Middle Market CLO Conference Notes 2022

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KEY FINDINGS

- MM CLOs are appealing relative to CLOs backed by broadly syndicated loans (BSLs). MM loans have shown strong historical performance, and CLOs backed by them have stronger protections than BSL CLOs.
- The direct lending/private credit space is expanding to include larger loans to larger borrowers with EBITDA exceeding $100 million. It is no longer the exclusive province of companies that fall in the MM size range.
- ESG considerations have become a key feature of the MM CLO landscape. Effective CLO managers must be able to handle ESG issues in order to address investor demands.

ABSTRACT

The **1st Annual Middle Market CLOs and Direct Lending Conference** attracted more than 700 registrants and was held on June 15, 2022, at Chelsea Piers in New York. Panelists generally expressed cautiously optimistic views for the sector. Key themes at the conference included uncertainty about inflation, the potential for a recession, the rapid growth in middle market (MM) lending, the increasing size of loans originated through private-credit/direct-lending channels, and the strong performance of MM collateralized loan obligations (CLOs) (and their underlying loans) during the COVID-19 pandemic. In addition, several sessions discussed new regulatory initiatives and the growing importance of environmental, social, and governance (ESG) considerations in MM CLOs.

SESSIONS COVERED — PAGE

Middle Market Finance Primer . . . 74
Co-Hosts' Welcoming Remarks . . . 75
Middle Market Finance Strategies and Trends . . . 76
The Direct-Lending Landscape: Opportunities and Threats on the Horizon . . . 77
Key Regulatory Developments for CLOs and Private Credit . . . 79
Health Check: Taking the Temperature of the Middle Market Sector . . . 80
Key Considerations for Investing in Middle Market CLOs: Equity and Debt Investor Roundtable . . . 81
Middle Market CLO Manager Roundtable: Poised for Growth . . . 83
Middle Market Private-Credit Investing: Why are LPs Allocating to the Sector? . . . 85
Emerging Middle Market CLO Trends, Strategies, and Structures . . . 88

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The following summaries reflect the remarks of the panelists who participated in selected sessions at the conference. For the most part, the summaries are drawn from notes that I prepared while watching recorded videos of the sessions. The summaries have not been reviewed or approved by the panelists. Although I have tried to capture panelists' remarks accurately, I apologize in advance for any inaccuracies and omissions. In addition, I wish to acknowledge the excellent work of DealCatalyst and the Loan Syndication and Trading Association in organizing and hosting the conference.

8:30 am: Middle Market Finance Primer

In a poll of the audience asking "how much have spreads on senior loan, bank asset-based lending (ABL) facilities changed in response to recent volatility," respondents indicated the following:

- Down 10 to 25 bps 29%
- Unchanged 4%
- Up 10 to 20 bps 18%
- Up 20 to 30 bps 32%
- Up greater than 30 bps 18%

Scope of the direct-lending/private-credit market: Borrowers have been drawn to the direct-lending/private-credit market because it is not constrained by the leveraged lending guidelines for banks.[1] An even bigger factor is speed of execution. Smaller groups of lenders in the direct-lending/private-credit space can reduce public disclosures of borrower information. Additionally, direct lenders generally intend to hold loans to their maturities, so they enter lending relationships with a different mindset than lenders that participate in broadly syndicated loans (BSLs).

Lines are blurring between the bank lending market, BSL market, and direct-lending market. Each is learning from the others and embracing potential advantages. Borrowers sometimes ask lenders to offer pricing on different structures for the different market segments. One of the issues in the BSL market is that agreements among lenders have become lengthy and complex because some lenders have experienced unpleasant surprises.

MM and other direct lenders tap bank financing, including asset-based lending (ABL) facilities, as sources of capital. Most direct lenders have a revolving line of credit backed by limited partner (LP) commitments. Then they add ABL facilities and later CLOs to provide additional tiers of capital. ABL facilities are essential for allowing a private-credit lending business to grow. However, ABL facilities can create

[1] Department of the Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, *Interagency Guidance on Leveraged Lending*, 78 Fed. Reg. 17766 (March 22, 2013), https://www.govinfo.gov/content/pkg/FR-2013-03-22/pdf/2013-06567.pdf.

mark-to-market risk for a private-credit lender. They can also create duration risk. Issuing unsecured notes and warehouse financing lines are other potential sources of funding.

MM CLOs provide a stable source of financing for MM and direct lenders. However, the CLO market is facing challenges because of difficult market conditions (i.e., wide spreads). The available supply of warehouse financing for CLOs is fully utilized. Warehouse facilities have accumulated lots of loans, and CLO execution is difficult. Many of the loans in warehouse facilities have been there for more than 180 days.

Direct lending offers certain advantages in various types of downside scenarios. It allows for more flexibility in working with distressed borrowers to achieve positive outcomes.

Valuation of MM loans is difficult because they are not traded. Some MM lenders avoid financing sources that depend on ongoing pricing of collateral. CLOs are advantageous in that they do not mark collateral to market.

The currently difficult market conditions can be a good time for lending because some of the larger borrowers are looking for funding in the direct-lending market. Also, borrowers are less resistant to providing protections against the kinds of things that hurt the lenders in the Chewy[2] and Serta[3] episodes—those risks are no longer merely theoretical. Underwriting is becoming more probing about the types of risks to which borrowers are exposed (e.g., supply chain risk).

