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What's Market: 2022 Mid-Year Trends in Large Cap and Middle Market Loans

by Practical Law Finance

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An Expert's View: Mark P. Ramsey, Kramer Levin Naftalis & Frankel LLP

Mark discusses basket reallocation and other loan agreement trends and borrower-friendly terms.

In your practice, what deal terms have attracted significant attention so far in 2022? What developments do you expect to see in loan document negotiations in the second half of the year?

2022 has been a year for the books in many ways. Coming off the intense level of activity and record-setting deal flow in 2021, it was not surprising that early 2022 started slowly. However, activity began to pick up into February, and expectations began to change, but the one-two punch of the Ukraine War and domestic (and global) economic woes put the brakes on any uptick. In light of this environment, it would be reasonable to assume that the deal terms pendulum, which has been more or less frozen in the direction of borrowers (in particular equity sponsor portfolio company borrowers) might, at least to a small degree, swing back towards lenders. The potential for a meaningful economic downturn and a rising interest rate environment would seem to shift the leverage towards lenders; however, that does not appear to be the case in practice. Because there is still significant competition in the leveraged lending market (in part due to the ever-expanding private credit market), with financial institutions of all stripes still flush with money to be invested, borrowers are still able to improve their position. While no specific issue seems to have attracted outsized attention vis-à-vis others, borrower-friendly improvements continue for provisions that have seen a lot of activity in recent years. Among those are:

- MFN spreads, which continue to move towards 75 basis points (although the majority continue to be 50 basis points), and MFN sunsets, which are all but universal, with many as short as 6 to 12 months.
- Leverage-based baskets for restricted payments and restricted debt payments, which are requiring less and less delevering (and, increasingly, no delevering) to access.
- The prevalence of EBITDA-based grower baskets in the middle market.
- Incremental facility starter baskets being set at the greater of closing date trailing twelve-month EBITDA and 100% of trailing twelve-month EBITDA.
- Available amount grower components permitting borrowers to choose between retained excess cash flow and consolidated net income, and, in some cases, EBITDA less a multiple of fixed charges (often 1.50x).
- Reduction or elimination of deleveraging requirements for use of the available amount to make dividends and restricted debt payments.
- Asset sale prepayment leverage-based stepdowns in the middle market.
- Thirty-day cure periods for breaches of representations and warranties that are capable of cure.

In addition to these "usual suspects" continuing to be areas of focus, the impending phase-out of LIBOR and the appearance of Term SOFR continue to impact documentation. One area of negotiation has been around credit spread adjustments.

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Many of the first SOFR-based loans had spread adjustments that increased with the tenor of the interest period, with adjustments often being 10 basis points for one-month Term SOFR, 15 basis points for three-month Term SOFR and 25 basis points for six-month Term SOFR. Increasingly, however, those adjustments are being negotiated down to a flat spread of ten basis points, regardless of tenor, or are being eliminated altogether. Given that SOFR does not purport to be a "cost of funds" rate and lenders do not even match fund theoretically, borrowers are increasingly able to argue for no spread adjustment at all. Focus on this issue will likely increase with the availability of twelve-month Term SOFR and with LIBOR continuing to fade into the distance.

The borrower's ability to reallocate basket capacity across different covenants continues to be a hot topic in many loan agreement negotiations. What has been your recent experience regarding basket reallocation?

In my experience, reallocating capacity from restricted payments and restricted debt payments baskets to debt and investment baskets has penetrated deeply into the middle market. In both broadly syndicated deals and private credit transactions, lenders seem to have little heartburn around permitting a borrower to reallocate baskets that allow leakage from the credit group to baskets that arguably keep the benefit (through loan proceeds or as the value and return on investments) within the ringfence. Where practice diverges is the reallocation of debt and investment baskets to restricted payment and restricted debt payments baskets. In large cap deals and, to some extent, among the very top of the top-tier sponsors in middle market deals, borrowers are sometimes successful in obtaining this reallocation right. However, down market, and with most sponsors in all markets, lenders continue successfully to resist this ask. For lenders, the rationale is clear: baskets that provide the borrower the ability to operate and grow the business should not be reallocated to baskets that permit cash and assets to leave the credit group or to repay other debt ahead of the senior secured debt. Nevertheless, sponsors often argue that there can be any number of reasons why the enterprise as a whole benefits, and therefore the holders of the senior secured debt benefit, when other debt is prepaid or when borrowers have the flexibility to pay dividends in a way that makes investment in the business more compelling.