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Dissecting a Lender Finance Transaction

By Valerie L. Gerard, George Lehnertz, and Patricia Voorhees

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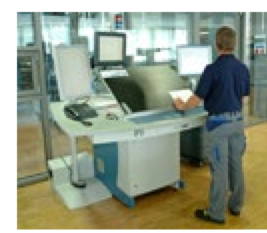
Problems and Issues for Brokers, Lenders and Referral Sources Under the California Finance Lenders Law

By Andrew K. Alper

The California Finance Lenders Law governs what brokers and referral sources may or may not do when brokering or referring commercial loans. The most recent revision, however, is causing confusion for various parties including lenders. Equipment leasing and finance organizations are seeking guidance from the state's Department of Business Oversight. Most likely, these groups also will be working to amend this law.



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Dissecting a Lender Finance Transaction

By Valerie L. Gerard, George L. Lehnertz, and Patricia M. Voorhees

In the aftermath of the Great Recession, new entrants — alternative, or nonbank, lenders — in such areas as financial-technology, venture capital, private equity, and even insurance — are providing more funding options for equipment lessors. Independent lessors stand to gain because of their nimble, yet disciplined, approach to origination and portfolio management.

The lender finance market today is thriving, characterized by significant growth opportunities for traditional bank and nonbank lenders, as evidenced by the number of new entrants. They have been providing more funding options for equipment lessors since the end of the Great Recession of 2007 to 2009. This situation represents a vast turnaround from the recession, when banks pulled back their lending activities to all but their top clients and nearly shut down the lender finance arena.

Nonbank lenders eagerly filled the small and medium business lending void created by the banks. These alternative lenders are so successful that they now, ironically, are the largest users of bank lender finance products. Traditional lender finance providers and nontraditional lenders — financial-technology (fin-tech) venture capital, private equity, and insurance firms — are looking at equipment lessors with renewed enthusiasm, given lessors' attractive performance throughout the recession. Looking ahead, independent leasing companies will continue to attract interest from lender finance providers because of the independents' nimble, yet disciplined, approach to origination and portfolio management.

WHAT IS LENDER FINANCE?

Lender finance is defined as specialized lending to nondepository financial institutions, secured by a portfolio of financial instruments executed by third-party obligors. The lenders vary, from traditional banks to newer entrants such as fin-tech venture capital, private equity, and, to a lesser extent, insurance firms.

Nondepository financial institutions, collectively known as alternative lenders, comprise the qualifying borrower base and include equipment leasing companies, asset-based lenders, middle-market loan companies, time-share companies, transportation lessors, healthcare lenders, and tax lien aggregators. Table 1 provides a complete description of the various alternative lenders as well as representative participants within the respective asset classes.

Market Size

The lender finance market is composed of several asset classes or end-user customers within the alternative lender universe, such as equipment lessors, asset-based lenders, and business development companies (BDCs). Although there are no league tables or formally tracked market-share statistics, the overall market size tends to be quite elastic, expanding and contracting in tandem with economic conditions as well as emerging, financeable asset classes.

Equipment leasing's share of the lender finance market is measured by the total balance sheet assets of independent lessors plus an assumption about usage by certain captive finance organizations. Anecdotal evidence suggests that the Equipment Leasing and Finance Association's lessor membership accounts for anywhere between 20% and 25% of the lender finance market.

Banks are attracted to the lender finance market because it allows them to participate in certain asset classes that are difficult, for either regulatory, structural, or geographic reasons. As an example, because rail operating lease assets are dominated by a few

