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Roundtable

Alternative Lenders & Traditional Banks:

The Changing Landscape in M&A

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Alternative Lenders & Traditional Banks: The Changing Landscape in M&A

Since the credit crisis, alternative lending companies have come roaring back into favor. With banks continuously facing harsher regulatory requirements, they have become more apprehensive to lend. Alternative lending companies have stepped in to fill the void and are actively looking for ways to work with traditional banks going forward. *Mergers & Acquisitions* convened a special roundtable co-sponsored by Fifth Street Management LLC and Proskauer Rose LLP to explore the symbiotic relationship between traditional banks and alternative lenders. Below is an excerpted version of the conversation.

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>
> Len Tannenbaum, Fifth Street Management

Danielle Fugazy: How would you characterize the alternative lending space today?

Len Tannenbaum, Fifth Street Management: Although Allied started the alternative lending industry totally wrong, it started the whole idea of alternative lenders working with private equity firms directly. Today, everybody uses business development companies differently and there is no right or wrong way. A BDC is a construct, and there are good managers and bad managers, the same as there are good private equity firms and bad ones. Just because we are all lenders doesn't mean we are all the same. We all have a different way of thinking about things. What will define the alternative lending space in the future are the five or six larger BDCs or alternative lenders. Smaller managers will go away. The next two or three years will define which lenders will remain, and everybody who calls us alternative lenders may soon simply call us lenders.

ROUNDTABLE PARTICIPANTS:

Stephen Boyko
Partner, Proskauer Rose LLP

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Gary Creem
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Thomas Hall
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Meghan Neenan
Senior Director, Fitch Ratings

Robyn Roof
Managing Director,
KeyBanc Capital Markets,
KeyBanc

Fugazy: How have new regulations for traditional banks changed the dynamic between traditional banks and alternative lenders?

Robyn Roof, KeyBanc: It's too early to tell. We all knew the guidelines were coming and now they are here. And like alternative lenders, all banks aren't created equal. Some have bigger portfolios than others, and some are further along in doing what the regulators want them to do than others.

The regulators want banks to underwrite on a standardized basis and centralize our leverage lending practices. You may have one bank that's thoroughly abiding by the guidelines and another that is totally off the planet. We can't say all banks will react the same way, but I do think it's going to be two years before we figure out if regulation will change the way we do business. That said, the regulation changes could leave room for the alternative lenders, but the alternative lenders need to figure out if they can build an infrastructure, buy an infrastructure or partner for infrastructure. The other question is: Who will develop to do the revolver?

Ted Goldthorpe, Apollo Global Management: Everybody knew that regulatory change was coming, and now it's here. The investment banks are moving more and more out of the alternative lending business, but I would call them partners of ours as opposed to competitors. It's a symbiotic relationship. We supply a balance sheet and they have front-end origination. Today the BDCs are investing in their platforms so they are coming into all these new areas where the investment banks used to be. There's a huge opportunity ahead for both banks and alternative lenders.

Fugazy: How have lending terms changed since 2007?

Eric Bacon, Linsalata Capital Partners: In every downturn we see traditional banks tighten up more quickly and severely than alternative lenders. Banks are now under unbelievable pressure from regulators. And we find ourselves immediately gravitating to the alternative lenders. That's the only way to get the deals done and so we move in that direction. That's the result of the regulation that came out of the recession.

The regulators want banks to take a standardized approach, and that's almost exactly what we don't want. We want creativity; tailored solutions. A better fit. Banks are at a disadvantage today and it's unfortunate. And one of our biggest technical problems is: Who is going to hold the revolver?

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> Eric Bacon, Linsalata Capital Partners

Roundtable Photographs by JohnCalabresePhotography.com

Patrick Frisch, ING Capital: Regulation is a dynamic that's here today. I was recently talking with people about bank liquidity requirements and revolvers. What does this look like on a bank balance sheet two years from now? Frankly, revolver pricing is starting to creep up. Banks are having to get paid two and a half, three points up front to even think about participating in the revolver. The point is that the future regulatory environment is impacting what banks are doing today and that creates disruption and opportunities.

And let's not forget the CLO landscape and the changes coming from that environment. The interesting thing about that is, if you think about the majority of loans, they are liquid, which is an area where BDCs haven't traditionally played and that's where the change in the regulatory environment for BDCs comes in. If leverage is increased in what BDCs are able to do, it will create an opportunity for BDCs to step into the more liquid side of the loan market.

