Fixed Income Insights

The case for U.S. middle-market loans

2017 was a record year for leveraged loan issuances with robust growth continuing to date in 2018. As demand has been building, much attention has been paid by investors and the media alike to market trends, particularly with respect to covenant deterioration or other perceived increases in risky behavior in the broadly syndicated loan (BSL) space.

U.S. Private Debt

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The search for yield in a low-interest-rate environment without accepting greater risk has become increasingly difficult. An alternative exists in the form of providing capital to non-public companies via privately negotiated deals in the mid-market space. These mid-market loans have historically been able to provide yield premium over BSL, combined with stronger covenants and protections for investors.

Mid-market companies are classified as having revenues of between $100 million and $500 million. BMO loan candidates generally have maximum revenues of $500 million and earnings (before interest, tax, depreciation and amortization) of $10 million to $50 million. The sector accounts for about one-third of all U.S. production, making this pool of potential borrowers a large and significant investment opportunity.

Mid-market loans are an efficient source of funding for growing companies, whose debt is too small to access syndicated loans organized by banks, but too large to access loans that are designed for small businesses.

The loans are characterized by floating rate coupons, providing protection against interest-rate risk, and the potential for increased returns in a rising interest rate environment. Despite multiple rate rises, interest coverage ratios have been stable in recent years.

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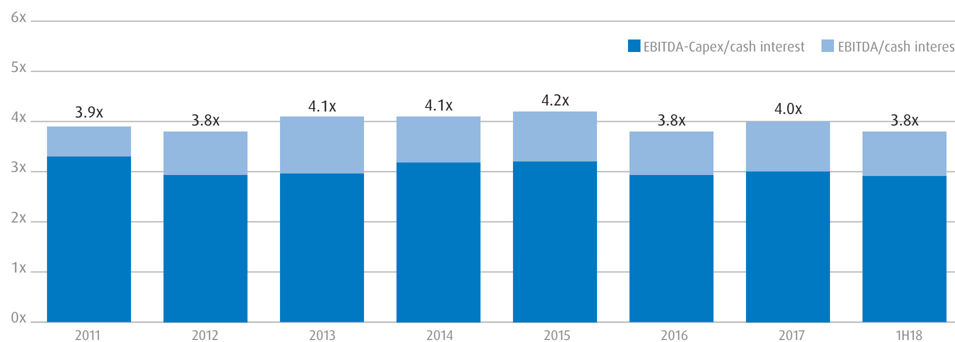
Average cash flow multiples of highly leveraged loans



Source: S&P Global Market Intelligence. Data as of June 2018.

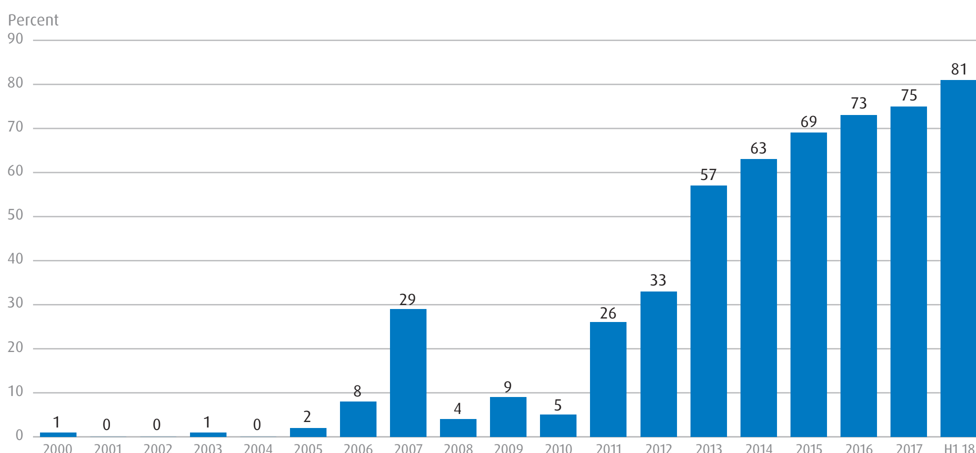
In 2017, mid-market loans generally provided a yield advantage of over 100 basis points relative to larger syndicated loans. In our view, mid-market loans have the following features that make them more attractive from a risk standpoint when compared with BSLs:

1. More conservative deal terms and financial covenant reporting

Covenant-lite refers to loans that have certain lender protections removed. Such protections give lenders the opportunity to be proactive in devising a solution for declining performance and can act as an early warning sign of a potential default situation.

New issue, broadly syndicated U.S. covenant-lite loans

Percent of all institutional loans



Source: S&P Global Market Intelligence. Data as of June 2018

Strong financial covenants remain a key element of mid-market lending as opposed to the vast majority of new issuances in the broadly syndicated market, which are increasingly "covenant-lite."