9:10 am: Co-Hosts' Welcoming Remarks

DealCatalyst organizes Virtual Credit Days, which are bespoke events that can be used by any firm that wants to conduct a roadshow to meet potential funding partners without the carbon footprint and expense of travel. Each Virtual Credit Day features an opening panel followed by an afternoon of carefully managed, one-to-one, operator assisted, virtual meetings. The focus is on networking, not just streaming content. Virtual Credit Days offer a solution for connecting with clients in all corners of the world.

The conference has more than 700 registrants. This reflects the meteoric growth of direct-lending/private-credit sector.

Next year's **Private Credit Industry Conference on Direct Lending and Middle Market Finance** will be held on April 27–28, 2023, at The Diplomate Resort in Fort Lauderdale. In addition, DealCatalyst and the Loan Syndication and Trading Association (LSTA) will hold **The Annual CLO Industry Conference** on May 16–17, 2023, at the Marriott Marquis in New York City.

The terms "private credit" and "direct lending" refer to lending by a single or group of nonbank financial organizations to a corporate borrower. It is a market segment that is changing and growing rapidly. Investor allocations to the sector exceed $1 trillion in North America. The private-credit market has grown alongside the BSL market, which is now roughly $1.4 trillion. Both markets have grown because of the realization that they offer attractive risk-adjusted returns. Most recently, individual investors have entered the direct-lending sector through business development companies (BDCs) and other closed-end vehicles.

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[2] Kenny Tang, Steve Wilkinson, and Ramki Muthukrishnan, *The PetSmart Case: A Deep Dive Into Its Equity Transfer of Chewy Inc.*, S&P Global Research Report (November 8, 2018), https://www.readkong.com/page/the-petsmart-case-a-deep-dive-into-its-equity-transfer-of-8301165.

[3] *LCM XXI Ltd. v. Serta Simmons Bedding*, No. 21-CIV-3987, 2022 WL 953109 (S.D.N.Y. March 29, 2022).

The LSTA's advocacy and lobbying activities have been critical in facilitating the growth of both the private-credit market and the BSL market. Current issues include the SEC's proposed private fund advisor rule and ESG rule.[4]

9:20 am: Middle Market Finance Strategies and Trends: Key Themes for 2022

The private-credit sector has grown significantly in recent years, driven partly by low interest rates. It is a compelling asset class. Most private-credit lending vehicles use modest leverage and target returns in the high single-digits or low teens. Private credit has delivered very stable performance. Private-credit facilities sponsored by private equity (PE) firms have cut into the lower tier of the BSL market and have been disintermediating banks. The large amount of capital in PE firms has contributed to the level of private-credit activity.

The toughest challenge for borrowers today is staffing. This must affect lenders' approach to credit and risk. MM lending is not a passive activity. It requires hands-on monitoring and the ability to act quickly in problem situations. Banks generally are willing to lend in workout situations. Nonbank lenders need to be more proactive in such cases. In underwriting credits, it is necessary to expect that there will be a recession *at some point* during the term of a five-year loan.

MM CLOs have been around for a while and generally performed well through the global financial crisis. Managers of MM CLOs were highly effective in deferring or working out troubled loans or replacing them with other loans. Additionally, during the Covid-19 pandemic, loan defaults in MM CLOs have been in line with loan defaults in BSL CLOs.

The current environment resembles the one at the start of the Covid-19 pandemic. Loans and structures will experience idiosyncratic stresses from the current challenges of rising rates, geopolitical conflict, and supply chain disruptions.

The private-credit sector has grown to include much larger loans than it did in the past. The size of loans made in the private-credit market ranges from the small- and mid-size loans that traditionally dominated the space, to multibillion-dollar loans to large borrowers. The increase in the breadth of the borrower population has allowed MM CLOs to achieve better diversification than in the past.

Private-credit loans have maintenance covenants that many BSL loans lack (i.e., "covenant-lite" BSL loans). On the other hand, BSL loans have better liquidity than MM loans. CLO investors should be mindful of the difference in the legal terms of loans that are included in CLOs, in both the MM and BSL sectors. This requires more work on the part of investors for scrutinizing what different managers are doing. Some investors have come to MM CLOs, while eschewing BSL CLOs, because they are familiar with MM loans. The "credit first" approach of MM lending is a good match for insurance companies and pension plans, which think in terms of duration matching and view borrower operations, rather than the sale of the company, as the source of repayment of a loan.

Rated feeder funds are less restrictive than CLOs and leave investors with greater exposure to manager discretion. Senior investors have a high level of protection. Mezzanine investors in a rated feeder fund have greater exposure to manager

[4] Securities and Exchange Commission, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Release No. IA-5955, 87 Fed. Reg. 16886 (March 24, 2022), https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf; Securities and Exchange Commission, *Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices*, Release Nos. 33-11068, 34-94985, IA-6034, IC-34594, 87 Fed. Reg. 36654 (June 17, 2022), https://www.govinfo.gov/content/pkg/FR-2022-06-17/pdf/2022-11718.pdf.

discretion than do mezzanine investors in a CLO. The top ratings in a rated feeder fund are typically at the single-A level.

The Bloomberg Barclays US Aggregate Bond Index (Barclays Aggregate) captures only about 50% of the bond universe in the United States. Also, the US bond market accounts for only about 40% of the global bond market. Private credit represents a segment of the fixed-income landscape that is not meaningfully represented in the Barclays Aggregate.