> **We have also seen a growing trend towards convergence of high yield terms and middle market terms.**
>
> Gary Creem, Proskauer Rose LLP

Gary Creem, Proskauer Rose: The key strength of the BDC platform, and a critical component of its competitive advantage in many cases, is its flexibility. BDCs have great flexibility in the types of products in which they can invest. Further, a flatter organizational structure makes BDCs more nimble, enabling them to capitalize on new trends quickly. Without the burden of regulation facing many traditional lenders, BDCs can be more innovative than many of their competitors, driving more business their way.

Fugazy: Debt levels have gotten to the highest level since 2007. Is there reason for concern?

Scott Cullerton, KKR & Co. L.P.: It's not something that we have a lot of concern about. We do see a tremendous amount of competition, but where we compete, it's usually not to get to the last dollar of leverage. It's certainly true that in large market transactions, six or seven times leverage is not uncommon at all. We don't see a lot of that in our market, and we are still able to be disciplined about covenant levels.

Eric Boyko, Proskauer Rose: One thing different in this cycle than the last cycle is that lenders that are reaching a bit on leverage or on terms are doing it for great credits, with a particular niche or strong management team. We are seeing our clients try to win those deals.

Goldthorpe: I'm concerned, but I would say that one of the cheapest things in the market is financing, so obviously all the BDCs are pushing out their liabilities. And the other thing is liquidity. A lot of these deals are getting done by liquid capital. Liquidity is mispriced.

Fugazy: Other than banks, who are the competitors for alternative lenders?

Goldthorpe: A couple of years ago, our biggest competitors were hedge funds. Hedge funds were very creative capital, but that isn't the case anymore as the tolerance for illiquid risk in the limited partner community is limited.

Tannenbaum: The hedge funds have tried to creep back in, but they can't. Why? Because our clients won't let them; they are uninterested.

Cullerton: We feel like we've actually just scratched the surface of the impact of the regulatory landscape developments. We have some insight from our internal capital market business, which deals with all the largest Wall Street banks. You still have lots of big banks aggressively trying to finance deals that are six-plus times leverage.

Maybe one bank is sitting out this deal or the next, but regulators only check in periodically and there's incentive to make hay while the sun is shining. There's tremendous pressure for banks to be in on marquee transactions, but you will see them acting selectively. We will see some banks willing to risk a few bullets for the best companies and you will see banks get around some of the requirements, like the six times leverage cap and the requirement for 50 percent of senior debt to be paid down. The point is there are lots of ways to keep the banks in the game and eventually it's likely that the regulators will make an example out of someone.

Thomas Hall, Credit Suisse: Speaking broadly for the syndicated efforts, we're arguably one of the most aggressive guys out there. We are doing deals at about six times under, except when we want to stretch for a relationship. We'll push the limits on what we think we can get away with to service our clients.

Frederick Buffone, Fifth Street Management: The guidelines should take into account industry, but they don't. Certain software and tower companies can easily support seven-plus times leverage, but should we put anywhere near six times leverage on a cyclical industrial? No.

The main difference between today and 2007 is the amount of leveraged buyout commitments. Today, it's still largely the three Rs: refinance, recaps and repricing. There aren't a lot of new money deals and you still have the corporate acquirers, which have tremendous cash on their balance sheets. Because of that, you have a lot more aggressive people coming in and buying deals. Today, I don't hear: "I'm not going to underwrite that deal of five, five-and-a-half times leverage because I don't think that can get done." What I hear people say is: "I am not going to underwrite it today at five times leverage. I'm going to look at this at five to six times. I'm underwriting it three to six months in the future."

Fugazy: What are the more common deal terms today?

Creem: There are two factors playing a part in the evolution of deal terms in the middle market. One is process related and the other is more substantive. Both trends are being driven by sponsors looking for more flexibility on terms. On the process side, what we have seen, and expect to continue to see, is a focus on the negotiation of terms upfront through the commitment paper process. Sponsors are motivated to obtain the best terms possible and are using the commitment letter stage to achieve this goal. With respect to specific terms, greater flexibility appears to be the key for sponsors. We continue to see requests for incremental facilities to satisfy possible future liquidity needs. There continues to be a focus on looser covenants (net leverage tests are an example) and greater EBITDA addback capacity. Permitted acquisitions and greater restricted payment flexibility continue to be a focus as well. Lastly, we have also seen a growing trend towards convergence of high yield terms and middle market terms.

