# Debt, Distress, and Restructuring of Small, Private Firms

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# DDR of small, private firms

- So far in class: debt, distress and restructuring of large, public firms

- Today: debt, distress and restructuring of small, private firms
  - Small and medium-size enterprises (SME)
  - Middle-market firms (MM)

- Environment very different:
  - No active secondary market (bonds are rarely issued)
  - No credit rating
  - Accounting less standardized (27% SMEs & 73% MMs use audited financials)

# Why care about small, private firms?

- 1996-2019: Number of public firms nearly halved from 8090 to 4266
- Employment (non-farm payroll)
  - 2000: 84M (74%) in private, 29M (26%) in public firms (Davis et al 2006)
  - Each private firm employs more today (Stulz 2020):
    - 1977-2012: Among firms with 5,000+ employees, publicly listed fell from 50% to 27%
- Investments: private firms generally invest more (Asker et al 2014)
  - Avg private (public) firms invest 10% (4%) of total assets each year

# Why care about small, private firms?

- High investments + low access to external equity => debt is crucial!
  - Not those VC unicorns that you hear from the news

- Key questions covered today:
  - Who are the lenders (bank & nonbank)?
  - What types of debt are used? What are contractual terms?
  - How is distress monitored and resolved?

- Separately consider:
  - Small and medium-size enterprises (SME)
  - Middle-market firms (MM)

# Data re. bank lending by firm type (as of 2019)

- Despite recent growth in nonbank lending, we should first look at bank lending universe to understand the relative size of each market

- Total bank corporate lending: \$4.61T commitment & \$2.25 outstanding made by 350 banks (FR Y9C) (Chodrow-reich et al 2022)
  - $\approx$10% are very small SME loans with loan size < \$1M
  - 70-80% with loan size > \$1M made by Fed-supervised banks (FR Y14)
    - Total bank debt held by public firms: \$1.7T
    - Total bank debt held across firm size distribution:
      - Assets below \$50M (mostly SME): \$287B
      - Assets between \$50M and \$1B (mostly MM): \$833B
      - Assets above \$1B: \$2.431T