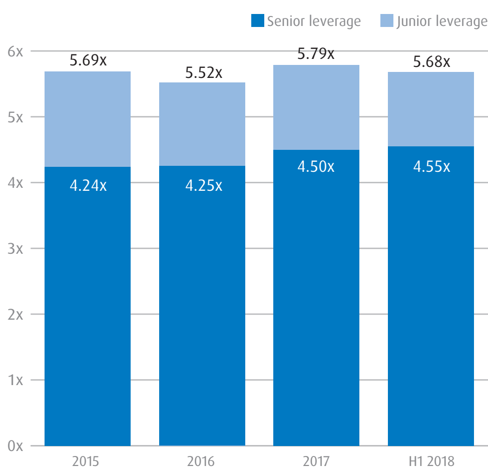
There are no mid-market loans in BMO Mid-Market Debt Strategies that are considered "covenant-lite."

2. Lower leverage vs. broadly syndicated market

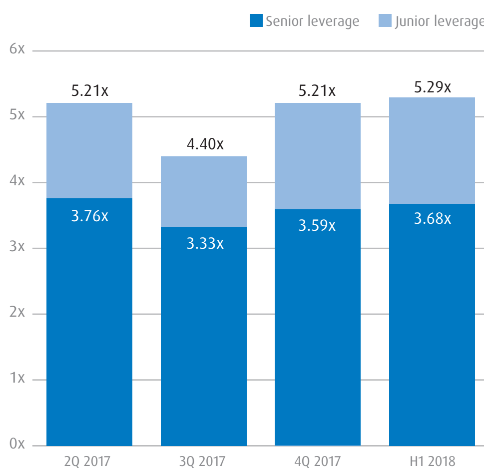
Debt/EBITDA is a measure of a company's ability to pay off its incurred debt. Debt multiples in the mid-market space are more conservative than the broadly syndicated loan market.

Debt multiples: broadly syndicated loans vs. BMO mid-market loans

Average debt multiples of large corporate LBOs



Average debt multiples of BMO mid-market loans



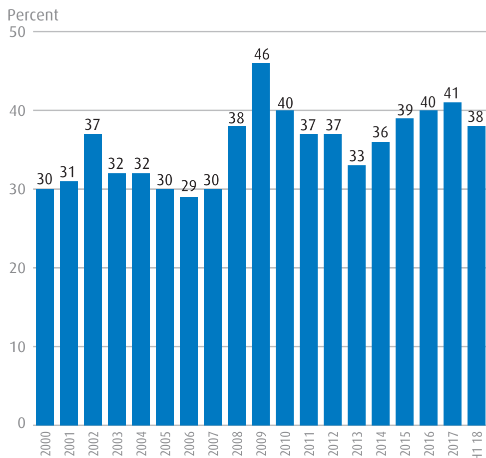
Source: S&P Global Market Intelligence, BMO Sponsor Finance. Data as of June 2018

3. Higher sponsor equity contribution vs. broadly syndicated market

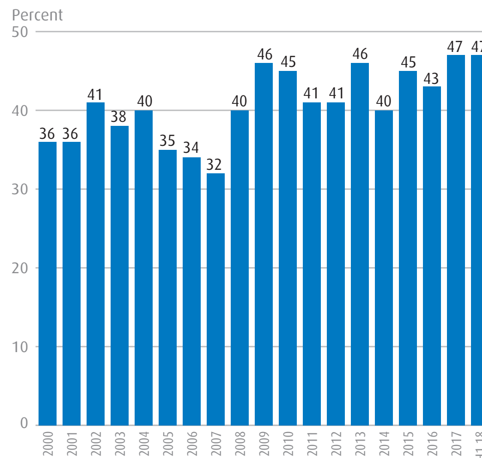
Equity contributions from sponsors in the mid-market space continue to be higher when compared to broadly syndicated loans. Equity provides a meaningful loan-to-value cushion.

Equity Contributions: broadly syndicated loans vs. middle market LBOs

Equity contribution for large corporate LBOs
$50mm or more of EBITDA



Equity contribution for middle market LBOs
Less than $50mm of EBITDA



Source: S&P Global Market Intelligence. Data as of June 2018

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Approximately 80% of the mid-market segment is issued as sponsored deals. This niche space within the loan market represents 100% of BMO GAM's specialized investable asset universe.

Private equity sponsors add value to smaller private companies in multiple ways:

- They invest cash equity in the business and perform detailed due diligence in support of the investment. This due diligence (e.g., a quality of earnings study done by an accounting firm) is also made available to lenders of a company.
- In the event that a company experiences financial stress, a private equity sponsor can help reposition the company for future growth and may also inject additional capital to support that transition.
- A private equity firm may bring best-practice corporate governance disciplines based on its experience investing across multiple businesses.

4. Greater issuer differentiation vs. broadly syndicated products

In broadly syndicated funds and collateralized loan obligations (CLOs), borrower overlap tends to be much higher across investment managers when compared to the middle market loan space. For example, large U.S. CLOs tend to have roughly one third of underlying borrowers in common, and this is as large as half of borrowers in European CLOs. In the middle market space, transactions are not syndicated due to the club nature of mid-market deals. As a result of this, obligors placed in BMO mid-market loan products tend to be highly differentiated from competitor offerings.

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