Why Borrowers Choose Non-Bank Lenders

(A Cliffwater survey of private equity sponsors investigates why non-bank lenders are gaining ground in the U.S. corporate middle market)

October 6, 2016

Cliffwater conducted a telephone survey of private equity firms to better understand the growth of non-bank lending to the sponsor market. GPs shared with us that increased bank regulation, including capital requirements and limits on types of lending, has 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 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 other supplier of debt financing.

The rapid post-2008 growth in non-bank middle market lending (defined as lending to companies with less than $100 million in EBITDA) has largely been attributed to increased bank regulation. Both the 2010 Dodd-Frank Act and the 2013 Inter-agency Guidance on Leveraged Lending have limited the amount of risk capital that banks can hold on their balance sheets and the amount of leverage that banks can underwrite in levered transactions.

However, our research has surfaced other reasons for the success of non-bank lending, particularly in the middle market. To better understand the reasons for why private equity sponsors may utilize non-bank lenders, we surveyed a broad group of 20 middle market buyout firms and asked them to share their principal considerations when looking for debt financing.

We found that the most important consideration in choosing a middle market lender was the pre-existing relationship that sponsors had with their lenders, regardless of a bank or non-bank source. Every sponsor surveyed highlighted the stable, pre-existing roster of bank and non-bank lenders that they return to for financing. These relationships are built over time on the basis of a successful history of closed deals and positive working experiences. Each sponsor placed very high importance on curating the lenders that participate in club financing deals. Failing to make the "preferred" group can effectively shut a lender out of the vast majority of the sponsor's deals.

When comparing the differences in bank vs. non-bank middle market lending, we did hear some recurring themes. First, middle market banks have ceded market share, primarily due to a diminished ability to hold loans on their balance sheets and the need to arrange club deals. As a result, many middle and lower middle market sponsors have turned entirely to non-bank lenders to provide solutions. Non-bank lenders tend to be more flexible when it comes to "out of the credit box" transactions and tend to be a bigger participant in club deals or in junior structures. Banks still participate in clubs and can remain competitive at the senior level in terms of pricing. However, for more complex deals, middle market banks generally have tougher underwriting standards, demand a heavier amortization schedule and require extra covenants. A full comparison is provided in Exhibit 1.

Exhibit 1: Bank vs. Non-Bank Lending Considerations

	Survey Findings
Underwriting Flexibility	Non-bank lenders tend to have more flexibility in structuring loans (leverage multiples, covenants, etc.), although for cleaner deals, banks remain competitive, particularly at senior levels of the capital structure.
Pricing	Non-banks tend to charge a premium of 25 to 100 bps for their flexibility. Interestingly, most sponsors have expressed low sensitivity to pricing as their higher ROE requirements leads to a preference for non-bank lenders that are able to finance very attractive deals in exchange for the premium charged.
Leverage Restrictions	Most middle market sponsors noted that they do not participate in highly leveraged deals, though a few have noticed that banks are no longer participating in highly leveraged transactions. Where applicable, banks tend to primarily participate in senior loans, whereas non-bank lenders are brought in for unitranche, second-lien and mezzanine structures.
Capacity and Deal Size	Middle market banks that compete for deals below $50mm in EBITDA have experienced eroding market share as their capacity to hold loans on their balance sheets has shrunk relative to the past. Additionally, non-bank lenders can accommodate add-on transactions, while banks are limited by the absolute dollar amount they can lend to any credit. Notably, investment banks that compete on deals over $50mm in EBITDA with the goal of syndication have seen only minor changes as a result of lending regulation.
Speed to Close	Almost all sponsors have noted that non-bank lenders tend to be faster due to quicker internal processes and fewer committees. Additionally, non-banks can move quicker in refinancing and add-on transactions because of dedicated coverage that maintains closer familiarity with the credit and the sponsor.
Covenants	Banks tend to have tougher covenants than non-bank lenders. However, the differences are usually limited to one or two more covenants and are driven by the desire for non-bank lenders to be more flexible than banks. A number of sponsors also cited a requirement by banks to amortize a large amount of the deal in the loan (i.e. ~50% over seven years).
Reporting Requirements	Most sponsors have reported no differences, although non-bank lenders may require more detailed reporting or board observer rights (in junior structures).
Industry Expertise	Banks generally tend to have more industry expertise, but while it can be helpful, it does not seem to be high on the sponsor's wish list given that a lot of non-bank finance company professionals are former bankers with some level of industry expertise.
Access to Capital	Interestingly, a few sponsors have noted that in the late 2015 and early 2016 turbulence in credit markets, non-bank lenders dependent on capital markets for funding (particularly BDC platforms) lacked the ability to provide timely capital and saw reduced negotiation leverage.
Restructuring Troubled Deals	Many sponsors have not seen enough troubled deals over the past seven years to provide comments. The few that have had challenges pointed to the importance of lender relationships in working out a troubled loan (and as such the importance of the participants in the club) as opposed to any differences in bank versus non-bank workouts. One common theme was the dislike for bank workout groups. This is a positive for non-bank finance companies where troubled credits stay with the original coverage officer.

When sponsors were asked about the specific impact of regulation, most sponsors noted the acceleration in the share of middle and lower middle market lending towards non-banks. Changes in bank behavior specifically attributed to regulation included the tilt towards more conservative underwriting and tighter covenants, the diminished ability to hold loans on their balance sheets and the relegation to club deals, the cap on 6x leverage and the higher principal amortization rate.

Gabrielle Zadra
Senior Managing Director
310-448-5018
gzadra@cliffwater.com

Bernard Gehlmann
Managing Director
212-317-4363
bgehlmann@cliffwater.com

Roger Cheng
Director
310-448-5055
rcheng@cliffwater.com