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INVESTMENT BANKERS

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Expanding Range of Credit Options

There are more choices for borrowers than ever before.

by Michael T. Newsome

Over the long haul of history, corporations have predominantly relied on banks for their credit needs. But, over the twenty-five years beginning in the early 1980s, the banking industry yielded market share to non-bank lenders and capital-market alternatives. As illustrated in the adjacent chart, in the early 1980s, banks accounted for about a third of total corporate credit. By the close of 2004, that share had declined to 18%. In the last ten years, banks have rebounded to arrest the fall and make some modest gains. In 2009, following the financial crisis, banks turned inward to clean up and protect balance sheets. With that effort in the rear view mirror, banks have reclaimed their market loss and have increased their share of corporate credit to 22% by the end of last year, buoyed by demand in the middle and small business market.

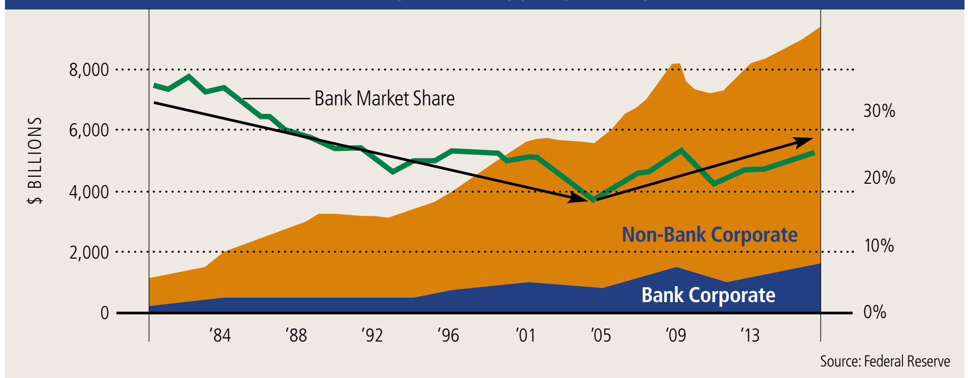
There are many forces at work; one of the most significant being the injection of liquidity into the economy by the Federal Reserve, the impact being lower capital costs across the spectrum. The modest economic recovery over the past five years has allowed large corporations to retire debt and build cash reserves rather than borrow to fund growth while still benefiting from higher valuations. The same forces have been at work in the middle market with the result being robust activity in sale and recapitalization transactions, with these transactions being funded with high levels of debt.

What we find interesting is the segmentation of market for credit to fund change of control transactions in the middle market – from banks and non-banks.

As credit size shrinks below public market levels and the need for customized structures increases, public markets yield their advantage to customized credit providers. Historically, middle-market corporate credit has been the turf of banks and asset-based lenders as a result of an information advantage derived from proximity and close familiarity with privately held businesses. There are two primary sources of credit to serve this middle market:

- *Commercial banks* provide customized credit structures with hands-on daily service, such as with lines of credit for working capital.

BANK AND NON-BANK CORPORATE CREDIT



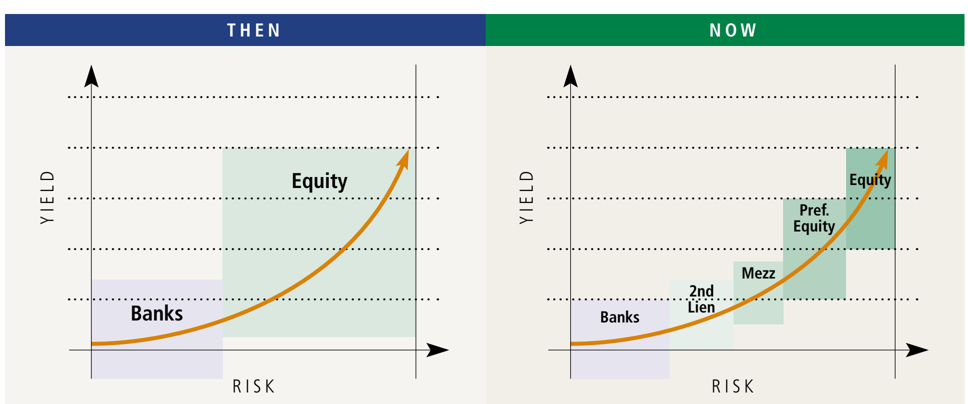
As a result of a highly leveraged capital structure, banks can offer very low-priced credit so long as the risk is commensurate. The inherent leverage in bank capital structures limits their tolerance for risk. Banks are well suited to and most cost effective in moderate leverage situations.

