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COMMENTARY

DBRS CLO Insights

Focus on the Middle Market

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Table of Contents

Middle-Market Lending and CLOs – A Market Overview

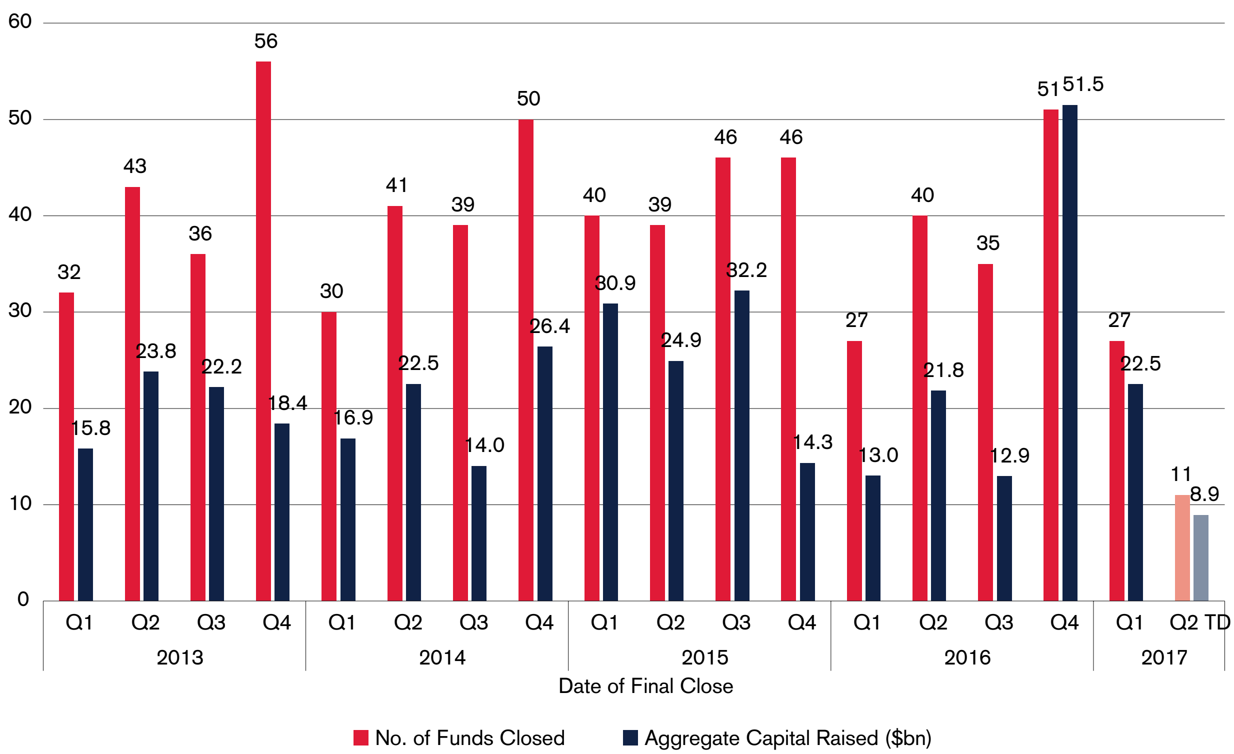
Since 2008, U.S. and European banks tightened lending in response to stricter regulations and capital requirements. This provided a gap in funding that set off a growth surge in the private debt market, a large amount of which tapped into middle-market companies. In this commentary, DBRS provides an overview of the state of core U.S. and European middle-market lending and the related collateralized loan obligation (CLO) market.

United States

Competition for middle-market loans is increasing. Middle-market CLO issuance is expanding in the United States and emerging in Europe. As part of this expansion, a variety of warehouse financing options for middle-market loans is available and the variability is increasing. The increased activity in the middle-market space is placing pressure on lenders, investors and arrangers as the demand expansion exceeds available supply.