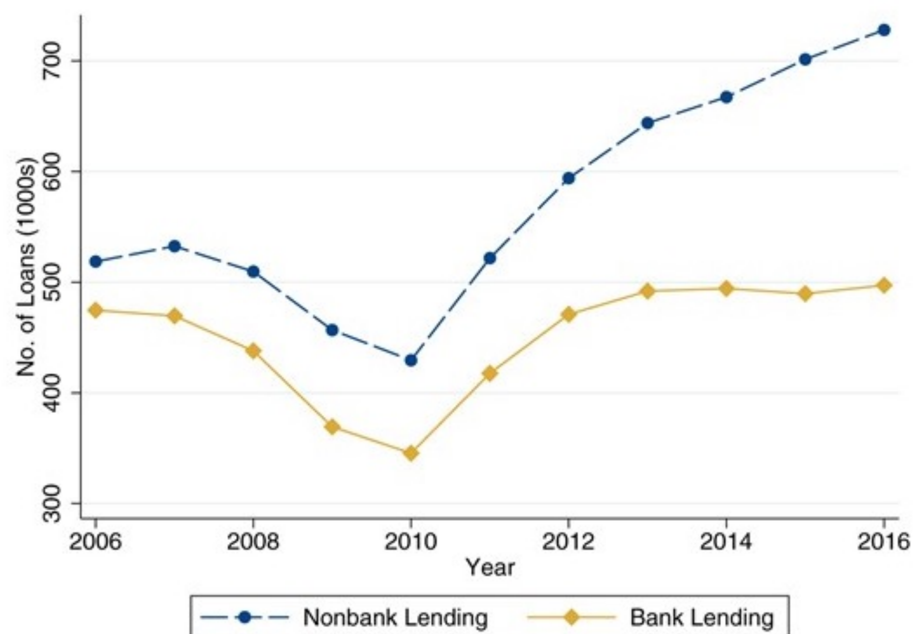
# SME Debt Financing

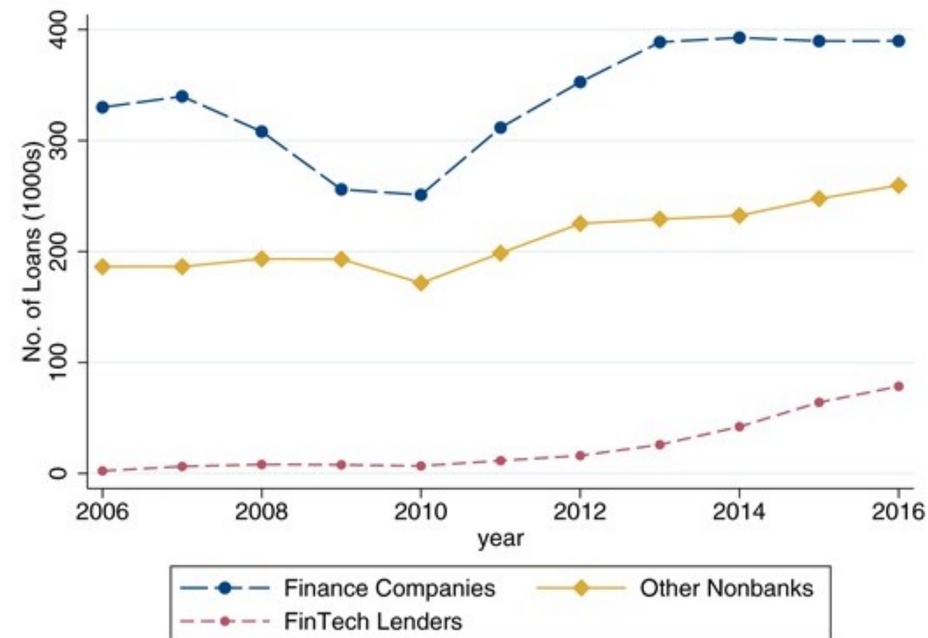
- No standard definition: e.g. assets < $50M or revenue < $10M

- Who are the lenders? (Gopal and Schnabl 2022)
  - Commercial banks (large bank holding companies & small, regional banks)
    - Top 5 banks: Wells Fargo, US Bank, JP Morgan, Bank of America, BB&T
  - Nonbank lenders: Finance companies and Fintechs
    - Unlike banks, no deposits and no capital regulation, and actually rely on bank debt
    - Fintechs primarily lend online
    - Top 5 Fincos: John Deere, CNH Capital America, Kubota Credit, GE Capital, Caterpillar

# Post-GFC rising market share of nonbank lenders

## Based on number of loans (from UCC filings; Gopal & Schnabl 2022)




- Today: around equal market share between bank and nonbank in ~1T SME loan market

# Debt, Distress and Restructuring of SMEs

- Debt type: mostly asset-based loans
  - Common collateral: real estate, equipment, accounts receivable, inventory
  - Interest spread: 3-400 bps (Federal Reserve Survey on Terms of Business Lending)
- Contractual features: borrowing base to limit debt capacity based on estimated liquidation value of pledged collateral
- Restructuring (?): Upon distress, typically hard to restructure and more likely liquidated via Chapter 7
  - Bernstein et al (2019); Lian and Ma (2021)
- Similar patterns across lender types (bank vs nonbank)

# Bankruptcy liquidation rates by firm size

Chapter 7 conversion by firm size 1996-2005 (Bernstein et al 2019)

| Employees in firm: | N Establishments | N Firms | % Liquidated |
|---|---|---|---|
| 0-5 | 8,000 | 7,000 | 44 |
| 6-25 | 11,000 | 10,500 | 44 |
| 26-100 | 11,000 | 6,500 | 41 |
| 101-1000 | 22,000 | 3,000 | 29 |
| 1000 | 77,000 | 1,000 | 13 |

