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What's Market: 2020 Year-End Trends in Large Cap and Middle Market Loan Terms

by Practical Law Finance

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An Expert's View: Middle Market Loan Developments and Trends

Paul W. Hespel, Michael G. Parisi, and Matthew J. Wrysinski of Alston & Bird LLP discuss the impact of COVID-19 on the middle market, distressed liability management transactions and predictions for the middle market in 2021.

What were the key developments in loan documentation that occurred in middle market loan deals in 2020?

Key developments in loan documentation were influenced by market conditions. The first quarter of 2020 was a continuation of the borrower friendly environment of 2019 until the COVID-19 pandemic resulted in a significant slowdown of economic activity. This slowdown caused market participants, during the Spring and Summer of 2020, to focus on their existing portfolio companies and resulted in a wave of restructuring and liability management transactions, including accessing excess liquidity, and amending credit facilities to reset or waive financial covenants, to implement cash conservation measures and to reduce flexibility once available under the negative covenants.

The middle market also saw its fair share of forbearance arrangements and bankruptcies, which led to a significant number of debtor-in-possession commitments and financings. In this restructuring environment, there was an increased use of financial advisors to analyze quality of earnings, cash flow and more generally the impact of the pandemic on EBITDA.

By the end of the summer, some industry sectors proved more resilient and were performing well despite or even because of the pandemic. These sectors included healthcare (aside from elective surgery or procedure providers), software development, business services, data centers and cloud computing. The pent-up demand for financings at these companies, combined with an overabundance of equity and debt capital available to be put to work (including using special-purpose acquisition companies (SPACs)), resulted in increased deal activity through the end of the year and caused deal terms in the middle market credit space to favor borrowers and private equity sponsors in these preferred industry sectors. Conversely, in sectors disproportionately and negatively affected by the pandemic (for example, the energy, travel, entertainment, and hospitality sectors and parts of the retail sector) and in the lower end of the middle market, covenant packages remained more lender favorable during the last quarter of 2020.

In terms of sector focus, we increasingly saw a willingness by middle market lenders to finance opportunities in the cannabis and crypto-currency related industries. A number of opportunistic debt funds, more used to trading in the secondary loan markets, also became more active as direct lenders in bespoke credits to take advantage of distressed asset prices.

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The pandemic and resulting lockdown decimated the cash flow of some borrowers, resulting in a rise in bankruptcies and restructurings, and an increased focus on liability management transactions. How have liability management solutions developed for middle market borrowers in 2020? What are key concerns for lenders?

The last time we saw a broad application of liability management tools in the loan markets was the credit crunch of 2008-2010. In light of the difficulties then encountered for providing additional liquidity to borrowers, several loan market features became commonplace, such as incremental facilities (including by incurring incremental equivalent debt or so-called "side-car" arrangements) and replacement facilities, the built-in flexibility to effectuate amend and extend transactions, and the ability for the borrower or its affiliates to repurchase the borrower's debt (either using an auction process or via open market purchases) or to participate as a lender. Since the start of the pandemic, these features, even though not universally adopted in the middle market, have been used to enhance corporate balance sheets. In the middle market, where club deals and small syndicates are more prevalent, liability management since the start of the pandemic most often consisted of a negotiated solution resulting in:

- A waiver or reset of the financial covenants.
- The inclusion of a temporary liquidity covenant.
- The ability to raise additional debt using incremental facilities, delayed draw facilities, or government sponsored programs (such as the Small Business Administration's Paycheck Protection Program loans and to a lesser extent, the Federal Reserve Board's Main Street Lending Program).
- The requirement for private equity sponsors to contribute additional cash or provide sponsor guarantees.
- The right-sizing of amortization profiles.
- Allowing for interest to be paid in kind.
- Waiving certain mandatory prepayment requirements.

We have seen an increased willingness of lenders, especially in the private credit space, to exercise remedies associated with the equity pledge and to take over the credit party group in the context of a break-down of negotiations among stakeholders, notably where equity holders found themselves out of the money and unwilling to contribute additional equity.

Under the thrust of some widely publicized cases in the large-cap syndicated markets, lenders in the middle market have increasingly focused on the ability of borrowers to:

- Incur indebtedness that is structurally or contractually senior in the capital structure (referred to as "uptiering" structures).
- Move assets out of the reach of existing lender groups (referred to as "drop-down" structures).

Lenders want to limit the ability of the borrower to incur indebtedness from certain existing lenders that is contractually senior to the debt of an existing lender group and to limit the ability of this sub-set of existing lenders, holding a required lenders voting position (to make any necessary amendments to the existing debt documentation), to participate in contractually senior debt (that is "uptiering"). Lenders are accordingly focused on the voting thresholds required to modify or waive the pro rata sharing provisions, the waterfall provisions, and the ability to subordinate the liens of existing lenders to third-party indebtedness. The ability of the borrower to make open market purchases of its indebtedness, to the extent available, is an exception to the pro rata sharing provisions and has been used in "uptiering" transactions to exchange the debt of existing lenders for the contractually senior debt.

In new issuances, lenders have been focused on limiting open market purchases using caps or requiring that these open market purchases can only be effectuated for cash or cannot be effectuated in the context of substantially concurrent issuances or exchanges of debt. The ability to subordinate the liens of existing lenders to third-party indebtedness is typically not protected by an all lenders or all affected lenders' vote. Lenders are keen to add protections by requiring higher voting thresholds, requiring that certain key lenders be included in the voting syndicate (which is more accepted in the private credit space) or requiring that existing lenders be given the opportunity to participate on a pro rata basis in any new issuances of debt intended to be senior in collateral recovery.

