The Current Credit Markets Provide New Financing Opportunities

As a new year of deal-making is starting to take shape, several factors will inevitably change the way many companies, especially middle-market companies and private equity (PE) groups, finance their deals. Most importantly, the seemingly ever-tightening regulatory rules aimed at banking institutions are limiting the ability of these institutions to finance deals. Since 2009, the Dodd-Frank Act created provisions that more strictly regulated the securitization market, and Basel III, whose key provisions will be implemented through 2018, increases banks' capital and liquidity requirements. Interestingly, the market share of leveraged loans for banks and security firms has declined from nearly 75 percent to less than 10 percent over the last 20 years.[1] It is expected that these new, added requirements may further limit bank participation in both the bond and loan markets.

However, the decrease in bank financing is not necessarily bad news for deal-makers. Other sources of capital are increasingly available for those interested in funding M&A transactions and these alternate sources may provide added benefits for acquirers. Over the last several years, there has been a proliferation of alternate investors providing debt capital in anticipation of the void created by banks. Such alternative sources include hedge funds, business development companies (BDCs), credit opportunity funds, and the resurgence of collateralized loan obligations (CLOs).

Creative structures allow issuers to customize their capital stack

Because of the perception of a more stable economy coupled with the proliferation of capital as new investors enter the U.S. capital markets chasing yield, lenders have once again become very competitive – similar to the situation in 2006 and 2007. Although usually more expensive than traditional bank financing, the financing products provided by these alternative sources typically offset a higher cost of capital with more flexible and creative financing solutions (e.g., uni-tranche facilities, Term A and Term B and mezzanine loan structures, light amortizations, convertible preferred and holding-company loans). Moreover, "covenant-lite" deals, often paired with working capital facilities, now represent over 50 percent of the new-issue, leveraged loan market, and although such deals have been isolated to the larger market, the middle-market could soon benefit if the overall credit market remains aggressive and investors continue to chase yield down market.

Issuers are also finding that the market is receptive to asset based lending (ABL) facilities that incorporate "springing" covenant coverage ratios that activate when certain thresholds are reached. The uni-tranche facility, which includes the combination of senior and junior credit risk into a single security, is very prevalent – especially in middle-market LBO's. Therefore, companies seeking capital may find that they are more easily able to put together an individualized financing package that addresses their specific needs.

[1] Source: S&P LCD.

Key items to consider when approaching the credit markets

While there may be an abundance of alternative institutions eager to supply capital and the market may be receptive to creative structures, deal-makers still need to be aware of several issues as they analyze their financing options. Currently, M&A activity is still not quite at the robust level expected in light of favorable market conditions and cash-heavy balance sheets. That lack of activity has translated into more capital chasing opportunistic deals, such as repricings and dividend recapitalizations. As previously highlighted, alternate sources of capital are becoming much more prevalent, especially for middle-market deals, and companies seeking to access the credit markets are finding that the interest rate spreads are tighter, there are more aggressive structures being instituted, and there is an increase in flexibility surrounding inter-creditor issues when both senior debt and junior debt are included.

However, it's important that even in this environment, companies still need to understand what their real financing needs will be beyond the transaction itself. In addition to looking at short-term needs, they also need to forecast the financing they will need to support long-term business goals. Essentially, companies should find the right financial partner not just for its immediate needs, but also, and more importantly, to support their ongoing growth initiatives. With so many financing options available in such a robust market, companies should contemplate running a competitive process to find that "partner." A well-thought-out business strategy must be part of any financing decision.

Despite the increased demand for deals and the prevalence of more aggressive structures, we are finding that lenders are being more diligent in both their screening of new deals and in their underwriting process. Therefore, the typical timeline may be extended and many middle-market deals usually take three to four months to close. Companies should be prepared for this approximate timeline, but also do everything in their power to simplify the process by having all required documentation organized and ready in advance.

Use the market to your advantage

Acquirers pursuing deals in the immediate future are likely to find themselves in the enviable position of approaching a very favorable market. It is certainly a buyer's market, and companies should push for more favorable terms than those available just a short while ago. Issuers should not only seek to have their financing partner favorably support M&A activity, but also for dividend recaps; and we've seen more and more companies taking advantage of today's environment to refinance debt that matures as far out as 2016.

Possible uncertainty ahead

As we have seen in the last few years, the capital markets can change rapidly in response to numerous political and other factors. These include the Federal Reserve's tapering of its bond buying program, an unanticipated increase in inflation resulting in accelerated policy tightening, and any number of possible geopolitical events. Therefore, those interested in accessing the credit markets should be aware of these possibilities as they plan their financing needs.

Conclusion

As market fundamentals remain favorable and liquidity continues to flow in, the credit markets should remain very active and supportive of both M&A and opportunistic deals. At the moment, companies will find that alternative sources of capital have more than picked up the slack from banks overburdened by regulations. Those seeking capital should use the market to their advantage, while at the same time focusing on selecting the right financial partner that will best support their long-term financing needs.

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