- *Non-bank specialized credit entities* provide risk capital in customized structures with limited covenants and controls. Their principal focus is financing M&A or recapitalization transactions. Examples of such entities include credit-focused hedge funds, business development corporations, known as BDCs, and family offices.

High activity credit facilities such as lines of credit for both small business and middle market borrowers and term credit to small businesses, that are inherently risky and demand collateral and personal guarantees, remain the purview of banks. Middle market term debt, on the other hand, is susceptible to competition from alternative lenders such as BDCs and hedge funds. These non-bank credit sources mostly compete in areas of bank weakness – higher credit risk – that emanates from leverage, term, or both. The emergence of a new regulatory regime of costs and constraints has made it harder for banks to fund longer maturities and higher leverage. Banks aren't fading away easily, but non-bank lenders are offering significant competition.

GREATER LEVERAGE AND BETTER MATCHING OF RISK

Credit markets are segmenting based on risk. Non-bank lenders are expanding their capacity to provide higher-risk credit products and structures with the aim of funding M&A transactions and recapitalizations. The effect



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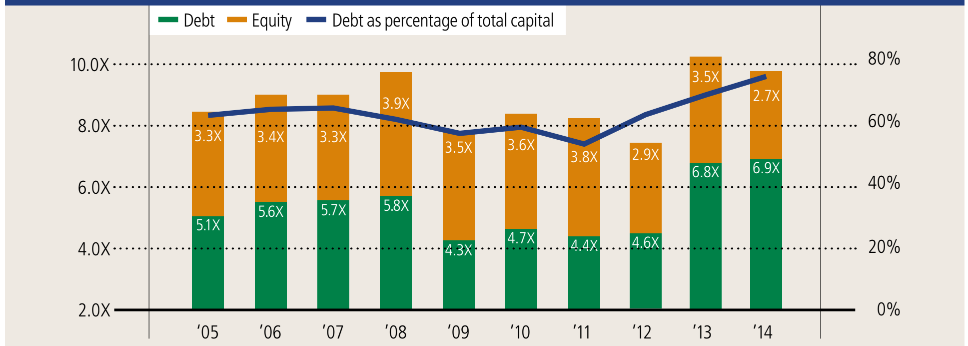
MEDIAN DEBT & EQUITY MULTIPLES



Source: Pitchbook

has been further segmentation of credit risk. If one looks back in time, buyout transactions were funded with senior debt, often calibrated by collateral coverage. Equity had to fill any capital gap. In today's market, capital components are increasingly granular thereby matching risk and returns. In doing so, alternative lenders have stretched the bounds of leverage.

The structure of non-bank lenders is conducive to absorption of greater risk. These lenders employ a fraction of the balance sheet leverage of a bank, translating into a willingness to grant greater leverage (6X EBITDA or more if the situation warrants). Of course, pricing reflects both risk and market conditions in the form of a blended coupon derived from two or three risk buckets: senior/second lien (6%-9%); mezzanine (9%-12%); and preferred equity (15% to 18%.)

THE POINT OF ALL OF THIS

As found in the nearby chart, the median share of debt financing to total capital for middle market buyouts this year is at a historical record of 72%. With a median leverage of 6.9x EBITDA, this lofty leverage surpasses the high-point established in the run-up to the financial crisis in 2007. As leverage has stepped up, so too has the prevalence of longer maturities and lighter covenant requirements.

The combination of relentless competition among banks and non-bank credit sources and greater overall risk tolerance has made debt capital readily available in forms that allow borrowers to better match capital to the risk. In situations where access to risk capital is a paramount consideration, banks are simply no longer the answer.

The capital structure tool bag is larger and more flexible than at any period in memory. If the opportunity arises to acquire a business, fund growth, or structure a recap to take wealth off the table, it is prudent to survey financing options to best match risk, flexibility, and cost. **ZS**

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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