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Race to the bottom for middle market lenders set to continue in 2020

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Middle market lenders are expected to continue to push into riskier deals and accept looser terms from borrowers this year, in what would be a continuation of a hyper-competitive 2019.

Amid private credit funds accumulating massive cash piles, banks reengaging in middle market lending following a financial crisis-spurred hiatus and fewer deals coming to the market, lenders made heavy concessions to put money to work and generate yield last year. With fundraising in the space still at heightened levels and the economic backdrop stronger than expected, the borrower-friendly environment is likely to continue and even accelerate in 2020, four industry sources said.

Direct lenders in North America raised USD 25.1bn through December 2019 split between 28 funds, according to data from Preqin. That compares to USD 27bn among 42 funds raised in 2018 and USD 34.5bn between 48 funds in 2017. Despite the decrease from the fundraising of two years ago, North American direct lenders were sitting on USD 50bn in dry powder at year end, marking the second-highest total on record, behind 2018's USD 54.2bn.

Up until recently, direct lending entrants were able to command competitive terms as banks—with their lower cost of capital—exited middle market lending. However, as the traditional lenders start making their way back to the space—for example, Credit Suisse and UBS recently winning out over direct lenders to syndicate deals such as **Shields Health Solutions** and **CoolSys**—deal terms are expected to continue to weaken, the sources noted.

Adding to the current dynamic, the number of deals for lenders to chase dropped with middle market loan issuance down 25% to USD 33bn year-to-date through 3Q19, according to *Debtwire Middle Market*'s most recent joint Private Credit Report with Piper Jaffray.

Macroeconomic uncertainty for 2020, such as ongoing trade disputes with China and the November presidential election, could further keep issuers at bay,

the sources said.

“The economy continues to defy expectations and continues growing in the US, but we haven’t solved the China trade war just yet,” noted Michael Ewald, managing director with Bain Capital Credit. “Toward the end of 2020 people might take a pause and see what the political environment looks like going forward.”

Until then, risky lending practices are likely to set the tone for the middle market, the sources agreed.

Capital oversupply

In the cash flush market, greater leeway for borrowers with EBITDA addbacks, as well as less restrictive asset sale and cash flow sweeps became more prevalent in the middle market in 2019, said Kristopher Ring, a partner in Goodwin Procter’s debt finance practice group. Loan documents also increasingly revoked certain lender voting rights and included relaxed language to cure covenant defaults, Ring noted.

“There are just so many lenders out there. You see more and more private debt funds and people that have moved into the space,” Ring continued. “And even banks, with leveraged lending guidelines being more relaxed, you’re seeing them being a little more aggressive. The market is so saturated.”

Stefan Shaffer, managing partner with SPP Capital Partners, which does middle market private debt placements, said that competitive dynamic is evident in the variety of financing proposals a widely shopped deal receives.

“It is astounding the difference between the best bid and the worst bid in a true auction process,” Shaffer said. “In the past that delta could be 50bps between the best bid and the least competitive, but today that delta could be as wide as 2% on pricing alone, it could be the difference between a one-covenant deal versus a three-covenant deal.”

Weighing opportunities

Against this backdrop, some direct lenders adjust their approaches or focus on niche strategies, the sources noted.

Direct lenders with the largest funds and ability to hold the biggest deals move up-market to compete with bulge bracket banks and finance deals, they said. In November, Golub Capital agented a USD 1.6bn unitranche loan for Kelso-backed **Risk Strategies**. But with bigger deals often comes less yield. At Libor+ 550bps, pricing on that deal was tight relative to the all-in average coupon of 8.36% for middle market unitranche deals in 3Q19, according to the *Debtwire*-Piper Jaffray Private Credit Report.

Meanwhile, earlier this week HIG WhiteHorse announced the closing of a USD 1.1bn direct lending fund which will focus on “off-the-run” deals.

In the search for more yield and tighter covenants, lenders can also turn to smaller companies. However, the threshold at which that difference becomes noticeable continues to get lower, all four sources said.

“Average EBITDA for us is about USD 10m,” noted Jeffrey Stevenson, managing partner with lower middle market specialist VSS. “That is in a range of USD 3m to USD 15m. In the past, it was USD 5m to USD 25m.”

As of November 2019, borrowers generating under USD 7.5m in annual EBITDA could obtain non-bank financing in the L+ 600bps-700bps range, while those producing more than USD 15m in annual EBITDA could borrow at L+ 400bps-550bps, according to SPP Capital’s November “Market At A Glance” report on middle market lending conditions.

But Ewald noted that competition has changed the value proposition even in the lower middle market.

“The premium you would see for a smaller company has been competed away to a large degree in our minds,” he said.

by Bill Weisbrod