Nonbank Lending

Isil Erel

The Ohio State University, NBER, and ECGI

@ The **Hoover Institution** at **Stanford** University

The Growth in Nonbank Lending to Middle Market Firms

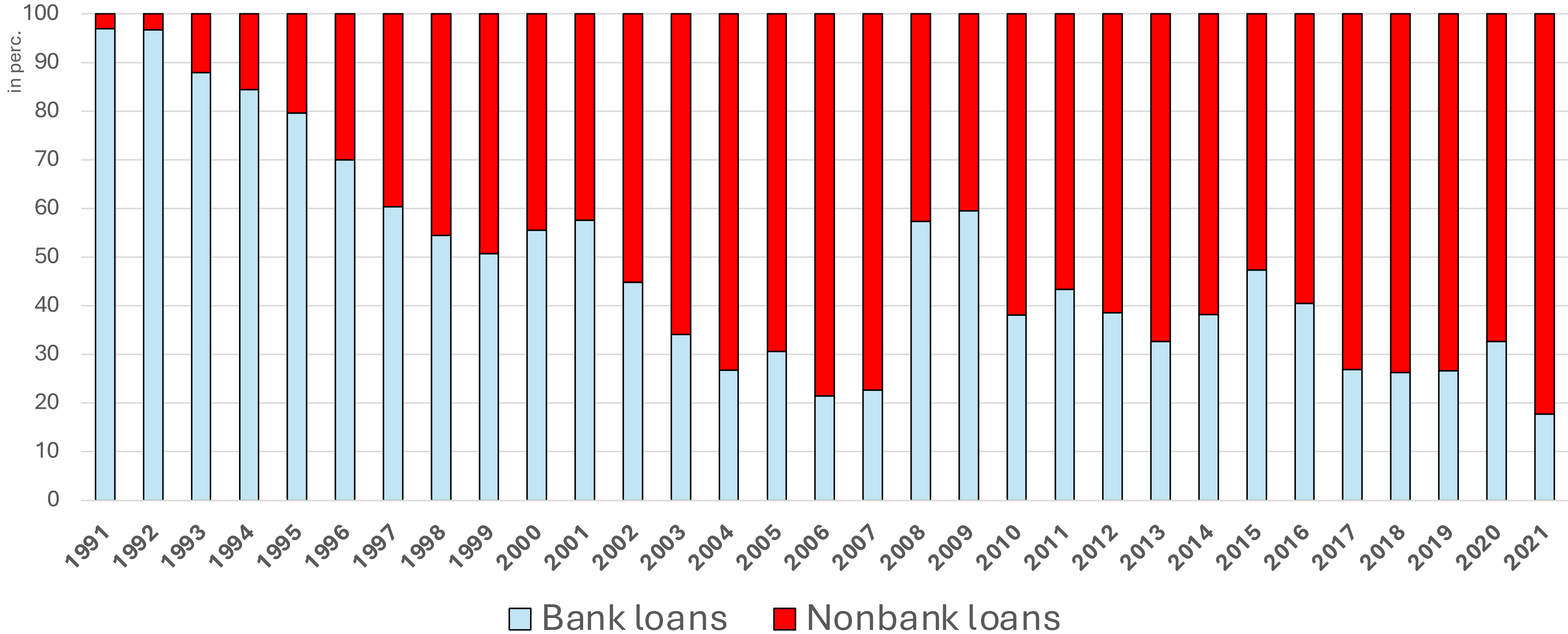
Why?

- Insufficient access to bank credit;
- **Bank regulation**;
- Flexibility and innovation;
- …

Limitations?

- **Higher loan rates;**
- Getting competitive;
- …

Let's remember:
Syndicated Leveraged Term Loans



Erel and Inozemtsev, 2024

Nonbank Direct Lending

Growing fast after the Financial Crisis;

Different from other shadow banks (e.g., CLOs) - in that they directly originate and hold the loans.

