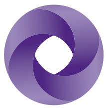

Grant Thornton

An instinct for growth™

Capital for Commerce

Fuelling growth through non-bank lending

Research methodology

In January and February 2014, Remark, the publications and research arm of Mergermarket, conducted research on behalf of Grant Thornton UK LLP. It comprised two studies, one of corporates and one of non-bank lenders.

Corporates

In the former, we spoke to 100 C-suite executives from UK-based, mid-market corporates. Of these, 33% had a revenue of under £100 million, 33% between £101 million and £250 million, and 34% between £251 million and £500 million.

Non-bank lenders

In the latter study, we interviewed 100 non-bank lenders. These represented a range of firm types, including private equity firms with direct lending arms, credit funds, and hedge funds. To qualify for our respondent pool, all non-bank lenders must have either lent to a UK-based corporate in the previous 12 months or planned on doing so over the next 24 months. Of those we spoke to, 98% have lent to a UK-based corporate, with the remaining 2% saying that they will do so in the near-term.

All responses are anonymous and presented in the aggregate.

About Remark

Remark, the events and publications arm of The Mergermarket Group, offers a range of publishing, research and events services that enable clients to enhance their own profile and to develop new business opportunities with their target audience.

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Executive summary

The lending landscape has changed

Will innovation in the financing of private equity, mid-market transactions, coupled with the prolific growth of non-bank lenders, change the rules of debt financing for mainstream mid-market companies?

Will smaller listed companies, family owned and private businesses in the mid-market, revenue between £50 million and £500 million, be able to take advantage of these changes in the debt market to fuel more rapid growth?

For decades, the funding landscape for large corporates and mid-market companies has been structurally different. Large companies, mostly with an investment grade credit rating, could access debt finance from a variety of sources, including large, syndicated facilities from multiple international banks, private debt from non-bank lenders, such as the US Private Placement market, and long term finance from the debt capital markets, such as bonds and convertibles.

Large businesses can obtain funding that tends to have fewer restrictive and financial covenants and repayment is weighted towards the end of the maturity date, rather than amortisation throughout the life of the loan or bond.

For UK mid-market corporates, without access to the debt capital markets, debt finance has historically been provided by a small group of banks. For bank term loans, the overwhelming presumption has been that a substantial portion of the original loan should be repaid during the loan period. This has diverted operating cash flows for these corporates away from investment in growth towards a reduction in debt.

The amortising nature of mid-market term loans has the advantage of removing some of the refinancing risk that a company faces when the term of its debt expires. The disadvantages are that less cash is available from operations for expansion and the scheduled nature of the amortisation increases the risk of default.

Innovation in mid-market financing has been driven by private equity transactions. This innovation has included longer maturities, amortising and non-amortising tranches, cash pay and payment-in-kind interest and ever evolving covenant structures. Leverage levels in sponsor led deals has increased back up to pre-crisis levels. Meanwhile, the funding landscape for private equity owned mid-market corporates in the UK has changed substantially over the last five years. Traditional banks are innovating and still actively lending, although they have curtailed some of their activities for certain sectors and types of transaction, due to a need to delever balance sheets, and increasingly stringent industry regulation.

The proliferation of non-bank lenders - which we define as financial firms that lend to businesses, but do not accept deposits – has been a key driver in these innovations and changes. With the global search for yield continuing, and fewer large-cap M&A and leveraged buy-out (LBO) transactions, an array of non-bank lenders have entered the sponsor led mid-market.

These firms have become a critical source of funding for the mid-market. Many non-bank lenders have greater risk appetites than banks, meaning that they will often lend to an extent that the banks would not. Other perceived attractions are that they can service financing needs more quickly and flexibly and that they are responsive to the needs of the companies to which they lend.

Critically, non-bank lenders earn their returns by putting their money to work. Generally, they do not seek ancillary revenues from transactional services and hedging, which are essential profit streams for banks.

Non-bank lenders are less attracted to amortising debt, outwith reducing excessive leverage, because as a loan is reduced, so is their total interest received. In contrast to most lending banks, non-bank lenders will often prefer a bullet repayment structure – where a payment of the entire principal of the loan is due at the end of the loan term. As with lending to large corporates, this opens up the possibility for mid-market businesses to invest more of their operating cash flows into fuelling further growth.

These possibilities are already being exploited by private equity sponsors in the mid-market. The question is whether non-sponsor backed companies will increasingly turn to non-bank lenders for their debt financing?

A lack of knowledge and existing relationships, and some misconceptions, mean that there has not yet been a significant volume of non-bank lending transactions in the mainstream mid-market space.

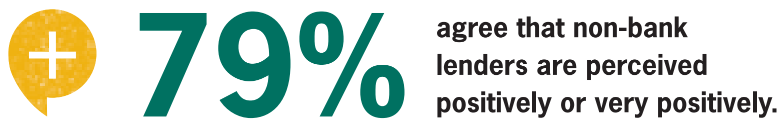
Grant Thornton UK LLP commissioned research from Remark, the events and publications arm of Mergermarket, to get to the heart of these issues and spoke to 100 UK-based, mid-market companies and 100 non-bank lenders that have or are looking to lend in the UK.

The research shows that appetites for non-bank lending are stronger than initially thought. Non-bank lending has progressed rapidly from a fringe activity to one widely considered normal by corporates, with an increased variety of product options previously only available to large corporates.

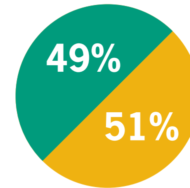
We hope you enjoy the report and welcome your feedback.

Key findings

Corporates



79% **agree that non-bank lenders are perceived positively or very positively.**



Respondents are divided over whether regulation would improve the attractiveness of non-bank lenders.

61% **of respondents have used a non-bank lender.**

34% identify access to capital as the most important factor when selecting a lender, followed by **terms and pricing (23%)** and **existing relationships with lenders (10%).**

Respondents (61%) who have used non-bank lending

56% used credit funds.