# MM Debt Financing

- Definition varies: sales $10M-1B, EBITDA < $100M, assets $50M-1B

- Equity ownership: Some public, but more private equity (PE) backed

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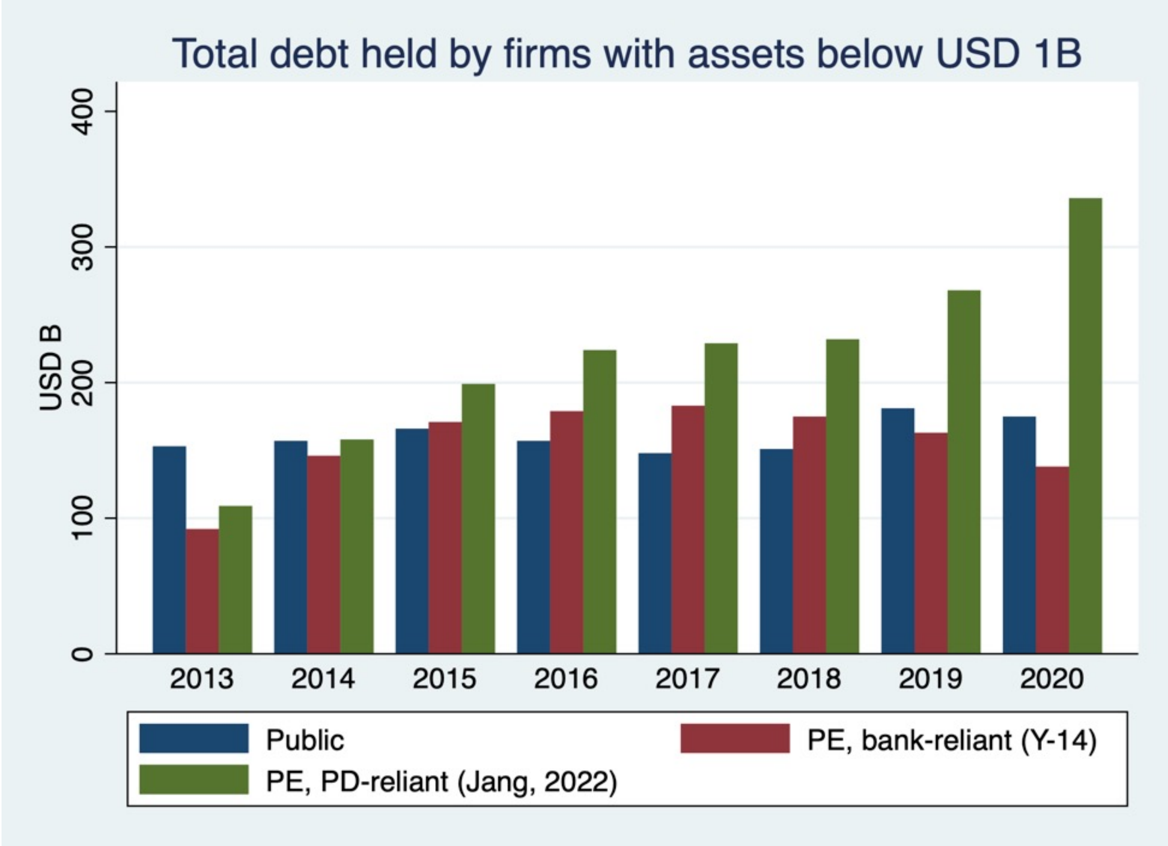