The New Business Banker: A Private-Equity Firm

Firms are lending more where traditional banks won't--and sometimes competing with them, too

The headquarters of Carlyle Group, one of the private-equity firms pushing into lending. PHOTO: SHAWN THEW/EPA/SHUTTERSTOCK

By Miriam Gottfried and Rachel Louise Ensign

Updated Aug. 12, 2018 4:51 p.m. ET

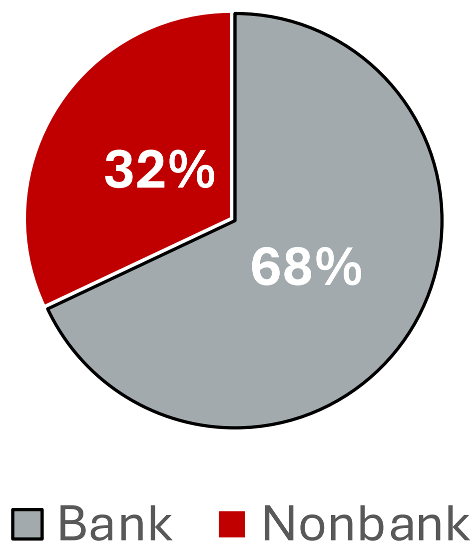
Private-equity firms have long been some of the biggest owners of companies. Now they are vying to become some of their biggest lenders.

Fueled by an influx of cash from yield-hungry investors, firms historically devoted to buyouts are now financing deals banks won't. Nonbanks—many private-equity firms—held more than half a trillion dollars worth of loans to midsize companies at the end of 2017, up from roughly $300 billion in 2012, according to estimates by private-equity firm Ares Management LP.

Findings from “**WHY DO FIRMS BORROW DIRECTLY FROM NONBANKS?**

Chernenko, Erel, Prilmier (2022)

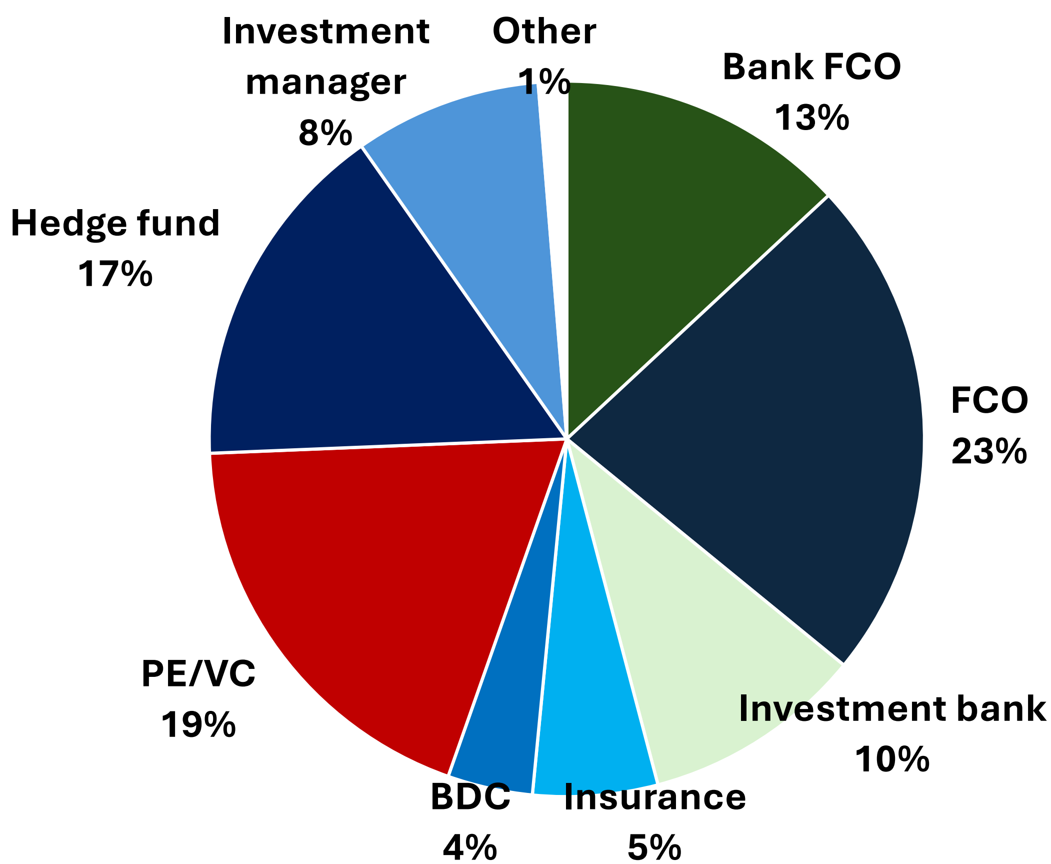
Bank vs. Nonbank Lending to Randomly-selected Public Middle-Market Firms*



*with sales between $10 million and $1 billion, have the right size for screening/monitoring intensive direct lending.