49% used private equity funds with direct lending arms.

40% used junior debt funds.

Respondents (39%) who have not used non-bank lending

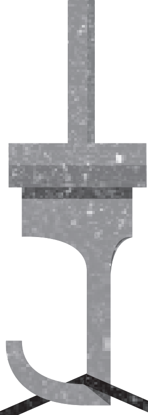
79% would **not** consider non-bank lending

Reasons include:

Focus on returns

Involvement in corporate management

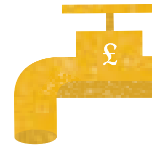
High interest rates



Gap in understanding regarding:

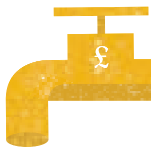
- **Terms**
- **Conditions**
- **Ownership**

Non-bank lenders



In the past year, **15%** of respondents have started more than **15 deals**, but only

2% have completed this number.



When considering why deals do not complete

82% **point to corporates' unrealistic expectations.**

41% **lack of awareness/ understanding.**

All respondents say that their preferred route to market is direct-to-corporates.

45% consider their strategies to be long-term.

37% of respondents said that their target rate of return is **10%**

A stereotype persists that non-bank lending is for distressed companies, however only

27% of respondents invest the majority of their funds in distressed corporates.

Who are the non-bank lenders and what do borrowers think?

Our research indicates that mid-market corporates are aware of the non-traditional lending options available to them. Strong appetites for non-bank lending show that these types of lenders are edging their way into the mainstream. Awareness of fund type and individual lenders is extremely high among respondents.

Awareness

- All corporate respondents named a type of non-bank lender when prompted.
- Three-quarters of interviewees are able to name a non-bank lender.

Tapping the sources

Respondents point to a range of non-bank lenders that they could access. They agree that the main sources of funding to mid-market corporates based in the UK are: private equity and venture capital (59%); bank lending (57%) and strategic investors (44%). It is interesting to note that credit funds appear relatively low down the list, with only 18% of respondents indicating this as one of the main funding sources for mid-market corporates, despite their apparent awareness of non-bank lenders. However, of those respondents who have used non-bank lenders, over half report having used a credit fund.

For corporates: In your opinion, what are the main sources of funding available to mid-market corporates in the UK?
(Please select up to three)

Positive perceptions

The general consensus among corporates is that non-bank lenders have become far more visible in the past two years. At 92%, virtually all corporate respondents think that non-bank lenders have been active or very active over the previous two years. In addition, non-bank lenders are viewed in a positive light and have become very receptive to the needs of borrowers. At 79%, a large share of corporate respondents agree that non-bank lenders are perceived positively or very positively.

"Non-bank lenders have been very active in the past few years, and are creating functions to improve their lending facilities. They also have aggressively expanded their commercial lending operations."

Finance Director

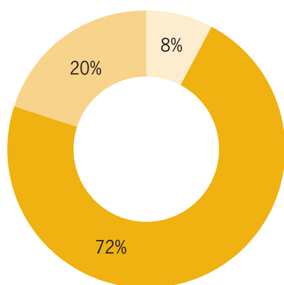
"Although non-bank lenders may be challenged from bank lenders active in the market, the non-banking lenders are perceived to have a positive approach towards corporates' requirements."

Finance Director

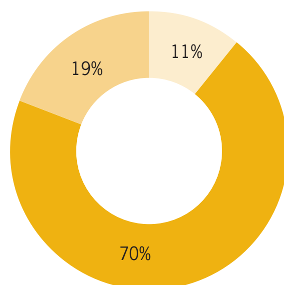
"Non-bank lenders have earned global recognition, and are very responsive to corporates' needs. The lenders are able to sanction funds quickly. They are looking to expand across the financial market."

Group Finance Director

For corporates: How active do you think non-bank lenders have been over the past 12 to 24 months? How active do you see them being over the next 12 to 24 months?

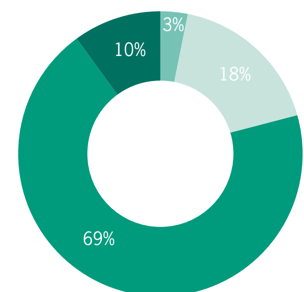


Past 12 to 24 months



Next 12 to 24 months

For corporates: How do you think non-bank lenders are currently perceived?



Moving westward?

With some banks retrenching and non-bank lenders becoming more prominent, are we moving towards a US model of funding?

In the US, non-bank sources of finance are well developed and considered much more common. As traditional lending has contracted in Europe and the UK, could we be moving towards a similar model?

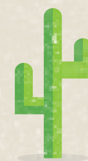
Bank lending in the US has gradually fallen from three quarters of the market 60 years ago to less than a third today. The remainder is undertaken by non-bank lenders and capital markets.

In the UK and Europe, funding has been dominated by the banks. But the effects of the financial crisis have contributed to European banks reducing the amount of funding they offer. This has left a gap in demand for other lenders to fill. Some experts have argued this means it is both inevitable and desirable that Europe will follow the lead of the US in developing its non-bank lending sector and politicians seem supportive of this move.

However, there are key differences between the US and European financing markets. The US's banking market is more fragmented than the UK's. This has allowed for greater competition amongst banks in the US. Non-bank lenders are also able to compete with banks, whether within states or across large regions, building a repeat customer base. Many of these non-bank lenders, including Business Development Corporations (publically registered corporations subject to regulations), have increased the choice of funding options for US corporates. With a more liquid and developed capital market, and a strong culture of accessing the capital markets, pure banks are relatively less important to US corporates compared with their UK counterparts.

Concentration and tradition in the UK banking market have made it difficult for new entrants – whether they are banks or non-bank lenders – to establish a foothold and grow their business. The re-emergence of TSB and Williams & Glyn demonstrates political willingness to open up the banking market to greater competition, though the effects are likely to be felt more in consumer and retail banking, as opposed to corporate banking.