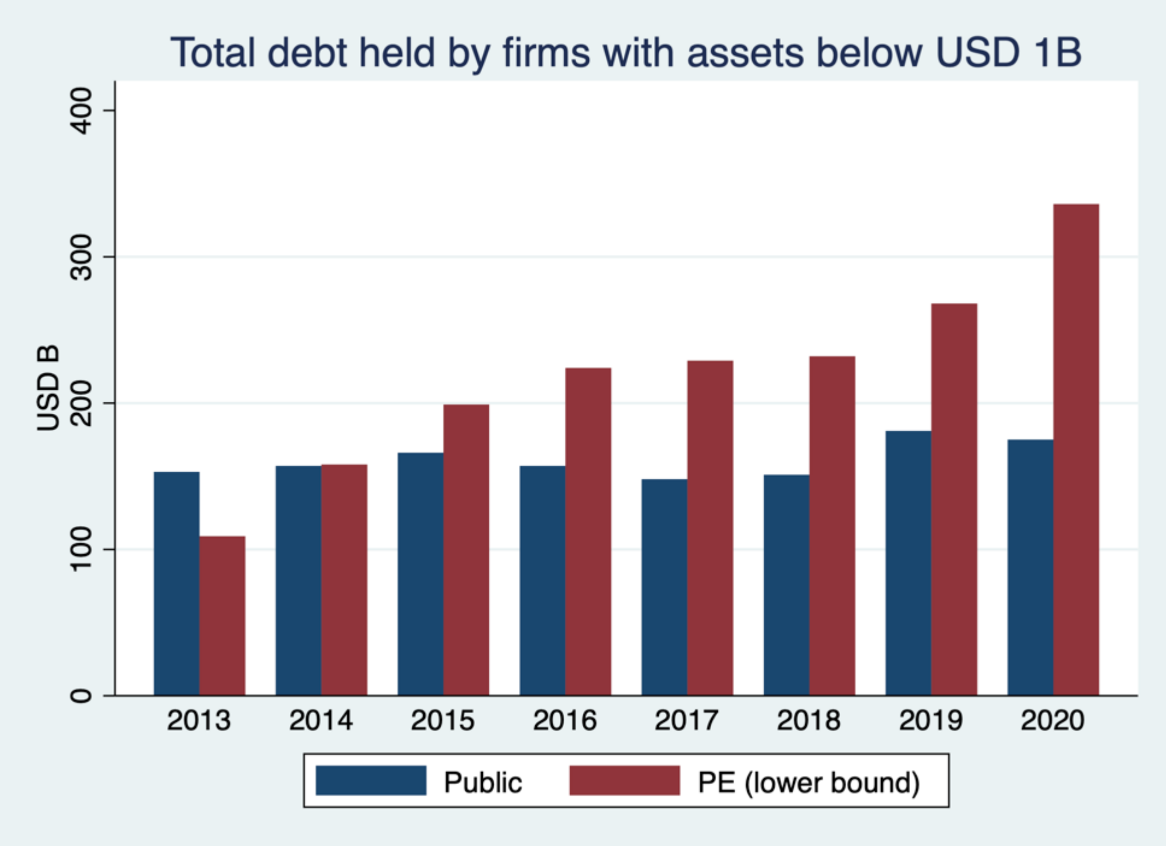


Source: Compustat, FR-Y14 (Haque Jang Mayer, 2023), proprietary database on private debt (Jang, 2022)
PE (lower bound) = max(PE bank-reliant, PE PD-reliant)

# MM Debt Financing

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- Equity ownership: Some public, but more private equity (PE) backed
- More lender diversity than SMEs: beyond banks, nonbanks include
  - Finance companies, insurance companies, hedge funds
    - More common among public firms (Chernenko et al 2022)
  - Direct lenders: Private credit funds & Business Development Corps (BDC)
    - Private credit (aka private debt) fund: Financed via closed-end fund (like PE)
    - BDC: + public equity (like REITs) & asset-level fair value disclosure requirements
  - Middle-market Collateralized Loan Obligations (CLOs)

# MM Debt Financing

Debt types and key contractual features differ by lender type!

- Banks provide both asset- & cash flow-based loans
    - Lian and Ma (2021); Gupta et al (2022)
- Direct lenders mostly provide cash flow-based loans with tighter covenants
    - Block Jang Kaplan Schulze (2022); Jang (2022)
- Other nonbanks more frequently pursue asset-based loans with less proactive covenant-based monitoring
    - Chernenko et al (2022); Gopal and Schnabl (2022)

# MM: Bank-syndicated vs Direct Lending

- Since this is a restructuring course, we focus on those that provide cash flow-based debt: banks & direct lenders
  - Remember, asset-based loans are designed to be liquidated upon distress
- What is direct lending?
  - Rarely syndicated and held to maturity by 1-5 lenders
  - Mostly senior loans (term loan & revolver); 2nd lien & unitranche common
- In both bank-syndicated and direct lending, covenants are most important to monitor distress
  - Often no credit ratings and no active secondary markets

# MM firm features & loan terms at origination (2013-19)

| Loan Type: | Public-Bank | PE-Bank | PE-Direct |
|---|---|---|---|
| Assets (pre-deal, median; $M) | 850 | 363 | 174 |
| EBITDA/Assets (pre-deal, median) | 0.10 | 0.18 | 0.19 |
| Debt/Assets (post-deal, median) | 0.34 | 0.77 | 0.64 |
| Debt/EBITDA (post-deal, median) | 3.83 | 6.30 | 6.29 |
| Loan size (median; $M) | 287 | 278 | 123 |
| Maturity (median; years) | 5 | 6 | 5 |
| Spread (median; bps) | 284 | 488 | 677 |
| I(Financial covenant) (mean) | 0.92 | 0.96 | 0.99 |
| N(Financial covenant) (mean) | 1.84 | 1.50 | 2.09 |
| N(CF-based covenant) (mean) | 1.45 | 1.26 | 1.59 |

Source: Jang (2022)

- PE usually smaller, more profitable, more levered, and pay higher rates than public firms.
- Direct lenders target smaller firms, charge more, and require more covenants than banks.
- In all, financial covenants are almost always there.