Table 1. Representative Examples of Alternative Lenders

Type	Description	Representative participants		
Equipment lessors	Providing both lending and leasing options for a variety of commercial equipment from small businesses to large, global corporations	• Ascentium Capital • LEAF Financial • Cisco Capital • Xerox Financial Services	• EverBank Commercial Equipment Finance • Hitachi Capital America • De Lage Landen Financial	• US Bank Equipment Finance • Deutsche Leasing • Element Financial
Transportation lessors	Specializing in leasing commercial transportation equipment	• Chicago Freight • Ryder • TAL International • American Railcar Leasing	• Penske Truck Leasing • Idealease • GATX • Trinity Leasing	• Air Lease Corp • Banks and equipment lessors
Asset-based lenders	Lending to businesses secured against inventory, accounts receivable and equipment	• Abacus Finance • Gerber Capital • New Star Business Credit • NXT Capital	• Oxford Finance • Prestige Capital • Saas Capital • Sierra Lending	• Major banks and equipment lessors
Middle-market loan companies	Providing a range of financings to businesses with revenues between $50 million and $1 billion	• CBAC • Cerebus Business Finance • Culver Capital	• Fifth Street Asset Mgmt. • MidCap Financial	• Banks, insurance companies, and equipment lessors
Time-share lenders	Financing fractional ownership in properties such as campgrounds, and recreational vehicles	• Capital Direct (Canada) • CapitalSource • LightSteam (SunTrust div.)	• Prosper (P2P) • TimeshareLending.net	
Healthcare lenders	Offering terms financing and revolving lines of credit for healthcare service providers	• AccessOne • Healthcare Finance • Gemino Healthcare • Lending Club	• Triumph Healthcare	• Captives of healthcare OEMs, major banks, and equipment lessors
Tax lien aggregators	Managing tax assets such as tax liens, structured settlements, and REO assets for investors, municipalities, and institutions	• Tax Ease • Terra Echelon LLC • MTAG Services	• Alterna • Law firms	
Business development companies	Offering publicly traded, closed-end funds that invest in private and public companies	• Ares Capital • Harvest Capital • Golub Capital • Medallion Financial	• Monroe Capital • Prospect Capital • Rand Capital • Solar Senior Capital	• TICC Capital

Source: The authors have developed all illustrations for this article.

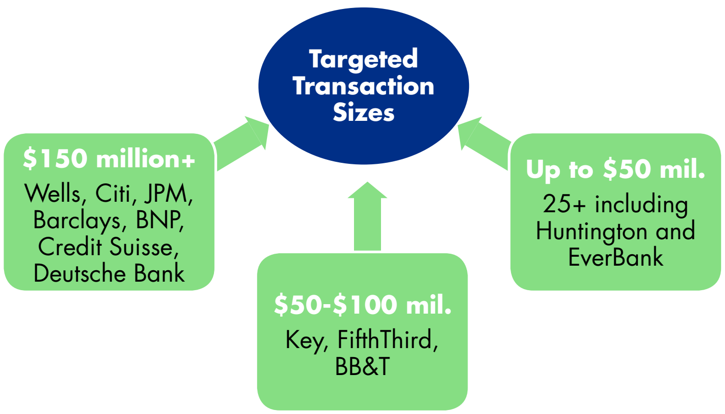
players, it would take years to obtain scale, let alone regulatory approval. However, a lender can profitably, more efficiently participate in this asset class by simply partnering with lessors that have the origination platform. Lender finance clearly enables the banks to develop significant scale in origination, asset, and obligor management.

> The number of lender finance participants has significantly expanded from 10 significant participants 15 years ago to about 50 participants today.

The Lenders

The number of lender finance participants has significantly expanded from 10 significant participants 15 years ago to about 50 participants today. These new entrants (again, mostly nontraditional lenders such as fin-tech venture capital, private equity, and even insurance firms) are attracted to the strong growth rates and attrac-

Figure 1. Three Tiers or Hold Positions of Lender Finance Participants



tive margins in the financeable new and emerging asset classes such as alternative lenders.

Lender finance participants generally fall into three categories that are a function of their hold position (Figure 1). At the top are investment banks and large money center banks that provide credit lines in excess of $150 million to $200 million as well as securitization and investment banking services. The next tier is large regional banks with significant footprints in the United States. Their lending sweet spot is in the $50 million to $100 million range. The final tier is comprised of regional banks, independent equipment lessors, and select captives offering credit lines up to $50 million.

