The Rise of Non-Bank Lending for Middle Market Companies

The Pros & Cons Every CFO Should Know

CEREBRO CAPITAL

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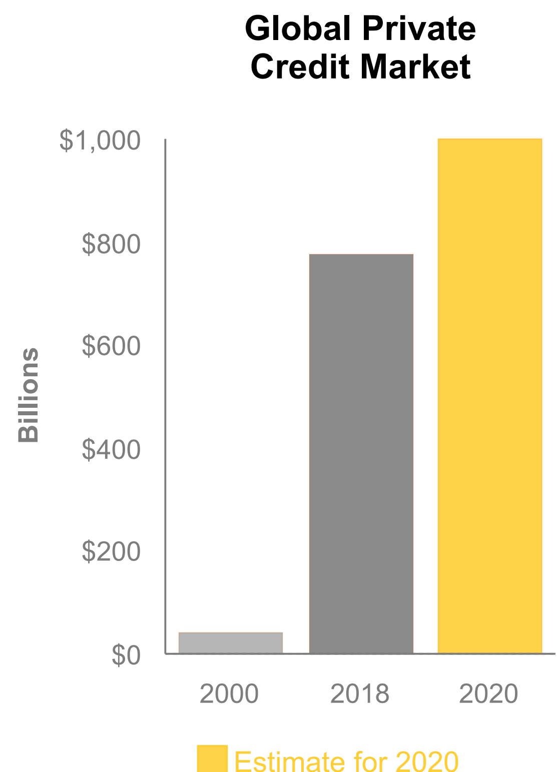
WHY THE RISE OF NON-BANKS?

Non-bank lenders have existed for decades but were typically considered a last resort option for companies on the brink of failure. However, in the decade following the financial crisis, middle market CFOs, business owners, and financial sponsors have been turning to non-bank lenders as a viable solution for growth capital, recapitalizations, acquisition financing, and other capital needs. This shift begs the question - what caused the change?

After the financial crisis abated, traditional banks faced increased regulatory scrutiny that resulted in tighter lending criteria. Credit committees declined more borrowers and reduced lending limits. Gone were the days when a long standing relationship could tip the scales for companies who were just outside the bank criteria. Many middle market companies who still had strong performance were left asking where to turn. Over the past decade, the vacuum created in the market was quickly filled by a proliferation of non-bank lending. With an ability to provide credit in structures and amounts a traditional bank cannot, these lenders experienced strong demand from well-performing firms willing to pay higher interest rates to ensure access to capital.

This demand was met by a strong supply of investment capital from institutional investors like pension funds and insurance companies. To help the economy recover faster, the Federal Reserve introduced low interest rate policy, which reduced the yield on traditional fixed income assets like treasuries and resulted in billions of dollars migrating to higher yield investments like direct lending.



In just the past two decades, “globally, private credit, which includes distressed debt and venture financing, has ballooned from $42.4 billion in 2000 to $776.9 billion in 2018. By one estimate, the total is likely to top $1 trillion in 2020.”
- Bloomberg (Butler)

NON-BANK LENDERS

And their effect on the middle market

> **"In the past 10 years, private funds that lend directly to companies have raised almost $500 billion."**
> - Bloomberg (Bakewell and Cannon)

This rapid influx of capital and investment alongside bullish expectations has increased debt structures and credit options for the middle market. However, non-bank lenders do not have the human resources nor the marketing budgets to find borrowers in the same way large banks can. This leaves the bulk of the work on middle market CFOs who have less resources to navigate the rapidly growing opportunities available for financing.

Corporate borrowers are forced to actively research and seek out private credit via lengthy RFP processes with little information on how each of the non-bank lenders put their capital to work. Additionally, some of these non-bank lending options are backed by fixed income funds, insurance companies, sophisticated family offices, etc., which makes the search process more overwhelming. Worse still is the lack of comparable information available to borrowers. How are borrowers supposed to know if they have uncovered the best deal in the market with so many options available?

COMMON TYPES OF NON-BANK LENDERS

- **VENTURE DEBT FUNDS**
- **ASSET-BASED LENDERS**
- **MEZZANINE FUNDS**
- **SBICS & BDCS**
- **PRIVATE DEBT FUNDS**

Until Cerebro Capital launched its loan marketplace in late 2017, there was no single platform to access middle market loan options across lender types. Today, Cerebro Capital has aggregated underwriting criteria from over 650 lenders, with 50% of those lenders in the non-bank lending market.

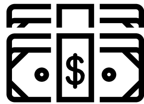
Now, corporate borrowers can easily access and leverage competitive pressure from multiple lender pools and debt tranches in one platform.

