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U.S. Structured Credit Roundtable: Despite BSL Slowdown, Middle-Market Loan Pipeline And Liquidity Remains Strong For 2016

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U.S. Structured Credit Roundtable: Despite BSL Slowdown, Middle-Market Loan Pipeline And Liquidity Remains Strong For 2016

Middle-market loan pipeline and liquidity remains strong in 2016 despite a slowdown in the broadly syndicated loan (BSL) market. Standard & Poor's Ratings Services recently hosted a roundtable to discuss middle-market loan performance, liquidity, and expectations for 2016 loan and CLO issuance with two industry experts.

Roundtable Participants

- Alexander Dennis (Director) and Eric Hudson (Senior Director) in Standard & Poor's Structured Credit group (moderators).
- Neil Rudd, Senior Managing Director and Chief Financial Officer, NXT Capital LLC.
- James Cassady, Managing Director, Monroe Capital LLC.

Discussion

What follows is an edited excerpt of the discussion. The opinions expressed in this article are the opinions of the individual participants and not necessarily of their employers or Standard & Poor's.

Standard & Poor's: How has the slowdown in the BSL market played out in the middle market? What is your outlook for the 2016 middle-market pipeline?

James Cassady: The slowdown in the broadly syndicated market has not had a meaningful negative impact on middle-market volume. In fact, we have seen fairly consistent middle-market deal flow. Some deterioration in deal terms and some more aggressive structures have crept down into the middle market, especially at the upper end. However, the middle market remains less volatile than the broadly syndicated market. Liquidity in the middle market has increased, so demand for deals should remain high. With higher valuations spurring private equity funds to monetize investments and more strategic buyers entering the market in certain sectors, it seems there should be decent supply in 2016 as well. We feel these factors will lead to a strong pipeline of middle-market deals in 2016.

Neil Rudd: Our pipeline entering 2016 is robust, and we believe that the U.S. middle-market transaction volume will stabilize after a 30% decline in 2015. Equity sponsors still have significant "dry powder" to invest, and in addition to change-of-control transactions, sponsors are aggressively pursuing add-ons to help portfolio companies grow. Ample liquidity, especially from non-bank capital providers, will be available to support these transactions, with several sectors expected to see continued growth, including healthcare, technology, and businesses providing goods and services at moderate price points.

Standard & Poor's: To what degree did you see trends in the BSL market moving into the middle market in 2015?

Neil Rudd: Through the first nine months of 2015, there was a steady creep of typical BSL market deal terms into larger (greater than $50 million) middle-market loans, including a growing proportion of covenant-lite transactions. Since then, we are seeing the pendulum shift toward more conservative terms in the same middle-market loans. Most notable among these are:

- Tightened leverage parameters for permitted acquisitions, junior capital redemptions, and dividends;
- Requirement for mezzanine financing versus second lien for more cyclical borrowers;
- More stringent EBITDA definitions, specifically controls related to pro-forma and run-rate synergies; and
- A general tightening of other covenant cushions

James Cassady: To some degree, traditional broadly syndicated investors have moved down into the middle market in search of yield. Some larger market private equity sponsors have also come down market to a degree. These trends have contributed to some deterioration in deal terms and some more aggressive structures in the upper end of the middle market. Across the entire middle market, we saw leverage multiples widen and pricing contract in 2015. However, the major drivers of these trends were more likely higher liquidity and increased competition for deals in the middle market, rather than a reaction to broadly syndicated market trends. Late in the year, we saw middle-market leverage and pricing trend start to plateau, or even reverse in some instances.

Standard & Poor's: How do you think about the relative differences in liquidity between BSL and middle-market? In a credit downturn scenario, would you expect a significant difference?

James Cassady: BSL market liquidity is much more volatile, driven to a much higher degree by macroeconomic factors. Outflows from retail funds and the slowdown in CLO issuance in the second half of 2015 have put pressure on secondary prices and impacted new issuance. Conversely, middle-market liquidity is on the rise, as institutional investors have increased investment in the space and new participants have emerged. Middle-market loans are by their nature less liquid and tend to be made by buy-and-hold type investors.

In a credit downturn scenario, BSL loan prices are much more volatile, and new issuance will be impacted to a greater degree. In our experience, the more conservative structures, meaningful financial covenants, and tighter credit agreement terms associated with middle-market deals lead to higher recoveries in troubled situations relative to broadly syndicated deals. The ability for middle-market lenders to intervene upon early signs of trouble and have meaningful participation in restructuring or workout processes is critical.

Neil Rudd: Middle-market loans have always been less liquid than BSL transactions. This is due in part to the fact that middle-market loans are typically not publically rated and require more specialized underwriting, but also because most providers of middle-market loans choose to hold them on their balance sheets or in funds that they manage. There is plenty of demand for BSL transactions when times are good. However, as we have seen recently, when the tide turns and you want liquidity the most, it often evaporates or is only available if you are willing to accept a sizeable discount. On that basis, I believe that the liquidity characteristics of middle-market loans and BSL are quite similar in a credit downturn.

Standard & Poor's: How are you seeing the anticipated risk-retention regulations playing out for middle-market CLOs?

Neil Rudd: I expect that risk-retention regulations will have a minimal impact on most legacy middle-market issuers, as they have almost exclusively used CLOs as a form of permanent financing. These issuers have retained all the equity, and in some cases, even the mezzanine tranches. These amounts have always been well in excess of the required 5%.

