Middle Market CLOs: A Rating Agency Perspective

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Middle Market CLOs: A Rating Agency Perspective

- Introduction
- Understanding the motivation
- Evaluating the collateral
- Assessing the originator
- Testing the structure
- Preparing for the future
Middle Market CLOs: Introduction

1998: Fitch rates CLOs with middle market loan component.

1999: Fitch rates European CLOs with 100% SME collateral.

2000: Fitch rates first CLO with 100% middle market loans.


2003: Fitch upgrades first 100% middle market CLO.
To date, Fitch has rated two CLOs where middle market loans have been a component of the portfolio. — Foothill Income Trust, L.P. and Antares Funding L.P.

Fitch has rated thirty-three CLOs in Europe where loans to SMEs represent 100% of the portfolio.

Fitch has rated ten CLOs in the U.S. where middle market loans have comprised 100% of the portfolio.

Of the 100% middle market CLOs in the U.S., performance has been positive with seven tranches upgraded out of a total of fifteen and no downgrades.
# Middle Market CLOs: Introduction

<table>
<thead>
<tr>
<th>U.S. Middle Market CLOs</th>
<th>Closing Date</th>
<th>Original Issuance</th>
<th>Rated Tranches</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACAS Business Loan Trust 2000-1</td>
<td>12-20-2000</td>
<td>153.87</td>
<td>115.40</td>
</tr>
<tr>
<td>MCG Commercial Loan Trust 2001-1</td>
<td>12-27-2001</td>
<td>353.63</td>
<td>265.22</td>
</tr>
<tr>
<td>ACAS Business Loan Trust 2002-1</td>
<td>03-15-2002</td>
<td>196.40</td>
<td>147.30</td>
</tr>
<tr>
<td>CapitalSource Commercial Loan Trust 2002-1</td>
<td>05-15-2002</td>
<td>275.28</td>
<td>247.75</td>
</tr>
<tr>
<td>ACAS Business Loan Trust 2002-2</td>
<td>08-08-2002</td>
<td>210.50</td>
<td>157.88</td>
</tr>
<tr>
<td>CapitalSource Commercial Loan Trust 2002-2</td>
<td>10-21-2002</td>
<td>325.49</td>
<td>292.94</td>
</tr>
<tr>
<td>CapitalSource Commercial Loan Trust 2003-1</td>
<td>04-17-2003</td>
<td>450.00</td>
<td>450.06</td>
</tr>
<tr>
<td>ACAS Business Loan Trust 2003-1</td>
<td>05-15-2003</td>
<td>308.30</td>
<td>23.74</td>
</tr>
<tr>
<td>CapitalSource Commercial Loan Trust 2003-2</td>
<td>11-25-2003</td>
<td>500.00</td>
<td>432.51</td>
</tr>
</tbody>
</table>

**Total Middle Market CLO Volume**

3,170.36  2,450.34
Middle Market CLOs: Understanding the Motivation

- **Balance Sheet**
  - Achieving capital relief and reducing risk exposure.
  - Example: European SME CLOs completed by large regional banks.

- **Financing**
  - Obtaining efficient costs of funding on a term basis.
  - Example: Unrated specialty finance lenders that would otherwise raise equity or use lines of credit to originate business.

- **Arbitrage**
  - Improving loan portfolio yield and diversity.
  - Example: Traditional investment managers looking for new asset class to deploy issuance proceeds.
Middle Market CLOs: Understanding the Motivation

- **Balance Sheet**
  - **Risks:** Negative selection
  - **Mitigants:** Static portfolio, loan mapping, bank default and recovery history

- **Financing**
  - **Risks:** Viability of the originator/servicer
  - **Mitigants:** Warm back-up servicer, financial institution rating

- **Arbitrage**
  - **Risks:** Expertise of the investment manager
  - **Mitigants:** Extensive meeting with manager and staff, Fitch asset manager rating (AMR)
Middle Market CLOs: Evaluating the Collateral

- Most borrowers are private, non-rated entities.
- Challenge to obtain information to evaluate the credit quality of the borrower and their expected default risk.
- Fitch analysts utilize a combination of the following approaches:
  - Mapping to the originator’s internal scoring system.
  - Scoring the borrower using the Fitch Credit Rating System (CRS)
Middle Market CLOs: Evaluating the Collateral

Mapping to the originator’s internal risk scoring system involves:

- Reviewing all credit files and shadow rating a sampling of portfolio loans. Ideally, Fitch shadow rates half of the borrowers.
- Calibrating the risk score to the equivalent shadow rating.
- Mapping the weighted average risk score to a weighted average rating of the portfolio.