Boyko: We've seen large cap terms coming way down since there isn't that much activity going on in the larger markets. Large sponsors that typically do the large cap deals are now doing the mid-market deals. We now see firms that typically do $30 million deals moving down to do deals that are $15 million or $20 million.

Buffone: This is going back to Fall 2011, right before we had that mini crash. There was a brand name investment bank that came in and put large-cap terms in place for a middle market company. They won the lead as a result and in the commitment letter we were forced to put in these terms that I would never agree to. Eventually, we got it sold within the flex terms, but we only agreed to underwrite it because the investment bank forced large-cap terms on us.

Creem: Another trend we are seeing in middle market deals is pressure on expense reimbursement for arrangers. As indicated, sponsors are using the commitment letter process to obtain the most favorable terms possible. Many sponsors are tying expense reimbursement to the closing of the financing, putting capital sources at risk if the transaction does not close. Pressure around expense reimbursement is another indication of the competitive nature of the deal process.

Tannenbaum: That's why we are focusing more on our long-term sponsor partners that we can be more flexible with, as opposed to taking on new relationships. In fact, in today's market, you pass on deals. One-stop financings briefly went to as low as seven-and-a half percent. In the last few months, and fortunately for us, it's gone up to eight-and-a-half percent. It's tough to turn down sponsors and say: "Sorry, call someone else," but, unfortunately, that's the market we have been in.

Roof: Everybody is shifting. Some lending sources are coming down market. Some lending sources are going up market. It's a new playing field for everybody. It's just changing the landscape of who is doing what.

Tannenbaum: I don't think we will really find out how the chips will fall until we see how all the lenders behave through the next cycle. We will see who remains after the next cycle.

> **"It's a symbiotic relationship. We supply a balance sheet and they have front-end origination."**
>
> Ted Goldthorpe, Apollo Global Management

Frisch: In terms of constraints on the banks, there are protective elements and if it means that certain institutions aren't able to participate, they will be cut out of the riskier deals earlier than alternative lenders. When the market does turn, banks could actually be protected because they took less risk and the alternative lenders may be the ones that struggle.

Fugazy: Where are we in the cycle?

Buffone: As a measure of where we are in the cycle in terms of the mythical number where large cap will play, it used to be $100 million of EBITDA. Then $75 million. Now it's $50 million. Same thing with covenants. When does the deal get forced down to covenant lite? The good thing with the middle market lenders is that even though we're getting pushed on covenant cushions, there's discipline in the middle market to keep covenants in the documents.

Goldthorpe: I don't want to give the impression that there's a credit bubble building in the middle market. Lenders are diversifying their businesses away from the sponsor business to keep growing their lending businesses. But, by and large, people in the middle market have been around for a long time and are very disciplined about investing.

Buffone: There seems to be a benchmark of EBITDA. The sponsors are going to the broad market collateralized loan obligations or other vehicles for loans. The large cap industry is institutionalized now. The question is how low will the syndications go in deal size? Are they going below $150 million?

Goldthorpe: The definition of a syndicated deal is changing. We just lost a deal that was broadly syndicated and it was for $50 million.

Roof: In our business, historically we did not compete with the broader platform. My firm lends largely to middle market companies, and I bump into them a lot more now than I did a year ago along with broad market terms.

Cullerton: We're seeing pressure around pricing, but we're still finding ways to put capital to work in a way that is prudent and rational. That being said, it is extremely competitive. I looked at a deal last year-- it was a refinancing of an existing sponsor portfolio company; a $40ish million EBITDA business. The structure was four and a half times and we were going to take down the second lien. They were going to market the first lien to the syndicated market. They ended up pulling out of the deal last year. It's back in the market now, and they are taking the first and second lien positions to the syndicated market because of how attractive that is right now.

Roof: As syndicators, we were once scared to death to do second liens because we weren't sure how they would work out in the scenario. Now we're talking about derivatives of these notes, but what it's going to push is more extensive capital structures, because the BDC community has a higher cost than that of traditional banks.