Pension funds have greatly increased their investment in private credit over the past 10 years. Some have increased their allocation to private credit (primarily MM lending) to be as high as 20%. Some use leverage for investing in the sector.

One panelist predicts that MM loans and CLOs are likely to display a range of performance over the next few years. This will contrast with recent periods, during which nearly all performed well.

A stressful environment is likely to accelerate consolidation of private-credit lenders and MM CLO managers. This can benefit investors who want to limit the number of platforms with which they work, while investing more with each one.

10:10 am: The Direct-Lending Landscape: Opportunities and Threats on the Horizon

In a poll of the audience about issues with which audience members are most concerned, respondents indicated the following:

- Inflationary pressures 52%
- Rising interest-rate environment 28%
- Supply chain constraints 10%
- Putting my dry powder to work 0%

Public market volatility and its effect on private markets: Despite widening spreads and tighter loan terms in the public debt markets, those changes have not yet happened in the MM space. The strong flow of capital into the MM space is a factor that pushes against spread widening. On the other hand, stress in specific industries—particularly consumer-facing industries—has caused spread widening for credits in those industries.

Top sponsors (i.e., PE firms that own borrower companies) in both the BSL and the direct-lending markets get the best terms. Lenders are working to diversify their portfolios as a risk mitigation strategy. The size of loans in the direct-lending space is growing sharply.

The rising-interest-rate environment creates challenges for leveraged borrowers. Lenders potentially benefit from higher interest rates, but there is greater risk that borrowers will default. Better-positioned companies with strong sponsors are often able to pass higher costs along to their customers. Leveraged borrowers generally have strong levels of interest coverage and debt-service coverage, which mitigates the impact of rising interest rates. However, there has been some evidence of pressure on EBITDA growth.

The credit-committee process at direct lenders has evolved as the economic environment has gotten tougher. Lenders are more cautious about cyclical credits and perceive a need to build-in a safety cushion in their loans. Some lenders are making larger loans, but to fewer borrowers—they are being more selective. Lenders are particularly focused on loan terms to prevent them from becoming victims of "trap door" financings.[5]

In a poll of the audience about the maximum leverage (as a multiple of trailing EBITDA) at which they would underwrite a new credit position, respondents indicated the following:

- 5.5x 22%
- 6.0x 50%
- 6.5x 17%
- 7.0x 11%

Lenders have gotten comfortable with higher leverage as enterprise values have increased. In 2022, many newly originated deals have had leverage greater than 7.5x. In some cases, lenders consider annual recurring revenue for early stage high-growth companies that do not yet have EBITDA. There are two ways to look at leverage. One is as a multiple of trailing EBITDA. The other way is loan-to-enterprise value.

During the early stages of the COVID-19 pandemic, there was very strong cooperation between lenders, borrowers, and sponsors. However, there has always been greater involvement and interaction among lenders, borrowers, and sponsors in the direct-lending space than in the BSL space. Sponsors played a key role in steering borrowers to take steps to be able to survive the stresses of the early stages of the pandemic. Sponsors add a level of sophistication.

In a poll of the audience about changes in private-credit spreads since March 31, 2022, respondents indicated the following:

- Tightened by 25 bps 16%
- No change 21%
- Widened by 25 bps 53%
- Widened by over 50 bps 11%

Panelists generally agree with the results of the audience poll.

Loan terms and pricing: Lenders are focused on potential leakage of collateral (i.e., trap door financings), even for top-tier credits. They are focused on the risks of spin-offs, reorganizations, uptiering transactions, and superpriority events. Lenders learned by having been burned. MM loans are more heavily negotiated than syndicated loans. It is now more of a lenders' market with respect to loan terms.

Lending on second-lien loans depends on borrower credit quality. The pricing spread between the first- and second-lien loans is not the primary consideration for lenders.

Lenders are being selective, but they also have pressure to put capital to work. The pace of lending has somewhat slowed as the environment has become more difficult. The solution for private-credit lenders is to be nimble in order to seize opportunities when they arise.

There has not been any movement toward incorporating interest-rate caps into direct-credit loans. However, some borrowers are using swaps to manage their

[5] D. W. Morse, "What's a Lender to Do? A Review of Some 2020 Cases on "Liability Management Exercises" and the Covenants to Address Them. "Program for the Association of Commercial Finance Attorneys (January 21, 2021), https://www.otterbourg.com/assets/htmldocuments/Liability%20Management%20Exercises%20Article%20ACFA%20Panel%20January%202021.pdf; D. W. Morse and V. Mason, "What's a Lender to Do? Some 2020 Cases on "Liability Management Exercises" and Covenants to Address Them." Webinar slides (May 20, 2021), https://www.otterbourg.com/assets/htmldocuments/Liability%20Managment%20Exercises%20Slide%20Deck%20May%2020%202021.pdf.

interest-rate exposure, and many BSL loans require the borrowers to do so. Some lenders are willing to offer fixed-rate loans.

There are enough noncyclical opportunities in lending to noncyclical borrowers for private-credit lenders to remain active, although the pace of private-credit originations is somewhat slower than it was in 2021. Both macroeconomic conditions and the war in Ukraine are sources of current headwinds.

Pricing services are critical partners for MM lenders.

