An Expert's View

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Peter exclusively represents alternative lenders and has extensive experience with sponsor and strategic acquisition financing, dividend recapitalizations, growth capital loans, and cross-border finance transactions across a wide array of industries.

Peter reviews middle market loan trends:

What were the key developments in loan documentation that occurred in 2017?

During 2017, the competitiveness of the market continued, if not accelerated, the market inclusion of upper market terms in the traditional middle market. We have seen a general shift towards capital market or broadly syndicated market terms in private credit transactions in areas such as debt incurrence, permitted investments, available amount baskets, and restricted payments, and extension of refinancing, amend-and-extend, and Dutch auction provisions. Overall, these provisions (and others) provide sponsors with ever greater flexibility to relever the business, engage in a broad range of investment activities without lender involvement, realize a return on their equity investment while maintaining control, and manage their lender group during both good and bad times.

However, the firewall preventing the expansion of these concepts traditionally was a requirement that companies have annual EBITDA in excess of $50 million. Transactions for companies with EBITDA of less than $50 million did not incorporate these more "aggressive" terms. In 2017 we saw these terms move down market to deals with sub-$30 million EBITDA, particularly with upper-market sponsors and their deal counsel who have come to expect these terms in their deals.

Are there particular issues in loan agreement negotiations that you believe will garner increased attention in 2018?

There will be continued friction on the points mentioned above. In addition, we expect to see increased attention paid to credit party exclusions (for example, unrestricted subsidiaries and immaterial subsidiaries) and permitted transactions between and among restricted subsidiaries and unrestricted subsidiaries, particularly as a result of the J. Crew Group, Inc. case. We also expect to see increased attention to excess cash flow deductions, which have started to include not only reinvested cash, but also cash used for any acquisitions, investments, or virtually any other use. We have also seen on occasion traveling change of control provisions coming down market.

Finally, regulatory and tax code changes may generate new discussions. Regulatory changes pertaining to the availability of the new US participation exemption for controlled foreign corporations (CFCs) raise questions about the absolute prohibition on 100% equity pledges of CFCs under Section 956 of the Internal Revenue Code. These regulatory changes call into question whether there is a material tax impact of granting 100% equity pledges in foreign entities and may put these stock pledges in play. Additionally, limitations on the deductibility of interest on corporate debt may push alternative lenders to other structures, such as preferred equity structures.

Direct lending continues to grow as an alternative form of capital. How has direct lending impacted the negotiation of loan terms? How will the evolving nature of the Leveraged Lending Guidance (LLG) impact direct lending?

Direct lenders, especially those with larger platforms and flexible mandates, have the opportunity to exert greater influence on deal terms than a syndicate of lenders. So we see our clients looking to hold the line on some of the trends identified above. For instance, while EBITDA add-backs are growing, our clients have had success in holding the line on synergies and cost savings add-backs with caps and shorter realization periods. They have been able to get MFN application more widely applicable not only to incrementals, but also to forms of *pari passu* debt, and are making headway in harmonizing the various debt incurrence provisions. They have pushed against step-downs to covenants (assuming there are covenants).

Meanwhile, the growth of direct lending is not going to abate, even if (as may be likely) the LLG is relaxed or withdrawn, particularly given the attractiveness of returns in this asset class on a risk-adjusted basis. Banks are not going to rush back into the leveraged loan market. They no longer have the platforms they once had ready to source and deploy capital, and in any event, direct lending funds use bank funding to finance their platforms, affording banks greater diversification. The main challenge for direct lenders will not be from banks, but instead from whether there will be enough deals to allow available capital to be deployed.