If efforts to open up the banking market to new entrants continue there may be a gradual transition, albeit a slow one, to a funding market with characteristics increasingly akin to that of the US.



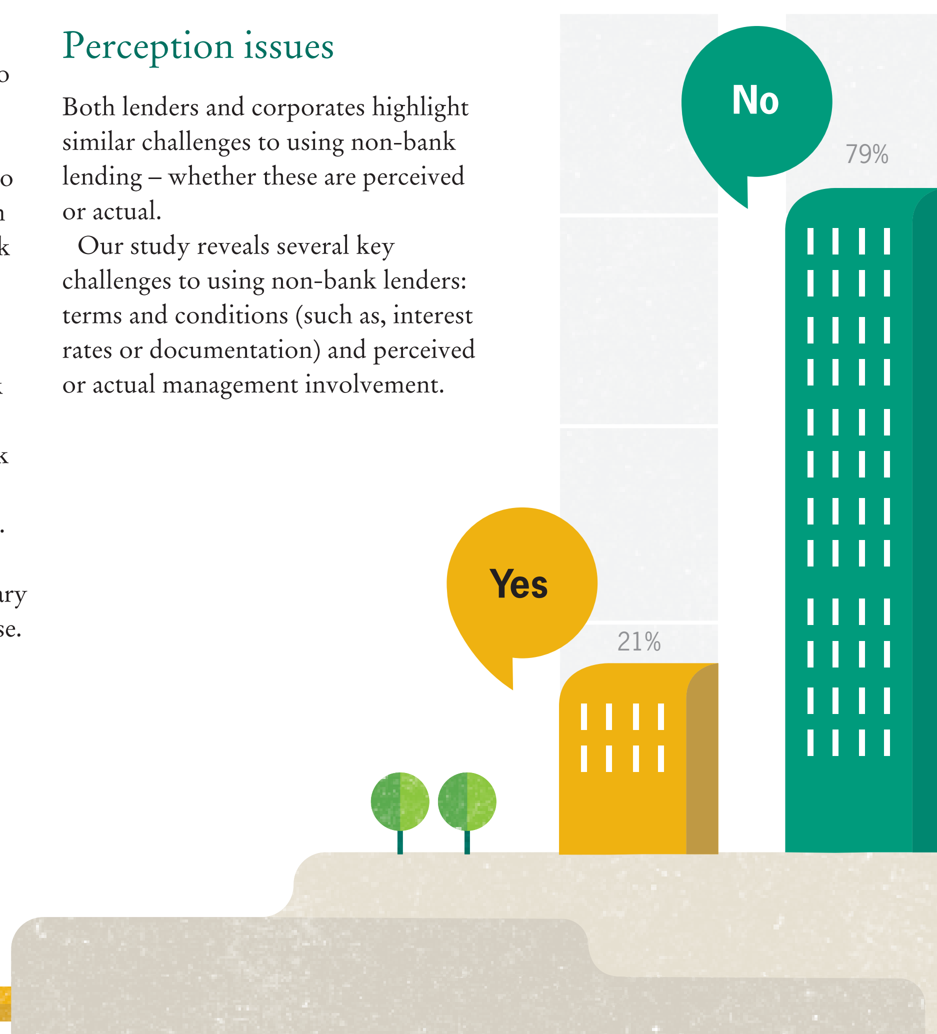
How do non-bank lenders compare to banks?

Despite the awareness and the positive perceptions of non-bank lenders, respondents identify a number of stumbling blocks to transacting with them.

Some of these issues stem from corporates using bank lending, with its accompanying costs and timescales, as benchmarks against which to compare non-bank lenders. This impacts firms' willingness to use non-bank lenders in the first instance and the ability to drive deals through to completion.

But our research and understanding of the sector show that non-bank lenders complement, rather than compete with banks. Their behaviours are different from banks. As such, they are not always appropriate for the same situation.

Would your firm consider using a non-bank lender in the future?
(Only asked of respondents who had not used a non-bank lender (39%))



Missed connections

There is resistance among corporates that have not used non-bank lenders to explore this option.

Of respondents who had not used a non-bank lender, 79% would not do so in future. This is despite many of them being broadly positive about non-bank lending elsewhere in the study. This suggests that such responses could simply be due to inertia rather than any fundamental flaw in the non-bank lenders' offering or relationship.

But, somewhat suprisingly, non-bank lenders may have been slow in raising their profiles to attract new customers. Our research reveals that non-bank lenders may not be taking the neccessary steps to broadening their customer base.

Perception issues

Both lenders and corporates highlight similar challenges to using non-bank lending – whether these are perceived or actual.

Our study reveals several key challenges to using non-bank lenders: terms and conditions (such as, interest rates or documentation) and perceived or actual management involvement.

Terms and conditions

A partner at a credit fund articulates the hurdles, whether perceived or actual, non-bank lenders' terms and conditions present:

"The challenges with non-bank lenders include: higher interest rates, higher penalties of defaulting, and higher lending risks."

A Group Finance Director agrees. "Non-bank lenders are only interested in returns and usually do not consider business owners' interests" he said.

Management involvement

The impression that non-bank lenders "do not consider business owners' interests" spills over into the second major challenge facing the industry – the idea, among certain corporates, that non-bank lenders will become too involved in the borrower's business.

"The interference of the investors in the firm's operations and management and the rising pressures to improve overall performance pose a challenge to the internal work flow," says one Group Director of Finance.

This view is echoed by a Finance Director: "Non-banking lenders sometimes try to influence the regular operations of recipient companies."

"Though the speed of acquiring the loan is lower compared to non-bank lenders, there is clear transparency and favourable terms and conditions with low interest rates when we work with a bank. Also the multiple options that they provide cater to our existing and growing needs."

Finance Director

"There are huge pressures from non-bank lending stakeholders to improve productivity and performance."

Chief Financial Officer

"Too many procedures and processes make non-bank lending very complex. This consumes a lot of businesses' otherwise productive time."