11:30 am: Key Regulatory Developments for CLOs and Private Credit

The regulatory landscape for lending does not end at the banks. It extends to nonbank financial intermediaries. Policy and regulatory concerns have focused on whether CLOs and leveraged lending create systemic risk for the financial system. Regulators have concluded that CLOs and leveraged lending do not inherently create systemic risk. However, there is $1.5 trillion in outstanding BSL loans and $1 trillion in private-credit loans. In any case US bank regulators would not be able to regulate nonbank lenders unless new legislation empowers them to do so.

SEC private fund advisors rule proposal: The SEC, on the other hand, has proposed various regulations that would cover private-credit activity. The key example is the SEC's proposed rule for private fund advisors,[6] which would cover CLOs. The proposed rule calls for quarterly reporting of fees, expenses, and performance. It is not the kind of information that is most relevant to CLO investors. The proposed rule would also call for annual financial audits, which would not make sense for CLOs. The proposed rule would also (i) limit indemnification of fund managers, (ii) require disclosure of all side letters, and (iii) require equal dissemination of information to all investors in a fund. There would be no grandfathering of old deals.

The LSTA has submitted a comment letter to the SEC proposing an exemption from the rule for CLOs. A blanket exemption is unlikely. Therefore, the LSTA has asked the SEC to allow CLOs to comply with the reporting requirements by continuing their current practices and not requiring audits because CLOs are cash-flow vehicles. The LSTA has also asked for grandfathering of existing CLOs.

Kirschner litigation: The Kirschner case,[7] currently before the US Court of Appeals for the Second Circuit, is about whether loans are securities. The case involves the bankruptcy of Millennium Labs. The bankruptcy trustee (Kirschner) sued the lead banks on a syndicated loan for failing to have disclosed certain information. The bankruptcy trustee asserted claims under both common law and the federal securities laws. The US District Court for the Southern District of New York ruled that the loan was not a security. It would be very disruptive to the loan market if the Second Circuit rules that the loan was a security because the ruling would potentially bring all BSLs and private-credit loans within the scope of federal securities laws. The applicable standard for whether a loan is a security comes from the Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). That case creates a four-part test: (i) do the loans have a "commercial" purpose, (ii) are they distributed like securities, (iii) do market participants view them as securities, and (iv) does another regulatory scheme address the issues. A decision from the Second Circuit is likely to come by the end of 2022.

[6] Securities and Exchange Commission, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Release No. IA-5955, 87 Fed. Reg. 16886 (March 24, 2022), https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf.

[7] *Kirschner v. JP Morgan Chase Bank*, No. 21-2726 (2d Cir., filed Oct. 28, 2021).

ESG: ESG issues have become an area of keen interest among investors and the SEC. The SEC has proposed rules about ESG issues.[8] Some of the proposed rules apply to funds that have varying degrees of ESG focus, and others apply to investment advisors. One of the objectives is to prevent greenwashing (i.e., when companies present themselves as being more environmentally friendly than they really are). The LSTA has created standard questionnaires that lenders and investors can use to perform due diligence on the ESG characteristics of prospective borrowers and investments.

LIBOR: The transition from the London interbank offered rate (LIBOR) to the secured overnight financing rate (SOFR) is not yet complete. There are $5 trillion of outstanding LIBOR-based BSL loans and another $1 trillion of LIBOR-based private-credit loans. Lenders need to work on remediation of those loans by May 2023, when LIBOR will disappear.

12:00 pm: Health Check: Taking the Temperature of the Middle Market Sector

The MM lending space has rebounded very well from a deep slump in 2020. US M&A activity in 2020 was down roughly 25% from the level of activity in 2019. Lenders focused closely on credit in 2020, emphasizing loans to businesses that are resilient through difficult times and avoiding borrowers in cyclical businesses. Loan documentation tightened in certain areas, but it did not change much overall. Capital was readily available for good borrowers.

A key factor for lender success during the early stages of the Covid-19 pandemic was applying conservative lending standards that focus on a borrower's ability to withstand stress for a reasonably long time (e.g., 12 months to 18 months). The pandemic environment shifted lenders' focus to real-time information more than trailing-twelve-month figures.

Default rates for BSL and MM loans were roughly the same in the years before the start of the pandemic. Once the pandemic started, BSL loans experienced a slightly higher default rate than MM loans. However, even though MM loans displayed a better default rate, they had worse post-default recoveries, particularly at the larger end of the MM range. Recovery rates for larger MM loans fell to around 50% from the 70% to 80% range.

Moving from 2020 to 2021, MM lending is in full swing. EBITDA remains the primary means of classifying loans. Many borrowers have special, Covid-19-related adjustments and supply chain–related adjustments in the EBIDTA calculations for their covenants. From a lender's perspective, it is necessary to evaluate a borrower's sustainable core earning capacity in a normal environment. Some borrowers have experienced earnings increases associated with the pandemic, and lenders should consider one-time events that may have boosted earnings (e.g., sales of patio furniture and wallpaper).

Rising interest rates are lowering company valuations. However, lenders place greater emphasis on EBITDA than on company valuations. They are willing to extend loans with higher LTVs provided that the cash-flow coverage remains strong. Also, rising interest rates affect different industries differently. Rising rates are very bad for the housing and mortgage lending sectors, but they can provide a boost to financial advisors. It is also important for lenders to consider a borrower's access to other sources of capital to enable it to weather storms.