COMMON LOAN TERMS & STRUCTURES

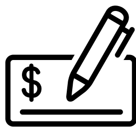
NON-BANK LENDERS

Not Regulated by FDIC

Larger Loan Sizes



More Flexible Structures



Less Onerous Covenants

VENTURE DEBT LENDERS

Purpose: Expansion, growth capital for technology focused service businesses
Typical Collateral: All asset lien, A/R, IP, other fixed assets
Amortization: 3 to 5 years
Term: 3 to 5 years
Interest-Only period: 6 to 12 months
Pricing: LIBOR + 5% to 15%
Loan Size: $1MM to $50MM - usually tied to a multiple of MRR or ARR
Structures: Term Loan, Delayed Draw Term Loan
Equity Sweetener: Frequently required
Covenants: Minimum Revenue, EBITDA Liquidity, or fully covenant lite

ASSET-BASED LENDERS

Purpose: Working capital for firms with long DSO
Typical Collateral: Lien on A/R, Inventory, Real Estate, etc.
Amortization: None
Term: 3 to 5 years
Interest-Only period: None
Pricing: LIBOR + 7% to 15%
Loan Size: $2MM to $100MM+
Structures: Line of Credit or Revolver
Equity Sweetener: Rare
Covenants: Covenant lite

COMMON LOAN TERMS continued

MEZZANINE FUNDS

Purpose: Expansion, growth capital, refinancing
Typical Collateral: Second lien tangible and intangible assets
Amortization: 3 to 5 years
Term: 3 to 5 years
Interest-Only period: 12 to 18 months
Pricing: LIBOR + 9% to 20%
Loan Size: $2MM to $100MM+
Structures: Term Loan, Delayed Draw Term Loan
Equity Sweetener: Required
Covenants: Cash Flow Leverage, Debt Service Coverage, etc.

What is an SBIC Lender?

Small Business Investment Companies (SBICs) are a little specialty subset of the non-bank industry. They offer debt structures using private capital and funds borrowed directly from the Small Business Association. They are not subject to the stringent regulations of commercial banks. These non-bank lenders offer similar terms to mezzanine lenders but their loan size is limited by the size of their funds and may vary. The borrower must meet Small Business Standards and have over 50% of their employees in the USA.

CASE STUDY

The operating manager of a well branded professional services company sought $12.5MM in financing to buyout 80% of the company. Due to the nature of the industry, the company had a very asset-light balance sheet and therefore the financing request fell outside of conventional bank loans. Even with a long standing relationship to a Top-10 US bank, the request was too far outside of the bank's investment criteria.

Cerebro's data-driven debt placement process was able to identify a top non-bank lender who matched based on industry, loan size, and EBITDA range, and was supportive of the company's growth plans.

Through the negotiation process, the management team found the non-bank lender to be more growth-oriented than previous commercial bank lenders, as well as willing to work with them in the coming years to achieve their goals.

WINNING TERMS

LOAN SIZE: $12.5MM
TENOR: 5 yr + 1 yr Interest-Only
INTEREST: 10% Cash + 2% PIK
WARRANT: 6.5% Equity

ADVANTAGES

Having A Non-Bank Lending Partner

1) Treasury Management Not Required

Surprisingly, conventional banks don't earn large profit margins off their loan services. Instead, they make the majority of their earnings from treasury management services. When selecting a new bank lender, they will almost always want you to switch your treasury management to their bank in order to achieve their profitability hurdles. Switching treasury management services can be a time-consuming process and is almost always dreaded by the finance team. Non-banks, conversely, do not offer treasury management services and therefore will allow you to maintain treasury services with your incumbent lender.

2) Higher Certainty of Close & Expedited Process

By nature, non-bank lenders are smaller organizations with less bureaucracy. Relationship managers sit much closer to the credit committee decisions. Information is more quickly disseminated to borrowers and they have fewer regulatory burdens to overcome when approving loans. All of these reasons lead to more certainty of getting to funding if a non-bank lender has provided you with a commitment letter. Due diligence processes will still be required, of course, but borrowers will have clearer views of closing timelines with non-bank lenders.

Is loan compliance different with non-banks?

Non-bank lenders, just like conventional banks, will most likely have some loan covenants tied into their credit agreements. While the financial covenant thresholds and ratios might be less stringent than traditional banks, you should expect to still have to report quarterly and annual loan compliance -- even monthly in some cases. The credit agreements will also contain non-financial covenants that should bear just as much consideration as the financial covenants.

Cerebro Compliance Navigator is the only online platform to monitor both the financial and non-financial covenants for any type of loan agreement. **Learn more here.**

ADVANTAGES continued

3) Long Term Flexibility

If a company misses targets and trips covenants under a regulated bank's loan agreement, the bank will oftentimes call the loan, liquidate the collateral, or force it into refinancing. With fewer regulatory requirements, non-bank lenders have the ability to create bespoke loan structures that include longer interest-only periods, custom amortization schedules, and lighter and more varied covenants. In exchange for higher interest rates, non-banks can reduce their cash payments with a portion of interest in PIK. They can also adjust the amortization schedule and maturity to align with the company's expected performance.