Investors have flooded the traditionally staid middle-market loan space in the United States with liquidity. The private debt asset class as a whole saw record fundraising in Q4 2016 with $51 billion of aggregate capital raised and Q1 2017 showing continued strong growth to a total of $23 billion raised in the quarter versus $13 billion in Q1 2016. Also, 57% of investors are looking to raise their exposure to private debt opportunities in 2017 than they did in the previous 12 months, based on Preqin interviews with investors.[1]

Exhibit 1: Global Quarterly Private Debt Fundraising, Q1 2013 - Q2 2017 TD (As at May 2017)



Source: Preqin

In response, middle-market loan issuance has increased as well. In Q1 2017, the total volume of middle-market deals with debt financing of $350 million or less was $8.00 billion, which is significantly higher than the $5.00 billion from Q1 2016. The second quarter is on a similarly strong pace. As of June 15, 2017, the rolling 90-day first-lien activity was $8.37 billion, according to Leveraged Commentary & Data (LCD) in the most recent *Middle Market Weekly*.

[1] Preqin Private Debt Spotlight, February 2017, Volume 2, Issue 1.

However, even with this increase in volume, the current pace of supply cannot meet the surging demand. The result is a scarcity of deals, allowing borrowers and arrangers to push for increased leverage and more aggressive terms. Leverage over the last three months as at June 15, 2017, has tipped significantly higher as leverage over 6.0 times (x) as well as a percentage of average leverage distribution from 2011 to 2015 spiked higher than during the same period in 2016, according to LCD.

Exhibit 2

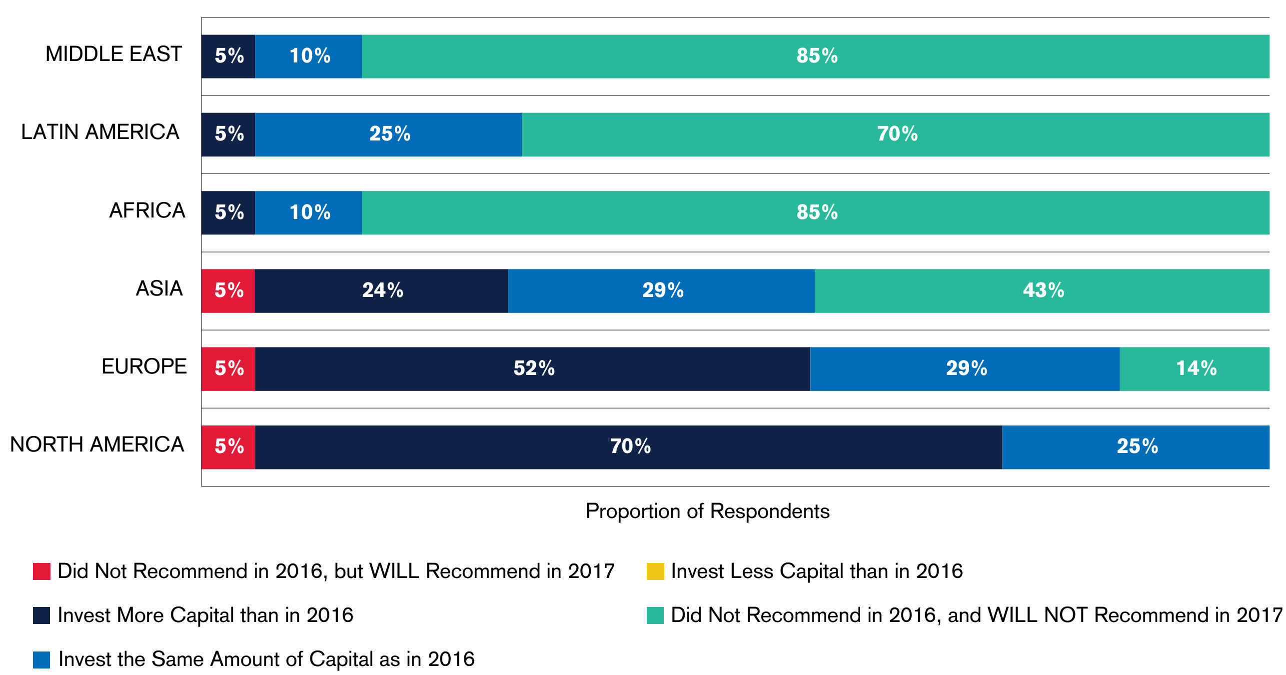
Leverage Distribution	3ME June 15, 2017	3ME June 15, 2016	Average 2011-2015
Less than 4x	0.0%	28.6%	28.5%
4 to 4.9x	10.0%	28.6%	37.8%
5 to 5.9x	20.0%	28.6%	20.4%
6x or higher	70.0%	14.3%	13.3%

Investor appetite for middle-market CLOs has followed suit with year-to-date primary issuance volume of $5.1 billion, nearly two-thirds of the entire 2016 volume of $7.7 billion, continuing the trend from 2015 with $6.4 billion. Alternatives to the use of CLOs have grown as well, including varieties of rated warehouse financing with greater flexibility in ramp-up terms and portfolio concentrations. A number of new firms and credit funds are also entering the market, issuing CLOs and warehouses in greater numbers.

