WHAT'S MARKET 2013 YEAR IN REVIEW

LOOKING BACK AND THE ROAD AHEAD

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2013 Year-end Trends in Large Cap and Middle Market Loan Terms

The US loan market had a solid year in 2013. Total US syndicated lending reached $2.14 trillion, a 36% increase from 2012.

This article looks behind the headline numbers and examines trends seen in loan transactions in the large corporate (large cap) and middle market segments of the US loan markets in 2013, including:

- The continued convergence between terms in high-yield bonds and the term B loan market.
- The migration of some deal terms from large cap deals to middle market deals.
- The evolution of loan terms that emerged in recent years.

OVERVIEW: COVENANT-LITE LOANS AND REFINANCINGS

Collateralized loan obligations (CLOs) continued to pump liquidity into the loan market, as CLO issuances totaled $81.3 billion in 2013, a 50% increase from 2012. The return of CLOs, coupled with a flood of liquidity from other loan market investors searching for yield, continues to help create a borrower-friendly environment for both large cap and middle market borrowers.

Market conditions fueled an acceleration in covenant-lite loan issuances with $238.2 billion coming to market in 2013, a 185% increase from 2012. Demand has become so strong that, in some deals, arrangers no longer have flex rights to add financial maintenance covenants to the terms of the deal in order to achieve a successful syndication. Until recently, these flex rights had been typical in syndicated loans.

Covenant-lite terms have also begun appearing in certain larger middle market deals, with $10.6 billion of covenant-lite loans being issued by middle market borrowers. While middle market covenant-lite deals may bear a higher credit risk than large cap covenant-lite deals, in the current lending environment lenders are attracted to the increased pricing of middle market covenant-lite deals.

Search Great Wolf Resorts, Inc. and Polymer Group, Inc. in What's Market for summaries of recent middle market covenant-lite loan agreements.

Continuing a key theme from the past couple of years, deal flow from M&A activity and other new money issuances continued to be far outweighed by refinancings, driven by repricings of existing loans and dividend recapitalizations (dividend recaps). Fully 72% of the $2.14 trillion of loan issuances in the large cap and middle markets were for refinancings of existing facilities.

Despite a slowdown at the beginning of 2013, dividend recap issuances surged in the second half of the year, totaling $49.8 billion in 2013, compared with what had previously been a record volume of $47 billion in 2012. While fears over the fiscal cliff and uncertainty about tax rates contributed to the high volume of dividend recaps in 2012, the increased activity in 2013 reflects the availability of funds at attractive rates. This gives sponsors an alternative to a sale or public offering of a portfolio company by allowing them to return cash to their investors without overburdening the company with unmanageable levels of debt and interest expense.

Search Generac Power Systems, Inc. and TriNet HR Corporation in What's Market for summaries of recent dividend recaps.

The large cap loan market remained very active in 2013, with $1.93 trillion of issuances coming to market in 2013, representing a 39% increase from 2012. In contrast, deal activity in the middle market did not see similar gains, despite lenders looking to put money to work. Market participants point to a number of factors that may have led to middle market loan issuances totaling $203.5 billion in 2013, a relatively small 12% increase from 2012. These include:

- A lack of meaningful M&A activity.
- Fewer opportunities to lend to quality credits.
- Concerns about excessive leverage for some borrowers.

Second lien loans performed well in 2013. Through the third quarter of 2013, second lien loan issuances reached $21.2 billion, an increase of more than 100% from the same period in 2012.

With interest rates remaining near historic lows and demand from investors high, the loan market has become tolerant of increased leverage levels and lower equity contributions that are approaching levels last seen before the financial crisis. Some large cap deals have included first lien leverage ratios of between 4.0x and 4.5x and total leverage ratios of between 6.5x and 7.0x, while in sponsored deals, larger sponsors have successfully negotiated equity contributions of 25% or less. A similar trend can be seen in middle market deals where total leverage ratios of between 5.0x and 5.5x are common, with required equity contributions commonly in the range of 25% to 30%.

MARKETS CONVERGE

With so much liquidity from investors flooding the US loan market in 2013 and the changing nature of the investor base, loan documentation in both the large cap and middle markets increasingly allowed for limited restrictions on borrowers and the erosion of other lender protections, creating a more borrower-friendly lending environment.