Managing Director
of a direct lending fund

The non-bank lenders' view

On the other side of the coin, non-bank lenders themselves identified corporates' existing relationships with banks, as well as complexities and convention, as being the main obstacles.

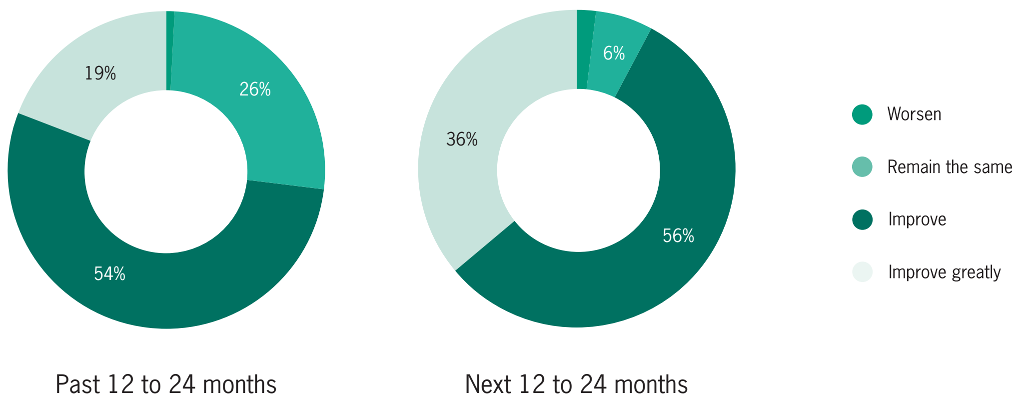
In terms of traditional lending, a partner of a direct lending fund states that: "Banks provide good solutions and services that are customised to businesses' objectives. Also banks' rates and prices are lower as they use deposits to lend."

The perception is that there will be more competition from banks in the near term. Almost three-quarters (73%) of mid-market corporate respondents think the bank lending environment – for example, pricing, availability, terms – had improved over the previous 24 months and 92% think it would improve over the next 24 months. The same percentage (92%) expect non-banks had been active or very active over the previous 24 months – the figure was 89% when looking at the next 12 months.

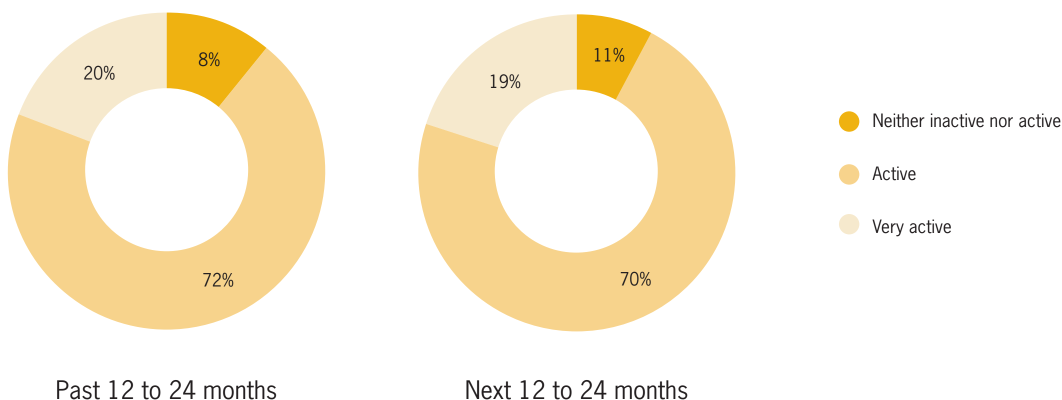
One Finance Director comments: "The economic recovery and reversal of downturn has stopped the further deterioration of banks' financial position and they are now improving overall in the market. They will now provide adequate financing for everyone which will have fewer restrictions up to certain levels in their financing area."

Whilst we may both agree and disagree with many of the views and reasons raised, it is clear that there are entrenched perceptions, some valid and others not, which will take time, education and effort to change.

For corporates: In your opinion, how has the bank lending climate (e.g. pricing, availability, terms) changed over the past 12 to 24 months? How do you expect it to change over the next 12 to 24 months?



For corporates: How active do you think non-bank lenders have been over the past 12 to 24 months? How active do you see them being over the next 12 to 24 months?



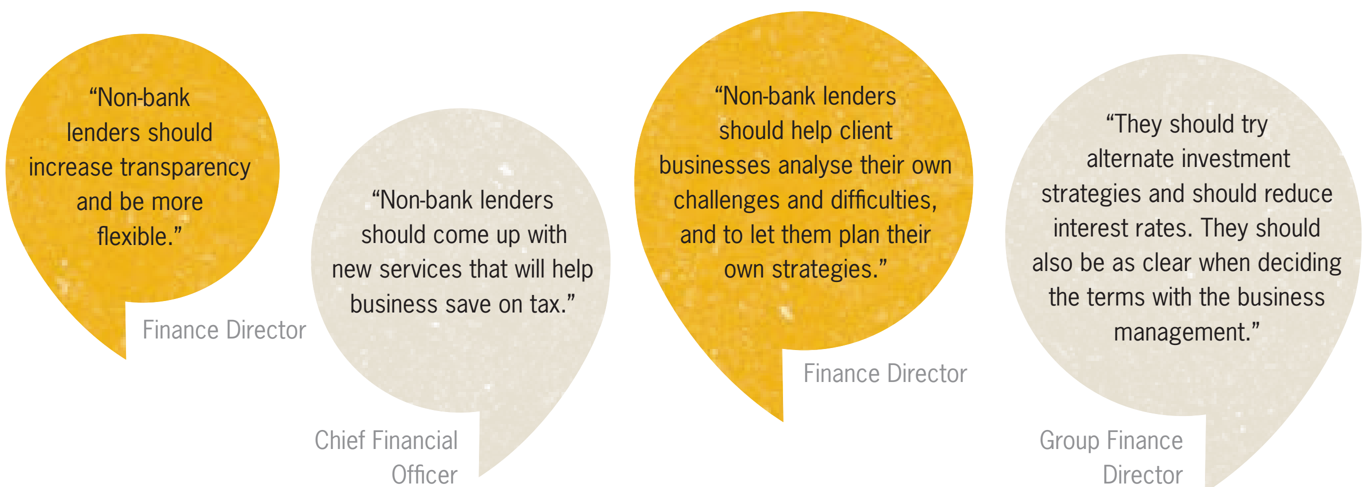
Meanwhile, perceptions about non-bank lenders are mixed. The majority view them positively, for example, because they have "captured the evolving market space", "implementing different strategies to keep the customer attached and maintaining positive relationships with customers."

