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The New Order: Leverage Finance in an Asset Management World (Last of a Series)

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While private credit is growing in popularity with both investors and issuers, banks are seen to be struggling with the new order. While arguing for more non-bank regulation to Congress and federal agencies, they are busy trying to start their own direct lending businesses or partnering with established firms.

Given the challenges of holding leveraged loans on their balance sheets, some banks are shifting their strategies to less leveraged, more amortizing so-called pro rata, term loan A offerings. This hearkens back to the 1970s and 1980s before the institutionalization of loans and the crafting of non-amortizing, term loan Bs for CLO, retail, and insurance buyers.

One example is a top US money-center bank focusing its direct lending efforts on middle market non-sponsored borrowers. Debt-to-Ebitda is kept below 4x (under regulators' radar), and with spreads at least 1% lower than market for LBO financings. These companies are found in manufacturing and industrials as well as service sectors.

Banks are concentrating on niche areas where in-house industry groups give them a competitive edge to finance larger deals. Financials, (e.g. *Truist Insurance*), aircraft (*Bombardier*), travel and leisure (*Hilton*), energy (*NorthRiver Midstream*), and commodities (*US Silica*) are instances (and recent issuers) where banks have been competitive for decades.

By providing fund leverage and financing lines to direct lenders, banks are entering private credit through the backdoor. Indeed, when top private credit managers began lending two decades ago, banks often got them started. Post GFC those relationships were critical to maintaining diversified, long-term liabilities' support through any business cycle.

Meanwhile the largest direct lenders are raising significant LP dollars to accommodate multi-billion-dollar debt financings. These buy-side asset managers have mimicked the sell-side investment banks by developing syndication desks to handle oversized commitments and feed external lending partnerships.

Educating investors clearly on the changing of the guard from banks to non-banks is essential to understanding how each category responds to various economic and market dynamics. Defaults, recoveries, prices, spreads, volatility – all emerge and operate in different ways depending on whether they occur in a bank-style regulated environment.

Fundamental distinctions will remain. Asset management will never be investment banking, though players may use partnerships and acquisitions to supplement their businesses.

Investors will benefit from those distinctions. The gravitational pull towards private capital means better access to higher quality, higher-yielding assets less sensitive to headline news. It also allows for more diversification of risk among sophisticated institutional investors and away from depositors.