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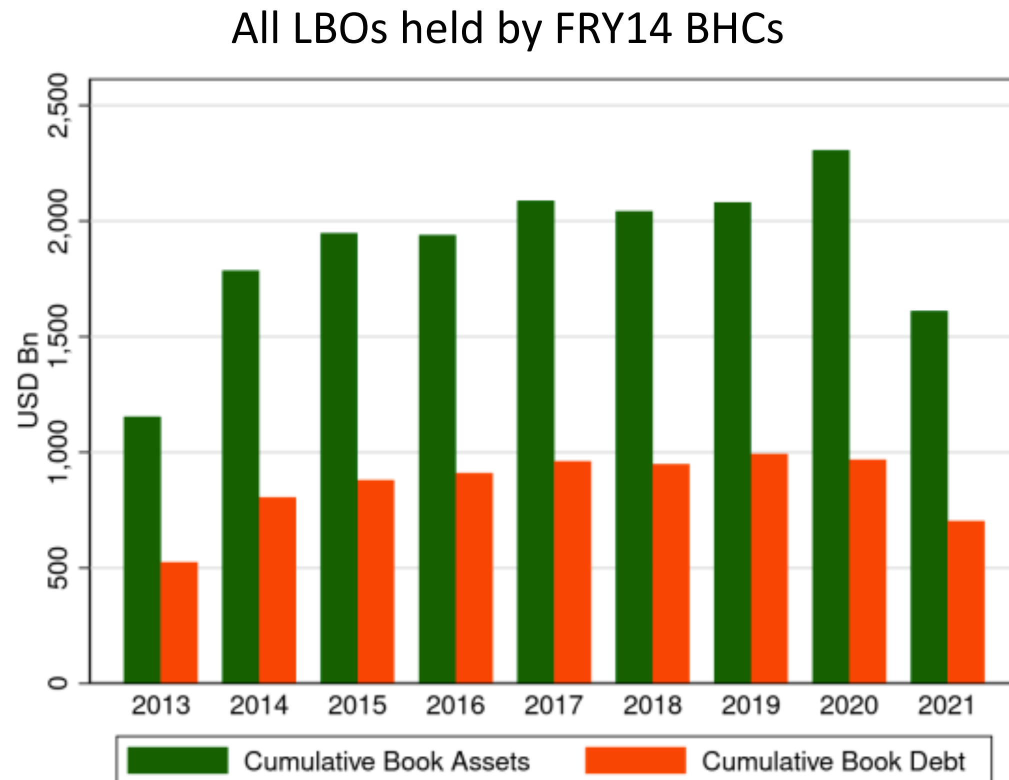
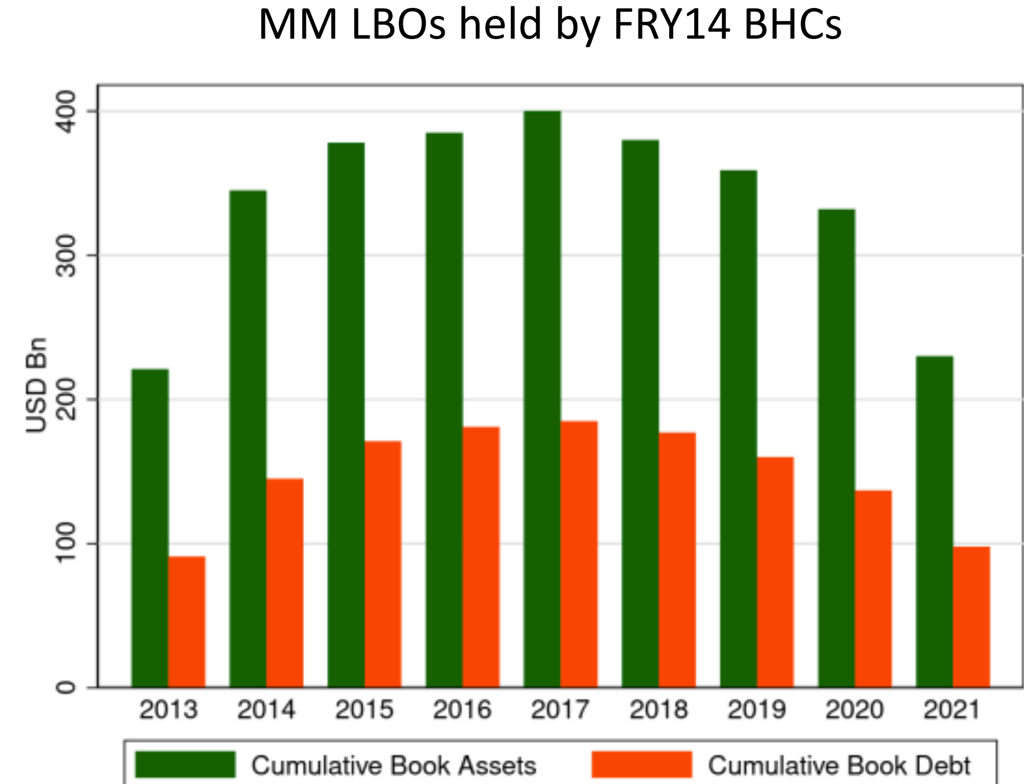
  - Often no credit ratings and no active secondary markets
- Post-GFC trend: direct lenders replace banks, especially in MM LBOs