HIGH-YIELD BOND AND TERM B LOAN MARKET CONVERGENCE

The increasing influence of institutional investors in the syndicated loan market, coupled with an emphasis on trading over holding loans, has resulted in more term B loans coming to market with bond-like features.

Bond-like features that now regularly appear in loan documentation relate to:

- Uncapped investments in non-loan parties.
- Builder basket calculations.
- Uncapped restricted payments.
- Permitted acquisition debt.
- Event of default cure periods.
- Changes in loan buybacks.
- Restricted and unrestricted subsidiaries.

Uncapped Investments in Non-loan Parties

Loan agreements often include a provision restricting the borrower's and other loan parties' ability to make investments in non-guarantor subsidiaries, including by requiring a cap on these investments. The rationale for this restriction is to limit the amount of funds that are allowed to leave the credit group and preserve the assets available to the lenders. In some recent large cap deals, loan parties have been permitted to invest uncapped amounts in any of their subsidiaries, including foreign subsidiaries, even if those subsidiaries are not guarantors of the borrower's loan.

Builder Basket Calculations

Often, large cap and some sponsored borrowers have been permitted to make restricted payments and permitted investments or prepay subordinated debt using a basket (builder basket) based on the borrower's retained excess cash flow (ECF).

In some recent large cap and sponsored middle market deals, the builder basket is instead based on the borrower's cumulative consolidated net income and also includes the proceeds of equity issuances and equity contributions, a formulation common in covenants in bond indentures. In other deals, borrowers have been permitted to increase the size of the builder basket by the amount of any declined proceeds from ECF mandatory prepayments. Sponsors have also successfully negotiated for the ability to switch between builder basket formulations to provide them with added flexibility.

Search Travelport LLC and Revlon Consumer Products Corporation in What's Market for summaries of loan agreements with builder baskets based on consolidated net income.

Uncapped Restricted Payments

Typically, large cap and middle market borrowers have been permitted to make restricted payments subject to a cap. In many recent large cap and middle market deals, borrowers have been permitted to make restricted payments subject only to being in pro forma compliance with a specified leverage ratio, rather than a cap or basket. This provides the borrower with even more flexibility than is customary in high-yield bond indentures.

Search Scientific Games International, Inc. and Hilton Worldwide Finance LLC in What's Market for summaries of loan agreements permitting uncapped restricted payments.

Permitted Acquisition Debt

In most large cap deals, the borrower can incur permitted acquisition debt if its pro forma leverage ratio does not exceed a specified level. In some recent top-tier sponsor deals, the borrower has been permitted to incur this additional debt as long as its pro forma leverage ratio is no worse than before the debt incurrence.

Search Scientific Games International, Inc. and Hilton Worldwide Finance LLC in What's Market for summaries of loan agreements with this flexibility for permitted acquisition debt.

Event of Default Cure Periods

In some recent large cap deals, borrowers have been given more latitude to cure certain events of default by including more flexible cure rights. In certain sponsor deals where the borrower's capital structure includes high-yield notes, if the borrower defaults under its indenture, which would typically trigger the loan agreement's cross-default, the cross-default event of default under the loan agreement is deemed to have been cured if the borrower cures the default under the indenture.

Changes in Loan Buybacks

In some recent sponsored deals, borrowers have been permitted to buy back loans on a non-pro rata basis, in some cases without a cap, with a corresponding dollar-for-dollar reduction in the borrower's ECF sweep. Non-pro rata purchases allow the borrower to buy back loans from individual lenders.

However, reducing the ECF sweep dollar-for-dollar by the amount used to buy back loans undermines the pro rata application of prepayment proceeds that is customary in loan agreements. Because borrowers are not currently doing buybacks in significant volumes, these provisions may have limited practical impact. In addition, the strain on relations between the borrower and its bank group that could arise if the borrower negotiated a repurchase of its debt with an individual lender that deprived the remaining lenders of prepayment proceeds may act as a disincentive to conducting a buyback on these terms.

