The Continuing Evolution of Nonbank Commercial Lending

By Gerald M. Sherman

A look at fundamental changes in the debt/equity paradigm.

Nonbank commercial lending has evolved over the decades as a natural market response to the limitations federal and state regulations place on the perceived levels of risk a bank lender can undertake. Over the past 20 years, in particular, several factors have coalesced to fuel a virtual explosion in the number of markets where nonbank commercial lenders—most specifically secured lenders—can successfully provide financing. Of particular interest, nonbank lenders are increasingly providing debt to borrowers in situations where equity would have been much more likely in the past. This article considers both the factors that have led to this expanding market for debt financing and the impact of this shift as it relates to lower- and middle-market commercial lending. Two case studies reflecting this evolution are discussed.

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Factors Leading to Change

What are the factors that have led to this expansion in the uses of debt financing? And should their impact be viewed as permanent? To consider these questions, it's important to consider the following three conditions:

1. An apparent shift in the assessment of risk/reward relationships by some investors
2. The impact of enhanced global communications on the flow of investment capital
3. The willingness of some nonbank lenders to assume different types of risk

Shift in the Assessment of Risk/Reward Relationships by Investors

Generally, debt has been viewed as offering lower yields than equities in traditional capital markets. Today, however, this paradigm has shifted somewhat. Certain types of loan transactions, particularly secured transactions, are being viewed as offering the potential for both relatively high yields *and* security of principal. For example, a commercial mortgage loan to acquire and finance a quality real estate development may fall outside traditional, that is, "bankable," loan-to-value parameters. At the same time, a *highly experienced* real estate lender may be able to make such a loan based on two basic determinations. The first determination would have to be that the project has a high likelihood of success. The second determination would have to be that the project will create *significant new value* as the result of the cash flow or net proceeds that the project would generate upon success. Given these determinations, the lender may, for example, be able to provide a mortgage loan with an interest rate of, perhaps, 12 percent annually with a *low level of risk—both in its eyes and in reality*. As a result, such a transaction, or pools of transactions with similar

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qualities, could be considered a very strong alternative to an investment in equities. Further, with the availability of opportunities like the one described above, many investment managers and individual investors are, in fact, choosing to put a portion of their funds into such opportunities, which offer both high yields and at least the expectation of relative safety. Alternatively, many investment managers and individuals are putting their money to work in similar situations *indirectly* by investing in hedge funds or nonbank lenders with this type of lending profile.

Impact of Enhanced Global Communications on the Flow of Investment Capital

Public capital markets such as the New York Stock Exchange (NYSE) came into existence to provide an efficient vehicle for matching sources and users of capital. Thinking back to 1792, when the agreement that eventually led to the NYSE was signed, both communications and the transfer of information were highly inefficient and time-consuming by current standards. Today, it's easy for both users and sources of capital to communicate directly and share information rapidly. Accordingly, large investors, such as pension funds, hedge funds and wealth managers, can easily circumvent the need for a public market to facilitate transactions. Further, these large investors are always seeking means to improve the yield of their investments. Given this combination of ease and need, it's not difficult to understand how investment capital could flow into nonbank lenders or loans generating higher yields.

Willingness of Some Nonbank Lenders to Assume Different Types of Risk

One essential difference between debt and equity is the potential for gain. Whereas equity investments, at least in theory, have an unlimited upside, pure debt instruments (those without special features to enhance yield) provide a limited and clearly defined yield regardless of how successful the borrower might eventually become. Traditionally, bank lenders have limited their loans, *at least in theory*, to situations where either a borrower's historical cash flow demonstrated a clear ability to repay debt or where the additional strength provided by collateral provided the lender with a very high probability of repayment. This strategy made complete business sense, not only because of regulatory considerations but also because of the limited profit margin on bank loans.

Over the decades, nonbank lenders typically helped meet the needs of borrowers that weren't bankable by relying more heavily on tangible collateral—either from within or outside the borrowing entity. Today, however, an increasing number of nonbank lenders are willing to go beyond the value of their tangible collateral. Sometimes, for example, nontraditional collateral such as intellectual property or the value of a revenue-generating group of delivery routes might be used. Regardless, these nonbank lenders are not taking what they perceive to be unsupportable levels of risk. Rather, these lenders operate from the perspective that their lending practices, experiences and abilities allow them to *mitigate* the risks they are taking. In other words, the expanded uses of debt financing don't reflect a fundamental change in the nature of debt transactions. Rather, by looking at nontraditional sources of repayment, *the lenders are confident that they can both mitigate their risks and earn a higher interest rate.*

It is also important to note the place of specialty finance companies. These lenders focus on niches where they can exploit an in-depth knowledge of a particular market and its borrowers to make loans with a far *different* risk profile than bankers can consider. The key concept to recognize with such lenders is that while the risk profiles of their borrowers may be different than those of a bank's borrowers, the specialized knowledge of these lenders allows them to reduce their financial risk to a very acceptable level. For example, a lender might be willing to make a loan secured by the assets of a dry cleaner for far more than their hard asset value because the lender understands the value of the dry cleaner's location and clientele. Similarly, a lender might be willing to finance the purchase of software systems, which typically have no tangible value. While this could be considered highly risky, particularly because of the risk associated with the failure of the software vendor, a lender with the knowledge and ability to arrange for ongoing software support for the borrowers can make a prudent loan that most lenders would consider foolhardy.

