall demand.

Middle market loan CLOs offer enhanced economics with relatively conservative structures, especially when compared with the more liquid and broadly syndicated markets. The stable performance of the asset class lends itself to appropriately structured leverage. As a result, interest in middle market CLOs has grown and continues to be popular with investors globally, a trend we do not expect to diminish any time soon. Middle market CLOs also provide investors with enhanced duration as compared with what the underlying loans offer, which is especially attractive to investors looking to match longer-dated liability streams.

Q How do middle market CLOs compare with other assets within a private debt portfolio?

DH: Middle market loans enjoy the benefit of capital structure seniority, relatively conservative structures (especially when compared to broadly syndicated loans), small club-like lender groups and floating rates of interest. Middle market loans also exhibit favourable correlation statistics, especially when compared with public equities, high yield bonds and even broadly syndicated loans. As such, including middle market loans in a diversified portfolio not only provides attractive yield opportunities but also dampens overall portfolio volatility resulting in improved Sharpe ratios and overall portfolio performance.

It is important to note that not all investors are set up to retain straight loan risk. For these investors, middle market CLOs provide attractive alternatives in the form of both rated and unrated investment opportunities allowing investors access to the middle market loan asset class in manageable sizes and by taking varying degrees of risk and resulting return.

Q What risks do you see in mid-market CLOs?

Shai Vichness: There are important differences between middle market loans and broadly syndicated loans, especially as it relates to risk. In terms of liquidity, the two are very different, as there is generally no active secondary market for middle market loans.

As a result, middle market loan investors adopt more of a buy-and-hold approach versus a trading mentality. In cases of credit deterioration, the performance of middle market loans are significantly impacted by a manager's ability to work out or restructure a given loan. This means that risk must be managed much earlier in the process. As such, it is critical that middle market loan managers possess the requisite experience and resources to manage their portfolios in challenging credit environments.

Over the past few years, a significant amount of capital has been raised in the middle market space with the establishment of a variety of new platforms. These new platforms have not been tested through a downturn, so it remains to be seen how they will perform when credit conditions become more challenging. Do they have the resources needed to deal with problems in their portfolio? Do they have the requisite experience to optimise outcomes?

Q What impacts do you see from the US exempting CLOs from risk retention rules?

SV: We expect the changes to US risk-retention requirements to have a meaningful impact on the broadly syndicated portion of the CLO market. Managers who previously found it challenging to source capital in compliance with the regulations will now find it easier to issue transactions without the need to co-invest. The resulting increase in broadly syndicated CLO issuance will bring more liquidity to this market at a point in the cycle when conditions are already frothy. Overall market conditions

Shai Vichness

and investor appetite for these loans have fuelled higher levels of leverage, weaker covenant protections – over 75 percent of the broadly syndicated market is currently covenant-lite – and compressed yields.

Risk-retention funds, vehicles raised to assist managers in complying with the capital requirements of the regulations, are likely to face challenges as targeted managers no longer require incremental capital to issue transactions.

For middle market managers who tend to use CLOs as a funding source to diversify their balance sheets, we do not expect there to be a significant impact from the relaxation of US risk-retention rules. Most middle market CLOs are made up of directly-originated collateral versus collateral sourced on a secondary basis. As such, these transactions still need to comply with US risk-retention requirements. However, since a good portion of middle market CLOs are sponsored by firms with a significant appetite for the risk, continued compliance with US risk-retention requirements should not reduce the availability of capital to the asset class.

Q How has the CLO investor base changed over time, and how difficult is it to educate investors about the current CLO market?

DH: The CLO investor base has witnessed substantial growth over time. Today, a wide array of institutional investors and asset owners are driving executions. Lately, several large Asian investors have rekindled their interest in the senior portions of CLO capital structures. These investors had served as an important part of the CLO market before the global financial crisis, but are only now just returning to the market. Because CLOs proved their mettle after the crisis, the resurgence of these investors has resulted in tighter liability pricing across the CLO market.

The unrated or equity portions of the CLO capital structure have also experienced significant growth in demand as investors search for attractive risk/return opportunities in a low yield environment. Fund of funds, including risk-retention funds, family offices, high-net-worth individuals and large institutional investors have demonstrated significant appetite for the generous returns offered by the product relative to comparable alternatives.

Q Does the prospect of a turn in the cycle or another global recession factor into your CLO strategy?

DH: Most market participants agree that we are in the later innings of a fairly benign credit cycle. As such, when considering the appropriate test levels to include in a new transaction, it's advisable to include structural flexibility for if – and when – credit fundamentals deteriorate. This is especially important in middle market CLO transactions. For example, since most middle market loans are not explicitly rated, managers must secure rating estimates for each loan in the CLO's portfolio. As we experienced in the 2008-10 timeframe, the rating agencies can be quick to downgrade these estimates, so it is important to ensure middle market CLO transactions have ample room for credit downgrades. ■