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PERSPECTIVE

Alternative lending likely here to stay

By David M. Nemecek and Brian Ford

"Alternative lenders" have taken significant market share over the last few years. Their newfound prevalence can be attributed in part to a general migration towards "private" capital but perhaps more significantly to recent changes in the regulatory environment governing leveraged lending.

While the term "alternative lending" can have a variety of meanings, here we are referring to lenders operating in the United States that make leveraged loans — i.e., loans above certain debt to EBITDA leverage thresholds, often to finance acquisitions — that are not regulated by the Federal Reserve, the Office of the Comptroller of Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). Alternative lenders take many forms, including as business development companies, affiliates of private equity funds and hedge funds and unregulated foreign banks and finance companies. They make loans ranging in size from a few million dollars to in excess of a billion dollars.

Current Leveraged Lending Guidelines

As part of their supervisory authority, the Federal Reserve, the OCC and the FDIC review leveraged loans by banks, bank holding companies and other financial institutions. In reaction to the perception that lenders were making overly leveraged loans, starting in March 2013 these regulators used their authority to establish new leveraged lending guidelines applicable to regulated institutions. While the guidelines include a laundry list of considerations to determine the acceptability of a leveraged loan, the two most important considerations are: (a) the borrower's leverage (leverage in excess of 6x total debt/EBITDA raises concerns for most industries per the guidance); and (b) whether the borrower has the ability to fully amortize its senior secured debt, or repay a significant portion (e.g., 50 percent) of its total debt, over the medium term (i.e., 5-7 years) using free cash flow.

Neither of these considerations — or any of the other considerations — is a bright line. Thus, a loan transaction may or may not be identified as "special mention" irrespective of whether, for example, a leveraged deal goes above the 6x total debt/EBITDA test.

Because the guidelines do not establish bright lines, they create significant uncertainty. The guidelines appear to be applied differently between deals/equity sponsors/industries/regulated institutions, and if the regulated institutions make an excessive number of "special mention" loans, they risk potential penalties from the regulators, both formal and informal, including limiting expansion by financial institutions to new geographies or into new products or services, limiting their ability to engage in M&A and/or delivering immediate attention letters or formal remedial action letters.

This uncertainty has chilled certain types of lending activity and leverage multiples have come down. According to a recent Thomson Reuters report, debt to EBITDA above 6x was seen on approximately 60 percent of leveraged buyouts in 2014, not much below the pre-crisis high of 62 percent, but this was cut to 51 percent in 2015 and 56 percent in 2016. Alternative lenders are filling the void created by the guidelines by providing loans that traditional financial institutions now sometimes pass on.

Alternative Lending Today

This shift towards alternative lenders is not an overnight phenomenon and the market share of these lenders is growing. Thomson Reuters' latest league tables had alternative lenders Antares, Jefferies, Nomura and Macquarie in the top 16 for U.S. bookrunner mandates for leveraged buyouts by volume for 2016.

Other alternative lenders are also leading major deals, often due to their ability to provide solutions that traditional money center banks cannot or will not provide. Bloomberg reported that when Citigroup failed to syndicate a $300 million term loan to AM General LLC, the maker of Humvees, KKR & Co. stepped in and arranged a $275 million term loan. KKR's edge was that they did not need to sell down the whole loan to make the deal work (many banks, like Citigroup, intend to hold only a small amount of leveraged loans for any particular transaction and plan to sell all or nearly all of the loans to other lenders — their primary economics come from their arrangement fees and not the interest on the loans). KKR was able to hold a significant portion of the loans on its and its affiliates' balance sheet, reducing the amount of loans that needed to be sold to third parties. The Wall Street Journal highlighted Thoma Bravo's use of an Ares Capital-led club to provide $1.1 billion in financing for the buyout of Qlik in 2016, when the syndicated loan markets became skittish. Of particular note, this transaction was structured as a unitranche loan, which combines senior and junior debt into one credit agreement at a blended cost of capital (in lieu of a "first lien/second lien" loan), a product historically limited to much smaller transactions.

While the syndicated markets may get more attention from the financial press, alternative lenders are particularly prevalent in single lender and "club" deal transactions. Loan sizes on these transactions are more often below $300 million. Because of the size and private nature of these transactions, they are not tracked with the same degree of precision as the transactions in the syndicated loan market, but we do know that the market is quite fragmented and that alternative lenders are major players.

What's Next?

The outcome of the 2016 U.S. presidential election brings additional uncertainty. President Donald Trump's recent nominations to his administration include Steve Mnuchin, a former Goldman Sachs partner and co-founder of regional bank OneWest, as treasury secretary and Wilbur Ross, a distressed debt investor, as commerce secretary. These nominees' familiarity and comfort with the leveraged finance market and suggestions that they want to get banks lending more has many speculating that the leveraged lending guidelines will be relaxed. Nevertheless, alternative lending in its many forms looks like it's here to stay, given the unused pools of private capital available to be deployed and the market share gained by alternative lenders over the last few years.

David M. Nemecek, P.C. *is a corporate partner in Kirkland & Ellis' Los Angeles office and* **Brian Ford** *is a corporate partner in Kirkland & Ellis' San Francisco office. Dave's and Brian's practices focus on representing capital sources, private equity sponsors, hedge funds, real estate investment trusts and public companies in complex financing transactions, including leveraged buyouts, recapitalizations, restructurings and other special situation transactions.*


DAVID NEMECEK


BRIAN FORD