Other corporate respondents still perceive non-bank lenders negatively because they "still offer high risk loans with exorbitant rates."

With the economy slowly improving and more confidence returning to banks, have non-banks done enough to bridge the gap in the market during the financial crisis - will life be a bit harder going forward? The signs are they will have to clarify their offering, overall profile and perception among borrowers to remain competitive.

How non-bank lenders can bridge the understanding gap

Some comments from our respondents give some guidance as to how this can be done.



Non-bank lenders can take comfort from the fact that mid-market borrowers rate access to capital (34%) and terms and conditions (23%) as most important when choosing a lender. Reputation (5%) and an existing relationship with the lender (10%) are least important. Given that banks tend to place emphasis on client relationships, this could be an opportunity for non-bank lenders to differentiate and take advantage of changing attitudes.

Among those who had never used a non-bank lender, some of the reasons given were that:

"We are quite satisfied with our existing funding provider and have already been accustomed to their processes and functions, so it is easier for us to focus on operational performance improvements."

Chief Financal Officer

"We like working with the banks as they are more organised and customer centric than non-bank lenders are."

Finance Director

"We see bank lending as more convenient and accessible compared to the non-bank lending."

Finance Director

How important are capital markets to the UK's mid-market corporates?

Debt capital markets – namely bonds – have traditionally been the reserve of large-cap corporates. But is the UK mid-market beginning to embrace capital markets?

Use of bond financing is surprisingly low in the mid-market. Only 27% of corporates surveyed have used bond financing, while just 35% have considered it. Only 35% of respondents said they think of bond financing when thinking about non-bank lending.

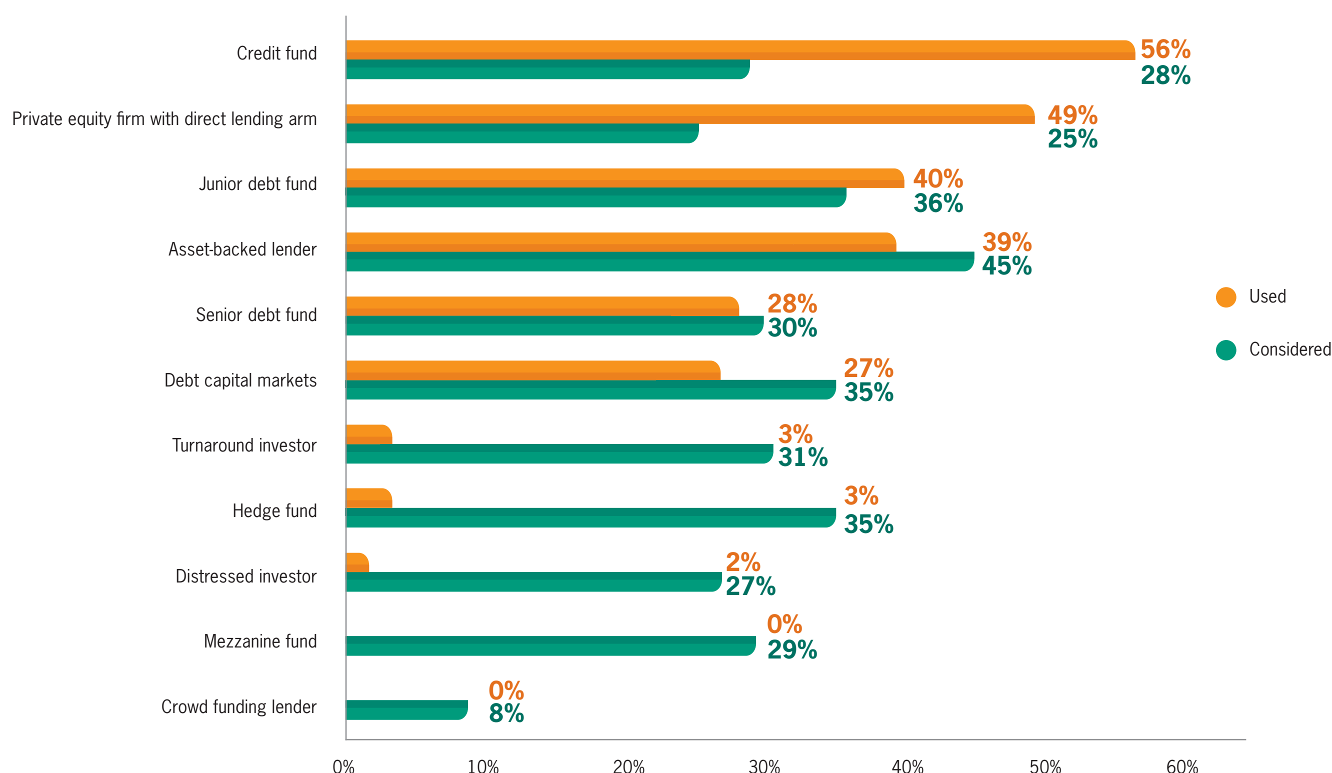
But this could be set to increase. Bond issuance is becoming more popular among mid-market corporates as traditional bank lending contracts and investors' search for yield - and willingness to accept higher risks - in a low-rate environment.

European bond markets have matured and will continue to progress as bank lending remains under pressure in the medium term.

