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## **Talking Mid-Market Finance with The Federal Reserve**

Last week I had the privilege of meeting with the senior leadership of one of the Federal Reserve Banks. For close to three hours we discussed the middle-market financing environment and the ramifications for smaller companies. Not only was it an incredible opportunity to interact with the people charged with overseeing monetary policy, it also gave me a chance to look back on the last few years and see a few trends more clearly.

We started the meeting by detailing the types of institutions providing middle-market financing today and the various types of lending structures they offer. What was quickly evident is that lending in the middle market is currently dominated by non-bank capital sources.

Certainly for companies with EBITDA below \$10 million, and often those with greater earnings but lacking a financial sponsor, banks are providing few senior cash flow options. We discussed the incredible amount of asset-based loans available and the low interest rates on those loans as a result of intense competition. But ask these same banks to move from an asset-based to cash flow structure, even with significantly higher interest rates, and you watch them head for the hills.

But interestingly, as the result of this market dislocation that began in 2008, non-bank institutions have emerged to fill the liquidity gap left by the departing banks, in many cases with innovative financing structures. Hedge funds, credit opportunity funds and business development companies have all become more active in the middle market.

But a critical moment during my meeting with the Fed came when we discussed how these lenders have internal yield requirements that often do not necessarily correlate to the general market. BDCs normally target 8-10% returns to meet their shareholders' expectations, and we often hear hedge funds talk about the need to deliver high single digit returns to their investors or else risk losing their capital to alternative strategies.

So, in many instances, despite the hard work by the Fed to create a low interest rate environment, it has had a marginal effect on the cost of middle-market borrowings, and, in many cases companies' capital structures today have higher weighted average costs of capital than in 2008 when the interest rate environment was significantly higher.

And that led to the next question. Do today's higher borrowing costs account for the lower than expected borrowing demands, particularly for acquisitions and growth financings?

If one doesn't take into account any other macroeconomic factors, then the simple an-

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swer would be yes – bring those rates down and the borrowers will come. But unfortunately, as so many discussions go today, the talk turned to the prevailing political climate and the uncertainty over Europe, our own U.S. budget issues, and the prospect for minimal to low growth for many years to come.

No doubt that a lower cost of debt would lead to higher equity returns, but sponsors and business owners need comfort that added borrowings won't result in their company's demise, as was the case in 2008-2009 for many leveraged companies, when revenue and earnings expectations failed to materialize. And, it's not just potential borrowers that are reluctant to enter into new financing arrangements right now. Some people attending the meeting were surprised that a lender's due diligence today is primarily focused on evaluating downside scenarios, including the ramifications to a borrower of another recession. The prospect of a repeat of 2008 seemed remote to many people sitting around the table, but a bad credit decision by a lender may not only cost his company dearly, but result in his own job loss.

It's important that cash flow money start to flow again and borrowing costs decline. But until business owners and their lenders feel confident in the future, borrowings are likely to stay lackluster.

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