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For Some Middle Market Companies, A Sudden End to the Credit Crunch

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Although credit conditions remain difficult for many U.S. companies following a deep recession and a painful banking crisis, now might be the time to act for middle market companies in need of bank financing.

Earnings pressures are driving U.S. banks to ramp up commercial and industrial (C&I) loan volumes. This rush is creating fierce competition among banks for the loan business of a much-diminished pool of middle market companies that have both an immediate need for credit and the financial strength to qualify for a loan. While many small and mid-sized businesses or companies with weaker financials continue to struggle to secure any credit at all, companies falling into this select group are being wooed by banks with offers of lower prices and longer loan durations.

Banks' performance projections for 2010 included assumptions of a meaningful recovery in C&I lending levels. However, because that loan demand never materialized, bank management teams are getting worried about earnings and they are getting more aggressive to hit their targets.

During the global market crisis, banks that were relatively unscathed assumed that business from harder-hit firms would naturally flow in their direction. For at least a brief period those assumptions proved correct for deposits. However, the actual amount of new lending business won by the strongest U.S. banks has been much less than expected. In part that has been due to the speed with which public concerns about bank solvency receded following the dramatic government interventions in 2009. Banks that would have otherwise gone bankrupt were saved, meaning that clients and business that would have been freed up in a more Darwinian process never left the troubled institutions.

In addition, all U.S. banks have experienced a sharp reduction in corporate loan demand. The share of middle market companies reporting that they borrowed money from a bank declined to 22% in 2009 from 44% in 2008. By the first quarter of 2010, companies tended to fall into one of three categories. On the one hand, many of the healthiest companies in the United States had taken out costs, put expansion plans, capital expenditures, and M&A on hold and built up strong cash positions during the crisis. These companies are coming out of the recession lean, cash rich and with little need for bank loans. On the other hand, companies that couldn't or didn't respond as well to the economic slowdown experienced deterioration in their businesses and balance sheets. These companies now often fail to meet banks' newly tightened credit policies and can't qualify for loans. What loan demand has emerged so far in 2010 had come from the smaller group of remaining companies that survived the recession with their financial health intact and are ready to make investments for future growth.

Companies in this last group find themselves in an enviable position. Top executives at U.S. banks report that prices on credit are falling dramatically due to the intense competition among banks — including both the healthiest banks and those most negatively affected by the global market crisis. In addition to lower pricing, banks are courting companies in this group with longer duration loans. While most companies have found it impossible in recent months to find loans with durations in excess of 3-5 years, banks are now willing and sometimes even eager to extend to 5-7 years. It's incredible that just months after the credit crisis, we again find ourselves in the position of too many lenders chasing too few deals.

The only thing bankers insist is not negotiable in the current environment is structure. Given the recent history of the banking industry, however, it is hardly an idle concern to wonder if structural requirements and credit quality will eventually begin to give way to competition. Complicating the situation for banks is a shortage of experienced C&I bankers following a decade-long period in which real estate lending dominated the U.S. banking business.

Pricing Plunges

Bank executives confirm that the decline in middle market C&I loan prices in recent weeks has been dramatic. During the crisis, a standard pricing floor emerged at about 300-400 basis points over LIBOR. Bankers now say that floor has been abandoned and that loans are getting done at much lower rates.

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Contributing to the magnitude and speed of this decline is the fact that companies have become more willing and adept at pitting one bank against another. Companies responded to the uncertainty of the global credit crisis by reaching out to new banks while maintaining existing relationships with their primary banks. Historically, only about 10% of middle market companies alter their banking relationships in any given year. During the credit crisis and into 2010 that share hit 30%.

New relationships were often formed with smaller regional banks and community banks that companies initially viewed as back-ups to current credit providers. However, companies quickly began shifting banking business to their new bank partners. Fifty-five percent of companies that formed a new banking relationship last year shifted up to a quarter of their business to the new banks and 25% of these companies moved three-quarters or more of their banking business to their new providers. What we saw was a near complete erosion of trust between companies and certain banks that were perceived as leaving them high-and-dry. Half the companies that formed new bank relationships over the period did not even bother to discuss it with the existing banks.

Conclusion

It is these same jilted companies to which banks are now turning as they look to ramp up loan volume. Of course, so close on the heels of the near-complete shut-down of corporate credit markets, companies are anything but an unwilling audience.

Banks are succeeding in creating that hockey-stick pattern in middle market C&I loan volumes, but they are competing very hard to win this business in the face of stiff competition. At a time when the economy is hardly on solid ground, we hope banks will not begin to comprise on loan structure or credit quality. We might soon find out whether the banks have learned their lesson from the last crisis.

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