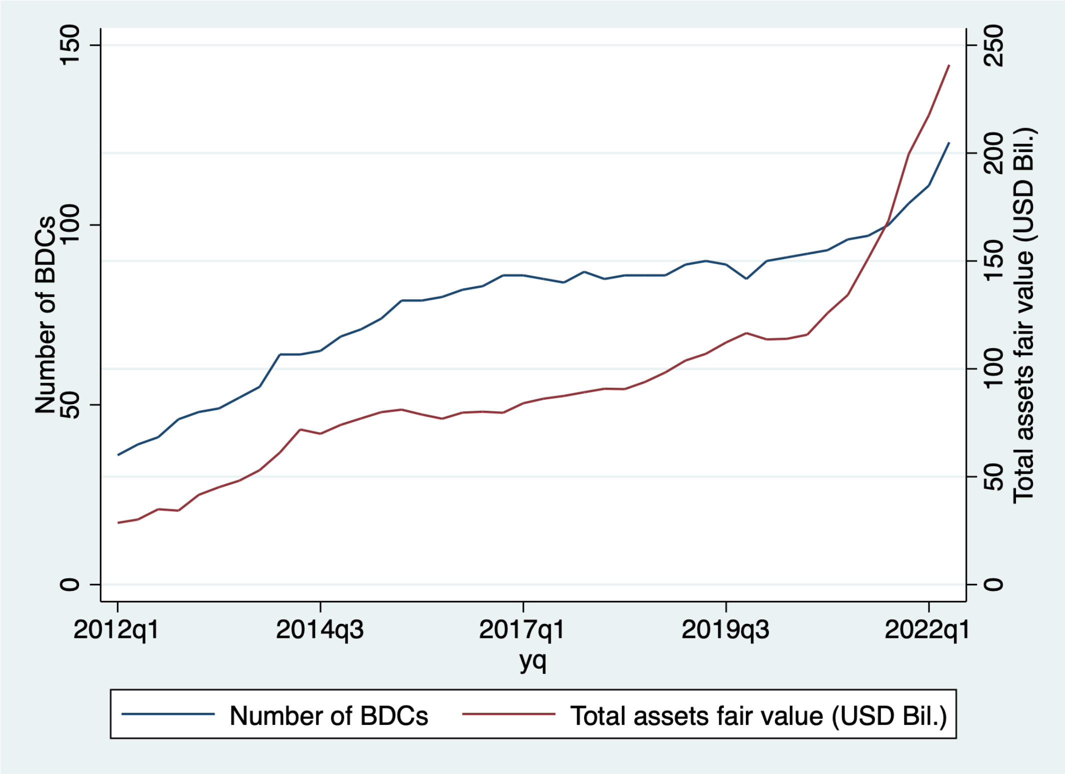
# Among LBOs, only MM shrinking in bank balance sheet