Europe

While the United States has been the leading supplier of leveraged loans, Europe is gaining interest from CLO managers and investors. As the lending environment in some sections of Europe remains constrained, direct lenders have been looking to take advantage of the opportunity. According to a survey conducted by Preqin, over half of the consultants recommended investing more capital in private debt in Europe in 2017 compared with 2016 while only 14% of respondents continued to advise against investing in Europe-focused private debt. Furthermore, the private equity dry powder has risen significantly in Europe to approximately EUR 320 billion from EUR 175 billion in 2010 in Q1 2017.

Exhibit 3: Investment Consultants Private Debt Recommendations 2017 (by Region)



Source: Preqin Investment Consultant Survey, November 2016.

European private debt funds are raising a large amount of capital that needs to be deployed in the next 12 to 18 months. In Q1 2017, approximately 125 direct-lending funds were raising capital, according to Preqin. USD 9.1 billion of European alternative lending fund closings in Q1 2017 represents nearly twice the amount of fundraising for all of 2016, according to Deloitte.

Funds are deploying more capital as a result, closing 79 new European deals in Q1 2017, which is the largest number of new transactions since Q3 2014 and second largest since the end of 2012. This has increased deal flow by 7% on a last-12-month basis compared with the prior year. To deploy capital in this competitive environment and to compete with European banks that are starting to aggressively defend their market share on the back of continued stimulus from the European Central Bank, the direct lenders are offering a greater variety of loan types than bank lenders, including more leverage (i.e., unitranche loans) and loans with more flexible terms to middle-market borrowers.

This competition is reflected in the pricing contraction, increased leverage and reduced covenants. The average yield to maturity for term loan Bs with a B rating reached 4.00% by the end of May 2017 compared with the high of 6.19% in April 2016, according to LCD. Furthermore, in the leveraged finance space, although total average pro forma leverage of 5.1x to the end of Q1 2017 is lower than the record high of 6.0x in 2007 (and has remained relatively stable at approximately 5.0x in the last four years), senior leverage has increased its share to 4.5x in Q1 2017 (similar to 2007). This indicates that the subordinated debt cushion has reduced to the lowest level to just 8% in Q1 2017 compared with 23% in 2007. In addition, the issuance of covenant-lite loans has increased to 71% in January 2017 to May 2017 from 51% in January 2016 to May 2016.

Extending from the demand for middle market loans, investors and arrangers are beginning to test the appetite for middle-market CLOs in Europe. Direct-lending and middle-market CLOs and warehouse facilities are currently being considered. Such facilities include regionally focused as well as pan-European portfolios.

While initial indications show leverage that is lower than similar U.S. facilities, European direct lenders must contend with different issues than their U.S. counterparts, including cultural, legal and economic environments that differ from country to country. European middle-market CLO structures will need to consider these differences as the market evolves but, given the recent success of the traditional leverage loan CLOs in Europe, the market has precedent to follow.

For questions or comments, please contact Jerry van Koolbergen at jvankoolbergen@dbrs.com.

Note:
All figures are in U.S. dollars unless otherwise noted.

Credit Estimates – Transparency in a Competitive Lending Environment

As competition for middle-market loans increases, how do investors tell the good from the bad?

Credit estimates bring transparency to middle-market CLOs and warehouses by providing investors with a way to tier risk among borrowers. A credit estimate is a numerical assessment of corporate default probability and can be roughly mapped to a rating scale. In a growing and expanding asset class, credit estimates can offer a means of differentiating one CLO from another and one loan from another within the pool.