4) Willingness to Assist in Growth Opportunities

Non-bank lenders often execute an equity sweetener alongside the debt transaction. In principle, most companies are initially opposed to any equity participation since the purpose of debt is often to avoid or reduce the dilution associated with a capital raise.

However, any kind of equity participation has a very powerful advantage because it aligns the lender's economic interests with the owners' interest in growing the business. This means that when the company sees opportunities to grow valuation that may require additional capital or more flexible existing debt structure, non-bank lenders will be much more willing to relax covenants, reduce cash interest payments, or increase their loan amount.

Commercial banks would never be willing to make such concessions because they do not directly benefit from an increase in company value.

"A recent report from law firm Proskauer found that for deals arranged in the private debt market, covenant-loose structures jumped to 59% in the first half of 2019 compared to 26% recorded in all of 2018." - Reuters (Brooke)

DISADVANTAGES

Having A Non-Bank Lending Partner

1) Higher Interest Rates

Non-bank lenders experience higher credit losses than a traditional bank; therefore, they charge higher cash-on-cash interest rates and may include PIK interest to further enhance total returns.

2) Frequent Requirement of Equity Sweeteners

Oftentimes, non-bank lenders will only participate in the deal if equity sweeteners are available. While this can be a positive indication of finding a long term lending partner, companies should still consider the downside of equity dilution. NOTE: Asset-based non-bank lenders are an exception to this rule.

3) Higher Prepayment Penalties

With many non-bank lenders allocating capital from vehicles with finite investment lives and capacity limits, they likewise need to ensure their capital is allocated in a manner that can align with the duration of their investment structures. To satisfy this need, non-bank lenders often include prepayment penalties which increase the switching costs for borrowers looking to refinance as soon as possible

4) Minimum Loan Sizes

While leaner organizational structures can reduce the time required to execute a transaction, it also reduces the bandwidth of the lender. As such, many lenders have instituted screening criteria that include a minimum deal size to ensure efforts expended result in an efficient deployment of capital relative to resource intensity. These minimums are often around a $5MM loan size.

Don't Miss These Negotiating Points

The best way to ensure you receive optimal terms in the market is to leverage a broad network of **Bank** & **Non-Bank** lenders. Rates and terms vary more than you think. Optimize terms by leveraging your existing lender relationships with a broader scope of options. Activate a team of capital markets professionals to ensure you receive the best rates in the market.

Reduce cash interest

Slash commitment fees

Extend interest-only periods

Limit prepayment penalties

Limit warrant participation

Increase Competitive Leverage With Cerebro

LEARN MORE

CHECKLIST: IS A NON-BANK LENDER RIGHT FOR YOUR COMPANY?

- [ ] My company has a weak balance sheet or assets below 10% of the requested loan amount.
- [ ] My company is seeking between $5MM and $100MM in debt.
- [ ] My company can afford to pay between 8-15% in interest.
- [ ] My company is projecting more than $3MM in EBITDA this year.
- [ ] My company has more than 50% of its employees in the USA.
- [ ] My company has tripped covenants or is experiencing tensions with its incumbent commercial bank lender.
- [ ] My company will be doing another capital raise and would like to reduce equity dilution.
- [ ] My company has experienced high double digit or triple digit growth and it is projected to continue.
- [ ] My company is backed by private equity or institutional investors.

If you checked more than three of the boxes above, a non-bank might be a good lending partner for your company.

Click here to Predict Loan Terms

Cost of Capital | Lender Density | Structuring Options | Deal Timing

ABOUT CEREBRO CAPITAL

Debt Placement Innovated

Cerebro Capital offers the only data-driven matching algorithm for middle market companies and lenders. Combining the power of technology, streamlined processes, and transactions team expertise, Cerebro offers the most certainty that your company will find the right lending partner in the market.

Benefits of the platform include:

650+ BANK & NON-BANK LENDERS

MATCHING ALGORITHMS

PROPRIETARY TECHNOLOGY

CONFIDENTIALITY & DATA SECURITY

TRANSACTION & LOAN EXPERTS

SUCCESS BASED FEE MODEL

Cerebro Capital is transforming the way middle market companies analyze, manage, and source their corporate credit facilities. The corporate borrowing industry has changed little in the last 30 years, until now. By offering best in class online software, world class security, and industry expertise, financial executives can transparently evaluate their corporate borrowing options and easily monitor their loan compliance. **Contact Cerebro**

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