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[8] Securities and Exchange Commission, *Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices*, Release Nos. 33-11068, 34-94985, IA-6034, IC-34594, 87 Fed. Reg. 36654 (June 17, 2022), https://www.govinfo.gov/content/pkg/FR-2022-06-17/pdf/2022-11718.pdf.

MM capital structures tend to be "loan only" (i.e., no subordinated debt). This can make MM loans structurally weaker than BSL loans, which often have borrowers with subordinated debt in their capital structure. A recent trend has been to add preferred shares to the capital structures of MM borrowers. This boosts credit quality. Preferred shares usually count as equity in analyzing an MM borrower. Subordinated debt held by the borrower's sponsor (i.e., a PE fund) also can sometimes be viewed as equity.

Relationships with sponsors are important. Lenders want to maintain strong relationships with sponsors, both for new deal generation and managing loans during their terms. Lenders can sometimes help sponsors/borrowers deal with problem by calling on other parts of the lender's network. Overall, the shared experience of the recent stresses has strengthened relationships between lenders and sponsors/borrowers.

Competition among lenders has increased as more lenders have entered the private-credit market. In 2020, only about 15% of MM loans were covenant-lite. In 2021, the proportion grew to roughly 30%. Additionally, as MM deals get larger, certain borrower-friendly terms are migrating into MM documents from the BSL side.

The outlook for the coming year is uncertain. Lenders will continue to focus on making loans to high-quality companies. The rising-rate environment will be a test for the private-credit industry. Companies still have strong liquidity, partly from stimulus provided during the early stages of the COVID-19 pandemic. Therefore, defaults are likely to remain low for the remainder of 2022 but could rise in 2023 as the effects of the stimulus wear off.

1:55 pm: Key Considerations for Investing in Middle Market CLOs: Equity and Debt Investor Roundtable

Key differences between MM and BSL CLOs: Investors should focus on four key areas when investing in CLOs: assets, liquidity, structure, and spread. A typical MM loan is to a company with EBITDA of less than $100 million and a rating of B–, while a typical BSL loan is to a larger company with EBITDA of $100 million or more and a rating of B (flat). Compared to BSL borrowers, MM borrowers typically have less leverage (despite their lower ratings) and offer wider spreads on their loans. On liquidity, the investor base for MM CLOs is dominated by buy-and-hold investors, so there is little secondary trading compared to BSL CLOs. On the other hand, MM CLOs offer somewhat higher levels of credit enhancement than do BSL CLOs. For example, the typical credit support for the single-A tranche of a BSL CLO is 18%, while it is 25% for an MM CLO (Exhibit 1). MM CLOs also offer wider spreads than BSL CLOs, and the gap is as much as 80 bps at the single-A level.

MM loan origination process: MM loans are generally smaller than BSL loans and there are fewer lenders on each loan. Direct lenders provide greater certainty of execution for borrowers. Having fewer lenders on a loan helps to promote cooperation among the lenders, which leads to good loan performance.

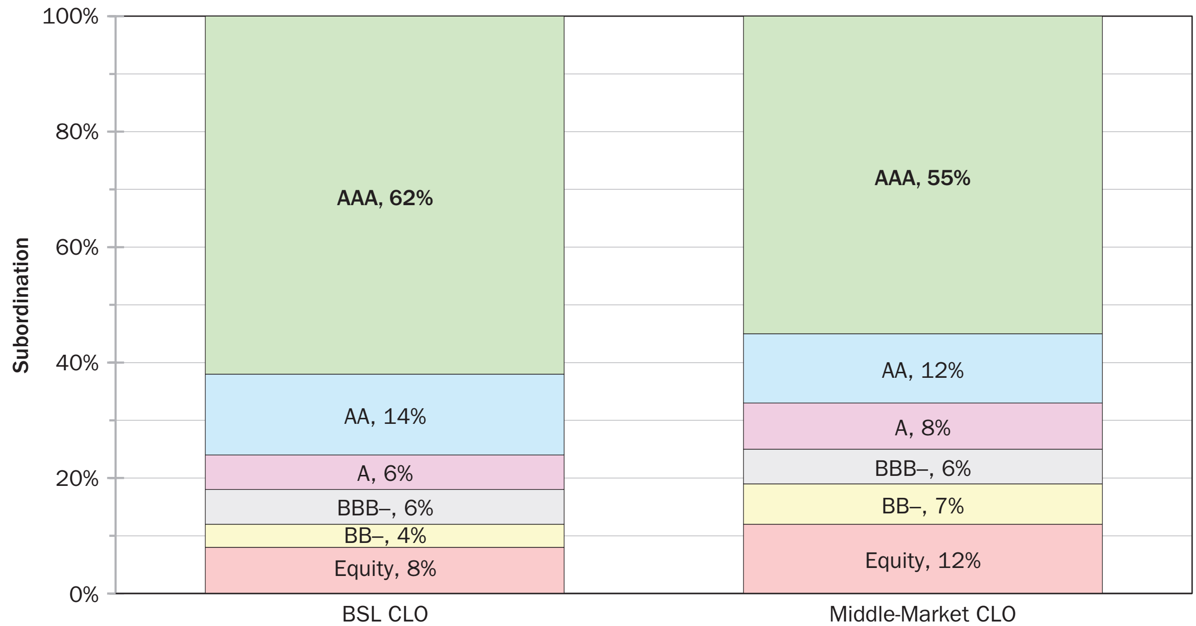
Compared to BSL CLOs, MM CLOs have stronger structural protections, such as concentration limits and collateral quality tests. MM CLOs are generally used as financing structures by MM lenders. An MM CLO must adapt to how its manager operates.