Previously, bonds have not been available to the small to mid-market because the costs of issuance have been prohibitive and bond investors have preferred tranches of at least £200 million, which gives more liquidity in the secondary market.

But increasingly, smaller issues are coming to market.

For corporates: Has your firm ever considered financing from any of the following sources? Which did your firm actually use?



We have recently seen a number of issues at or below the £200 million threshold, including Marlin's £150 million and Pendragon's £175 million notes, respectively. The standout issue has been Soho House, with an issue of £115 million, but we see this as a particular exception. The volume of these smaller transactions strongly suggests that the markets have opened up to mid-market firms.

It is significant to note that investors view most smaller issues as high-yield or leveraged credits. Very few, if any, are regarded as investmade grade or can attain an investment rating. This is down to a host of factors, but size is the predominant one.

Among survey respondents who have used bonds, there was a broad spread of company size by turnover. Though the data set is small, this does provide more evidence of the trend towards the use of bonds in smaller companies.

The pros and cons of bonds

Bonds are ideal for long-term funding. But the fact that they are fully drawn at issuance and have bullet repayment profiles – where a payment of the entire principal of the loan is due at the end of the loan term – means they are not designed for funding fluctuations in working capital. For this reason, bonds are often supplemented by revolving credit facilities (RCF) from a bank, which are given super-priority in relation to the bonds.

A further advantage of using bonds is that banks may be relatively relaxed about advancing an RCF if it represents a small part of the borrower's debt funding and is supported by a much larger tranche of longer-term funding.

The bond market for smaller companies is still embryonic. Pricing for smaller issues remains expensive in comparison with bonds issued by larger issuers.

The main hurdle for new issuers is the initial investment in management time and effort required to draft and verify the prospectus and to navigate the ratings process. For smaller management teams this can be testing.

However, once the company has launched a bond on the markets, repeat issuance is much easier and can be completed within a few weeks. This is a key consideration for management teams to take into account.

The opportunity for the mid-market may be limited in time as low interest rates appear temporary. The Bank of England has said that even when rates do rise, they will stay "materially below" their pre-crisis levels. This may present a unique window of opportunity as the majority of bonds are issued with a fixed rate of interest rather than floating rate of interest. But any rise, when it comes, will reduce, to an extent, investors' search for yield which has created demand for smaller-sized corporate bonds. It is clear that, with bank lending harder to secure, the opening of the bond market to mid-market corporates looking to grow is a welcome development.

What gaps exist between borrowers and non-bank lenders?

The survey results indicate positive attitudes from borrowers and non-bank lenders in relation to the development of the market. But gaps in understanding still exist that could present strong growth in borrowings.

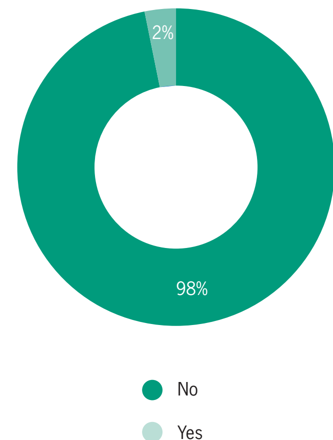
Profile

Nearly all non-bank lenders in our survey (98%) stated that they had not actively taken steps to raise their profiles directly among UK-based corporates.

Access points to lending opportunities for non-bank lenders are primarily via private equity sponsors and debt advisory firms.

A reluctance to directly raise profile could also be explained by the fact that 79% of non-bank lenders respondents say they find it "straightforward" to attract corporate opportunities to their firm. Respondents put this demand down to factors such as flexibility, proven investment strategy and recognition within the market. "A proven track record and good relations with existing private equity investors make us a recognised lender and investment management institution," notes the Chief Investment Officer of a credit fund.

For lenders: Has your firm actively taken steps to raise its profile directly among UK-based corporates?



Investment strategies

Our research shows that 45% of non-bank lenders are focused on the long term (ten years or more), while only 28% saw themselves as short-term investors (five years or less).

A partner at a direct lending fund is keen to make this point: "We have chosen to invest long-term, as this helps in both fundamentals and the economics."

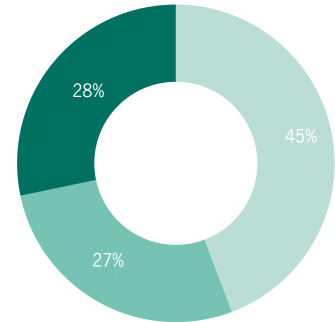
Nearly three quarters of respondents (73%) have total target rates of return for their funds of 10% or more. It is worth highlighting that these returns include all elements of the lending, e.g. arrangements fees, and not just the headline interest rate. However, these target rates of return are at odds with current pricing levels that are being seen from traditional bank products, which can be significantly below these levels.

Several non-bank lenders stated that more work is required to reduce interest rates and make products more competitive. A Managing Director of a credit fund says the industry needs to be more transparent on pricing.

"We strategically offer each borrower what they are looking for. Flexibility is a key factor in the economy right now. Our policies are designed to keep our clients happy."