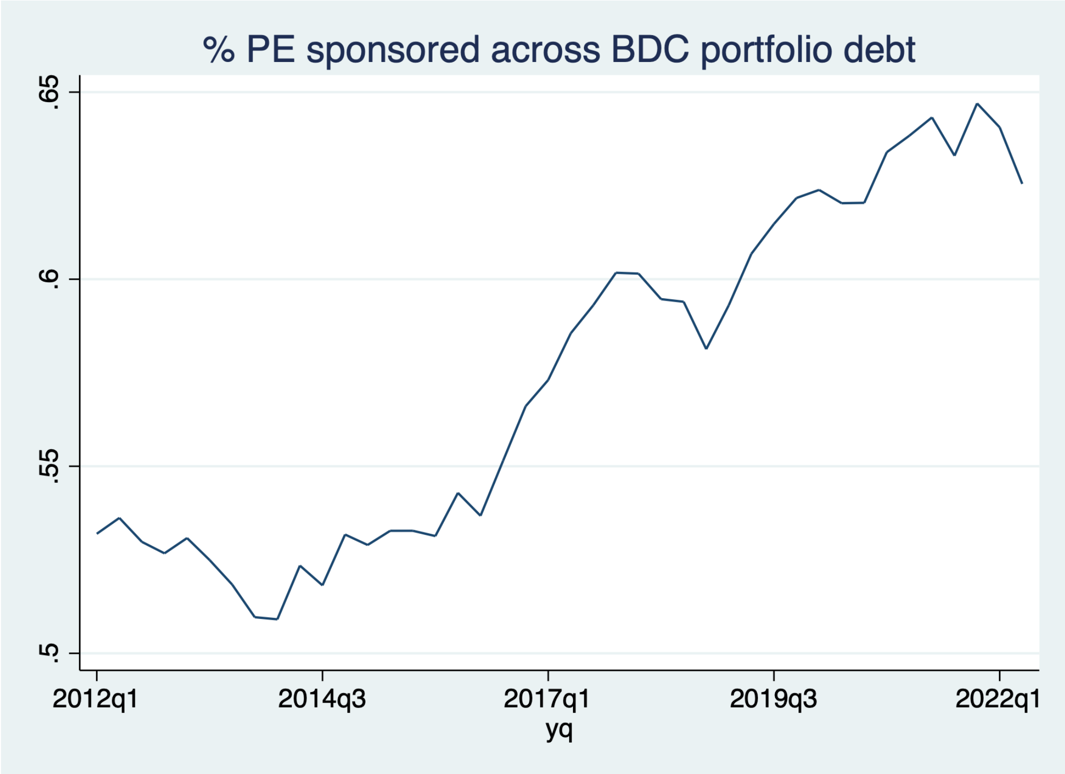



Note: Complete data coverage 2014-2020; Source: Haque Jang Mayer (2023)

# MM LBO gap being replaced by direct lenders




Source: BDC Collateral, Pitchbook

Survey (Block Jang Kaplan Schulze 2022): 78% of direct lending is PE-sponsored

# Why the Increase in Private Debt/Direct Lending?

- Bank consolidation & increased banking regulation
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  - Small size for bank syndication, low tangibility, low transparency
  - Preference for asset-based loans if lend to small firms

# Why do banks would not want to finance companies that are reliant on private debt?

| Answer choices | Europe | | US | |
|---|---|---|---|---|
| | % of respondents | % of responses | % of respondents | % of responses |
| Tangibility: Firm has low amount of tangible assets as quality collateral | 55.2% | 22.2% | 53.3% | 19.8% |
| Profitability: Cash flow is too low or unstable | 30.1% | 12.1% | 26.7% | 9.9% |
| Size: Firm size is too small for bank syndication | 52.4% | 21.1% | 70.0% | 25.9% |
| Transparency: Due diligence is messy due to less clean financials or a lack of sophisticated internal systems | 45.5% | 18.3% | 50.0% | 18.5% |
| Specialization: Firms operating in niche sectors | 37.8% | 15.2% | 23.3% | 8.6% |
| Other/s | 28.0% | 11.2% | 46.7% | 17.3% |

Source: Block Jang Kaplan Schulze (2022)

Banks avoid lending to small firms with lack of tangible assets and low transparency

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- Reliance of direct lenders on PE sponsors for deal flow
- Direct lenders' advantage in providing customized needs
  - Stronger commitments, higher leverage, more effective covenants, and more flexible distress resolution

# Why do firms choose private debt over bank debt?

| Answer choices | Europe | | US | |
|---|---|---|---|---|
| | % of respondents | % of responses | % of respondents | % of responses |
| Certainty and speed of execution (vs long / uncertain bank syndication process) | 83.0% | 23.8% | 91.2% | 23.1% |
| Stable relationship with lender's expectation to hold to maturity (vs bank originate-and-distribute model) | 34.6% | 9.9% | 64.7% | 16.4% |
| More flexible covenant structure | 52.9% | 15.2% | 76.5% | 19.4% |
| Diversification of financing sources | 39.9% | 11.4% | 23.5% | 6.0% |
| Longer investment horizon than banks are willing to support | 39.2% | 11.2% | 26.5% | 6.7% |
| Higher leverage than banks are willing to support | 54.2% | 15.5% | 82.4% | 20.9% |
| Did not approach banks due to fear of rejection | 6.5% | 1.9% | 8.8% | 2.2% |
| Bank loan application was rejected | 28.8% | 8.2% | 5.9% | 1.5% |
| Other/s | 9.8% | 2.8% | 14.7% | 3.7% |