The definition of MM loans has drifted over time. Some loans as small as $20 million can be considered MM. A key characteristic of the MM lending space is that lenders have greater control over loan documentation. The wider spread on MM CLOs compensates for complexity and lower liquidity.

Both MM CLOs and BSLs CLOs have performed very well. However, the reasons may be quite different. BSL CLOs may have performed well because of strong refinancing opportunities for borrowers. The strong performance of MM CLOs is likely attributable to skill on the part of MM CLO managers in dealing with problem situations.

EXHIBIT 1

Hypothetical BSL CLO vs. MM CLO Subordination Levels



NOTES: The subordination level for a tranche is the *y*-axis value at the bottom edge of the segment representing the tranche. It equals the combined thickness of all the tranches beneath it. Thus, the subordination for the AA tranche of the BSL CLO is 24% (i.e., 24% = 8% + 4% + 6% + 6%), and the subordination for the A tranche of the MM CLO is 25% (i.e., 25% = 12% + 7% + 6%).

Adding exposure to MM CLOs allows an investor to boost diversification because there is little overlap in managers between the MM side and the BSL side. The wider spreads offered by MM CLOs can be very appealing to spread oriented, buy-and-hold investors. However, the lower liquidity may be a significant obstacle for total return investors with shorter investment horizons. BSL CLO notes arguably offer an appealing total return opportunity because of their discount prices in the current (stressful) environment. Their prices will likely improve as the economic climate moderates.

The cash yield on MM CLO equity has been more stable than the cash yield on BSL CLO equity. This is largely attributable to the higher credit support levels in MM CLOs.

Investors should focus on the alignment of a CLO manager's interest with that of investors. With the pandemic abating, credit standards have started to loosen, and managers will differentiate themselves depending on how they balance origination volume and credit quality going forward.

The ever-present question for MM CLO investors is whether the incremental spread over BSL CLOs is enough to compensate for the reduced liquidity and lower transparency of the underlying loans.

Compared to BSL CLOs, MM CLOs accumulate loans more slowly. MM lenders tend to have warehouse facilities with longer tenors.

Investor due diligence on CLO managers focuses not just on the manager's CLOs, but also on its effectiveness across all asset management and financing platforms. Investor due diligence should also focus closely on the manager's operations in both originating loans and managing credits over time.

LIBOR to SOFR transition: The spread between LIBOR and SOFR spiked briefly early in the year, which produced a windfall for the equity in CLOs that had LIBOR-based assets and SOFR-based liabilities. More broadly, though, basis risk is nothing new for the CLO sector (i.e., 1-month vs. 3-month LIBOR). The LSTA recommended a spread adjustment of 26 bps for switching from LIBOR to SOFR, but there has been significant variation in the spread adjustments actually used.

Rating agency considerations for MM CLOs: As with BSL CLOs, many MM CLOs have only one rating agency rating a deal's full capital structure. There is typically only one credit estimate for loans to unrated borrowers. Some investors in triple-A tranches insist on having at least two credit ratings on the senior tranches. Still, understanding the manager is more important than credit ratings for many investors in MM CLOs. Credit estimates on unrated borrowers tend to be more conservative than public ratings (based on leverage and other metrics). Investors (and managers) want to understand what could drive potential rating volatility.

An MM CLO can include BSL-type loans. This can happen if the manager is trying to accumulate assets quickly, and it can boost diversification of the asset pool. From an investor perspective, it is important to assess whether any BSL loans included in an MM CLO are consistent with the manager's strategy and capabilities.

CLO issuance is likely to slow down, in concert with a slowdown of leverage-loan originations broadly.

2:40 pm: MM CLO Manager Roundtable: Poised for Growth

Ramping and originating assets in an MM lending portfolio takes more time than it does in the BSL area. MM lending requires careful scrutiny. Also, lenders are originating loans before having determined which funding source they will use for them (e.g., MM CLO, private-credit fund, or business development company). Therefore, the loans must have broader suitability beyond CLOs. It helps that most MM borrowers have PE sponsors behind them. As the definition of MM has expanded, there is now some secondary trading of MM loans. Nonetheless, most loans are originated to be held to maturity. This helps align the originator's interest with that of CLO investors if the loan is included in an MM CLO. Managers of MM CLOs also often retain substantial pieces of their CLOs' equity.

MM CLOs tend to have larger equity tranches and wider spreads than BSL CLOs. On the other hand, they have larger triple-C baskets and higher concentration limits than BSL CLOs. Also, MM CLOs rely more heavily on private rating estimates on the underlying borrowers than do BSL CLOs. MM CLOs must comply with US risk-retention requirements,[9] while BSL CLOs do not.[10] Because MM CLOs comply with US risk-retention rules, they also generally comply with EU risk-retention rules.[11] This makes marketing somewhat easier for MM CLOs. Both MM CLOs and BSL CLOs

[9] 17 C.F.R. Part 246 (2021); see also 12 C.F.R. Parts 43, 244, 373, and 1234 (risk retention regulations of the OCC, Federal Reserve, FDIC, and FHFA, respectively); Office of the Comptroller of the Currency (OCC), Federal Reserve System, Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), Securities and Exchange Commission (SEC), and Dept. of Housing and Urban Development (HUD), *Credit Risk Retention*, 79 Fed. Reg. 77602 (December 24, 2014).