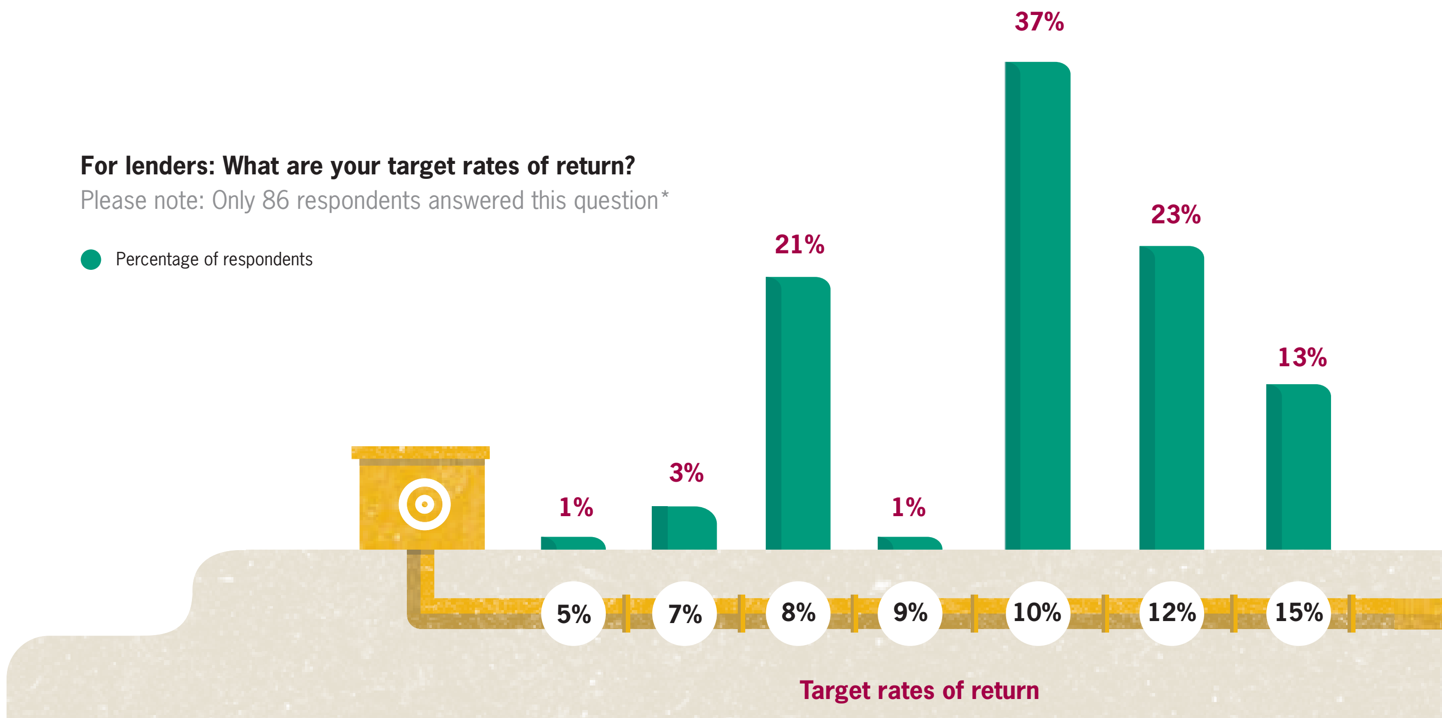
Managing Director
Private equity firm with a direct lending arm

For lenders: Do you consider your fund's UK investment strategy to be long-term (10+ years), medium-term (5-10 years) or short-term (under 5 years)?

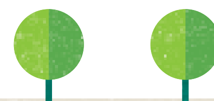


Long-term
Medium-term
Short-term

For lenders: What are your target rates of return?
Please note: Only 86 respondents answered this question*



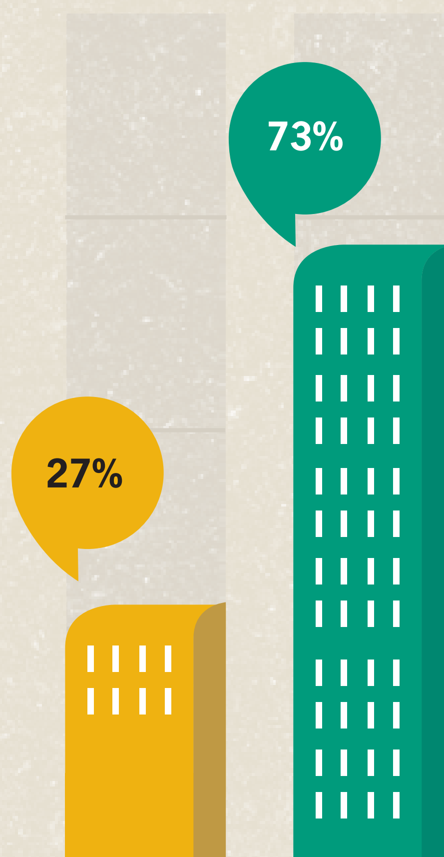
*Respondents were not asked to differentiate between levered or unlevered rates of return.



One misconception of non-bank lending is that it is all about distress

Nearly half of businesses (45%) associate non-bank lending with distressed investors. While distressed lending is an important part of the non-bank market, it only represents about a third of all business in the sector, so there is a challenge to overcome this issue.

These misconceptions, we believe, have been driven by the recent economic environment which has resulted in number of high profile cases of companies in distress who have turned to distress / turnaround investors. Cases of success generally do not generate headlines in the same way and therefore we believe that as more non-bank lending deals complete and successfully reach maturity, this perception is likely to change.

