THE WALL STREET JOURNAL.
WSJ

Private-Equity Firms Push Into Lending

By Miriam Gottfried and Rachel Louise Ensign
Updated Aug. 12, 2018 4:51 p.m. ET

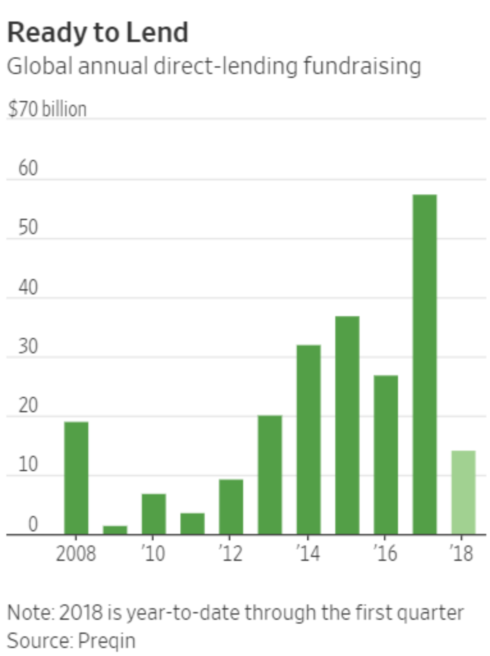
Private-equity firms have long been some of the biggest owners of companies. Now they are vying to become some of their biggest lenders.

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 ARES +0.24% LP.

The influx of money has led to intense competition for borrowers. On bigger loans, that has driven rates closer to banks' and led to a loosening of credit terms. For smaller loans, "I don't think it could become any more borrower friendly than it is today," said Kent Brown, who advises companies on debt at investment bank Capstone Headwaters.
The market is poised to grow as firms ranging from private-equity behemoths to smaller outfits angle for more action. In December, KKR KKR -1.48% & Co. struck a partnership to create the largest business-development company, an investment vehicle dedicated to making business loans.

Blackstone Group BX -1.41% LP and Carlyle Group CG -0.54% LP plan to raise billions more dedicated to business lending. Apollo Global Management LLC and entities affiliated with it, already sizable players, have been buying and expanding lenders to get access to a broad array of deals.

Ares, an early player in the business, raised a record $10 billion for middle-market lending in the second quarter alone. Overall, firms completed fundraising on 322 funds dedicated to this type of lending between 2013 and 2017, with 71 raised by firms that had never raised one before, according to data-provider Preqin. That compares with 85 funds, including 19 first-timers, in the previous five-year period.



"This is a seismic change in the marketplace," said Richard Farley, chair of the leveraged-finance group at Kramer Levin Naftalis & Frankel LLP. "What was once a business that was just for deals that were too risky or too small for the banks is now a business that could compete with the banks."

In the decade since the financial crisis, buyout firms have aggressively moved into the business of lending to midsize companies.

The boom in nonbank lending may help explain why business-loan growth at banks has been sluggish despite a strong economy. Nonbank commercial loans grew 7.5% in the first quarter from a year earlier, while bank loans in the sector were up 3.6%, according to an Autonomous Research analysis of Federal Reserve data.

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Loaning money to companies with the lenders keeping the loans on the books, known as direct lending, is the latest way private-equity firms are encroaching on banks' turf. Banks shed many of their riskier businesses after the financial crisis due to new regulations and a desire to avoid the mistakes of the past.

Opportunistic and lightly regulated, private-equity firms have taken their place in parts of the middle-market lending market, shifting the risk--and the reward--of those loans out of the banking system.

Durham, N.C.-based Eco-Site wanted a loan earlier this year to build hundreds of new cellphone towers. Wells Fargo & Co., the bank that kept Eco-Site's checking account, turned it down, saying it was too small and not profitable enough, said Chief Executive Dale Carey. The private-equity-backed cell-tower operator instead borrowed $50 million from Varagon Capital Partners, a direct lender founded in 2014 with backing from affiliates of private-equity firm Oak Hill Capital Partners and insurer American International Group Inc.

Varagon looked at Eco-Site's projections and determined the company was growing quickly enough, according to the lender.

Eager to diversify, private-equity firms have moved into real estate and hedge funds, while expanding into areas like insurance. As low interest rates have driven institutional investors to seek better yields than traditional bonds and Treasurys, direct lending is among private equity's fastest growing businesses.

Direct lenders typically focus on borrowers with less than $50 million in annual earnings before interest, taxes, depreciation and amortization, although borrowers can be larger.

Companies often turn to direct lenders because they don't meet banks' strict criteria. A borrower may have a one-time blip in its cash flows, have a lot of debt or operate in an out-of-favor sector.

Sometimes borrowers use the money to expand. More often, they're being bought by private-equity firms and are using the loans to finance their own buyouts. The lending arms of private-equity firms regularly finance competitors' deals. Some fund their own buyouts, setting up the potential for conflicts.

Buyout firm Thoma Bravo needed $230 million in debt to finance the acquisition and merger of two mileage-tracking software companies it announced in January. It didn't approach banks in part because the transaction was too complicated to get a good rate, according to people familiar with the matter. Instead, it turned to TPG Sixth Street Partners, the credit arm of private-equity firm TPG, and Owl Rock Capital Partners, a direct lender founded in 2016 by alumni of Blackstone, KKR and Goldman Sachs Group Inc.

For institutional investors such as pension funds, direct lending has been a good bet. An index created by private-markets adviser Cliffwater LLC to gauge the performance of middle-market loans before fees has returned 9.3% over the past five years.

Direct loans are typically floating-rate, meaning they earn more in a rising-rate environment. But borrowers accustomed to low rates may be unprepared for a jump in interest costs on what's often a big pile of debt. That risk, combined with increasingly lenient terms and the relative inexperience of some direct lenders, could become a bigger issue in a downturn.

Regulators like that banks are wary of lending to companies that don't meet strict criteria. But they are concerned about what's happening outside their dominion. Joseph Otting, U.S. Comptroller of the Currency, said earlier this year: "A lot of that risk didn't go away, it was just displaced outside of the banking industry."