Source: Block Jang Kaplan Schulze (2022)

Direct lenders provide greater commitment, higher leverage, and more flexible covenant structure than bank-syndicated lending

# COVID distress resolution

## PE-backed firms with payment/covenant defaults (Mar 2020 – Mar 2021)

Source: Jang (2022)

| | (1) PE-Direct | | | | (2) PE-Bank | | | |
|---|---|---|---|---|---|---|---|---|
| | N | mean | median | sd | N | mean | median | sd |
| COVID revenue growth | 171 | -0.153 | -0.137 | 0.224 | 59 | -0.179 | -0.163 | 0.190 |
| I(Payment default) | 171 | 0.363 | 0.000 | 0.482 | 59 | 0.373 | 0.000 | 0.488 |
| I(P&I deferral) | 171 | 0.251 | 0.000 | 0.435 | 59 | 0.085*** | 0.000 | 0.281 |
| I(Covenant renegotiation) | 171 | 0.772 | 1.000 | 0.421 | 59 | 0.695 | 1.000 | 0.464 |
| I(Restructuring) | 171 | 0.123 | 0.000 | 0.329 | 59 | 0.305*** | 0.000 | 0.464 |
| I(In-court restructuring) | 171 | 0.029 | 0.000 | 0.169 | 59 | 0.153** | 0.000 | 0.363 |
| I(Out-of-court restructuring) | 171 | 0.094 | 0.000 | 0.292 | 59 | 0.153 | 0.000 | 0.363 |
| I(Sponsor equity injection) | 171 | 0.398 | 0.000 | 0.491 | 59 | 0.220*** | 0.000 | 0.418 |
| I(Sponsor exit) | 171 | 0.111 | 0.000 | 0.315 | 59 | 0.237** | 0.000 | 0.429 |
| I(CEO turnover within 6 months) | 171 | 0.064 | 0.000 | 0.246 | 59 | 0.034 | 0.000 | 0.183 |
| I(CEO turnover within 1 year) | 171 | 0.158 | 0.000 | 0.366 | 59 | 0.136 | 0.000 | 0.345 |

Compared to banks, direct lenders provide more flexibility (defer payment and interest obligations, renegotiate without restructuring, and avoid bankruptcy via out-of-court restructuring) while requiring greater skin-in-the-game from PE sponsors.

# Key attributes by lender type

| | Direct Lenders | Commercial Banks | CLOs | Finance Companies |
|---|---|---|---|---|
| Borrower type | Middle-market | All | Mostly large public, some middle-market | Mostly SME, some middle-market |
| Loan Characteristics | | | | |
| Syndication | Not frequent | Frequent | Always | Likely not frequent |
| Loan type | Term loan / Revolver | Term loan / Revolver | Term loan | Revolver |
| CF vs asset-based | Mostly CF-based | Both | Mostly CF-based | Mostly asset-based |
| Covenants | Financial & Negative | Financial & Negative | Typically only negative ("Cov-lite") | N/A |
| Origination/liquidity | Mostly self-originated & held to maturity | Self-originated & sold off to institutional investors | Bought through primary market syndication or secondary market trading | N/A (likely self-originated) |
| Use of leverage (debt/capital) | < 50% | > 90% | > 90% | 80-90% |
| Source of financing | Mostly equity, some bank debt | Mostly deposits and other short-term debt | Long term bonds, tranched by seniority | Mostly long-term debt, some commercial paper |

Source: Block Jang Kaplan Schulze (2022)

# Takeaways

- Debt, distress, restructuring of small, private firms
  - Small, private firms as important, if not more, as large, public firms for economic activity (employment, investments, and debt financing)
  - Different environment: bond issuance, trading, credit rating, accounting standardization all rare
  - Diverse nonbank lenders: direct lenders, finance companies, fintechs, etc
  - Banks continue to lose market share to nonbank lenders
- SME: asset-based loans and liquidation upon distress very common
- MM: CF-based loans with covenants and out-of-court restructuring becoming more common with growth in PE and direct lending

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