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SFA Research Corner

Private Credit Fuels Middle-Market CLO Issuance

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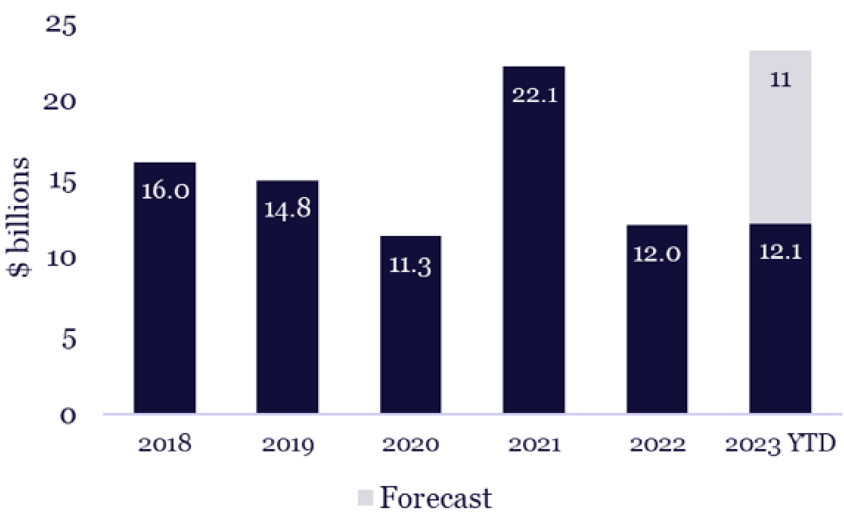
Issuance of middle-market CLOs (MM CLOs) has reached $12.1 billion so far in 2023, surpassing the supply recorded for all of 2022 and on track to reach a new high of $23 billion, according to Deutsche Bank Research. The uptick has been facilitated by an increase in private credit, nonbank lending (see sidebar).

Middle-Market CLO Issuance YTD On Track to Best 2021 Record



Source: Deutsche Bank Research

There is no consensus market definition for MM lending, however, these loans are typically made to businesses that are "larger than small busineses but too small for large-scale commercial lending or syndicated credit," according to the Federal Reserve. Middle market (MM) companies, of which there are over 200,000 in the U.S. contributing 33% to the U.S. economy, are often privately held, not rated and carry higher debt-to-income ratios and lower cash flows than larger corporations. Annual revenues range between $10 million and $1 billion. Lending is typically relationship-based.

Given the private nature of this market, total dimensions are difficult to come by. If looking at the market of loans less than $500 million, Fitch estimates that about $170 billion were issued in 2022. Fitch notes that

The Thriving Private Credit Market

A $1.3 trillion financial market, private credit exists outside traditional bank lending, the bank-intermediated broadly syndicated loan market, and the public bond market. The private credit lending platform includes business development companies (BDCs), middle-market collateralized loan obligations (MM CLOs) and closed-end direct loan funds. Over 90% of private credit loans are unitranche first-lien senior secured loans to nonrated or low-rated middle market companies, small businesses and distressed companies. Financings may also include secured second liens, secured and unsecured mezzanine loans, and preferred equity. Lending in this market tends to be more relationship driven.

Private credit lending has been thriving in recent years, buoyed by a low interest rate environment and strong demand from small and mid-sized companies. Following the 2008 financial crisis and tighter regulations around leveraged lending, banks pulled back on providing loans to small and mid-size companies. Private creditors, who are not subject to leverage limits imposed by the U.S. federal banking agencies, stepped in and provided companies access to much needed capital. By the end of 2021, there were over 700 funds providing private credit. The recent banking turmoil and difficult macroeconomic forecast also presents an opportunity for private credit funds to grow as regional banks sell off loans to bolster liquidity and retreat from certain types of lending. Moody's forecasts that demand for private credit will continue to grow, surpassing $2 trillion by 2027.

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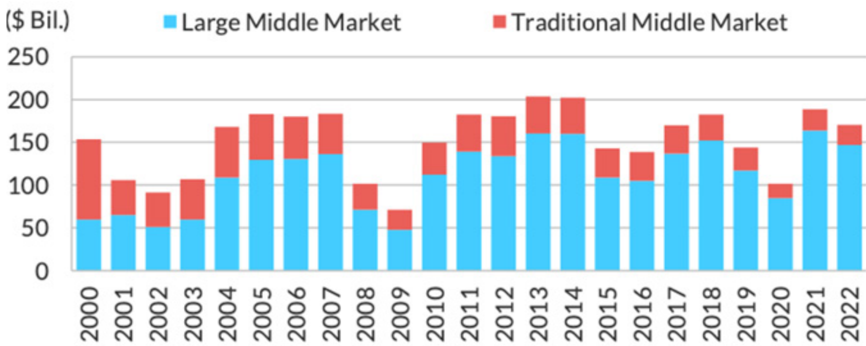
direct lending accounted for 62% of MM loans during this period while 72% of these loans were made by private nonbank creditors which includes CLOs managers, business development companies (BDCs), alternative asset managers, credit opportunity funds and regional banks.

