A Survey of Borrowers' Views on Bank and Non-Bank (Direct) Lenders

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Our 2016 survey of middle market "sponsored"[1] corporate borrowers focused on why borrowers were looking to direct lenders for financing rather the traditional banks.[2] GPs shared that increased bank regulation, including capital requirements and limits on types of lending, had curtailed some bank lending. On the other hand, GPs cited the flexibility of non-bank lenders to structure creative deals, their ability to take on larger portions of a loan (both senior and junior), and the speed at which they can close deals as attractive reasons for moving business to non-bank lenders and away from traditional banks. Despite these trends, the most important consideration continues to be the relationship between the GP sponsor and lender, regardless of whether it is a bank or non-bank supplier of debt financing.

Sponsors described a large universe of willing non-bank lenders and an ability to choose lenders that best fit each company. Despite the amount of competition amongst non-bank lenders to win financing mandates, lenders have not compromised their due diligence process nor have they moved significantly to more borrower friendly terms compared to three years ago. The erosion of sponsor relationship with bank lenders has created room to accommodate the growing field of non-bank lenders.

Our 2019 survey has expanded from 20 to 30 private equity firms focused on middle market buyouts. Responses were gained through one-on-one interviews which we have found to be more responsive and detailed than the cyber-surveys commonly used. The 2019 survey also changed direction somewhat and asked more trend-oriented questions that have been raised by clients and investors since our last survey. Below we list the 12 questions presented to GP borrowers followed by a summary of their responses. Importantly, our summaries mask a wide range in responses for almost every question, making the expression "it depends" very applicable.

1. *How often are you using direct lenders versus traditional lenders?*

   Most borrowers use both bank and non-bank lenders, with non-bank lenders constituting roughly 60% to 70% of all sponsored financings of those surveyed. We found that some sponsors still using bank lenders in 2016 have largely transitioned to non-bank lenders. Banks are still used for larger deals where borrowers are not averse to syndication of their loans. Non-bank, direct lenders are preferred for smaller loans (of companies with less than $50 million in EBITDA) where borrowers prefer a single buy-and-hold lender or small club of lenders. Complexity, speed of execution, and follow-on financing also drive borrowers to direct lenders. Sponsors also identified several banks that have stopped lending to the middle market in the last couple years.

2. *How many lenders do you typically talk to on a potential financing?*

[1] "Sponsored" identifies corporate ownership as a private equity firm, also referred to as "GP" or general partner. Our research shows that approximately two-thirds of middle market corporate loans made by direct, non-bank, lenders is sponsor-backed.
[2] Cliffwater Research: "Why Borrowers Choose Non-Bank Lenders", October 2016

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Surveyed sponsored borrowers seek competitive pricing and terms from a group of 5 to 10 potential lenders, generally but not always including a bank. Familiarity continues to be important with the same lenders given repeat consideration. However, any core group of lenders can change depending upon the nature (industry, complexity, etc.) of the financing.

3. *Do you use lenders that are part of larger private equity firms or do you view using such lenders as a competitive threat? What if the lender is part of a firm that has a distressed debt focused fund?*

   There emerged three answers to this question. By and large, sponsored borrowers did not seem to mind working with direct lenders backed by large private equity platforms, viewing the credit groups as largely separate from private equity activities and understanding that these larger platforms tend to manage potential conflicts very well.

   Lenders linked to middle market private equity firms were less welcome. Several GP borrowers raised both competitive issues and confidentiality. Borrower concerns were sufficiently frequent and strong that we intend to focus more on this issue in due diligence of lenders linked to middle market private equity firms.

   Finally, sponsored borrowers had a strong negative reaction to lenders attached to "distressed" platforms, citing examples of these lenders lacking patience and pushing early restructuring or additional fees. One lender owned by a well-known distressed manager was identified several times in the survey.

4. *Do your private equity fund LPs act as lenders to underlying portfolio companies?*

   Private equity fund-of-fund managers are using their equity GP relationships to source loan deals that fuel newly created direct loan and/or debt co-investment fund-of-funds. Independent LPs as well are starting to do the same thing.

   A small minority of our survey group borrow from their equity LPs. Those that do reference LP interest in mezzanine loans. Some sponsor borrowers are open to LP lending, while others see conflicts and discourage it.

5. *Has lender diligence changed over time?*

   Virtually all borrowers in our survey say lender due diligence has not changed. However, they cite a more demanding but speedier level of due diligence by direct lenders compared to banks.

6. *Has direct lenders' willingness to provide covenant lite loans changed?*

   The average borrower response was a 3.5, on a scale of 1.0 to 5.0 where 1.0 means more lender friendly and 5.0 means more borrower friendly. The responses were not widely dispersed, suggesting covenant terms in the middle market are a little more borrower friendly, but not the 5.0 score that most see in the broadly syndicated market.

7. *Are direct lenders more willing to accept EBITDA add-backs?*

   Roughly the same 3.5 score as found for covenants. Borrowers find that they are getting some adjustments but only those that the lender finds as reasonable.

8. *Have borrower terms changed more broadly?*

   Approximate score of 4.0 from the survey group, but some cited a move in the other direction in the fourth quarter.

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9. *How have rising interest rates impacted your financing strategy?*

   The survey respondents said rising interest rates were not really impacting financing. A couple cited switching to fixed rate mezzanine debt or replacing mezzanine altogether with unitranche loans, which was viewed as cheaper than a senior/mezzanine structure.

10. *Have interest deductibility caps impacted your use of leverage compared to two years ago?*

    All survey respondents answered no.

11. *Are you continuing to see talent migrate to direct lenders versus traditional banks?*

    Borrowers continue to see talent move from banks to direct lenders but say this is not a new trend and it has not picked up.

12. *If you went through a company restructuring in the past 24 months with a direct lender, please describe your experience relative to historical experiences with traditional banks (resolution timeline/efficiency, how practical/commercial were they, etc.)*

    Answers to this question were mixed. Many sponsors did not answer because they had not recently gone through a restructuring. Others cited satisfaction with the flexibility and understanding of their direct lenders in contrast to bank inflexibility. Greater clarity on this question will undoubtedly come after the next recession.

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