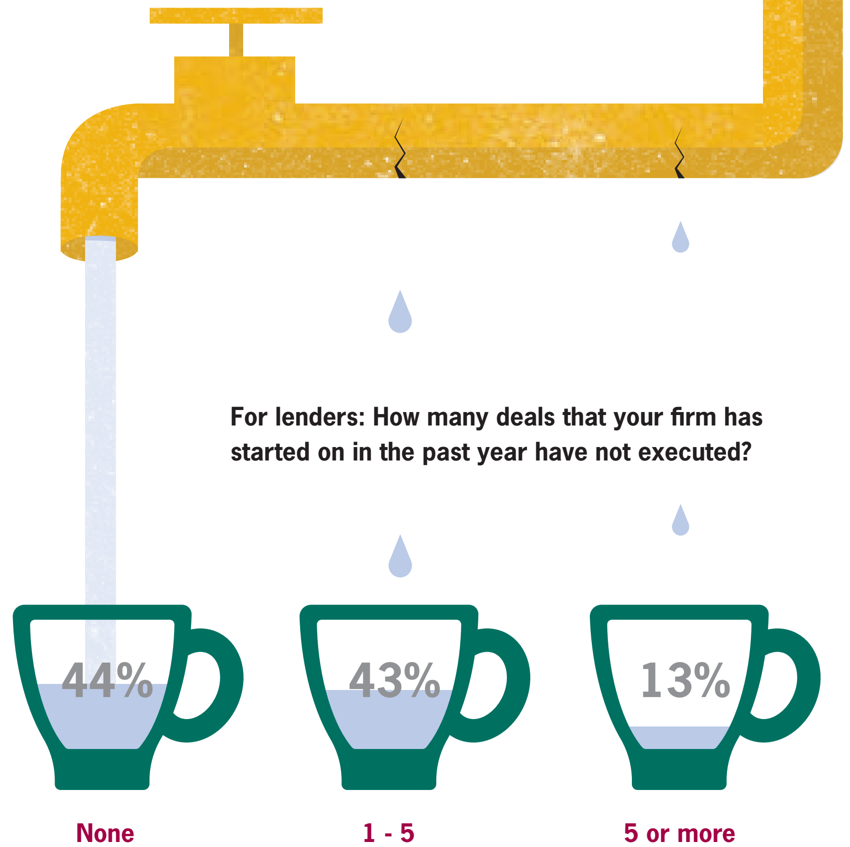


For lenders: In the past year, roughly what share of your lending was to distressed companies?

- More than 50% of lending to distressed companies
- Less than 50% of lending to distressed companies

Execution risk

Non-bank lenders most frequently point to mismatched expectations (82%) and a lack of understanding among corporates (41%) as the reasons why potential transactions fail to complete.



For lenders: When considering deals that do not complete, what do you think the biggest hurdles are?

Corporates' unrealistic expectations
82%

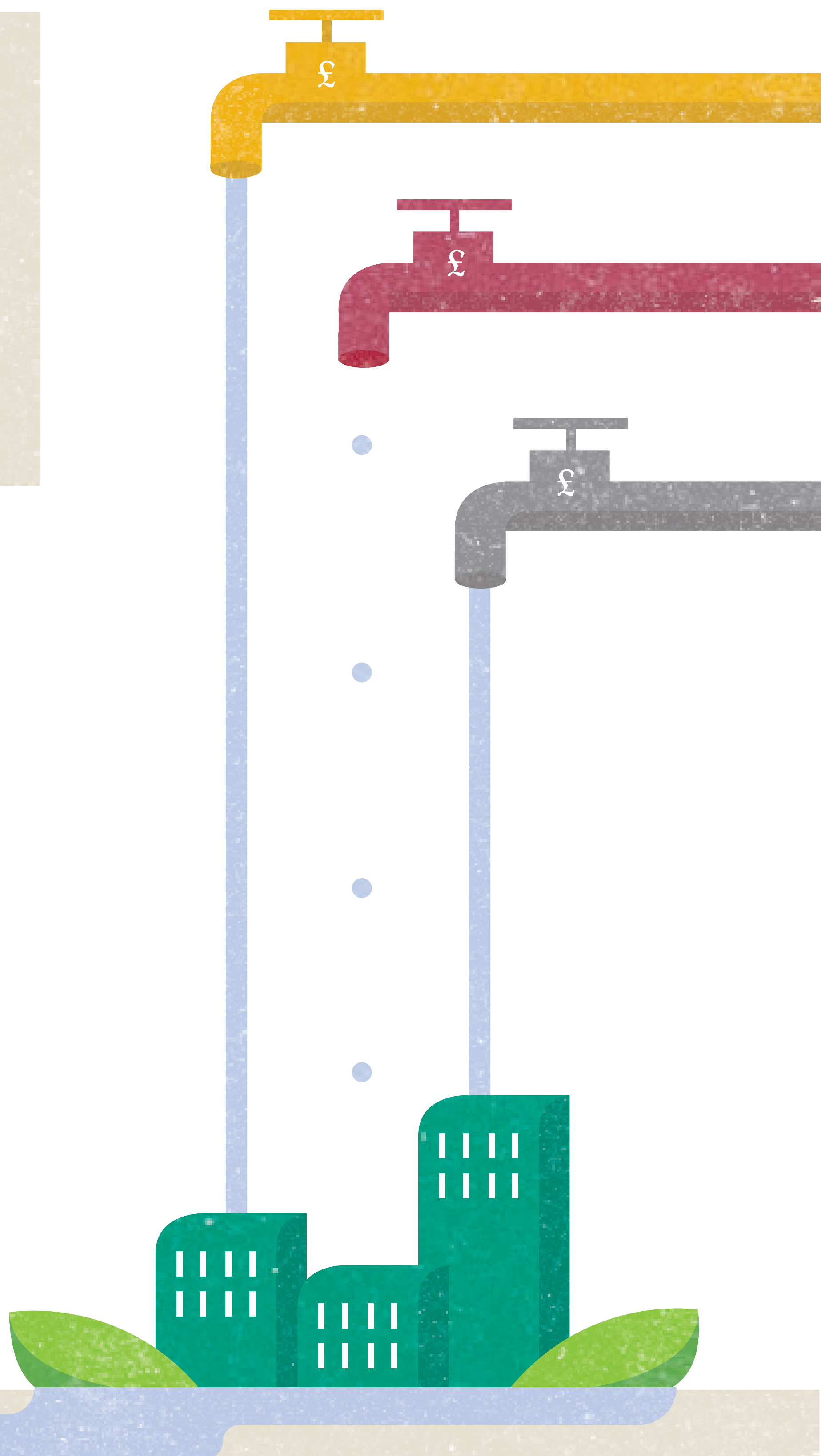
Lack of understanding/awareness by corporates
41%

Findings in the due dilligence stage
39%

Not enough adviser support
22%

The right advice

Advisors can be essential in delivering value for both non-bank lenders and corporates. Acting as a bridge in providing advice (on either side of a transaction) can ensure misunderstandings do not occur and that execution risk is minimised as far as possible, particularly in relation to terms, conditions and ownership expectations.



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