# Trump and the Middle Market

THE LEAD | November 29, 2016

At this writing it's only been three weeks since the November 8 "tectonic shift" – as veteran financier Henry Kaufman dubbed the US election results. And while this Brexit-like outcome has injected a high degree of uncertainty into capital markets globally, there are potential positives emerging.

In particular, we are encouraged by possible tailwinds for private credit and the middle market. Many of the dynamics we have seen over the years we expect will remain in place as the environment for middle market lending remains favorable. Keeping in mind that prognostication is a long way from policy, we've considered several issues where these sectors might benefit in the context of a Trump administration:

*Bank Regulation.* Recent commentary on likely approaches the President-elect may take on bank regulation suggests a reduction in "red tape" for banks. If the campaign's populist approach is any indicator that suggests attention will be primarily focused on areas in which commercial and community banks are already active. These would include mortgage lending, credit cards, student loans and auto finance; loans with a direct link to Trump's constituency – the lower and middle income consumer.

*Capital Requirements.* It seems unlikely that the incoming administration will focus on (or have domestic or overseas support for) reducing bank capital requirements. Basel III is an international bank solvency standard and has a far greater impact on the middle market lending area. The gradual increase in these requirements has pushed banks (particularly the largest ones) further into investment banking and other fee-based activities and away from middle market lending – an arena that is today dominated by non-bank institutional investors. The consensus is that these capital requirements have strengthened US banks and made it less likely that they would ever be imperiled by a global financial crisis.

*Economic Growth.* Trump's economic policies as outlined in the campaign are clearly designed to benefit domestic businesses. He has specifically cited "small business" as a beneficiary for more government-friendly policies. The middle market is comprised of companies whose customers and revenues are predominantly US-focused. As one team of equity analysts noted, the president-elect's "protectionist lean" should favor "US small cap as a function of its higher domestic revenue exposure."

*Private Equity.* Sponsors have struggled recently to justify higher purchase price multiples as the tepid overall economy has inhibited growth. If US GDP moves higher than the 2% range it's been stuck in since 2010, this would help boost PE returns. In the six years leading up to the Great Recession (2002-07), GDP averaged almost 3%. That buoyed PE investing and related debt financing activity.

*Interest Rates.* The early read from economists is that Trump's proposed pro-growth initiatives will create upside pressure on inflation and interest rates. That view is echoed in lower bond prices of late, and improves the chances of a Fed hike in December. Holders of floating rate assets, which are accretive in a rising rate environment, should benefit relative to fixed income instruments.

*Tax Policy.* The lightening of corporate tax and trade tariff burdens on US companies will clearly be on the agenda over the next four years. Smaller US companies are expected to be specific beneficiaries of any protectionist trade policies, particularly in traditionally middle market sectors like manufacturing.

If Dodd-Frank is repealed, would banks return to leveraged loans? Bank consolidation triggered their exit from leveraged and middle market lending in the early 1990's; their share dropped from over 70% to less than 20% before the recession. Today that figure is 10%.

Even if banks wanted to jump back into the middle market, there are now other significant barriers to entry. It's a high-touch, higher overhead practice than large corporates; huge resources would be needed to rebuild infrastructure and capacity. Where would talent come from? Experienced lenders left for non-banks years ago. Few regional banks remain in the top tier of middle market players. There's also the formidable credit culture banks built after the downturn. Tough to unwind in a business that's proven to be cyclical.

And if banks chose to re-enter the fray with the non-banks, which have built a sizeable competitive advantage with large hold levels, will they also risk political winds shifting again in four years?