Spotlight Q&A: Crystal Financial on competition, regulatory change and tax-driven activity in the middle market

— by Leela Parker

Crystal Financial, a commercial finance company that originates, underwrites and manages asset-based and cash flow financings for middle market borrowers, spoke with Thomson Reuters LPC to discuss middle market lending, which has proved to be resilient and highly competitive in a year defined by macroeconomic and regulatory uncertainties. Senior Managing Director Colin Cross and Senior Managing Director Steve Migliero discuss the challenges, competition for larger hold sizes and expectations for an M&A and tax-driven 4Q12 pickup in deal flow.

Though many middle market participants lament the limited supply of dealflow in 2012 so far, the middle market has weathered the macro volatility quite well. What has been the biggest challenge during the origination process this year?

Steve Migliero: For us, the biggest challenge has not been dealflow. As banks remain selective to whom they want to lend, we have actually seen a number of very attractive opportunities. We're focusing on transactions that are a little more unique in their financing needs – less than "A" credits, slightly unfavorable industries or a story that makes a credit fall away from being bankable within a commercial bank. But from a cost of capital perspective I think there is still a misalignment at times between these borrowers and lenders like ourselves. There is a difference between the prices borrowers can get from commercial banks compared to the non-bank market.

Colin Cross: In talking about the market in general it's kind of a bifurcated market – where the bank quality credits are very competitively priced, very low pricing, probably the lowest in years and then there are a number of borrowers who can't obtain credit in that market. It's really not a question of another 100bp or 200bp, it really shifts completely into the non-traditional direct loan market where we participate. It's more of a high single digit, low double digit. It's quite a bit more expensive – so one of the biggest challenges is borrowers understanding where they fit in the market.

SM: Another challenge we've experienced is that the deal process has slowed because of uncertainty in the economy. It's harder to nail down projected financial performance which can lead to disagreements between the buyer and seller on price. Bridging expectations has been challenging.

The competition to win mandates is fierce. Many lenders are seeking to commit larger hold sizes in order to be competitive. What is Crystal's view on this approach?

SM: Certainly the ability to do an underwrite is absolutely a competitive advantage. Simplicity and certainty of execution is very important and people are willing to pay for that. The market is still a little bit jittery, and the ability to take the financing uncertainty off the table is definitely a competitive advantage. While we don't have formal partnerships, on larger deals we have a group of lenders that we partner with on a regular basis. By doing so, we reduce execution risk and the borrower does not have to deal with a full syndication process.

"Because it's an election year, there will be continued uncertainty for the remainder of the year."

CC: For select transactions we have committed to some large underwritings. We did an $80 million transaction with American Apparel and there are a couple other deals we've done in the last two months in the $45 million range, which for our middle market space is a good size. On hold levels, I think most lenders would prefer a hold level somewhere in the $25-35 million range, even if they underwrite a larger amount. So really we approach it two ways, in situations where can commit larger amounts, we do, and in others, as Steve said, we have a very strong group of club partners that we work with regularly to underwrite and close larger loans without syndication risk.

How is the changing regulatory environment impacting middle market lending? To what degree are you seeing evidence that banks – facing stricter capital reserve requirements – are lending less? And what about competition with respect to pricing?

CC: One way to illustrate the current regulatory environment is that when we talk to bank lenders about a specific credit, the first thing they do before they dig in deeply is determine internally what the credit rating will be within their institution. So they are focused primarily on the risk rating rather than the collateral. And I think that's a shift from previous years when poorly rated credits with good collateral could be done more readily with banks. It's clear that most banks today are focused on the risk rating and to make sure it fits their criteria from a credit rating standpoint. It's binary. The business development officer may determine that the borrower has good collateral. But if the credit comes back with an unsatisfactory risk rating, it will be declined. I think what's driving this is the increased regulatory oversight and banks being fairly conservative in credit at this stage in the credit cycle.

SM: I believe banks know that an increasingly difficult regulatory environment is coming. Some banks are already starting to operate as if that new regulatory environment is in place, but most are not changing day to day behaviors in the marketplace. I'm hearing: "We do discuss it, but today we're doing nothing differently." It is coming but banks appear more concerned with near term performance than how they will manage once the new regulatory environment is put into place. Eventually, despite market conditions, the regulatory environment is going to change behaviors and will result in banks being more conservative.

CC: The regulators don't get on their case about price. They get on their case about credit

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and the global portfolio. Now, where pricing will be impacted from a regulatory standpoint is when banks are required to comply with Basel III standards. That will impact cost of capital – how much banks have to reserve of each loan based on the credit rating. So yes, pricing in the future, maybe as early as next year, is going to be more of an issue. Today for a really good quality credit, pricing is not an issue.

And to what degree is that generating opportunities for private debt capital providers and institutional investors?

CC: In terms of credit, we operate in a space where banks have retrenched and effectively created a market for us. Our market this year is better than it's ever been. We're growing rapidly. We're establishing ourselves as a leader in the secured lending segment of the middle market in the non-traditional, non-bank space. 2012 will be record year for us. Part of that may be driven by a number of leveraged buyout loans we've done this year that just didn't fit the mold of traditional lending, some have been for companies that have gone through a bankruptcy, or are in a transition/recovery, for instance, and most of the senior lenders have stayed away from that.

Assuming that U.S. tax laws governing corporate tax rates and capital gains will change at the end of the year, what do you expect the impact to be on dealflow – in particular in terms of M&A activity as well as dividend recaps?

SM: I expect it will lead to increased activity and increased debt opportunities for us. From a dividend recap perspective, yes. From an M&A perspective, if you are not in market right now with an M&A process, 90 days is not much time for due diligence, to get it funded, and closed. As discussed above, it feels like transactions are taking longer than ever to get completed. I think there will be a year end rush. But even so, it really needs to come in the next 30 days or it won't be able to meet that year-end timeframe.

After a surprisingly busy summer, what is your outlook for the remainder of the year?

CC: Because it's an election year, there will be continued uncertainty for the remainder of the year. Even after the November election, we won't know what the impact will be until early next year. I also think that we are going to see a very busy 4Q12 because of increased M&A and dividend recap activity. We've had a record year and we've got a very strong pipeline. I'm anticipating that level of activity will continue to be excellent for us, and generally for the market.

SM: I still feel market certainty and confidence is fragile, so a major European event or negative economic indicator within the U.S. could still create choppiness and delay deals coming to market. I don't think the market will power through negative information just because demand is strong. But I agree with Colin: it's a good environment, as long as general economic information remains stable.