Tannenbaum: To diversify, we have explored new areas of business. For example, we recently accessed the institutional bond market. This opens up a whole other area which most BDCs have not been able to access before. Accessing that market could lower the cost of capital dramatically for BDCs.

Fugazy: Are BDCs a reliable source of capital?

Meghan Neenan, Fitch Ratings: We've been covering the BDC space since the early 2000s. We were on that ride up and down. The space has grown significantly since then. Now, there's close to 60 registered names, and they've raised $15 billion of capital since the crisis.

Back in the early 2000s, you had missteps by Allied and that affected the whole market because everyone thought the market was homogeneous. Now that we have more BDCs and they are all different, there's potentially more reliability of the capital.

Boyko: We've seen BDCs work through multiple cycles. What we've seen through the cycles is that these are folks that are very smart, very creative and are able to deploy their capital from different pockets within their institutions. Most of the BDCs that we work with are pursuing all different types of strategies, including real estate, direct origination, and sponsor transactions. These BDCs were there for their clients, worked through the tough issues, and provided additional capital when capital was needed.

Bacon: We have several alternative lending partners we've been with for 15 years and two cycles. We can count on them, and they account for a good percent of what we do. There's only one or two we lost track of throughout the years. They were around before the cycle and are not here anymore. However, the longer the lenders are in it, sticking to their knitting, the better chance they have of surviving.

> **"It's a new playing field for everybody. It's just changing the landscape of who is doing what."**
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> Robyn Roof, KeyBanc

Boyko: We've been in the business about 15 years now. What we've seen over the years is that the industry has doubled or tripled, but it's still really not that large. You still see a lot of the same faces that have stayed at one shop and then migrated to another shop. So there are folks with new BDCs, but the people have been around for a long time, so you know how they're going to act for the most part.

Cullerton: We have a mix of retail and institutional capital. We have a BDC platform and then we have a bunch of funds in separately managed accounts, and as we look across our platform, it's a diverse mix. We have been proactively trying to grow the retail component of our business by tapping into those channels as we think this pocket of capital is growing in the way the institutional capital is not.

Our BDC is a private BDC. It is predominantly retail capital and the way it's structured, we don't worry about mismatch of capital commitments we're making to the liquidity of the funds. When you're trying to find yield, and everyone's trying to find yield, that is a vehicle that lets you tap into it five years down the road.

Tannenbaum: With 90 percent of our business coming from sponsors, one of the things we demand is to participate in the first lien debt. One of the frustrating things for us has been: How do you do that in a vehicle that is not set up for that? So, we took a blind pool public in July 2013, Fifth Street Senior Floating Rate Corp., which was very difficult to do. The reason we did this was to cut management fees, get more leverage and to be able to do sponsored deals even if they are in the $10 million to $20 million range. At the same time, we're in the process of starting a CLO program. We can also do revolvers now. It brings a whole new level of credibility to us to be able to do low-cost senior financings and revolvers, and team up with our own company or the company of Fifth Street Finance Corp. and do the second lien piece.

Fugazy: How will rising interest rates affect the BDCs?

Goldthorpe: Higher rates are definitely good for us. Obviously generating the kinds of returns that shareholders want in a zero interest rate environment is made easier with higher interest rates. If you think about BDCs, they're disciplined on the liability side. The market doesn't give them a lot of credit for it, but a lot of BDCs are opposite of banks, borrowing long and lending short. From our perspective, it's dilutive for us to raise longer-term debt to pay down our revolver, but we think it is good for shareholders over the longer term.

Tannenbaum: FSC has approximately 70 percent floating rate assets. The retail shareholders don't understand any mix. I can't tell you how many analysts write about the BDC sectors hurting from the interest rates.

Boyko: Well, over the past year some of the stronger sponsors have pushed back on interest rate hedging for their portfolio companies. Some of these companies have pretty tightly wound capital structures. So think about where we may be headed in a rising rate environment. LIBOR is effectively zero now but 500 bps is the historical average. If we get halfway there and we go to 250 bps, that will put significant pressure on companies that have floating interest rates.

Fugazy: Why are we seeing consolidation among alternative lenders?