Nonbank Lenders

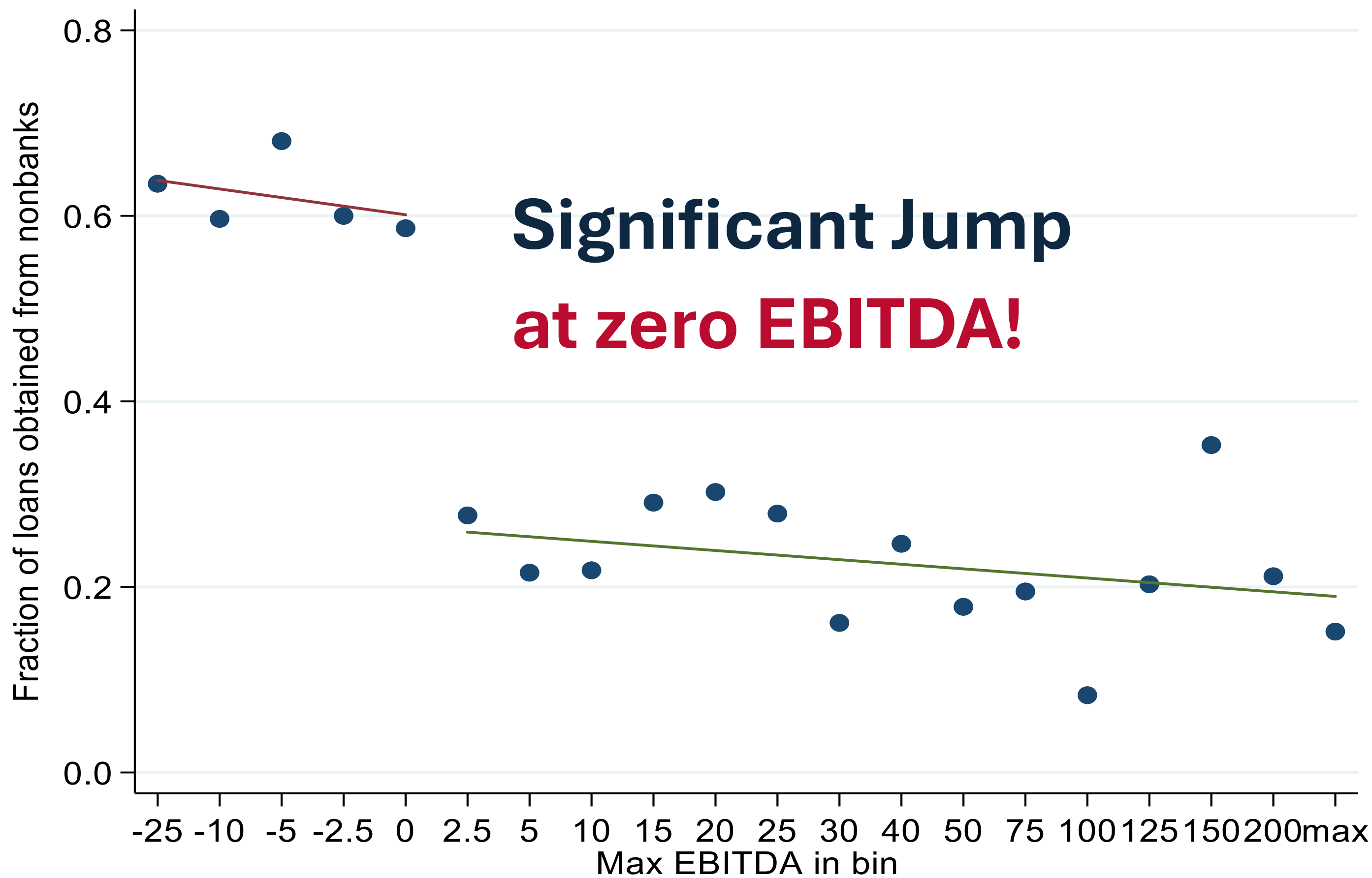
2010-2015



Who are typical borrowers from nonbanks?

