

## 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.

The views expressed herein are the view of Cliffwater LLC (“Cliffwater”) only through the date of this report and are subject to change based on market or other conditions. All information has been obtained from sources believed to be reliable but its accuracy is not guaranteed. Cliffwater has not conducted an independent verification of the information. No representation, warranty, or undertaking, express or implied, is given as to the accuracy or completeness of the information or opinions contained in this report. This report is not an advertisement, is being distributed for informational purposes only and should not be considered investment advice, nor shall it be construed as an offer or solicitation of an offer for the purchase or sale of any security. The information we provide does not take into account any investor’s particular investment objectives, strategies, tax status or investment horizon. Cliffwater shall not be responsible for investment decisions, damages, or other losses resulting from the use of the information. Past performance does not guarantee future performance.

Exhibit 1: Bank vs. Non-Bank Lending Considerations

	Survey Findings
<i>Underwriting Flexibility</i>	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.
<i>Pricing</i>	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.
<i>Leverage Restrictions</i>	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.
<i>Capacity and Deal Size</i>	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.
<i>Speed to Close</i>	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.
<i>Covenants</i>	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).
<i>Reporting Requirements</i>	Most sponsors have reported no differences, although non-bank lenders may require more detailed reporting or board observer rights (in junior structures).
<i>Industry Expertise</i>	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.
<i>Access to Capital</i>	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.
<i>Restructuring Troubled Deals</i>	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](mailto:gzadra@cliffwater.com)

Bernard Gehlmann  
Managing Director  
212-317-4363  
[bgehlmann@cliffwater.com](mailto:bgehlmann@cliffwater.com)

Roger Cheng  
Director  
310-448-5055  
[rcheng@cliffwater.com](mailto:rcheng@cliffwater.com)