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Current market debt terms: one size fits all?

In recent years, mid-market borrowers/sponsors have been striving to incorporate terms more commonly seen in large-cap financings and high yield issuances into mid-market leveraged finance transactions (up to €300m). This briefing provides an overview of the key current documentary battlegrounds between borrowers/sponsors and their lenders and examines how what is seen in today's large-cap finance documents frequently makes its way into tomorrow's mid-market term sheets.

Arguably the key theme which emerges from any analysis conducted on mid-market leverage finance terms in recent years is a loosening of the controls which lenders have over their borrowers; such that deals written in the mid-market today incorporate a lot of technology which would previously have only been seen in large-cap transactions. This is principally attributable to the glut of committed capital which alternative credit providers have at their disposal (and are at some level under pressure from their investors to deploy) and the competitive tension which has emerged between such lenders and traditional banks. In our view the best examples of this shift in mid-market terms centre on the following areas:

FINANCIAL COVENANTS

- The traditional suite of four maintenance covenants (leverage, cashflow cover, interest cover and capital expenditure limits) has been steadily eroded, to the point that a common mid-market position is now a leverage covenant only (occasionally supplemented by a capital expenditure covenant set with a high degree of headroom to capex forecasts in the banking case).

- This erosion of covenant protection has steadily fed down from the large-cap market into the mid-market, although it has been interesting to see the reluctance of mid-market lenders to embrace cov-lite structures (save perhaps in the upper mid-market). Cov-lite structures are those where the only financial covenant is a springing leverage covenant which applies only when the revolving credit facility is 30-40% drawn, and a breach of which allows only the revolving credit facility lenders to take enforcement action (although if they do so, then term lenders may take enforcement action via the cross-acceleration event of default). Given that cov-lite transactions have been the mainstay of the large-cap market for some time, we would have expected this to have filtered down into the mid-market by now if it was going to; it therefore seems such deal structures are currently a step too far for mid-market lenders.

- Equity cure provisions in mid-market deals have become more borrower-friendly and EBITDA cures are relatively common (albeit limited to only one of the available cure rights). There has also been an erosion of the amount of the cure amount which is required to be applied in actual prepayment of the debt, with 50% being the typical position (and no prepayment not being uncommon). Deemed cure provisions have made their way down the market from large-cap financings to become a feature of mid-market deals which is commonly accepted by lenders. In contrast the covenant mulligan (i.e. only the second financial covenant breach giving rise to an Event of Default) continues to be robustly resisted by lenders.

PERMITTED BASKETS

- Permitted baskets in mid-market facilities agreements have undergone a number of changes in recent years, many of which have trickled down from the large-cap market. It is now common to see scalable baskets, which commonly provide that upon either completion of a permitted acquisition which increases EBITDA by a certain percentage, or upon EBITDA being grown organically from initial structuring EBITDA to a pre-determined level, the borrower can elect that the permitted baskets increase by the same proportion.

- However, the large-cap trend of using automatic grower baskets (i.e. baskets which are the greater of £[x] and [y]% of EBITDA) has not yet been widely adopted by mid-market participants. It will be interesting to observe whether this formulation does eventually trickle down, or whether (as with cov-lite structures) it is seen as a bridge too far.

- Additionally, in large-cap financings it is increasingly common to see a 'builder basket' (with or without a starter amount), to which a percentage of consolidated net income or EBITDA is added each year, for permitted payments to shareholders, occasionally subject to a leverage test. This is further technology which does not seem to have been adopted in the mid-market yet, but potentially could be in future.

INCREMENTAL FACILITIES

- Whilst incremental facilities have been seen in mid-market financings for a number of years, the conditions for establishment of such facilities have recently moved towards those seen in larger transactions. The most significant change has been the removal of the fixed amount cap on incremental facilities, with many mid-market facilities agreements now incorporating leverage-linked caps only (i.e. an unlimited amount of incremental debt that can be incurred provided that leverage is below the lower of opening leverage and the leverage level specified for the most recent covenant test date (sometimes minus 10%)).

- Additionally, the restrictions around which entities can access the incremental facility (previously Bidco only) seem to have fallen away recently, with the mid-market adopting the customary large-cap position that any additional borrower can draw the incremental.

- Most-favoured-nation (or "MFN") provisions in mid-market transactions have also been influenced by recent trends in the large-cap market, through (i) a stretching of the yield differential which is required before lenders under existing facilities are compensated, (ii) a move towards looking at only margin differentials rather than all-in-yield (leaving open the possibility of borrowers paying higher fees/OID to effectively game the restriction), and (iii) the imposition, and subsequent shortening, of MFN sunset periods.

TRANSFER RESTRICTIONS

- The traditional mid-market position that borrower consent (deemed given after 5-10 business days without a response) is required unless a transfer is (i) to a lender or an affiliate/related fund of a lender, (ii) to an entity on a pre-approved new lender list, or (iii) made at a time when an event of default is continuing has been steadily eroded in recent years. It is now increasingly common in mid-market financings to see narrower categories of events of default which dis-apply the borrower's consent right (typically only non-payment, financial covenant breach and insolvency) and absolute prohibitions on transfers to any industry competitors and loan-to-own investors or hedge funds.

- Additionally, the provision which has been common in large-cap deals for some time that transfers of undrawn facilities can only be made to financial institutions which fall within the "Acceptable Bank" definition (i.e. have a requisite rating from major rating agencies) is starting to make its way into more mid-market financings. The rationale for this is clear, as the borrower is essentially taking credit risk on an institution which acquires an undrawn commitment and it has a legitimate interest in ensuring its creditworthiness.

- Finally, two further terms which have filtered down to the mid-market from larger transactions are (i) the ability of a sponsor to remove a certain number of entities from the pre-approved new lender list in each financial year (frequently with no corresponding obligation to add a replacement entity) and (ii) disenfranchisement of any entity from voting on any lender decisions if it acquires a participation in breach of the transfer restrictions.

CONCLUSION

In many ways the flow of documentary terms from the large-cap market into the mid-market is nothing new and simply reflects an increase in the supply of capital which lenders have to deploy. This has enhanced competitive tension and allowed mid-market borrowers/sponsors to push harder for increased flexibility. The challenge for well advised lenders and their counsel is to consider the above points in the context of the strength of individual credits and the circumstances of the wider transaction.

However, as has been demonstrated above, it has not been the case that all large-cap technology has marched straight into mid-market documents, as lenders have generally stood firm on cov-lite structures, EBITDA-linked grower baskets and the usage of "builder baskets". It will be interesting to see whether the uncertainties surrounding Brexit and any consequential macroeconomic adjustments cause any degree of retrenchment from lenders in making loans available to UK based borrowers (or other companies with large unhedged GBP exposures), such that the lenders who are still prepared to write business in the UK are able to tighten up the documentary terms which they offer.

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