Smaller, riskier, and unprofitable firms; firms with higher leverage

Probability of Borrowing from a Nonbank



WHY?

1. Tighter bank regulation (especially for OCC-supervised banks) explains two-thirds of cash-flow based nonbank lending!

- The effect of negative EBITDA is concentrated among cash flow loans.

- Negative EBITDA firms in markets dominated by OCC-supervised banks are significantly more likely to turn to nonbank lenders for funding!

2. Flexibility/innovation in nonbank loan contracts...

Price Terms

Nonbank lenders charge about 200 basis points higher interest rates!

- **about 4% higher for Hedge Funds/PE Firms/BDCs!!!**

controlling for observable loan and firm characteristics (PP&E, current ratio, log firm age, market-to-book, volatility, past return).

Then, access to funding, rather than prices, is why firms borrow from nonbanks!

Non-Price Terms (More Innovative!)

- Loans from nonbank lenders are 37% less likely to include financial covenants, but more likely to include warrants.

- They are also less likely to be secured with some type of collateral.

See also:

- Davydiuk et al. (2024): BDCs substitute for middle-market lending done by banks subject to regulatory stress tests.

- Gopal and Schnabl (2022): finance companies and fintech lenders have significantly expanded their lending to small businesses.

- And others…

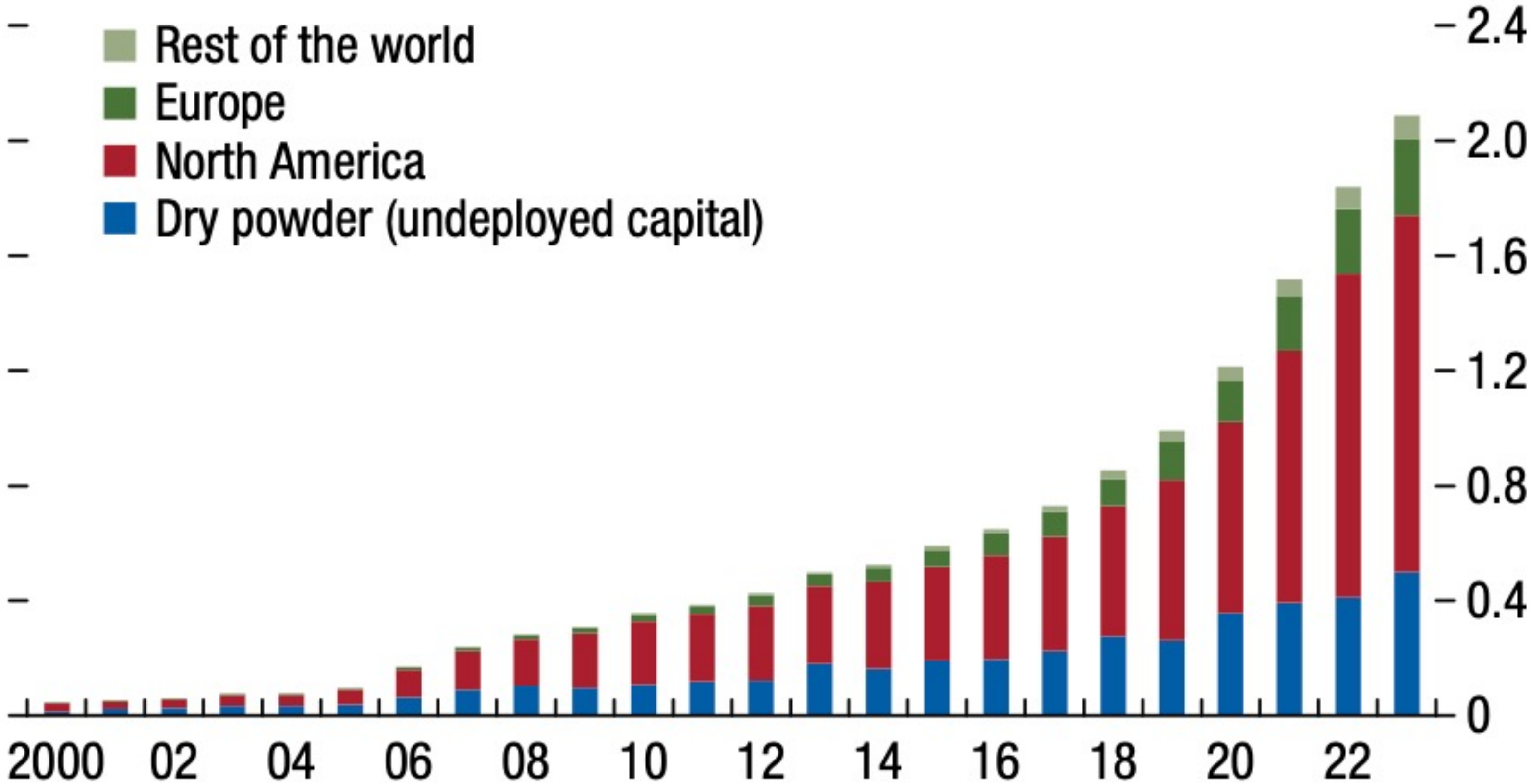
Future of **PRIVATE DEBT?**

Asset class with the largest growth

- Private debt (funds) as an emerging asset class has more than tripled in size during the past decade reaching $1.75 trillion, with almost $1 trillion in direct lending (Pitchbook, 2024).

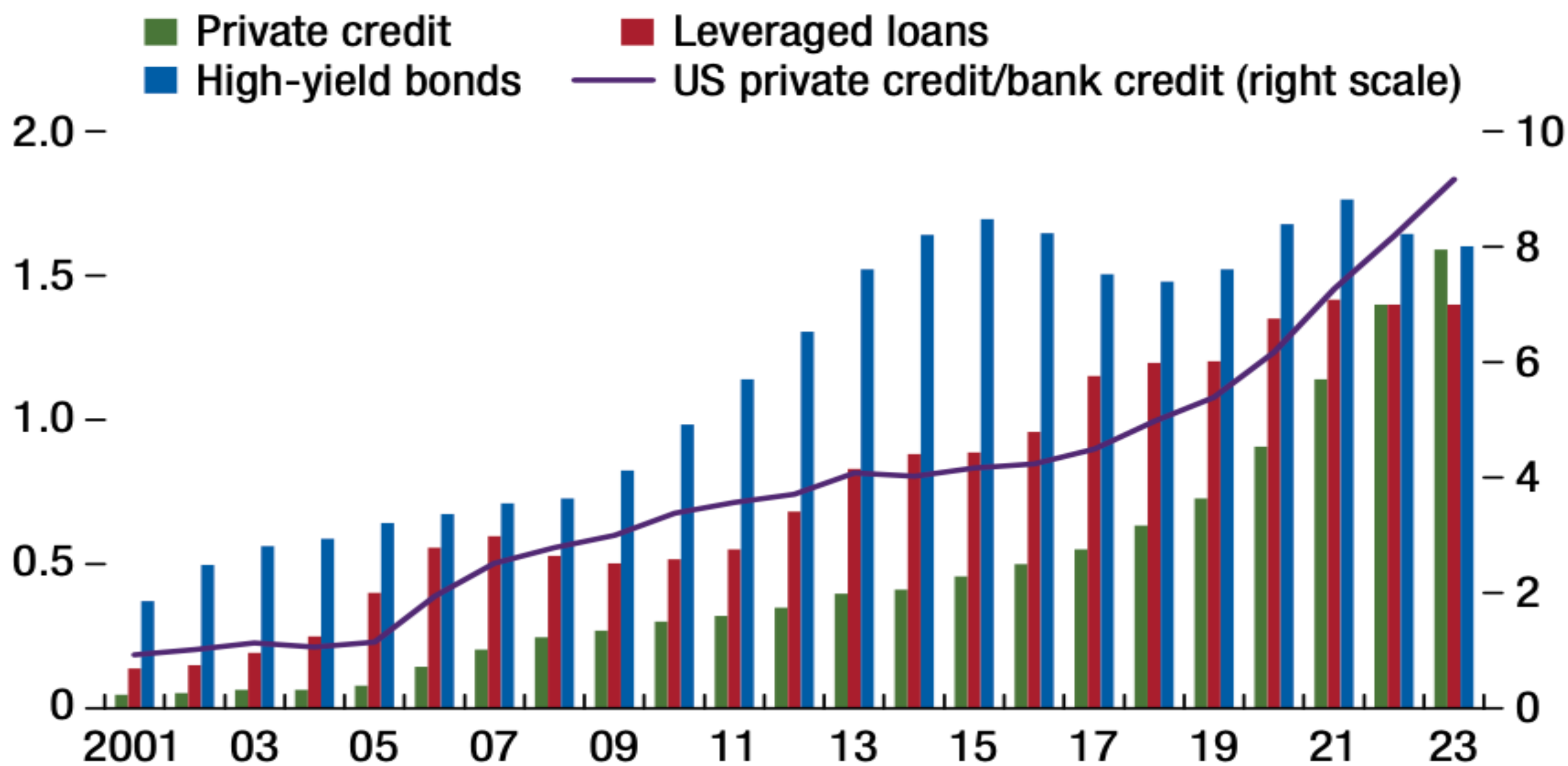
- Credit funds raise money from investors (LPs) and provide mostly direct loans to firms that typically cannot get bank loans based on their creditworthiness.
  - Sponsored by private-equity funds or business development companies.

