CLO: Warehouse structures providing ramping and marketing benefits to middle-market direct lending funds.

An increasing number of middle market direct lending fund managers are employing securitisation technology to facilitate the ramp-up and marketing process for their funds. By employing a structure similar to a CLO warehouse, the direct lending funds can be more easily marketed across Europe, while also posing regulatory capital benefits to investors.

According to Oliver Fochler, managing partner and CEO of Stone Mountain Capital, a number of managers have set up - or are in the process of setting up - CLO-type structures in order to ramp up mid-market direct lending portfolios. These structures are typically domiciled in Ireland, Malta or Luxembourg.

As part of this process, the fund managers can obtain a credit facility from the banking teams that typically underwrite credit facilities for CLO warehouses. In doing so, the direct lending fund managers get a facility on committed capital in the lending fund.

Leverage is available, although not at the same rate typical for a CLO warehouse, and the spreads are normally higher due to the underlying collateral.

"If the direct lending fund is structured as a securitisation, investors have the option of buying a note as debt rather than shares as equity," said Mr. Fochler. "Under Solvency II there's a benefit of investing in a securitisation over a fund because of the solvency capital ratio. A securitisation structure also typically comes with fewer marketing restrictions than an AIF."

Investors including insurance, pension, fund of funds and family officers are currently typical investors in the direct-lending securitisation structures.

To hold a share investment in a direct lending fund, insurance companies typically need to hold a 49% solvency capital against the position, similar to an equity investment. If it is structured as a securitisation company, insurers would typically have to hold a lower solvency capital ratio for unrated deals. If the structure is rated, solvency capital requirements could improve further down to c.20%, depending on the achievement of an investment grade rating.

Middle Market CLOs were a common component of the structured finance scene pre-crisis, with programmes such as Credit Suisse's Clock Finance and Capital Efficiency Group's Preps being frequent issuers. Mr. Fochler said he does not anticipate a resurgence of European middle-market CLOs like those seen pre-crisis, however. The direct lending CLO structures or securitisation companies currently in use are, unlike traditional middle market CLOs, not tranched. Structures are also typically unrated and placed in the private market.

Stone Mountain Capital has recently structured an in-house European Direct Lending Fund for lower middle-market corporates in AIF format with an associated securitisation vehicle.

A recent report from rating agency DBRS highlighted that 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, the rating agency stated, with such facilities including regionally-focused as well as pan-European portfolios.

In contrast to Europe, the US market has, year-to-date, issued $5.1bn in middle market CLOs, according to DBRS. 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.

DBRS said that 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.

"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," the rating agency said. "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," DBRS added.

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