As competition for loans increases, the performance of individual loans in non-granular CLO portfolios becomes ever more relevant. As the variety of CLO warehouse financing options has expanded, including portfolios with greater industry concentration or longer ramp-up periods that expose investors to more concentrated pools of borrowers, idiosyncratic risk has increased. Accordingly, as idiosyncratic risk increases, the performance of individual loans becomes ever more relevant.

Credit estimates can be used to tier risk among borrowers in rated middle-market CLOs or warehouses. DBRS assigns a numerical assessment (i.e., a credit estimate) of corporate default probability to each unrated borrower in a rated securitization. The credit estimate is the result of a qualitative and quantitative analysis, a process supported by a linear regression-based proprietary statistical model.

Credit estimates are expressed as DBRS risk scores, which can be broadly mapped to DBRS long-term rating scales. Investors can use credit estimates to differentiate borrowers with risk scores that can be mapped to B-rating categories from those mapped to CCC categories. They can also compare scores within rating categories and analyze trends in portfolio credit quality. While credit estimates are not monitored and expire one year post-assignment, they are updated when managers notify DBRS that material changes have occurred with an obligor.

DBRS has a team of middle-market credit specialists located in the United States and Europe that evaluate borrowers and assign DBRS credit estimates. DBRS credit estimate analysts interact with managers to answer questions and gather information needed to complete analysis.

Managers may disclose DBRS credit estimates to investors in rated middle-market CLOs and warehouse facilities through trustee reports, providing added transparency to investors in CLOs with private market collateral, such as middle-market loans.

Credit estimates are not ratings and have other limitations. For further information, please refer to *A Guide to DBRS Corporate Credit Estimates*.

For questions or comments, please contact Jerry van Koolbergen at jvankoolbergen@dbrs.com, Orest Gavrylak at ogavrylak@dbrs.com or Cecilia Pierantoni at cpierantoni@dbrs.com.

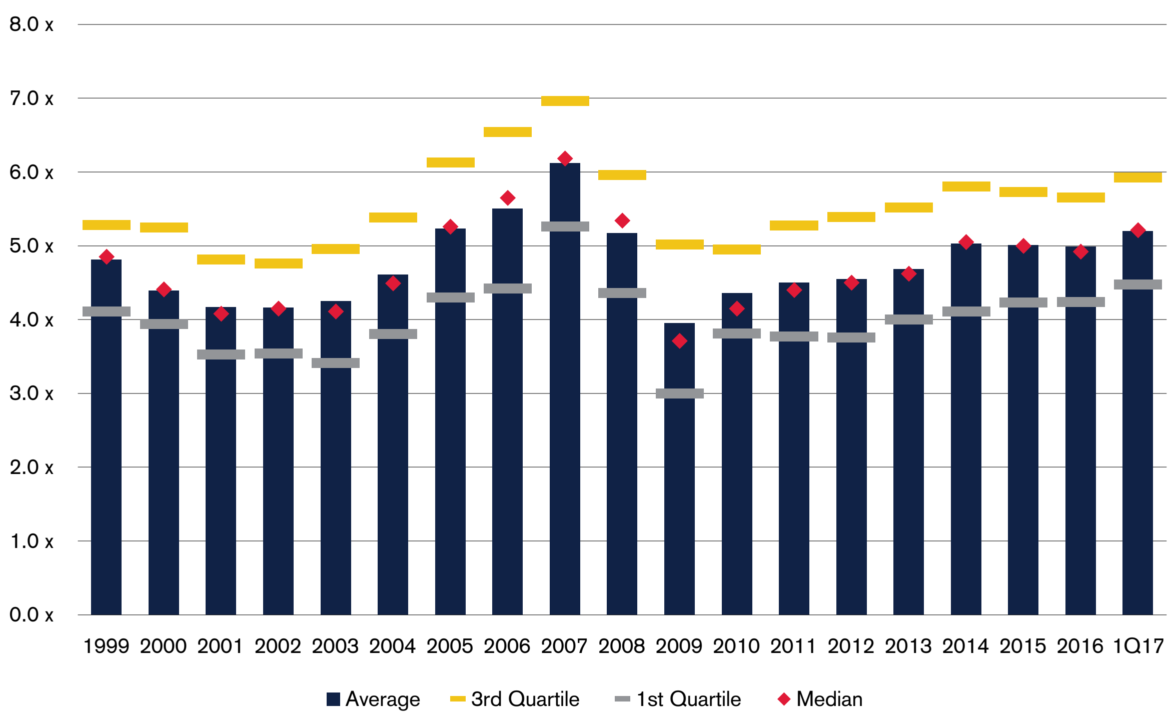
European Leverage Guidelines

On 16 May 2017, the ECB published guidance for banks on leveraged transactions.[1] The much-anticipated guidance falls largely in line with previous guidance offered by the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency in the United States in 2013,[2] subsequently clarified in 2014 and 2015.