THE STACK OF LENDER FINANCE PRODUCTS

Lender finance products that are available to independent leasing companies typically fall into four broad categories: discounting paper, warehouse lines, bank lines, and securitization (Figure 2). The product or, more likely, the mix of funding products a lessor uses is largely dependent on where the lessor is situated in earning assets, in growth, and on the performance spectrum.

Discounting paper is the primary funding tool for small lessors that do not have the level of equity to hold significant assets on their balance sheet. Similarly, larger independent and bank lessors use a form of discounting paper, buy/sell desks, to manage customer credit or vendor concentration risk and to enhance current margin.

Regional banks offer warehouse lines, often to lessors that have established a performance track record and have built some equity. These lines are typically in the $10 million to $100 million range, are secured by the underlying lease or loans, and allow lessors to hold transactions for typically up to 12 months before selling them to investors, which include the buy/sell desks described above.

Once a lessor has achieved meaningful scale and above-average portfolio performance, it may become eligible for bank lines, which are offered by regional, large national, or international banks. The rest of this article will analyze such a bank line.

The most sophisticated tool in the lender finance spectrum is securitization transactions of portfolios above $100 million, which carry a rating by a rating agency and offer a 35 to 50 basis point cost advantage over bank lines. The largest independent lessors use securitization, together with bank lines and transaction and portfolio sales, to optimize cost of funds and funding capacity.

Figure 2. Lender Finance Products and Lessor End-User

Lenders	Lending products	Lessor borrower
Investment banks, money center banks	Syndicated bank lines > $100 mil.	Largest captive and independent lessors > $100 mil. equity • 11 captives • 11 independents
	Securitization	Large captive and independent lessors $25 – $100 mil. equity • 2 captives • 18 independents
Bank leasing companies, large independents and captives	Warehouse lines	Medium nonbank independent lessors and captives $10 – $25 mil. equity • 9 captives • 20 independents
	Discount / Buy/desk purchases	Nonbank lessors, captives and brokers Up to $10 mil. equity • 145+ companies

> The most sophisticated tool in the lender finance spectrum is securitization transactions of portfolios above $100 million, which carry a rating by a rating agency and offer a 35 to 50 basis point cost advantage over bank lines.

> Together with securitization, bank lines offer a perfect pairing, enabling fluid capacity for lessors to fund volume, package for sale through securitization, and free up new capacity.

DISSECTION OF A BANK LINE

Lenders remain eager to lend to independent finance companies, yet the bar to qualify has risen. Due to increased bank capital requirements following the Great Recession, lessors are seeking diverse funding sources via multiple bank lines. Together with securitization, bank lines offer a perfect pairing, enabling fluid capacity for lessors to fund volume, package for sale through securitization, and free up new capacity. In this section we will review key aspects of a bank line, including the underwriting and the elements and mechanics of a deal.

The Underwriting

The underwriting process for a bank line involves the evaluation of information developed under the criteria presented in Figure 3. There are three central questions lenders are asking:

- Who is this company?
- How has it performed against its plan and peer group?
- Does it track, measure, and report in a manner easily evaluated by a lender?

Answers to each of these questions will ultimately determine the lessor's eligibility for a bank line and drive the pricing and terms. The strength of the balance sheet, financial performance against plan and peers, and in particular, the amount of tangible equity, (typically a minimum of $10 million but $25 million is deemed well capitalized) will determine whether a lessor meets a bank's underwriting standards.

Figure 3. Lender Finance Underwriting Criteria

KPIs–key performance indicators

Bank lines typically have a 1- to 3-year term and range from $125 million to $300 million. Pricing is in the 100 to 275 basis point range over 30-day LIBOR for used lines and 25 to 35 basis points for the unused portions. A crucial piece of the underwriting that significantly affects price is the advance rate. Advance rates provide a cushion for credit losses for the lender and are based on the overall borrowing base.