Neenan: There are a variety of reasons. Regulatory changes with the risk retention rules coming into play have created opportunities for CLOs to consolidate. From our perspective, in some cases consolidation is also investor driven. The limited partners want to consolidate more of their investment capital. That way they get more flexibility in terms of the mandates. The regulatory environment will continue to support more consolidation.

Steven Friedman, Greenhill & Co.: You've got the traditional factors involved in consolidation, whether it's efficiency or to take money out of your bottom line. Oftentimes, you can move into an adjacent or complementary line of business that will positively impact your other businesses. And you've got a diversification of assets, and ultimately the earnings derived from that. Unlike a lot of other businesses, this is a scale game. At some size, my cost of funding becomes an advantage, so if I can get to that right size to a point where I can access that and do that in an effective way, I've really created a real advantage for my company.

Bacon: Nothing about consolidation is good for us, but if it lowers your cost of capital and makes you more competitive, presumably there is something in this for us. However, generally when consolidation happens, it's not good for us. We are looking for more competition, not less. So, for the most part, we aren't in favor of consolidation.

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> Scott Cullerton, KKR & Co. L.P.

Buffone: There has been consolidation. We saw it in 2008 and 2009 when a lot of CLOs went away. It's the ebb and flow of the market. Now we're seeing more new entrants coming into the market. Then, once the market cracks again, when the next cycle hits, a lot of smaller players will go away.

Goldthorpe: What is good for private equity in terms of consolidation is that we are able to do more creative and complex things. Sponsors are asking for us to be more and more creative with our lending. When we look at acquiring, we look for expertise. We look to add products that we didn't have before. We're acquiring specialty verticals in industries like aircraft or energy.

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> Meghan Neenan, Fitch Ratings

Fugazy: Are there lots of consolidation opportunities? Is it a buyer's market?

Goldthorpe: People are buying origination. There are some interesting things out there, but the bid-ask gap is massive right now and I think you'll see that continue.

Tannenbaum: The bids are starting to go higher because developing an origination platform today is very, very difficult. FSC went public in 2008. We had capital when no one had capital, which helped us build relationships and created new opportunity for us to grow. In fact, we have built walls around our clients. Once you do five or six deals together, it's not easy for a private equity firm to say they're going to go somewhere else. We expect them to have two or three relationships. We don't want to be the only relationship, but we expect them to stay with us too.

Bacon: Some of it is habit and some of it is comfort. Some of it is that you don't have a lot of time to make decisions. Your relationships get the benefit of the doubt. There are different kinds of cracks, but once they have the foot in the door and you do a good deal with a lender, they are part of your orbit.

Hall: I closed one deal with a sponsor and they have called me ever since, so the relationships are there.

Roof: We're going to see a lot of interesting partnerships, as banks and alternative lenders work together to make clients happy.

Fugazy: What will the winners in this space look like? What do the traditional banks and alternative lenders look like going forward?

Buffone: Having syndicated middle market transactions for many years, I know successful platforms have discipline. Will they stretch a little bit in cycles for the right sponsor? Yes, a little bit. But will they maintain discipline? Yes. And the other thing the winners will have is a fairly broad platform where they can put investments in a particular pocket. The firms that have discipline and access to capital will continue to grow even through the down cycles.

Neenan: To retain your credit rating and have the flexibility to do what you want, you have to do what you say you are going to do, stick to your knitting and back off when things get tough.

Frisch: The investment discipline part is the hardest thing to assess. Whenever you have a conversation about people who are doing covenant lite deals and who is pushing the envelope in terms of structure, it's hard to find out who is remaining disciplined in their investment process. Until you get to the next crisis and it proves itself out, you don't know. Diversification is a big driver of which alternative lenders are going to succeed in the long run.

Goldthorpe: One big misnomer is that banks are dead or are dying. It's not true. People have been calling for demise of banks for a long time. Banks are very smart, creative and they'll be back doing great things in years to come. Wall Street is a very resilient place.

Friedman: There are very smart people on Wall Street who will figure it out. Once we get the playing field leveled and the regulatory environment settles down, that's when people will figure out what is the best way to make money in the new environment. We need a little bit of time to allow for all of that to shake out. It will happen.

Boyko: I think you may see more alternative lenders re-thinking the relationship between banks and themselves. Over the past couple of years we've seen a lot of firms starting to tie together either formally or informally. I think you're going to see more of this.

Tannenbaum: It will be an exciting two years. ■

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