Search Mariposa Merger Sub LLC and H.J. Heinz Company in What's Market for summaries of loan agreements permitting buybacks with a corresponding dollar-for-dollar reduction in ECF.

An Expert's View

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Meyer discusses deal activity in the large cap market and key issues the Loan Syndications and Trading Association (LSTA) is considering addressing in its Model Credit Agreement Provisions (MCAPs):

What factors do you see potentially affecting the level of deal activity in the large cap market in 2014?

2013 was another record year for the leveraged loan market, with volume exceeding $600 billion. As we begin 2014, with continued low benchmark rates and investor appetite for higher-margin leveraged loans, there are good reasons for optimism. However, there are strong headwinds that could adversely impact leveraged loan volume in 2014 and shift capital structures towards more asset-based loans and bonds.

First, in March 2013, regulatory agencies issued final Interagency Guidance on Leveraged Lending, which provided financial institutions with "high-level principles related to safe-and-sound leveraged lending activities." In the guidance, the agencies articulated that total leverage ratios in excess of 6x raise concerns and advised financial institutions to risk rate loans considering borrowers' ability to delever (explicitly referring to the ability to repay all senior secured debt and at least 50% of total debt within five to seven years).

Because the guidance did not become effective until May 2013, many transactions completed in 2013 were underwritten in accordance with pre-guidance standards and it is not yet clear what additional procedures financial institutions will implement in 2014 in response to the guidance. However, anecdotal evidence suggests that some financial institutions have reacted to the uncertainty surrounding the guidance by declining to participate in certain highly leveraged transactions.

Market participants also continue to consider appropriate mechanisms to provide large cap and middle market borrowers (and sponsors) with increased flexibility to conduct loan buybacks while, at the same time, trying to standardize buyback procedures. Issues commonly considered include:

- Whether buyback procedures should be specified in the loan agreement.
- Whether borrowers should be permitted to make open market purchases (as opposed to purchases through Dutch auctions), and whether or not there should be a cap on those buybacks.
- Whether sponsors need to give a non-public information representation for open market purchases or whether an affiliated lender must identify itself.
- Additional procedures and safeguards for assignments to affiliated lenders, including caps on the buyback amounts and limitations on voting rights.

Restricted and Unrestricted Subsidiaries

In many recent large cap and larger middle market deals, borrowers may designate unrestricted subsidiaries that are not subject to the loan agreement's covenants or events of default and are not required to guarantee the loans or grant a security interest over their assets.

Search Scientific Games International, Inc. and Hilton Worldwide Finance LLC in What's Market for summaries of loan agreements allowing the borrower to designate unrestricted subsidiaries.

Search Term Loans and High Yield Bonds: Tracking the Convergence for more on high-yield bond and term B loan market convergence.

CONVERGENCE BETWEEN MIDDLE MARKET AND LARGE CAP DEAL TERMS

With high levels of demand for investments in loans and middle market borrowers increasingly backed by top-tier sponsors, many large cap deal terms continued to find their way into middle market loan transactions.

Large cap terms that are now appearing in middle market commitment letters include:

- Limitations on expense reimbursement.
- The specification that sponsor's counsel will be responsible for drafting the loan documentation.
- Looser "SunGard conditionality."

Additionally, large cap terms that are now appearing in middle market loan agreements include:

- Financial performance measurements that are being negotiated.

Second, in August 2013, regulatory agencies re-proposed rules for implementing the credit risk retention requirements of the Dodd-Frank Act. Under the rules, the manager of a CLO is required to keep at least 5% of the "fair value" of securities issued by the CLO. While the rules outline various ways of establishing compliance, any of the mechanisms will adversely affect the economics of the CLO manager and potentially chill new CLO issuances.

The rules do provide an exception for CLOs that hold only loans in which lead arrangers keep at least 5% of the principal amount. However, the commercial viability of this exception is not clear, as loans are not commonly issued on this basis today and some market participants are skeptical that they ever will be. As CLOs are major investors in leveraged loans, any decrease in the issuances of new CLOs will have a material effect on market demand.

In sum, while conditions are generally conducive to another strong year, the increased regulatory scrutiny of underwriting standards, combined with a potential reduction in demand from new CLOs, may have a negative effect on 2014 leveraged loan volume.