"Drop-down" transactions take advantage of carve-outs to the guarantee and collateral requirements, of permissive baskets under the negative covenants related to investments, restricted payments, and debt incurrence (some of which are described above) and of the ability to create unrestricted subsidiaries. When used in conjunction, these carve-outs allow borrowers to remove productive assets from loan parties so they can be separately financed by structurally senior debt. Lenders have reacted in a piecemeal fashion to these transactions.

In sectors where intellectual property is significant, lenders have focused on the ability of loan parties to use any necessary intellectual property (including license rights from foreign subsidiaries that own the intellectual property) and have imposed restrictions on the ability of material intellectual property to be owned by and/or transferred to non-loan parties. Sometimes an exception is made for a bona fide sale to unaffiliated parties for fair market value coupled with a requirement to mandatorily prepay the debt irrespective of annual thresholds and reinvestment rights.

Lenders have also focused on the ability of borrowers to transfer equity stakes in wholly owned guarantor subsidiaries, causing these subsidiaries to be released from the collateral and guaranty requirements. In many cases permitted transfers are limited to arm's-length transactions with unaffiliated third parties, with the express requirement that the primary purpose of the transactions is not a release of the related guarantees or liens. If a subsidiary is released from guaranty or collateral requirements, the borrower is deemed to have made a new investment in the resulting non-wholly owned subsidiary and that investment is permitted under the credit documents.

Are there particular issues in loan agreement negotiations that you think will garner increased attention in the middle market in 2021?

In continuation of the dynamics observed in the last quarter of 2020, we anticipate that covenant terms from the large-cap sponsor driven acquisition financing space are likely to continue to trickle down into the middle market. As markets recovered during the second half of 2020, borrowers sought to execute on aggressive borrower-friendly terms, subject to significant market-flexibility protection for lenders as markets were in discovery mode. Several areas where deal terms are likely to continue to be negotiated in 2021 are:

- **Mandatory prepayments**: For mandatory prepayments with asset sale proceeds, the inclusion of leverage-based step-downs, the prepayment requirement only to apply to dispositions of collateral (rather than all assets), and more liberal annual thresholds. For mandatory prepayments with excess cash flow, whether leverage based step-downs are calculated on a pro forma basis before or after giving effect to the proposed payment, the ability for the borrower, at its election, to deduct certain cash expenditures traditionally deducted from the calculation of the determination of excess cash flow itself, on a dollar-for-dollar basis from the excess cash flow prepayment (that is, below the line), and the inclusion of annual excess cash flow prepayment minimum thresholds and the carryover to later years for both eligible dollar-for-dollar deductions and minimum threshold capacity not previously used.
- **Incremental credit facilities**: These include:
  - the inclusion of additional builder components in determining available incremental capacity (in addition to the unlimited ratio-based basket) (for example, general debt baskets and available amount baskets);

  - the negotiation of carve-outs for incremental term loans with a maturity date inside the maturity date of existing term loans;
  - limits on the applicability of most favored nation pricing protection, the length of any associated sunset and the quantum of the related yield protection; and
  - the inclusion of a leverage neutral (or "not more levered than") unlimited basket for permitted acquisitions.
- **EBITDA definitions**: An increased focus on diligence by lenders to ascertain to what extent pandemic related costs and losses are included in deemed EBITDA numbers and quality of earnings reports; and widening (or the absence of) caps related to certain add-backs to EBITDA, including related pro forma cost savings (with lengthening "look forward" periods), extraordinary, non-recurring or unusual items and quality of earnings add-backs related to permitted acquisitions.
- **Autocure of events of default**: The inclusion of the concept that any event of default under the loan documentation— including an event of default arising independently from the borrower's failure to notify the agent of another event of default— shall be deemed not to be "continuing" or "existing" if the events, acts, or conditions that gave rise to the event of default have been remedied or cured or have ceased to exist.
- **Material adverse effect definition**: The exclusion of the effect of the pandemic on the bringdown of representations and warranties and ability to borrow.
- **Flexibility relating to negative covenants**: This includes:
  - relaxed conditions around the use of the available amount (or cumulative credit) basket;
  - the sharing of general baskets across various negative covenants, including restricted payments (so called, "pick your poison" baskets);
  - the ability to create basket capacity under the negative covenants using equity contributions;
  - the ability to execute on "drop-down " structures (also discussed below), due to the absence of consequential limitations on the incurrence of secured debt by non-loan parties (that is, structurally senior debt), on investments in or acquisitions of non-loan party subsidiaries, on dispositions of assets not constituting collateral and on the creation of unrestricted subsidiaries; and
  - treatment of the transactions with affiliates covenant as an affirmative covenant, which subjects the covenant to a cure period before ripening into an event of default.

LIBOR transition is likely to be an area of increased focus for 2021, although an extension on the publication of certain US dollar LIBOR rates to June 30, 2023 is currently contemplated. The middle market credit documentation was early to adopt an "amendment approach" to the replacement of LIBOR. As more clarity develops around the replacement benchmark and as a Term SOFR index is likely to gain wider acceptance, we anticipate the middle market to embrace a "hardwired approach" in line with ARRC recommendations.

One additional item of note on the underwriting side is the continued focus on including environmental, social, and governance factors in credit decisions. In the lender's due diligence, the borrower has to show a greater commitment to corporate responsibility in its policies and procedures, but this falls short of requiring covenant compliance.