James Cassady: We believe the risk-retention rules will slow middle-market CLO issuance to some degree in 2016, especially for new CLO managers with little or no track record. For the most part, the market has already digested the new rules, and several alternative structures have been developed to comply. CLO managers with long histories and good track records will be able to comply with the risk-retention rules and continue to raise and manage middle-market CLOs in 2016 and beyond. Managers that are able to establish long-term relationships with CLO investors, especially at the top and bottom of the CLO structure, definitely enjoy an advantage.

Standard & Poor's: How do CLOs fit into your overall financing strategy, and how do you see this changing (if at all) going forward?

James Cassady: Monroe has developed diversified funding sources over the years, including CLOs, private credit funds, small-business investment company funds, and public funds through our business development company. The majority of our assets under management is comprised of middle-market loans directly originated by Monroe. CLOs are an important compliment to our direct origination business. The deep company and industry knowledge we gain through comprehensive due diligence and underwriting on our originated transactions help us to make more informed decisions when selecting CLO assets. Conversely, the broad industry knowledge and perspective on competitive landscapes we gain from underwriting and investing in larger middle market and broadly syndicated CLO assets play an important role in is our analysis of lower middle-market direct originations. Monroe will continue to manage new middle market and broadly syndicated CLOs in the future.

Neil Rudd: CLO issuance is an integral part of NXT Capital's diversified financing strategy. CLOs provide permanent, non-recourse financing that effectively match funds our loans. CLO issuance also lets us diversify our financing sources to include a wide array of institutional investors. However, relying solely on CLOs, or any other single source of financing, is perilous as markets shift. We balance the use of CLOs with revolving and term financing from multiple banks, and third-party capital in funds we manage. Over time, we may emphasize one alternative over another, but in the big picture, we expect CLOs to remain an important part of NXT's financing strategy.

Standard & Poor's: What is your outlook for middle-market loan defaults, recoveries, and middle-market CLO performance in general?

Neil Rudd: Based on trends we are observing in our portfolio, we believe U.S. middle-market companies will experience generally stable performance and that most industries will continue to see modest growth. Indeed, many experts, as well as the timing of the Fed's long-awaited rate increase, suggest that the economy still has room to expand. Default levels will likely increase in 2016, with continued elevated default rates in oil and gas, metals, mining, and commodities, coupled with potential incremental defaults from higher-ticket capital good providers. In the event of a default, we anticipate that first-lien loans with prudent covenant and security terms will experience recovery rates equal to or better than the 80% rate that is often attributed to loans of this type.

James Cassady: We believe that middle-market loan defaults will trend upward somewhat in the coming year, especially in more cyclical businesses. In our experience, recoveries on middle-market loans have been relatively higher than recoveries on broadly syndicated loans. We expect this to continue. We believe middle-market CLOs continue to be an attractive risk-adjusted investment opportunity and that middle-market CLO performance will continue to be largely driven by the CLO manager. Manager-driven CLO characteristics, including asset selection, careful attention to industry concentrations, active management style, and a track record of achieving higher recoveries in default situations versus the market average, are all critical elements to middle-market CLO performance. For Monroe, specifically, we'll continue to stick to a conservative asset management style and stay defensively positioned as we have in the past, avoiding more speculative and cyclical industries including oil and gas, commodities, chemicals, high-end retail, and others.

Standard & Poor's: What other factors will most likely affect middle-market CLO issuance in 2016 and beyond?

James Cassady: Liability pricing will be a major factor for middle-market CLO issuance in 2016, as the arbitrage simply has to work for deals to be printed. Several macroeconomic factors can impact the liquidity available for investment in CLO liabilities, including global capital market changes, interest rate changes, and a host of other factors. The universe of investors for certain portions of middle-market CLO structures has also been fairly thin, so the entrance or exit of investors for their own internal reasons could impact the creation of new middle-market CLOs. To a lesser extent, the new risk-retention rules could cause some delay in middle-market CLO issuance, but, in our opinion, these rules will not create a long-term decline.

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Despite these risk factors, Monroe is currently warehousing assets for future CLO issuance, and we feel confident that the market will be open in 2016 for us and other managers with strong track records, long-term investors, and proven risk-retention structures.

Neil Rudd: The biggest constraint for middle-market CLO issuance in 2016 and beyond is the dearth of 'AAA' investors. Over the past four years, there have been a number of major investors participating in the market that are currently on the sidelines. As issuers, we need them to re-engage while we continue to do "missionary work" to attract new investors from the BSL market. If we are unsuccessful, the level of issuance in 2016 will likely decline year over year, and potentially more transactions will be completed on a bi-lateral basis with single investors. The other wildcard is the added supply anticipated as Antares Capital moves out from the GE umbrella and as rumored becomes a regular issuer in the CLO market. On one hand, it could benefit the CLO market by expanding its size, drawing the attention of new investors and moving it from the margins to the mainstream. Conversely, it could make life more challenging with another "mouth to feed."

The other factor that will be critical to 2016 CLO issuance is the performance of post-crisis transactions if there is a downturn in the credit cycle. If the loans and structures perform as anticipated, it will provide important validation of the value of the premium available for investing in middle-market CLOs as compared to BSL, and will likely bring more investors to the table.