# Boxes

## An Expert's View: Developments in Middle Market Loan Terms

*Steven R. Rutkovsky of Ropes & Gray LLP explores developments in middle market loan terms:*

**What were the key developments in loan documentation that you saw in middle market loan deals in 2014?**

In 2014 we saw an increase in the number of middle market acquisitions being financed on a private basis by direct lending sources. There has been a surge in capital available to alternative financing providers, such as BDCs, small business investment companies (SBICs), mezzanine funds, credit affiliates of private equity fund managers, joint ventures and other specialty lending vehicles. The main factors behind this trend include:

- The regulatory impact of the Interagency Guidance on Leveraged Lending (Leveraged Lending Guidance), which has made banks more cautious about underwriting highly leveraged transactions.
- Increasing volatility in the syndicated loan market, which has made club/private deals relatively more attractive due to their lack of market flex provisions.
- Greater competition between sponsors and strategic bidders for M&A targets, which has led to a shortening of the period between signing and closing, making a full syndication process more difficult to accomplish.

A consequence of the growth in club/private deals has been increased variation in the forms of loan documentation and issues that are a focus of negotiation. While loan documentation for broadly syndicated loans is often based on an agreed-upon sponsor or public precedent, the documentation in club/private deals is less standardized.

Many smaller direct lending sources use proprietary or off-the-shelf forms of loan documentation and a broader range of outside counsel, who may be less familiar with the syndicated loan market terms expected by sponsors. There is also greater variation in the business approach taken by direct lending sources, as some lenders bring a cash-flow perspective to the transaction, whereas others have a more asset-based approach to negotiating loan documentation.

On the other hand, certain provisions have become more standardized. These include prohibitions on assignment to “disqualified lenders,” limitations on assignment to “affiliated lenders,” provisions relating to compliance with the FCPA and other anti-corruption laws, and OFAC sanctions and anti-money laundering regulations. The LSTA has recently published several market advisories and updated its model credit agreement provisions on these topics.

**What issues do you think will be the focus in middle market loan agreement negotiations in 2015?**

Certain provisions identified as risk factors in the Leveraged Lending Guidance may become the subject of increased focus in loan agreement negotiations. These include the absence of “meaningful” financial covenants, which may result in fewer transactions that are covenant-lite, as well as reductions in the “cushion” used in setting covenant levels.

Incremental facility and "sidecar" provisions, which permit the issuance of additional pari passu loans or other secured debt, may also become subject to increased negotiation. As regulators focus more closely on these provisions, banks may face greater pressure to reduce the size of incremental debt baskets or may subject them to more stringent leverage tests.

Another factor identified in the Leverage Lending Guidance is the borrower's ability to repay a substantial portion of its debt over a five- to seven-year period. The pressure to demonstrate significant de-levering may lead to:

- An increase in scheduled amortization.
- An increase in the percentage of annual cash flow required to be applied to repay debt.
- Tighter restrictions on incremental facilities and dividend recap transactions.

Additionally, the recent bankruptcy court decisions in the *Momentive Performance Materials* case, which narrowly interpreted a provision requiring payment of a premium upon acceleration, may lead to greater specificity in drafting these provisions. Even more troubling to secured lenders was the court's decision to permit the debtor to distribute below-market rate debt to secured creditors as part of the plan of reorganization. This may cause secured lenders to seek more onerous subordination and turnover provisions in intercreditor agreements in an attempt to offset the decision's impact.

**In large cap deals, borrowers are negotiating for more flexibility in the way they manage their businesses. Have you seen a similar push for operational flexibility in middle market loan agreements?**

A common area of negotiations is the flexibility to do add-on acquisitions. Whereas broadly syndicated loan agreements often have no limitation on acquisitions, many middle market deals, particularly club/private deals, contain limitations on acquisitions. These may include an aggregate or per transaction cap, a pro forma leverage or other financial test and limitations on foreign acquisitions, since assets outside the US are typically excluded from the collateral package. As middle market companies are increasingly seeking growth opportunities outside of the US, the flexibility to do foreign acquisitions may receive greater focus in negotiations.

Adjustments to EBITDA are another common topic of negotiations. Private equity sponsors often seek to acquire companies that can realize significant operational improvements through increased investment in technology or infrastructure, cost reductions or other optimization strategies. Sponsors include EBITDA adjustments in their financial projections to reflect these strategies and they expect the lenders to provide similar adjustments in the covenant calculations included in loan agreements.

Adjustments for "non-recurring" charges and "run-rate" cost savings and synergies are often the most difficult to negotiate. Sponsors view these adjustments as integral to their business strategies, whereas lenders may view them as providing excessive cushion to financial covenant levels. The negotiations often center around the types of non-recurring charges that may be added back and an overall cap as a percentage of EBITDA.

Many private equity sponsors seek to expand their portfolio companies geographically by investing in new facilities. Therefore, another common area of negotiations is the ability to adjust EBITDA by adding back start-up losses or run-rate EBITDA for new facilities opened during the preceding 12 months.