TRENDING TOPICS

MIDDLE-MARKET FINANCING FACES CHALLENGES FROM ECONOMIC UNCERTAINTY, REGULATIONS

Trending Topics represents an executive summary compilation of news, information and perspective on matters affecting businesses and business leaders today. This insight is being provided to keep you up to date on the latest developments and trends influencing these topics. These views do not necessarily represent the views and opinions of PNC. For additional research on these topics, please consult the sources cited in this article.

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ECONOMICALLY AND FINANCIALLY, 2015 WAS UNPREDICTABLE

Stock markets worldwide gyrated through 2015 and began 2016 with even more turmoil. Once high-flying emerging market economies — even China's — have unnerved the markets with their volatility and remain in the doldrums. And interest rates in developed economies, most notably Japan, have turned negative.

Nevertheless, U.S. middle-market companies, broadly defined as having between $5 million and $2 billion in revenue, are still growing organically and through mergers and acquisitions, and their sources of financing have remained plentiful. In fact, as stocks around the world continue to yo-yo, secondary-market loan prices remained essentially unchanged.

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The newsletter also points out that $800 million of retail cash flowed out of loan funds in the final week of August 2015, a puzzling shift given that those floating-rate funds are secured and an excellent hedge against rising interest rates, the threat of which has played a part in recent stock market volatility.

INTEREST RATE UNCERTAINTY

In fact, the uncertainty so prevalent in the markets today may be the ultimate generator of headwinds for the middle market. One of the more troubling uncertainties is whether the Federal Reserve will continue to increase short-term interest rates throughout 2016. Rising rates will increase borrowers' cost of capital and likely reduce their demand for funding. In addition, there's tremendous uncertainty about how a rate increase would impact the financial markets and the economy overall, important factors in determining lenders' willingness to lend.

NEW OCC LENDING GUIDELINES

A factor impacting the supply side of the middle-market financing equation and likely to continue doing so is the Office of the Comptroller of the Currency's new middle market lending guidelines. Whether specific loans work under the new regulatory environment has been a top concern of lenders for more than a year, often seemingly taking precedence over a deal's credit quality, sponsor or industry.

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The guidelines have essentially pushed banks into a box and prompted them to focus on more conservative deals, disrupting the high-octane lending party of the last few years. While nonbank lenders are taking up some of the slack, loan features such as leverage have dropped significantly.

LeveragedLoan.com notes that stricter regulatory guidelines have pushed down the leverage that banks are willing to provide, resulting in debt multiples falling to a 2.5-year low in the first half of 2015. In addition, fixed-charge ratios are better cushioned, increasing for the first time in four years, it says.[3]

BASEL III IMPACT

New risk-based capital guidelines stemming from Basel III present another potential disruption to the flow of middle-market financing.

"Banks continue to face significant regulatory pressure; risk-based capital charges for non-rated loans, and tier 1 capital ratio increases (of 25% or more by 2018) will make it increasingly challenging for banks to provide middle-market loans efficiently," notes White Oak Global Advisors.[4]

FEWER BANK LENDERS

White Oak points out that while there have been 150 or so nonbank entrants to the middle-market lending space over the past five years, the number of U.S. banks has shrunk by approximately 1,219.[5]

"New capital providers have formed to replace those who left the financing market. So, capital is available, it's just more difficult to find," says Dennis McCarthy, an investment banker at Monarch Bay Securities, in an article published on equities.com.[6]

A survey by the Axial Network echoes that concern. It found that 34% of more than 100 CEOs of middle-market companies cited the availability of funding as a major concern last year, and 28% of respondents listed completing a financing process or finding the right financial partners to help them as a top priority in 2016.[7]

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1 "Why Volatility Matters (Part 1)," *The Lead Left*, Sept. 10, 2015 https://theleadleft.com/why-volatility-matters-part-one/

2 "Middle-Market Momentum Stalled in August," *Mergers & Acquisitions*, Sept. 10, 2015 http://www.themiddlemarket.com/news/strategic_m_a/middle market-momentum-stalled-in-august-257990-1.html

3 "Leveraged Loans: Stricter Guidelines Send Middle Market Debt Multiples South," LeveragedLoan.com, Aug. 11, 2015 http://www.leveragedloan.com/leveraged-loans-stricter-guidelines-send-middle-market-debt-multiples-south/

4 *Private Debt Market Outlook – 2015*, White Oak Global Advisors, page 2 http://www.whiteoaksf.com/pdf/WhiteOakWhitePaper2015.pdf

5 Ibid

6 "What Are the Biggest Challenges for Middle Market Companies in 2015?" Equities.com, Feb. 9, 2015 https://www.equities.com/news/what-are-the-biggest-challenges-for-middle-market-companies-in-2015.

7 "Middle Market Monday: Funding, Talent & Economy Top Issues in 2015," *Forum*, Powered by Axial, Jan. 27, 2015, http://axial.net/forum/middle-market-monday-issues-2015/

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