What are some of the key issues the LSTA is considering addressing in its MCAPs?

Many of the issues that the LSTA is considering in the update to its MCAPs, including provisions addressing amend & extend transactions, borrower buybacks/affiliate lender assignments and cashless roll mechanics, are generally accepted or administrative in nature. However, one subject that will likely generate much focus, and have the greatest potential impact on loan transactions, is the inclusion and implementation of a "disqualified lender" exception for assignments.

To prevent competitors and other disfavored institutions from obtaining sensitive information and participating in decisions affecting its capital structure, borrowers increasingly insist that assignments of loans to specified disqualified lenders be prohibited. Certain borrowers have further requested:

- Broad descriptions of disqualified lenders (for instance, including "all affiliates").
- The ability to update the disqualified lenders list at any time without lender consent.
- That the disqualified lenders list be maintained and administered by administrative agents.

While prohibiting assignments to specific institutions identified to the syndicate before the closing date has gained acceptance, to avoid materially impacting the liquidity of the underlying loans, lenders have strongly resisted each of the additional requests (other than a limited ability to update the disqualified lender list). In addition, administrative agents have similarly rejected any obligation to monitor lenders' compliance with these lists. Given the broad inclusion of buy-side participants in the MCAPs update process, the scope and mechanics of disqualified lender lists are likely to be vigorously debated.

- Amend & extend provisions.
- Incremental and refinancing facilities.

Limitations on Expense Reimbursement

Smaller middle market and public company borrowers typically must reimburse the arrangers for expenses regardless of whether the deal closes. Similarly, borrowers looking to add incremental capacity to their existing loan facilities must also reimburse arrangers for their expenses even if the incremental financing does not close. By contrast, many large cap and sponsor acquisition deals require expense reimbursement only if the transaction closes. Some recent middle market commitment letters are making expense reimbursement contingent on closing.

Search ACP Tower Holdings, LLC in What's Market for a summary of a middle market commitment letter with contingent expense reimbursement.

In other deals, mostly in the middle market, the expense reimbursement obligation can vary based on the creditworthiness of the borrower and may:

- Require the borrower to make a deposit against its expenses despite being required to reimburse the arranger's expenses regardless of whether the transaction closes.
- Require the arranger to provide a fee estimate when the commitment letter is signed.
- Cap the arranger's fees that must be reimbursed.

Sponsor's Counsel to Draft Loan Documentation

In many recent larger middle market sponsor deals, sponsor's counsel has drafting responsibility for the loan documentation, rather than lender's counsel which is the traditional approach. In other recent cases, where lender's counsel drafts the loan documentation, sponsors are often permitted to specify a precedent or form on which the loan documentation will be based. In certain deals, where the borrower has a pre-existing relationship with its lenders, the borrower can be permitted to designate counsel for the lending group.

Search ACP Tower Holdings, LLC in What's Market for a summary of a middle market commitment letter permitting the borrower to specify a precedent.

Looser SunGard Conditionality

Many commitment letters for acquisition financings contain SunGard clauses that limit the representations and warranties made by the borrower and the delivery of certain types of

collateral required by the lenders on the loan closing date. In many recent middle market deals, the types of collateral required to be delivered at closing are becoming more limited.

Most middle market lenders now only require at closing a perfected security interest in collateral that can be perfected by filing Uniform Commercial Code financing statements, as well as the delivery of stock certificates. However, in a refinancing where the exiting lender has possession of the stock certificates, the new lender typically does not require their delivery at closing. Unless intellectual property assets are an important part of the borrower's overall worth, lenders typically do not require borrowers to execute intellectual property security agreements on the closing date.

Negotiation of Financial Performance Measurements

The negotiation of net leverage ratios and EBITDA add-backs (typically a list of deal specific charges and expenses incurred by the borrower) in financial performance measurements is now common in middle market deals, aside from the smallest deals.

However, in some cases these add-backs are subject to caps. In addition, in some deals, the percentages of ECF required to prepay loans and the related step-downs based on financial ratio tests are also being negotiated.