[10] *Loan Syndications & Trading Association v. S.E.C.*, 882 F.3d 220 (D.C. Cir. 2018), https://cite.case.law/f3d/882/220/.

[11] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017, laying down a general framework for securitization and creating a specific framework for simple, transparent, and standardised securitization, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012, Art. 6, 2017 O.J. (L 347) 35, 48–50, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402&from=EN; Regulation (EU) 2021/557 of the European Parliament and of the Council of 31 March 2021, amending Regulation (EU) 2017/2402 laying down a general framework for securitization and creating a specific framework for simple, transparent, and standardised securitization to help the recovery from the COVID-19 crisis, Art. 1, § 4, 2021 O.J. (L.116) 1, 8, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0557&from=EN.

can invest in loss-mitigation assets in connection with workouts. BSL CLOs generally allow for post-reinvestment-period investing, while MM CLOs do not.

Loans in the BSL market tend to be to larger companies with public ratings and disclosures. The loans tend to be broadly syndicated. By contrast, MM loans tend to be to smaller companies without public ratings, and the loans are held by only one or a small group of lenders. Private credit has been steadily expanding since the 2008 financial crisis. Recently, the private-credit market has started funding loans of larger size, sometimes as large as $1 billion. Borrowers and their sponsors are increasingly turning to private-credit lenders as the BSL market experiences disruptions.

MM CLO structures are very flexible and have allowed private-credit lenders to offer credit to even large borrowers when BSL solutions were not suitable or fast enough to meet a borrower's needs.

Recent exogenous events have caused spread widening for MM CLOs. However, despite currently difficult conditions, MM CLO issuance is likely to increase over time.

The direction of MM CLO spreads for the rest of 2022 is uncertain. There are reasons to have a bearish view. On the other hand, the fundamentals of the MM lending sector are very strong.

New manager landscape: A challenge for new managers is a lack of stability of spreads at the triple-A level. This is a challenge for all managers, but it is especially acute for new managers. A second challenge is a dearth of triple-A anchor investors in the market. There are only a handful of them, and they focus on working with larger managers and managers with which they have worked on past transactions. This makes it harder for a new manager to break into the business. A third challenge for new MM managers is deciding whether to forgo flexibility in order to facilitate future CLO issuance or vice versa.

Investing with new MM CLO managers creates a diversification opportunity for CLO investors. In addition, new MM CLO managers are usually lenders that have been operating successfully in the private-credit space for a long time. This means that the extra spread on CLOs from new MM CLO managers is often more than fair compensation for investing with a new name. Even though the MM CLO market is somewhat soft right now, private credit is booming.

Appeal of CLOs as a funding structure for direct lenders: Both the lender base and the investor base for MM credit have expanded. Investors should focus on the fact that MM CLOs are generally issued by fund complexes that use multiple types of financing facilities. Examples of those other types of financing facilities include revolving credit lines and business development companies. CLOs are a piece of the financing mosaic for a successful private-credit lender. CLOs are one of the financing options that does not entail mark-to-market risk. The demand for financing by the MM lending community will only grow, and MM CLOs will grow along with it. Additionally, CLOs are the only structure that offers rated securities for investors.

Like BSL CLO managers, MM CLO managers have warehouse facilities for accumulating loans. However, a key difference is that warehouse facilities for MM CLO managers have longer maturities, allowing the managers a longer time to accumulate loans. MM CLO managers also use asset-based loan facilities (ABLs), bank lines, and other credit facilities. Some of those types of facilities can resemble CLO warehouse facilities, but others do not. The different kinds of financing facilities can have very different features and provide an MM lender with varying degrees of flexibility for dealing with deteriorating or defaulted loans. In some facilities, defaulted loans become ineligible as part of the collateral base.

Structuring trends: CLO structures changed in early 2020. Reinvestment periods became shorter, moving to two years from four years. Static deals became more prevalent, and there was a slowdown of MM deals. Activity increased after mid-2020.

It is possible that the recent stress in the market will drive a return to a greater prevalence of static deals and shorter reinvestment periods.

The SEC has proposed a rule for private funds[12] that would cover CLOs because they rely on the private funds exemption under 1940 Act § 3(c)(7). If adopted, the rule would require annual audits and quarterly financial statements and would limit indemnification of CLO managers. The rule would not allow for grandfathering of existing CLOs. Some market participants are suggesting that static CLOs might be able to use the exemption under 1940 Act Rule 3a-7, which is primarily for regular asset-backed securities (ABS). This is another factor that may lead to greater prevalence of static deals going forward.

How to evaluate an MM platform: Investors should focus on how an MM CLO manager deploys cash when existing loans are repaid. Is the manager deploying cash quickly or holding large cash balances? Investors should also focus on how much leverage there is in the manager's new loan originations. Also, what is the manager's track record in dealing with problem loans?

Different managers approach the MM space differently. They target different size companies and different amounts of leverage. Investors can choose among managers based on their different approaches to MM lending.

3:55 pm: Middle Market Private-Credit Investing: Why are LPs Allocating to the Sector?

