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Lead Left Interview – Stephen Lewis

THE LEAD | April 13, 2016

This week we chat with Stephen Lewis, Managing Director, Headwaters MB. Headwaters is a middle market focused investment bank. Steve's focus is cross border debt capital markets.

The Lead Left: *Steve, it's been over two years since we last spoke. What's changed since then?*

Stephen Lewis: The world is not the same place we knew even two years ago. Just look at Europe and see how the lending community is in the process of being re-made. In the US, lending to the middle market has been historically dominated by non-banks. In Europe it has been just the opposite. Now, as a result of regulatory pressures and public backlash, the European banks have had to scale back leaving a wide open opportunity for new market entrants, mostly non-regulated "alternative" lenders, to come in to fill the void.

TLL: *What's been the impact of all this regulation from a competitive perspective?*

SL: Basel III, and the effect the US Dodd-Frank rules have had on the off shore operations of US banks, have created a very different playing field. New direct lenders, such as finance companies, have popped up in a wide variety of shapes and sizes. These include private equity, hedge funds and even family offices. This is a real sea change for the European marketplace. These players, like the pension investment community, are all looking for ways to generate consistent returns. And they're all called "debt funds," but each is different from the next.

TLL: *Which drives us crazy. These different risk profiles shouldn't be lumped in the same basket.*

SL: But all of them have to underwrite the risk of getting their principal and interest paid back consistent with their risk appetite. Because they are not all homogenous "debt funds" or underwriting risk the same way, it takes time to know "how they tick". But these alternatives allow borrowers more choices when picking a lender to customize a financing to more closely fit their needs. For these new lenders, the consistent returns generated by the loans keeps their investors happy. In some respects, you might say this is a win-win for the middle market.

TLL: *Is lending in the wine drinking countries worse than lending in the beer drinking ones?*

SL: I wouldn't say lending in the wine drinking countries, meaning Southern Europe, is "worse." Lending there has challenges not found in Northern Europe. The secured lending rules, laws, customs and practices are more creditor friendly in Northern Europe which means "alternative" lending has grown there first. That region is slightly ahead of the curve, but even now Southern Europe recognizes now's the time to take advantage of the market opportunity.

TLL: *Are bankers getting educated on these challenges?*

SL: The World Bank has recently asked the Commercial Finance Association to provide training to governments and local country lenders on the benefits of secured lending and how to go about setting up a secured lending scheme that works for all the stakeholders.

TLL: *Why the World Bank?*

SL: Because the middle market drives the European economy – as it does here. Think about the similarities: both the US and Europe have roughly the same populations, the same land mass, and the same size GDP. All of the middle market companies in Europe, just like those in the US and the rest of the world, need the same access to capital to fuel their economic engines. With the banks pulling back, it is in the best interest of the World Bank and the central European banks to explore innovative ways to provide alternative sources of capital. Secured lending is demonstrably effective in helping middle market companies grow.

TLL: *What's your view of middle market lending appetite among the European banks?*

SL: The so called "clearing banks- banks like Lloyds TSB, RBS, and HSBC being British examples, and their equivalents in other jurisdictions – need to put €25-50 million to work per deal and for regulatory and other reasons are not really looking to move down market. For this reason RBS and other clearing backs have set up commercial finance lending arms so that they can address the needs of the middle and lower middle market. However, many of those commercial finance lending arms will only provide true asset-based loans on a traditional formulaic basis. They're shying away from "air balls" for regulatory compliance reasons.

TLL: *Are banks focusing on sponsor finance activity?*

SL: The large commercial banks clearly like sponsored transactions and continue to court and support the financial sponsor marketplace. But regulation has clamped down on their ability to provide higher leverage. So the rules of the game have changed. For classified leveraged loans, banks must post more capital, which affects credit criteria and returns. That causes banks to make leveraged loans to their most credit worthy clients.

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