The borrowing base is the total amount of volume projected for a bank line or total assets pledged. Based on the loss history of the borrower's portfolio and the credit mix of the end-user borrowers, the bank will settle on an advance rate for each line. For example, if the advance rate is 92%, the line will fund 92% of each transaction with the remainder funded with the lessor's equity. Because the entire portfolio secures the line, the bank is protected on losses up to 8% suffered in the secured portfolio.

Deal Elements

A key document governing a bank line is the security agreement. The first purpose of this agreement is for the borrower to grant the lender a security interest in the underlying lease assets. In doing so, the borrower assigns, grants, and conveys its rights, title, and interest to the lease documents and all payments payable under the lease as well as a security interest in the leased equipment.

The security agreement establishes what the borrower is representing and warranting about the assets, any covenants or promises it is making, and the services it will perform. The purpose of representations and warranties is to assure the lender that the borrower has

Table 2. Common Key Representations, Covenants, and Service Obligations

Representations and warranties	Corporation is licensed and in good standing. Borrower has delivered GAAP-compliant audited recent financial statements. Representations and warranties in the lease documents have not been breached. No Information has been withheld that adversely affects lender's interests. All taxes have been paid.
Covenants	Equipment under the lease has been delivered and accepted. Borrower will not assign rights and interests in the leases to anyone other than lender. Lease provisions will not be modified without consent. Borrower will maintain full and complete GAAP-compliant financial records.
Service obligations	Collection of payments Payment reconciliation Delinquency reports Establishes lender's ability to assume billing and collections in the event of borrower payment default, inability to service, or bankruptcy

good title to the assets and that the borrower has not otherwise incurred indebtedness secured by the same assets that pledged to the bank line. Table 2 summarizes common key representations, covenants, and service obligations.

Deal Mechanics

The timing and amount of payments by the borrower against the indebtedness during the term of the bank line are laid out in the promissory note, another key document associated with bank lines. As amounts under the line are paid off due to leases reaching their end of term or assets being securitized, capacity is freed for new funding. The agreements spell out conditions under which the line begins amortizing, largely due to portfolio deterioration or degradation of the borrower's financial position, or by reason of default.

Reporting required during the term of the line is robust, as is described in Table 2, and it is designed to assure the lender that the borrower and the assets remain of the same quality or better than at the time of underwriting. Areas of reporting include full financial statements, account delinquency, losses, lease margins, and credit and collateral mix of the lease assets. Losses include static pool analysis, or the net losses sustained in a pool, typically a fiscal year, of originated transactions.

OPPORTUNITIES AND CHALLENGES FOR LENDER FINANCE PROVIDERS

Opportunities

Lender finance presents a growth area for lenders, as demonstrated by the emergence of a new breed of financeable asset classes within the alternative lender space, namely fin-techs such as OnDeck, Kabbage, and PayPal. Based primarily on the lack of performance history, margins on lending facilities to these new asset classes are quite high, thus offering substantial profit opportunities.

As that sector grows and demonstrates cycle-tested performance metrics, its need for financing products will evolve from plain vanilla credit lines to even more lucrative products such as securitization in order to benefit from competitive funding capacity for growing volume.

Challenges

The key challenges facing lender finance providers are three:

1. The regulatory compliance burden continues to get heavier every year and is driving up the cost of compliance, which, in turn, has increased the overall cost of lender finance transactions.
2. A related regulatory challenge is the possibility that the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Federal Reserve System will lump lending to alternative lenders with highly leveraged transactions (HLTs). Some regulators believe lender finance transactions exhibit leverage characteristics common to HLTs, which are restricted for banks. Thus, it is up to the banks to explain the structural differences between HLTs and lending to alternative lenders — namely that the financings are typically on a portfolio basis and are well structured, with eligibility requirements for investments.
3. The final major challenge comes from some of the lender finance providers' own customers, namely the asset-based lenders, middle-market loan companies, and BDCs, which eagerly provided credit to small and medium-sized businesses during the financial crisis, when the banks tightened their risk acceptance criteria. These firms constitute the fastest growing competitor, drawing away historic bank customers. Also pressuring the banks are the fin-techs, which are using new tech-

> Lender finance presents a growth area for lenders, as demonstrated by the emergence of a new breed of financeable asset classes within the alternative lender space.

nologies to reach traditional bank customers and therefore are disrupting the traditional go-to-market practices.