The guidelines base their definition of leverage on an EBITDA ratio, in particular, total debt-to-EBITDA. Using this metric, a transaction is defined as a "leveraged loan" when total debt-to-EBITDA reaches 4.0x. In both Europe and United States, a level of 6.0x begins to raise concerns and, according to the ECB, should only be exceeded under exceptional circumstances.

As shown in Exhibit 4 below, debt-to-EBITDA for European leveraged loans is largely range-bound between 4.0x and 6.0x. Average leverage only breached a level of 6.0x in 2007 and only fell below 4.0x in 2009. Overall, leverage has been slowly creeping up in Europe, reaching above an average of 5.2x in Q1 2017 with the third quartile of loans touching 5.9x.

Exhibit 4: Pro Forma Debt/EBITDA for Sponsored Deals



Source: LCD (an offering of S&P Global Market Intelligence).

Based on the U.S. experience from the guidelines above (and other factors), Europe should expect to see a rise in middle-market loans, direct-lending funds and marketplace lenders. Non-bank lenders are already approaching the European market with a number of direct-lending funds recently raised, targeting leveraged European corporates. DBRS recently commented on the U.S. phenomenon on middle-market lending here as well as in this issue of CLO Insights. Comments regarding the rise in online lenders can be found here. Lastly, the DBRS Financial Institutions team commented on rising U.S. leverage in 2016, the details of which can be found here.

[1] https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170516.en.html.
[2] https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf.

European Middle-Market CLOs

European direct senior lending funds are evolving, adding leverage to increase returns and broaden investor appeal. Rated varieties of leverage are being considered, which are leading to the emergence of a European middle-market CLO product. Leverage on direct-lending funds is not new. European banks led the first wave of fund leverage, offering a turn or so of leverage. Bank credit facilities include features such as mark-to-market triggers, asset approvals and other strong bank-lender control rights.

As more funds seek leverage, European banks are looking to syndicate these credit facilities to investors. This syndication progression mirrors the evolution of middle-market fund financing in the United States, including bank credit facilities, club syndicated bank credit facilities and distributed middle-market CLOs.

A variety of rational leverage options signals a maturing market. Bank credit facilities themselves can serve as both permanent financing for portfolios of middle-market loans as well as warehouses for other financing, including distributed middle-market CLOs. In the United States, middle-market and direct-lending funds have access to rated and unrated varieties of bank credit facilities, club syndicated bank credit facilities and distributed middle-market CLOs. It is no small stretch to imagine the emergence similar portfolio financing options in Europe.

Indeed, European banks are already syndicating credit facilities to pension funds and insurance companies, and rated varieties of both bank credit facilities and European middle-market CLOs are in the works. Ratings add a new dimension to the market as the underlying borrowers are typically too small to carry ratings and rating agency statistical analysis is often better suited to evaluate credit rather than market risk.

Rated credit facilities and CLOs differ from typical bank mark-to-market credit facilities. Rated credit facilities are typically longer dated and are often term facilities without or with lower emphasis on mark-to-market triggers. Rating agencies review borrowers in the portfolio based on information provided from lenders and assign credit estimates to be used in their portfolio analysis. Portfolio characteristics are parameterized with covenants, rather than assets approved on a case-by-case basis, to allow rating agencies to perform statistical analysis.

The analysis for European middle-market CLOs and rated credit facilities follows the DBRS CLO methodology, *Rating CLOs and CDOs of Large Corporate Credit*. European middle-market CLOs bring additional challenges that reflect the dynamics of the European direct-lending space, including longer ramp-up periods consistent with longer origination processes, more concentrated portfolios, legal and economic frameworks that vary by country and foreign-exchange risk. Rated credit facilities and warehouses pose additional challenges to analysis, given the potential for variability in leverage and changes in portfolio composition over the life of the facilities as well as added risk of portfolio concentrations. DBRS analyzes each potential covenant and leverage combination as a unique transaction and all must pass the applicable DBRS stress levels.