Amend & Extend Provisions

Many recent middle market deals include provisions permitting the borrower to amend and extend its loans. These provisions are being included despite the argument by lenders that this ability is not necessary because these provisions do not constitute a commitment by any lender to extend their portion of the loan at a later time.

Search Radiation Therapy Services, Inc. and Vince, LLC for summaries of middle market loan agreements with amend & extend provisions.

Search What's Market: Amend & Extends for more on amend & extend provisions and recent precedents.

Incremental and Refinancing Facilities

Incremental facilities have become common in many middle market deals. In some of these deals, however, lenders are hesitant to allow additional lenders into the deal and have required that they be given the right of first offer before a borrower accepts commitments from new lenders.

Search Tropicana Entertainment Inc. and RE/MAX, LLC in What's Market for summaries of middle market loan agreements with incremental facilities.

Search What's Market: Incremental Facilities for more on incremental facilities and recent precedents.

Refinancing facilities are now permitted in certain larger middle market deals, though typically only when the loans are syndicated. In smaller middle market deals, refinancing facilities

An Expert's View

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Cassandra reviews developments in middle market deals:

What factors do you see potentially affecting the level of deal activity in the middle market in 2014?

The factors that may affect 2014 deal activity are not markedly different from past years. Not surprisingly, M&A activity will have a major impact on middle market deal volume. Hopes are high that 2014 will be a better year than 2013 was for M&A, but a lot will depend on both buyers' and sellers' expectations for purchase price multiples.

Continued regulation or "guidance" of the bank lending market could also have a major impact on deal activity in the middle market. Specifically, it will be interesting to see how bank lenders implement internal policies and procedures with respect to the Interagency Guidance on Leveraged Lending, and whether these policies and procedures affect overall middle market deal activity.

The general stability of both the US and global economies may also affect deal activity. Interest rates also have the potential to have an impact, although I would not expect to see big changes in early 2014.

Is middle market loan documentation affected by the closer relationship between the borrower and its lenders and, if so, in what ways?

In many cases, especially for private equity-backed deals where the sponsor may work with the same lender or group of lenders on many deals, documentation certainly is affected by the closer relationship in several ways.

First, documentation tends to be completed at a faster pace for multiple reasons, including:

- The parties' familiarity with "hot button" issues for both the lender and the borrower and how these issues have been satisfactorily addressed in prior transactions.
- The use of previously negotiated loan documentation (including many of the boilerplate provisions and materiality thresholds for covenants and representations and warranties that often take a protracted time to negotiate).
- An overall comfort level with each party's policies and procedures.

Second, a long-term relationship helps build confidence in, and trust between, the borrower and its lenders. This confidence and trust often leads to more straightforward communication and quicker resolution of disputed deal points. Lenders may also be more willing to "stretch" on terms somewhat more for a borrower with whom it has a long-standing relationship, for example, justifiable EBITDA add-backs, net leverage, basket levels for negative covenants, grace periods and cure rights. Ultimately, however, the deal needs to make sense in terms of the lender's risk return analysis or it is not going to get done no matter the length of time a lender and a borrower have been doing business together.

Third, in a default scenario, a resolution, whether documentation pursuant to a waiver or a forbearance, may be achieved more quickly in deals where the borrower and the lender have a close relationship. This is especially the case where the parties have worked amicably through a default situation and reached a resolution satisfactory to both in other deals. Confidence and trust are particularly important in this situation.

are not as common because of the smaller size of the deals and the closer relationship between the borrower and lender.

Search Norcraft Companies, L.P. and PGT, Inc. in What's Market for summaries of middle market loan agreements with refinancing facilities.

Other Notable Terms

There are several additional large cap terms that had previously appeared in some middle market deals and continued to be seen in 2013, including:

- No financial ratio closing condition.
- Fully negotiated covenant levels.

- Bifurcated governing law provisions.
- Affected lender standard for amendments.