The search for yield is a longstanding theme in investing. Private credit offers a boost of 200 bps to 400 bps compared to other fixed-income investments. Large investors can both invest with private-credit managers and originate loans themselves. The range of investors includes insurance companies, pension plans, high-net-worth individuals, and sovereign wealth funds. Private credit becomes a part of the alternative asset allocation for large investors. It is often a way to diversify away from mainstream investments. Investors can access private credit as an asset class via CLOs, business development companies (BDCs), or other vehicles.

Private jumbo uni-tranche loans are a reflection of larger companies looking toward the direct-lending market rather than the BSL market. It is also a reflection of more capital moving into the private-credit/direct-lending space. The trend toward larger loans made to larger companies through direct-lending channels gives investors more options for the kind of borrowers in which they want to invest. PE sponsors prefer to have their companies borrow in the direct-lending space because it offers better speed and flexibility. Private credit/direct lending has become an asset class in its own right, through which investors seek to capture an illiquidity premium.

Investors are drawn to private credit as an asset class for several reasons. First, a typical private-credit loan is at the top of the borrower's capital structure—a senior loan with a first- or second-lien on collateral. Second, private-credit loans are generally floating rate, which addresses interest-rate risk. Third, private-credit loans are generally diversifying assets, with little performance correlation with the public equity and debt markets. These factors have also driven the strong growth of the private-credit sector in recent years. Additionally, strong private-credit performance over the past decade creates further momentum for growth. Realized losses have remained in very manageable ranges. Today, the larger issue for investors is how to get access to the sector.

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[12] Securities and Exchange Commission, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Release No. IA-5955, 87 Fed. Reg. 16886 (24 Mar 2022), https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf.

Private-credit investors tend to be buy-and-hold investors who hold loans for long periods and develop relationship with the lenders and with the PE sponsors of the borrowers. Private-credit investors need to be comfortable with the relative illiquidity of private-credit loans and must build systems for monitoring illiquid positions. Investors in MM CLOs need to be able to perform due diligence on the managers and their origination platforms.

Insurance investors need to consider regulatory capital charges and rating agency treatment of investments in private-credit loans. Private-credit managers have created vehicles that issue rated notes backed by pools of private-credit loans. These are designed to achieve favorable treatment under insurance capital regulations. These vehicles are now coming under scrutiny.

The top current issue for investors is macroeconomic pressure. New deals are becoming riskier. Pricing is not reflecting differences in risk in recent deals.

4:40 pm: Emerging MM CLO Trends, Strategies, and Structures

MM CLOs held up well through the COVID-19 pandemic. Only five junior tranches were downgraded. Most deals were passing their overcollateralization (OC) tests, except for a few deals that failed their junior OC tests. The quality of the underlying loans deteriorated slightly, by roughly a rating notch. That was offset by other features such as more subordination and higher weighted-average excess spread. Additionally, lenders and PE sponsors provided liquidity relief for borrowers, and borrowers were able to draw on revolving lines of credit. This helped to avoid defaults during the pandemic downturn.

MM CLO performance has been stable. Compared to BSL CLOs, the underlying loans are about a notch riskier (B3 vs. B2), but MM CLOs have more subordination and more excess spread. Going forward, challenges for MM borrowers will include high debt service costs from rising interest rates and high refinancing risk because many MM borrowers have high leverage. Additionally, borrowers in certain industries face ongoing supply chain issues. Weaker borrowers could be vulnerable in a recession. The structures are designed to withstand reasonably foreseeable stresses.

MM CLOs are a financing product, not an arbitrage product. As a financing product, MM CLOs compete with other financing products to provide capital for lending to MM companies. Various private-credit lenders that have not previously issued MM CLOs are now considering doing so.

Tiering among MM CLO managers has not been as pronounced as the tiering among BSL CLO managers. This is likely because only the largest and most successful MM lenders have issued MM CLOs.

Several major investors have started investing in MM CLOs over the past two years. New investors continue to enter the market.

Some private-credit loans have recently been originated without the customary protective covenants (i.e., covenant-lite loans). However, typical MM loans still have protective covenants. Lenders will extend covenant-lite loans only to the largest tier of borrowers with the strongest track records. When such loans are included in MM loans, they are not necessarily riskier than others. Likewise, loans based on recurring revenue rather than EBITDA may be appropriate for start-up companies.

Technology is finding its way into MM lending. It can improve both originations and management of loans by integrating with borrower systems and accounts.

The levered loan universe comprises 6,800 loans, according to IHS Markets. About 1,800 of those loans are in the BSL space.

Major financial institutions recently announced the launch of a new electronic platform for trading CLOs and syndicated loans. The platform is called Octura.

ESG: ESG considerations are part of the whole investment landscape, including CLOs. Sustainability requirements have been included in BSL loans, and they are likely to become a feature of MM loans. If the borrower achieves a specified sustainability target, it gets a slightly reduced interest rate. Such loans have been included in BSL CLOs. CLOs also sometimes exclude companies in certain industries, such as weapons manufacturing, coal, and private prisons. The exclusions are embedded in the CLOs' indentures. Other CLOs target companies with high ESG scores (usually under the CLO manager's proprietary scoring framework).

A challenge for implementing ESG investment policies is a lack of information. The LSTA has created a framework for borrowers to provide ESG information, but many borrowers do not have the information (e.g., they do not know their carbon footprint). The ESG area is continuing to evolve. The stakes are high because investors and regulators are wary of greenwashing.