Shadow ratings on the entire portfolio may be necessary if the originator does not maintain a meaningful or granular internal risk scoring system.
Middle Market CLOs: Evaluating the Collateral

- FitchCRS is an analytical tool promoting consistency and transparency in the credit ratings process.
- FitchCRS delivers corporate unsecured ratings benchmarked against agency ratings. These models use both financial statement data and equity information to generate an ‘agency like’ rating.
- FitchCRS is calibrated by industry sector for accurate results.
FitchCRS is a tool that provides ‘through the cycle’ ratings based on a number of financial measurements from the latest available audited financials:

<table>
<thead>
<tr>
<th>Total Assets</th>
<th>EBIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Intangible Assets</td>
<td>Gross Interest Expenses</td>
</tr>
<tr>
<td>Total Equity</td>
<td>Operating Leases</td>
</tr>
<tr>
<td>Long Debt</td>
<td># Shares Outstanding (If Applicable)</td>
</tr>
<tr>
<td>EBITDA</td>
<td>Share Price (If Applicable)</td>
</tr>
</tbody>
</table>
Choice of rating model depends on purpose:

- FitchCRS generates a rating with increased responsiveness to new information but relatively lower volatility.
Given the unavailability of significant data on the default rates of middle market loans, Fitch utilizes historical defaults from the high yield market.

The Fitch VECTOR model is the primary driver of the default and recovery rates used for the modeling of middle market CLOs.

The VECTOR model determines default rate assumptions based on the credit quality of each asset, as well as the industry and jurisdiction of the borrower.

The default rates output from VECTOR are the required hurdles that the portfolio must withstand in order to achieve a desired rating level.
Middle Market CLOs: Evaluating the Collateral

The VECTOR model utilizes a multi-step Monte Carlo approach that increases the accuracy of the simulation.

- Simulates default events in annual steps
- Applies conditional default probability each year
- Correlations calibrated to multi-step process
- Produces default distribution over term
- Allows accurate modeling of amortizing portfolios
Middle Market CLOs: Evaluating the Collateral

- Model’s theory requires asset correlation
- Correlation analysis calibrated to annual steps
- Worldwide data set: 6,000 constituents from 34 countries
- 25 corporate industries
- Intra-Industry correlation
  - How much of the correlation is explained by industry exposure (systematic)
  - How much of the correlation is explained by unique sources (idiosyncratic)
Middle Market CLOs:
Evaluating the Collateral

- The recovery rates utilized for middle market loans are determined by the security position of the asset.
- Asset based and real estate loans receive special treatment since they benefit from a defined borrowing base and frequent reporting.
Middle Market CLOs: Assessing the Originator

- Where does securitization fit within the originator’s overall business plan?
- What is the financial strength and operational viability of the originator?
- What is the division between loan origination, credit underwriting and loan monitoring?
- What is the originator’s credit underwriting standards? Are they applied consistently over time?
- How consistent and thorough is the originator’s monitoring process?
- What is the originator’s commitment to servicing the loans it originates?

Fitch Ratings
Fitch believes there are several best practices employed by successful middle market loan originators:

- Clear division between business development and credit
- Strong underwriting standards for new loans and migration
- Defined credit approval process with written guidelines
- A comprehensive and granular internal risk rating scale
- In-house teams of industry experts
- A system to ensure continuity and maintenance of borrower relationships
- Enforcement of timely appraisals and updated liquidation scenarios
- Consistent, accurate and updated records of borrower reporting covenants and audited financials
Middle Market CLOs: Testing the Structure

- Fitch conducts cash flow modeling to stress the credit enhancement of the structure.

- Default timing scenarios for middle market portfolios include:
  - Front-loaded default timing
  - VECTOR base case default timing
  - Back-loaded default timing (if a meaningful weighted average life)

- Interest rate stress scenarios include:
  - LIBOR up, down and flat
Middle Market CLOs:
Testing the Structure

- Fitch evaluates the break even default rates under all nine stress scenarios.
- If the break even results are sufficient to meet the required default hurdles output by VECTOR then the tranche will be rated at the corresponding rating level.
- The structure will be tested on an annual basis to ensure that the ratings are commensurate with the risk to note holders.
Middle Market CLOs: Preparing for the Future

Going forward Fitch expects continued positive performance of middle market loans due to:

- Greater underwriting scrutiny
- Active relationships
- Strong covenants

Future trends in middle market CLOs may include:

- Revolving structures
- Consistent reporting
- Additional liquidity