Case Study: Venture-Backed Start-up Obtaining a "High-Cost" Line of Credit

A venture-capital-backed service company is ready to begin operations but has largely exhausted the $10 million in equity capital it has raised to date. The company has the relatively unusual circumstances of having been started solely for the purpose of selling one service to one customer. Facing a payment cycle of 30 days to 45 days, the company finds itself in a position where it doesn't have the funds needed to pay ongoing expenses for the period between the time the service is provided and the time payment is received. After considering its options, the company's management chooses to pursue debt financing rather than sell additional equity. Because the company is a start-up and has only one customer, albeit a creditworthy one, banks would not consider the loan. The company ends up arranging a line of credit with a rate far over 20 percent with a nonbank lender. Why did this transaction occur and how?

- From the borrower's standpoint, the opportunity to meet its needs with debt, almost regardless of cost, was preferable to selling more equity just before the value of company had the potential to increase dramatically.
- The lender made the determination that the receivables it was being asked to finance would provide strong collateral, despite the issues inherent with a start-up company with only one customer.

Why could a nonbank lender make this loan while a bank couldn't? Fundamentally, the nonbank lender was willing (and able) to accept the risk of a start-up with just one customer. Why? For the simple reasons that (1) the lender was confident that the borrower's customer was creditworthy and (2) the lender was willing to expose itself to the possibility that the borrower would fail.

Why was the lender willing to expose itself to the potential failure of a start-up? Simply because the lender was confident that, on a worst-case basis, it could fully collect on its loan through the collection of the receivables due from the borrower's customer. In other words, the lender didn't necessarily consider the situation to be one with high risk. Rather, the lender understood that it would have to manage its loan carefully and that by doing so, even a liquidation or bankruptcy shouldn't jeopardize either its collateral protection or eventual repayment in full—including any fees, penalties or collection costs.

Case Study: Investor-Financed/ Bank-Financed Specialty Commercial Mortgage Lender

This case reflects the trend of expanded commercial lending from two perspectives: the specialty lender's use of debt where equity had more typically been used for many decades and the capital structure of a specialty lender itself.

A highly successful real estate developer had occasionally provided financing for smaller, less well capitalized projects. Based on the successes of both his company's projects and the projects he financed, the developer came to view the ability of his organization to identify projects with strong prospects for above-average profitability as a significant organizational strength. Taking this to the next step, he concluded that he could provide financing for developments *in their very early stages* in the form of a secured, high-rate loan that was *mutually advantageous* for both the developer and his borrowers for the following reasons:

- From the developer's standpoint, the secured position provided the ability to take over a project if the borrower couldn't complete it successfully. Further, if the developer's organization had analyzed the project correctly, the developer would be able to recover all of his principal, interest, fees and development costs by completing the project.
- From the borrower's standpoint, the cost of borrowing from the developer, even at rates far above bank levels, was far less expensive than giving up significant equity in a project.

To capitalize the new venture, the developer was able to arrange subordinated loans from several wealthy private investors at interest rates of between 12 percent and 15 percent. The two investors were paid interest on a monthly basis and required no equity in the lending company itself. Combined with this subordinated financing, the developer was able to obtain a secured line of credit with a local bank at traditional bank rates. The mortgages the new company was generating were pledged to the bank, and the bank limited its advances to 60 percent of the face value of the mortgages. Based on this structure, the developer maintained complete ownership of the new company and earned a significant spread over the cost of funds.

Looking to the Future

Capital markets, like all markets, experience highs and lows, changes and trends, with the subprime mortgage debacle of 2007–2008 being just the most recent example. The expanding use of secured debt financing, however, exhibits a number of characteristics that suggest a permanent shift—not just a fad—has occurred. Four of the major characteristics follow:

1. Legitimate, continuing financing needs are being met.
2. The opportunity for profit—on a prudent basis—is significant for the lender.
3. As traditional industries evolve and entire new industries are created, it would appear that the opportunity to develop *and* exploit new bodies of knowledge through specialized, secured lending will continue to grow.
4. The use of debt financing for nontraditional, secured transactions meets an ongoing need for a significant group of capital sources that continuously seek out opportunities for higher yields relative to the associated risks.

Given these dynamics, it would appear that entrepreneurial lenders will continue to see expanded opportunities. In particular, lenders that are able to develop, or acquire, significant expertise in emerging areas should be able to exploit nontraditional lending niches with success. At the same time, many borrowers should also be able to consider new and potentially more advantageous financing opportunities for their businesses.