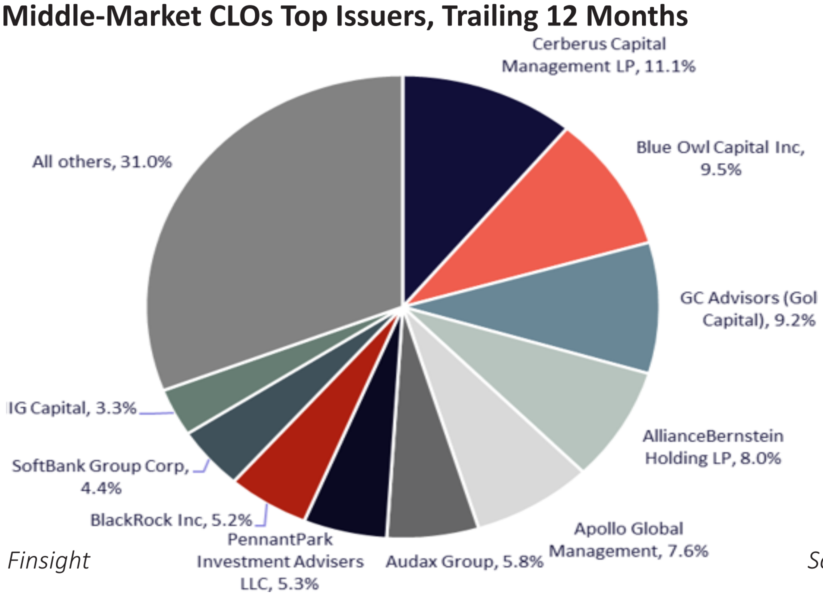
Middle-Market Loan Issuance



Note: Large Middle Market is defined as deal sizes $100 million–$500 million. Traditional Middle Market is defined as deal sizes less than $100 million. Source: [Fitch Ratings The 2023 Annual Manual – A Primer on the U.S. Leveraged Finance Market](#) using data from Refinitiv LPC.

These loans, and the sometimes-tenuous nature of the companies, generally mean that loans to middle market companies will have tighter loan documentation, stronger covenants and more robust reporting requirements than loans to larger, rated companies. The fact that these loans are relationship-based has also meant that during periods of economic stress, such as in 2020 when many middle market companies experienced heightened liquidity pressures, creditors and borrowers can work together to quickly to shore up liquidity. According to an [S&P](#) review of middle-market CLOs in 2020, almost all of the credit agreements contained some form of financial maintenance covenant. When the borrowers faced a deep decline in earnings, borrowers with financial maintenance covenants were able modify their agreements to address their immediate liquidity needs. Having said that however, it remains to be seen how well the MM CLOs segment, and private credit overall, responds to a ["rising tide of distress."](#)

Middle-Market CLOs Top Issuers, Trailing 12 Months



Source: Finsight

Corporate Leverage Loans in Securitization

A CLO, or Collateralized Loan Obligation, is a securitization vehicle backed by corporate leveraged loans. Of the $1.3 billion out-standing, about 90% are categorized as CLOs backed by Broadly Syndicated Loans (BSL CLO) with the remaining 10% backed by Middle Market loans (MM CLOs). CLOs are typically actively managed by a collateral manager, who may be an asset manager who purchases loans in the primary or secondary capital market for their portfolios or, in the case of middle market CLOs, a private credit lender who directly originates the loan.

For both types of CLOs, the principal and interest proceeds collected from the leveraged loan pool are used to service the bonds by order of seniority, with senior triple-A tranches being paid first, subordinate tranches next, and equity tranche holders claiming any residual cash after each payment period. All CLOs contain collateral quality tests and concentration limits that, when breached, result in cash flow diversions that are designed to protect the senior most tranche holders. According to S&P, a typical MM CLO holds loans from 50 to 80 different companies across 15 to 20 industries.

MM CLOs Currently Offer Investors a Spread Pick Up Over BSL CLOs

2023 YTD AVG – pricing (bps)

	AAA	AA	A	BBB	BB
BSL	198	266	333	549	845
MM	257	369	460	677	1000
diff	60	103	126	127	154

Source: Deutsche Bank Research