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Overview of Certain Middle and Lower Middle Market Credit Trends

BY JOSEPH PRICE

With heavier competition for bigger deals, larger private equity sponsors have increasingly turned to the middle market as a source for new acquisitions. In connection with this trend, certain large-cap deal terms have migrated into the middle and lower middle market debt financing arena. For example, limiting a borrower's or shell company acquisition vehicle's obligation to reimburse a debt financing arranger for out-of-pocket fees and expenses to a reimbursement obligation *only* in the event that the subject transaction actually closes is increasingly common in debt financing commitment papers. Likewise, commitment papers may require the arranger to provide periodic updates of its estimated out-of-pocket fees and expenses or may cap the arranger's reimbursable fees and expenses. In addition, sponsors often insist that their counsel draft the definitive loan documentation for the debt financing and use sponsor-friendly loan document precedent specified in the commitment papers for the transaction. Looser "SunGard" style conditionality to closing is also a trend, with more limited types of collateral required to be delivered at closing. Coupled with strong competition among potential financing sources, many of these developments are of course also attributable to the increasingly common practice of middle and lower middle market sponsors drafting the commitment papers for their acquisition financings.

Other deal terms more traditionally found in large-cap financings are appearing in middle and lower middle market loan documents. Pro forma costs savings, synergies, and optimization expenses projected by the borrower (although generally capped at a percentage of trailing 12 month EBITDA) are being added to adjusted EBITDA in connection with financial performance covenants and related incurrence/ratio based measurements.

Incurrence/ratio based debt and restricted payment (including ability to prepay second lien and/or other subordinated debt) flexibility is becoming more and more common. Although more typically seen in larger middle market transactions, the size of incremental term loans and incremental revolving facilities may be uncapped and governed by an incurrence based test measuring pro forma indebtedness to adjusted EBITDA and sunset provisions (usually between 12 and 18 months) with respect to "most favored nations" pricing in connection with such incremental facilities are often negotiated. Leverage ratios calculated net of unrestricted cash of borrowers and their subsidiaries (both capped and uncapped with respect to the amount of cash netted), step-downs in the percentage of excess cash flow required to prepay term loans and equity cure rights with respect to financial covenant defaults are more or less commonplace now in the middle and lower middle markets. Stand-alone covenants measuring capital expenditures are rare.

Sponsor term loan purchases are generally permitted, although the amount of term loans purchased by sponsors and their affiliates (other than debt fund affiliates) is generally capped at a percentage of the aggregate amount of term loans outstanding at the time of purchase and voting rights with respect to such loans are limited. Another borrower friendly term is the "builder basket," whereby in addition to a hard dollar basket (such baskets being less common in lower middle market deals), borrowers may utilize a percentage of retained excess cash flow or consolidated net income for additional restricted payments, permitted acquisitions, other investments, and/or capital expenditures. The inclusion of "amend and extend" provisions, refinancing facilities, and disqualified lender and borrower competitor blacklists with respect to assignments of loans and commitments have also benefited middle and lower middle market borrowers recently.

Joseph Price, *Member*

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In addition to the sponsor favorable deal terms discussed above, the increased presence of and competition among alternative lenders has allowed for greater flexibility and customization of financing structures in the middle and lower middle markets, including low amortization, amortization holidays, PIK toggle features, and “unitranche” facilities. Unitranche financing, which has become a major debt financing option for borrowers in this space, combines senior and subordinate tranches of debt into one credit facility with a single loan agreement (and lenders agreeing among themselves on first and last out tranches). Benefits of unitranche facilities to borrowers include lowered debt service and loan administration costs, reduced or eliminated syndication and flex risk, accelerated closings, and an increased amount of available senior debt.

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