Lead Left Interview – M. Grier Eliasek (Part Two)

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This week we continue our conversation with M. Grier Eliasek, President and Chief Operating Officer of Prospect Capital Management. Prospect is a $7+ billion AUM leading provider of flexible private debt and equity capital to sponsor and non-sponsor owned middle market companies.

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The Lead Left: *How much do CLOs represent? What are you seeing happening with spreads?*

Grier Eliasek: Of our over $7 billion in total AUM, CLOs represents about $1.2 billion. Our BDC is a yield animal. We get lots of repeat business on the sponsor side. But you can't be 200 bps wide of the market. Spreads have continued to decline, with such trend more acute on the smaller end of the middle market.

TLL: *Interesting. I would have thought more on the larger end. How active are things right now?*

GE: More lenders can hold smaller deals, increasing spread compression at smaller deal sizes. And larger companies are better credits, all other things being equal. We have invested with over 50 sponsors. This year has been a good one. We're already at around $3 billion in gross originations. We've had about $1.5 billion in refinancings, so we've had around $1.5 billion in net asset growth. But our business of originations and repayments can be lumpy, so it's tough to predict from one quarter to the next.

TLL: *What about structures? Have you seen the same general loosening of terms everyone else has?*

GE: There have been attempts to migrate broadly syndicated loan packages to the middle market. Middle market issuers have had less success eliminating covenants altogether compared to the broadly syndicated market. Many middle market lender facilities from banks to BDCs and private lenders require covenants for facility eligibility, so that's a limiting factor.

TLL: *Plus you have all the big baskets, aside from the financial covenants.*

GE: Yes, for example, builder baskets allowing dividend distributions. Some of these asks have gotten through at the larger end of the market, though in a limited fashion.

TLL: *Does it feel like we're back in 2007?*

GE: No, because spreads have not declined to the same levels. Interestingly, we see spreads decrease at a faster rate in the middle market than with broadly syndicated loans. The larger and more liquid loans may not have covenants, but they've stayed within the L+350-400 range. Compare that with when they were at L+200-250 in

2007.

TLL: *True, although Libor was 4% back then. And there's still a middle market premium.*

GE: The middle market premium has shrunk, but there will be a floor premium based on illiquidity. We have less fervor being defenders of the middle market than competitors who are talking their own book. That's why our broadly syndicated CLO business is so attractive. We're enjoying 20% returns on a cash basis with a far less than a one percent default rate. That's pretty attractive versus a 6% yield for straight middle market loans. We can pivot between middle market and broadly syndicated loans.

TLL: *How much of your overall business is control related?*

GE: The breakout is about 50% sponsored transactions, 20% CLOs, 25% operating and financial buyouts, and 5% other. Other includes real estate properties, aircraft leasing, and online lending to consumers and small businesses.

TLL: *How big is online lending?*

GE: Online lending is only about one percent of our total business, but growing rapidly. When the BDC rules were written in 1980, it was focused on small entrepreneurial companies. But it wasn't realistic to dispense $50,000 loans to these groups. Now thanks to the internet, you can. Stay tuned to that online business. We're positioning ourselves as market leaders in that industry for the future.

TLL: *Grier, what's been your biggest surprise so far this year?*

GE: The degree to which regulation can impact your business. Some divide the lending world simplistically between regulated banks and non-regulated so-called "shadow banks." This description is misleading because "shadow banks" like BDCs are heavily regulated. Regulation is intense across our industry and needs to be carefully monitored. People will come to realize how many resources are needed to comply with regulations as a BDC. Roughly 50% of our headcount – including accounting, tax, and legal – is dedicated to compliance.

TLL: *That's a big expense base to carry around.*

GE: Large incumbent BDCs have a first mover scale advantage because they can afford the infrastructure to deal with all these growing regulations.

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