Despite Concerns, Middle Market Loan CLOs Should Generally Be Able to Withstand a Downturn

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Morningstar Perspective

Participants gathered at SCI's inaugural Middle Market CLO Seminar on June 26 to discuss the state of the market, which has grown significantly over the past few years. The overriding question on many attendees' minds was whether middle market collateralized loan obligations will be able to continue performing in a deteriorating credit cycle. Panelists agreed that while dispersion in performance across asset managers is inevitable, the sector should generally be able to withstand an eventual credit downturn because most of the underlying assets are diversified and resilient. The agenda also covered a broad range of other topics, including the rise of direct lenders and direct lending funds, regulatory issues, and the expanding investor base.

Manager Experience Is Paramount

Most panelists were generally optimistic about the MML CLO market's ability to withstand a credit downturn, in large part because of asset composition and seasoned managers. Manager experience was ranked as critical in being able to navigate successfully in a down market. The number of issuers has grown considerably over the past several years, from less than ten core managers historically, to more than 20 today. These run the gamut, from large global asset managers to smaller MML specialists. Panelists noted that although dispersion in asset manager performance will occur, the larger and more experienced asset managers are likely to be able to weather a turn in the credit cycle. According to Todd Fritchman, head of middle market finance at Morgan Stanley, "[The] manager is everything in this space."

Indeed, a speaker on the investor panel said that the biggest differentiator in manager selection is what is known about the team, its track record, and its experience. In addition, investors also place great emphasis on due diligence efforts when it comes to asset selection. Since many managers are directly originating business, they are going out and kicking the tires. Because managers are underwriting these credits to own them and not necessarily trade them, there tends to be a much higher level of scrutiny of the assets.

During the panel, Joshua Gatmaitan, vice president at Morningstar Credit Ratings, LLC highlighted three factors of concern when looking at MML CLOs: the ratings on the underlying loans, diversification of assets, and increased competition in the middle market lending space. Typically, there is a fair amount of unrated loans that can be sizeable holdings within the portfolios for these transactions and Morningstar works with its corporate credit team, which provides credit estimates on these unrated assets. Asset composition also becomes a concern if there are large concentrations in specific names, impacting portfolios' diversity, which is a factor Morningstar stresses in our analysis. Meanwhile, a more competitive landscape in the middle market space with newer entrants interested in the area may lead to more compromises in documentation standards, which may also make recoveries less certain down the line.

Throughout the day, other panelists cited the importance of documentation, as well as covenant-lite, EBITDA addbacks and increasing leverage. The absence of covenants has gotten so pervasive that one panelist referred to it as "covenant-wide," with liquidity being a concern. However, another panelist noted that leverage is not as worrisome as it was during the great financial crisis because increasing leverage and risk is on the corporate side this time, whereas before, the exposure was in the residential mortgage market. Nonetheless, the larger concentration of 'CCC' assets has led to lower recovery expectations. Newer entrants may be aggressive in order to compete, especially regarding covenant-lite loan composition. The expectation is that larger players will have greater bandwidth to be able to push back on the deterioration in credit quality and documentation.

Risk Retention Remains a Focus

Despite the overriding negative attention given to "shadow banking" in the press, Elliot Ganz, general counsel and chief of staff at the Loan Syndications and Trading Association does not believe there will be any legislation introduced under the Trump administration. Instead, Ganz believes we'll only see hearings until 2020. Meanwhile, the role of the Japanese investor remains a focus, especially as the Japanese Financial Services Agency, Japan's financial markets regulator, appears to be more cautious about the sector. Ganz believes the JFSA is not going to be comfortable simply with the requirements for CLO managers to retain at least 5% of the fair value of the CLO. Unlike in the United States where the 5% risk retention equates to compliance, the JFSA is worried about regionals and as a result, is likely to apply additional scrutiny to CLO manager activity.

The Investor Base Is Expanding

In this low interest-rate environment, it should not be surprising that every investor is looking for a way to create yield. Thus, we are seeing more issuers and investors coming into the MML CLO market. One panelist said that a lot of capital raising is occurring on the private equity side. With the growth in the market, however, there is worry over the potential for negative ratings migration in the wake of more aggressive underwriting.

The Outlook Is Cautiously Optimistic

While the mood at the conference was generally positive, there is concern about the eventual downturn in the credit cycle because dispersion in asset manager performance is expected. As competition increases, deterioration in credit quality and lower recoveries are likely. Asset managers with a longer and more established track record will probably be able to withstand a turn in the cycle. However, when the cycle will turn remains to be determined. As Randy Schwimmer, senior managing director and head of origination and capital markets at Churchill Asset Management, noted, we have been in the "seventh inning with a big rain delay."

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