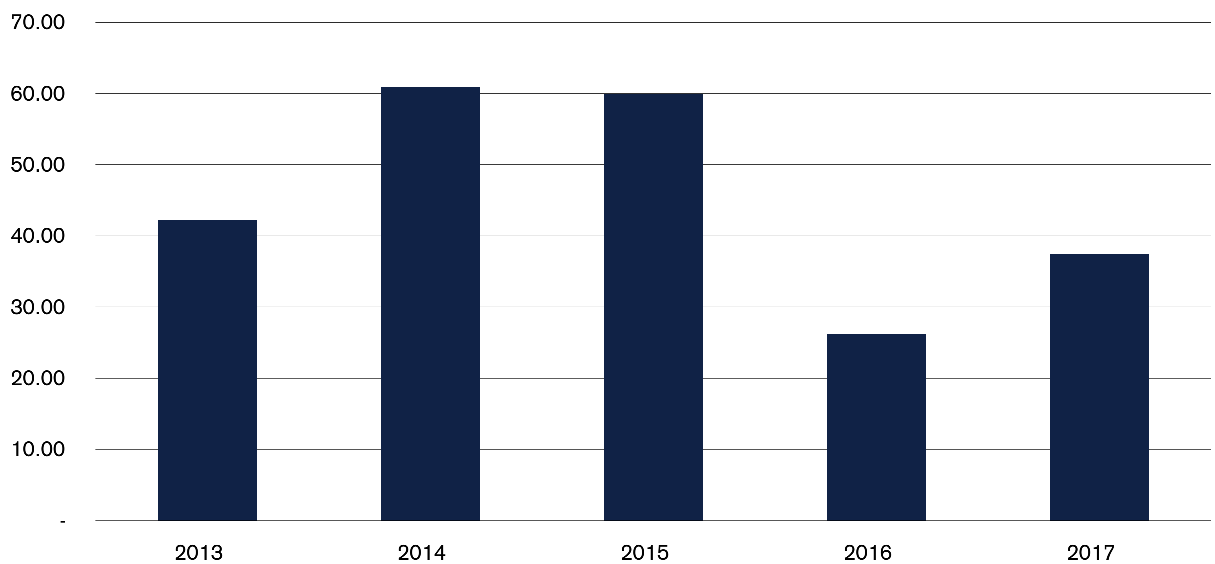
The analysis of European middle-market borrowers in CLO portfolios follows the DBRS credit estimate process. Underlying middle-market and direct-lending borrowers are typically not rated and, as a result, warrant individual analysis to estimate their credit quality. This often takes the form of a corporate credit estimate. In February 2016, DBRS published *A Guide to DBRS Corporate Credit Estimates*, which answers commonly asked questions about credit estimates.

For more information on DBRS's rating methodology for European middle-market CLOs or other portfolio lending facilities, please contact Jerry van Koolbergen at jvankoolbergen@dbrs.com, Carlos Silva at carlos.silva@dbrs.com or Mudasar Chaudhry at mchaudhry@dbrs.com.

CLO Market Update

After a collapse in U.S. CLO market issuance last year, the market has bounced back in H1 2017. There has been a total of USD 37.5 billion in issuance in H1 2017 versus USD 26.2 billion in H1 2016. This remains far from a recovery to the levels of USD 60 billion in H1 2015 and USD 61 billion in H1 2014, and even remains below the USD 42.3 billion in H1 2013. While the market is still reeling from the impact of risk-retention requirements, adjustments have been made, capital has been raised and the market is returning, lifted by growing investor interest in CLOs reflected in spread compression at all levels of the CLO capital structure.