OPPORTUNITIES AND CHALLENGES FOR USERS OF LENDER FINANCE

Opportunities

The securitization market has strengthened post-crisis and continues to provide a consistent tool for medium to large independents to fund their growth. The strong performance of the leasing asset class during the Great Recession has not gone unnoticed by nonbank lenders and investors — such as insurance firms, hedge funds, and venture capital funds — that have made forays into investing in the industry on both the debt and equity side.

Regulatory pressure has meant that some banks have narrowed the focus of their own direct leasing companies, thereby reducing the competition in the lower credit and smaller ticket credit sphere. This gap is creating an opportunity for alternative lenders as well as a chance for smaller to medium-sized independent lessors active in this product space to maintain or improve pricing margins.

Challenges

There are four key challenges facing independents using a lender finance product:

1. Availability of funding for growth is a significant and ongoing challenge for independent lessors. Only the largest independents — roughly 20% of ELFA's lessor membership — qualify for the underwriting criteria required by the banks. That leaves about 100 independent lessors in need of funding beyond the target market for large lender finance providers.
2. Compared to bank lessors, independents with access to bank lines and the securitization have a 100 to 200 basis point cost-of-funds disadvantage. To bridge the pricing gap with the banks, these medium to large independent lessors must continually enhance the flexibility of their product offerings, service levels, expertise in select equipment types, industry specialization, and focused client relationship management.
3. Independents must continue to diversify their funding sources, especially in light of the continued uncertainty around bank regulations. Of particular concern is whether the lenders will view higher levels of managed solutions deals as ineligible for funding because of existing financial covenants around eligible assets.
4. Alternative lenders are beginning to encroach on traditional independent lessors. If fin-tech alternative lenders were to experience significant losses on their working capital and loans in the next economic downturn, that development might prompt regulatory concern that this performance will spill over to small-ticket lessors generally. The resultant regulatory costs and complexity may very well render some business models unsustainable, as increased pressure on pricing and underwriting standards will threaten the ability of alternative lenders to achieve an acceptable return on investment.

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Valerie L. Gerard, a managing director with The Alta Group, is based in Nanaimo, British Columbia. She leads Alta's management consulting practice. Her consulting work focuses on market entry, capitalization strategy, rating agency advisory and market intelligence projects. Working in the financial services, media, and telecommunications industries over the past 25 years, Ms. Gerard has developed deep expertise in business strategy, capital markets/funding, corporate reputation, investor relations, and rating agency relations. Before joining The Alta Group in 2010, she founded Intellectual Capital Advisors. Earlier, she served as chief investor relations officer for several S&P 500 and FTSE 100 companies in New York and London, such as CIT Group, Cable & Wireless, Dow Jones & Co., and AT&T Capital. She ran Fitch's Finance and Leasing Co. Group, where she published more than 100 pieces of industry and company-specific research. Ms. Gerard formerly chaired ELFA's Investor Relations Advisory Task Force and launched the association's first investors conference. She completed the advanced management program at Harvard Business School and received her undergraduate degree at Vassar College, Poughkeepsie, New York.

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Based in Chicago, George L. Lehnertz has been a director with The Alta Group since 2011. He brings executive experience with vendor and captive finance services, domestic and international financial institutions, and industry mergers and acquisitions. He has helped develop, build, and manage profitable business operations; purchase, sell, and integrate companies; and create successful business teams. From 2004 to 2007, he served as managing director of Banc of America Leasing's Global Vendor

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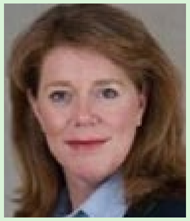

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