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Middle-market banking | Pockets of credit

Nineteenth-century banking makes a comeback

CONSIDER the priorities of the leaders of big American financial institutions in the aftermath of the financial crisis. They must cope with a deluge of murky new rules, respond to reams of litigation, reorganise mind-boggling capital structures, pacify anti-banker mobs (and anti-banker reporters), and cut compensation while artfully preserving their own perks.

Put simply, says the head of one vast and troubled financial institution, risk must be reduced, liquidity increased and costs controlled. Missing from the list: providing credit for borrowers.

One of the many vacuums this emphasis has produced is for middle-market lending—a statistically murky category whose rough definition could be credit for companies small enough to lack access to public markets but big enough to require vastly more funding than informal channels such as friends and family could provide.

Not long ago this was prime territory for banks. It has not been entirely abandoned. GE Capital, CIT, SunTrust, Wells Fargo, US Bank and Bank of America are significant participants. But thousands of smaller banks, once a mainstay of this market, are no longer in business. Others have merged and lend less to midsized firms than their constituent parts once did.

Among the reasons for this withdrawal are the managerial challenges of analysing the creditworthiness of small companies with none of the crutches that come from credit-rating agencies and the public data disclosed by larger firms. New, onerous regulatory demands tied to lending, not least rules requiring banks to set aside more capital against loans, do not help.

That has provided an opening for a raft of new entrants. Golub Capital, which is thought to be a leading participant, receives special notice, not only because its loan portfolio grew by 25% this year to $5 billion, but also because it says much about the shifting financial landscape.

After spending time at various well-known banks, Lawrence Golub created a debt-oriented investment fund in 1998 on the premise that the market for loans to firms had already thinned. His timing initially appeared disastrous—it was the peak of easy money from stockmarket investors—but now looks clever. It took him three years to invest a piddling $150m in seed money and only another three to become a significant force.

Golub's scope is limited. It provides credit to about 150 borrowers within a handful of categories: including business software, aerospace, health care and direct marketing. Property, biotech, energy extraction and commodity manufacturing are shunned. It is structured with a parent company running various funds, each of which targets a different kind of debt, from senior secured to mezzanine, tied to the risk preferences of investors. Most importantly, loans are always held to maturity. Credit analysis is everything.

Early this year Medley, another middle-market lender, launched a public fund. It had been founded in 2005, as was CIFC, an asset manager that is indirectly backed by Harvard's endowment. In 2006 yet another middle-market lender emerged, Churchill Financial, and its founder had worked at too many places to count.

Although all of these companies have different operating models, they share certain characteristics beyond the size of their target investments: their primary managers come from prominent firms, funding is by institutions or family offices rather than insured deposits, and loans are held to maturity. They also appear to be doing well. "There are lots of growing companies to finance even in a flat economy," says Joe Schmuckler, Medley's managing partner. Whether their success continues is absolutely not guaranteed. New competitors are sniffing opportunity, including some specialised hedge funds.

The institutions providing these lenders with capital require meaty returns, not merely a modern replacement for a mattress. That has huge implications for their funding costs, which will be relatively high. Moreover, since deposits are not insured, there are no provisions for public bail-outs. Some of these companies may be successful; others may disintegrate.

That makes them radically different from modern banks, but not all that different from what banks looked like in the 19th century. In short they will be institutions that will take risks on the real economy—a trait that at the moment is all too rare. ■

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