Exhibit 5: U.S. CLO H1 Issuance, 2013 – 2017 (USD billions)



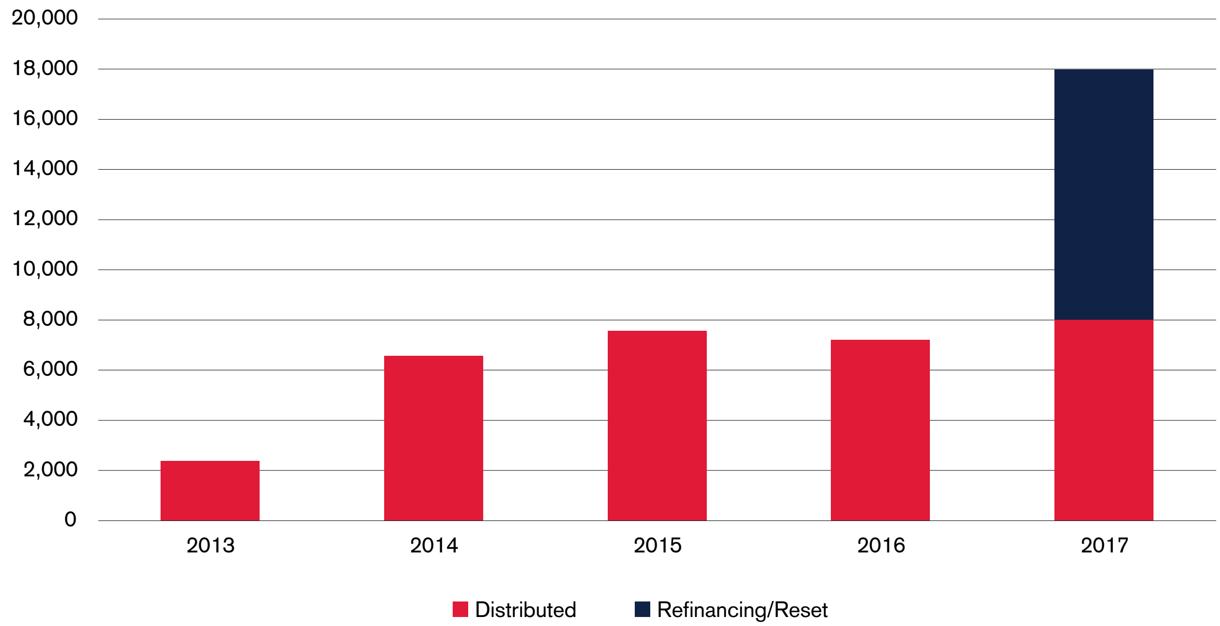
Source: LCD.

Europe Dominated by Refis in H1

European CLO issuance has been steadily recovering with year-over-year growth since its 2013 return from the financial crisis of 2008. In 2017, there has been a massive surge in issuance in the first half with EUR 18.0 billion of deals in the market versus EUR 7.2 billion in 2016; however, more than half of 2017's issuance is refinancings and resets with EUR 10.0 billion to date from 29 different transactions. This is largely because of the unique opportunity presented by the market with a tightening in liability spreads to new lows. With many post-crisis CLOs containing collateral with high-yielding loans purchased in the past several years, the opportunity to refinance the liabilities of the transaction at much tighter spreads is proving to be a unique opportunity to improve the position of equity holders.

While refinancing and resets have been a large part of market activity in Europe, there has still been a great deal of new issuance with EUR 8.0 billion of transactions so far this year, up from the EUR 7.2 billion in H1 2016 and EUR 7.6 billion in H1 2015.

Exhibit 6: European CLO H1 Issuance, 2013-2017 (Euro millions)



Sources: ConceptABS, SCI and DBRS Research.

CLO Warehouse Ratings

Volume of U.S. and European broadly syndicated loan (BSL) CLO warehouse remains lively, reflecting buoyant activity in the CLO market. DBRS provides warehouse ratings to a variety of warehouse providers and warehouse structures on a public and private basis. DBRS rated 27 BSL CLO warehouses (11 in Europe and 16 in the United States) since 2016, including 12 in 2017 (three in Europe and nine in the United States).

DBRS also rates middle-market CLO warehouses. DBRS has rated 46 middle-market CLO warehouses since 2007.

DBRS rates CLO warehouses by applying the DBRS CLO methodology, *Rating CLOs and CDOs of Large Corporate Credit*. For European CLO warehouses that include borrowers that are not publicly rated, DBRS completes credit estimates for each unrated borrower.

For more information on DBRS's rating methodology for CLO warehouses or other portfolio lending facilities, please contact Jerry van Koolbergen at jvankoolbergen@dbrs.com.

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