Growth of Private Credit Markets (in $Trillions)



IMF Global Financial Stability Report, 2024

US Private Credit (comparable with) Leveraged Loans and High-Yield Bonds ($Trillions, left scale; %, right scale)



IMF Global Financial Stability Report, 2024

Fun Facts

- Default rates (1.6% in 2023) are lower than syndicated loans and HY bonds, but recovery rates are also lower (Cai and Haque, 2024);
- Deal sizes/borrowers are getting larger (e.g., majority LBOs, Block et al., 2024)
- Direct lenders act like banks rather than arm's–length investors;
    - They include larger number of covenants than banks do; renegotiate more; help in times of financial distress as much as banks would do (Jang, 2024)
- Since 2015, banks have increased their loans to nonbanks 5X the rate of growth for their commercial and industrial (C&I) loans!

(ARES, Understanding Private Credit, 2024)

Risks: Financial Stability Implications

- Opaqueness! (no data)
- Inter-connections with the banks! (Acharya et al., 2024; Chernenko et al., 2024)
- Risks to their borrowers, especially in an upcoming downturn:
  - Who will serve these riskier borrowers with large amount of leverage?
  - With increased corporate leverage, are they more vulnerable to economic shocks?
  - Increased competition and increased dry powder → lax underwriting standards?
- Risks to their investors (increasing exposure of pension funds and insurance companies): liquidity constraints? unexpected losses in a likely downturn?

Returns to Private Credit

Practitioners tout the high returns of credit funds given their risk

> "If you can earn 12 percent, maybe 13 percent on a really good day in senior secured bank debt, . . . with almost no prospect of loss, that's about the best thing you can do" – Steve Schwarzman, co-founder of Blackstone!
>
> Financial Times, 2023

- The growing role of nonbanks in private credit questions the *specialness* of banks!

- **Are private debt funds special and capable of earning alpha?**

Risk-adjusting Returns to Private Debt Funds
(Erel, Flanagan, and Weisbach, 2024)

Projecting the cash flows of funds onto public market benchmarks to form a replicating portfolio that mimics the risk profile of the private debt funds…

Approach adapted from Gupta and Van Nieuwerburgh (2021) and Flanagan (2023)

Cash-Flow Data Description

- Burgiss-MSCI Data: 532 private credit funds
  - Fund-level data set, including distributions and contributions, directly sourced from LPs (no survivorship bias).
- Primary Dataset is the total **net of fee cash-flows** paid to LPs
  - Represents the average LP

What’s the Alpha?

It all depends on benchmarks…

- Using only debt as a risk factor, $1 generates significant NPV of about $0.11,

1.8% net alpha!

But,

Equity-linked investments are an important part of the funds' portfolio **(20 percent)**!

→ Zero Net Alpha, using also the equity benchmarks!

Gross alphas are around 4 percent, which is approximately equal to what manager GPs would earn with management fees of around 1.5 percent and carried interest of around 15-20 percent.

Net Alpha for Private Debt? **No!**

LPs earn only a rate of return appropriate for the risks that they take (plus GP fees), not more.

THANK YOU!