ONGOING TRENDS

The following loan market trends emerged or evolved in recent years and continued through 2013:

- **Second lien loans.** In the current lending environment, investors are drawn to the higher pricing of second lien loans. For the most part, these investors are content for the non-economic terms of second lien loans to mirror the terms of the related first lien deals with additional cushions around covenant levels in the second lien loans. As between first and second lien lenders, there is often little pushback on intercreditor agreement terms, with many second lien lenders accepting limited rights over shared collateral as the price for the higher interest rates. For summaries of second lien loan agreements, search Eastman Kodak Company and Black Ridge Oil & Gas, Inc. in What's Market.
- **Unitranche financing.** Still a uniquely middle market financing option, unitranche loans are structured as single debt instruments (one tranche of loans) that combine senior and subordinated tranches of debt into one facility with a blended interest rate (which is often less than the combined rate the borrower would pay for two separate facilities). Outside the loan agreement, the unitranche loan is divided into first and second lien tranches, with lenders entering into an agreement among lenders (AAL) that provides for the treatment of priority issues. AALs are rarely disclosed and not standardized between different lenders.
- **Cashless rolls.** Because many pre-financial crisis CLOs are now outside their reinvestment periods, they are restricted from making new investments with the proceeds of loan repayments. To be able to maintain its investment in any portfolio loan that is to be refinanced by its borrower, an older CLO must roll exposure of its loan into the refinancing facility without first being repaid for the original loan. A cashless roll is a mechanism to allow a refinanced loan not to be categorized as a new loan and therefore permit an older CLO to keep its investments. Cashless rolls also allow offshore lenders who prefer not to participate in primary syndications of loans to US companies to keep their investments in the refinanced loans. Concerns among practitioners continue around:
  - whether a transaction should be characterized as a continuation of an existing loan or as a new loan facility (with normal syndication procedures to follow);
  - whether a cashless roll should be accomplished using an amendment to the existing loan documents or a separate letter agreement;
  - the level of involvement by the administrative agent in the process, such as whether the administrative agent should be required to sign off on the characterization of the transaction and whether the loan agreement's exculpatory provisions apply to any role the administrative agent plays in a cashless roll transaction; and
  - whether language should be added to loan agreements explicitly permitting cashless rolls, regardless of the form they take.
- **Call periods.** One of the factors that has helped to encourage the refinancing boom has been the expiration of call protection in borrowers' loan agreements at a time when interest rates are at historic lows. While the borrower can refinance its existing loans without paying a penalty once its call period terminates, it must still consider other costs associated with the refinancing. These include:
  - legal fees and expenses;
  - transaction expenses; and
  - time and energy of the borrower's management spent away from running the borrower's business.
- **Disqualified lender lists.** Large cap borrowers continue to push for more expansive lists of disqualified lenders and for the ability to add to the list post-closing. However, lenders are still resistant to these points. Discussions among market participants concerning disqualified lender lists include the following issues:
  - whether affiliates of the borrower's competitors should be included;
  - whether the list should be attached to the loan agreement as a schedule; and
  - the consequences of assignments to a disqualified lender.
- **Precap provisions.** Precap provisions (which allow the sale of a borrower's equity interests without triggering a change of control event of default) continue to be available for top-tier sponsors in large cap deals. However, in practice, transactions using precap provisions remain rare.

LOOKING AHEAD

Although 2013 was a year of readily available credit on favorable terms for many borrowers in the US loan markets, many market participants continue to be concerned about the potential impact of the Interagency Guidance on Leveraged Lending. These guidelines were issued by federal regulators in March of 2013 in response to concerns that lenders' underwriting practices do not adequately address risks in leveraged lending. The guidelines may significantly reduce the extent to which lenders can offer loans on today's borrower-favorable terms and may weigh on loan market activity as lenders implement them.

Despite the 36% increase in syndicated lending in 2013, M&A activity and other new money issuances were not primary drivers of loan market volume, as market participants had hoped they would be. While market watchers were hopeful that the announcement of a handful of large, high profile transactions (such as Verizon Communications, Thermo Fisher Scientific Inc. and Amgen Inc.) had signaled a broader return of M&A activity, this turned out not to be the case. However, in the second half of 2013, new money deals made up nearly 60% of all institutional issuances, with M&A activity accounting for 50% of those issuances, according to *Fitch Ratings Ltd*. This shift could be a promising sign for the loan market in the coming year.

The market statistics cited in this article were provided by Thomson Reuters LPC, except where otherwise noted.