Keeping it private

Public European middle market CLOs are struggling, but private deals are booming

The success of middle market CLOs in the US and the ever-present search for yield has led to much talk about the European market following suit. However, the European middle market is much smaller than its US counterpart and has different hurdles to overcome. Consequently, public deals such as Alhambra SME Funding 2018-1 (SCI 18 December 2018) have struggled to launch and the private market is where the real activity is taking place.

Oliver Fochler, managing partner and ceo of Stone Mountain Capital, observes: “Multi-tranche public European middle market CLOs haven’t really taken off. While they make good theoretical sense – you should get a higher yield from such deals than from those using syndicated loans – there are issues around the size of both the companies involved and the underlying market.”

He continues: “As loan yields go up, the loans get more illiquid and the related firms more risky – the larger the firm the more it is likely to withstand a broader economic crisis, for example. CLOs are successful as they revolve around sizeable loans for sizeable companies, both of which have transparency - including usually being rated. But middle market, by its nature, involves smaller companies and smaller, usually unrated, loans, which makes it much harder to assess credit quality and much harder to build in diversification to the CLO.”

At the same time, the limited underlying markets also add an element of complexity, says Fochler. “There is really only Germany and the UK to speak of and that immediately introduces cross-currency risk, if you have to blend loans from the two jurisdictions in a broader public middle market CLO.”

However, this doesn’t mean deals aren’t getting done in the sector. “Direct lending funds are playing to the lower middle market in Europe and are utilising a CLO structure in a delta one form; i.e. setting up a securitisation company that issues a single tranche of debt, to execute private deals,” Fochler reports.

He continues: “This works perfectly when the issuer and investor already have an established relationship and understand the borrowers of the loans being incorporated and the risks involved. You can then create a section 110 company in Ireland or an SPV in Luxembourg and that makes the whole process much more straightforward as the manager doesn’t need to be regulated and nor does the structure. Further, it is cheaper than setting up an equity fund.”

Such structures are often referred to as levered sleeves. While their use is increasing and deal sizes are growing – for example, this year’s Ares Capital Europe IV direct lending fund had its final close in July at €6.5bn, which, including anticipated leverage, can be increased to up to €10bn in total capital – usage of such loan-on-loan financing for leverage remains limited.

“Structured fund financings like these loan-on-loan facilities collateralised against direct lending assets are increasingly a big part of what we do for both the fund borrowers and bank financiers,” says Rupert Wall, partner and European head of finance at Sidley Austin.

However, the barriers to entry can be high, given the range of expertise required to successfully structure a levered sleeve, according to Wall. “This is a truly hybrid instrument – the cash loan-on-loan financing will usually be based on LMA documentation, whereas the structuring often borrows very heavily from CLO technology in terms of its regulation, tax and structure. Eligibility criteria, collateral quality tests, portfolio profile tests etc are borrowed from rating agency CLO technology, for example, such that you really need practitioners who understand both structured finance and ABL leveraged finance concepts, as well as funds, tax and financial regulation of securitisations - all in the context of a much more illiquid asset, such as a mid-market or direct lending loan.”

Nevertheless, Wall says: “There’s a great deal of potential for the market and it is growing in tandem with the growth of the direct lending market itself. A lot of banks are tempted by the sector and looking at it closely in the hope that in the future there’ll be enough volume and diversity in the underlying direct lending assets for the market to go public, such that their CLO desks can start creating public middle market securitisations.”

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