What's Market: 2017 Mid-Year Trends in Large Cap and Middle Market Loan Terms

In contrast to last year's fluctuating activity levels, the US leveraged loan market is off to a strong start in 2017. Although M&A loan volume has struggled to pick up the pace, refinancing levels have risen dramatically, and second lien and dividend recap issuance also has surged. Additionally, the proliferation of direct lending and emerging technologies, such as blockchain, are expected to continue this year, influencing the loan market dynamic.

OVERVIEW

Total US syndicated lending increased to $924.6 billion through May 2017. Compared to $718.0 billion for the same period last year, this represents a 28.8% increase. Leveraged lending levels rose from $263.7 billion through May 2016 to $561.3 billion through May 2017, an impressive 112.9% increase and, with levels only slightly below the record set in 2013, the second highest year-to-date total through May 2017. Institutional loan issuance jumped to $389.9 billion, a staggering increase of 323.3%, compared to the $92.1 billion recorded at the end of May 2016. Investment grade issuance, however, dropped to $266.6 billion through May 2017, down from $354.7 billion for the same period last year, a decrease of 24.8%.

M&A leveraged loan issuance fell to $89.1 billion, a 16.5% decrease compared to $106.7 billion for the same period last year. Leveraged buyout (LBO) activity totaled $43.3 billion through May 2017, up 64.6% from $26.3 billion for the same period last year. Non-LBO sponsored issuance surged 314.1%, amounting to $229.0 billion, compared to $55.3 billion through May 2016.

A breakdown by industry sector shows that healthcare, financial services, and technology were the top three industries in terms of loan issuance in both the leveraged loan and institutional markets through May 2017.

The Leveraged Lending Guidance continued to provide a challenging regulatory environment for banks, and less regulated non-bank institutions remained aggressive competitors. Direct lenders, or alternative debt capital providers that negotiate and extend loans directly to borrowers without an intermediary, were also active players in the market this year. Initially focusing on simple club deals and serving smaller, middle market sponsors, these lenders have evolved to arrange committed deals for large borrowers and top-tier sponsors. Offering features such as limited or no flex, limited or no syndication, and the ability to provide financing for the more difficult parts of the capital structure, market observers expect the role of direct lenders to continue to grow.

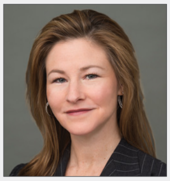
Lawmakers recently have expressed doubt about the legality of the Leveraged Lending Guidance, which could have a dramatic impact on regulation. Patrick Toomey, a US Senator for Pennsylvania, questioned whether the Leveraged Lending Guidance was actually a "rule" cloaked as guidance and asked the Government Accountability Office (GAO) to determine if the Leveraged Lending Guidance is in fact a rule. Under the Congressional Review Act, Congress has the power to reject a rule within 60 days of it being finalized. Senator Toomey argues that if the Leveraged Lending Guidance is a rule, Congress was denied its right to reject it.

Senator Toomey initially requested that the GAO issue a ruling on the matter by June 1, 2017, requiring that the Leveraged Lending Guidance be resubmitted to Congress for review. On May 23, 2017, the GAO agreed to determine the legality of the Leveraged Lending Guidance, stating it expects the decision to take at least a few months.

The Federal Reserve Bank (FRB) might also be preparing to announce interest rate hikes on a more regular basis going forward. The FRB, which first raised rates in December 2015 after a nine-year pause, recently announced its third increase since December 2016. Market observers expect the FRB to raise rates at least once more in 2017, although with an uncertain political climate and possible turnover of staff expected at the banking agencies, what will happen remains to be seen.

Following the increased number of loan defaults that occurred at the beginning of last year for many oil and gas companies, overall default activity through May 2017 has slowed. The number of defaults in the retail sector, however, has risen from 2016. The retail sector ranks as one of the most troubled sectors of the economy, as traditional department stores and

An Expert's View



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Jennifer shares her thoughts on current issues in the loan market:

The first half of 2017 has been marked by a wave of repricings. What developments in the loan market do you expect to see in the second half of 2017?

It would be impossible to answer that question without noting the impact of direct lenders and unregulated financial institutions that have entered the leveraged loan market during the last few cycles. The presence of these new entrants has created a broader group of potential lenders that borrowers can contact for each transaction to take advantage of the various structuring strategies these lenders might provide. Not only does the increased competition often result in more aggressive terms, but combining multiple lending sources might lead to more creative financing structures as the year progresses.

However, these new borrower-favorable terms have increasingly caused borrowers to expect that recent market-clearing terms are locked in, often through the use of an underwritten document precedent which looks backward in time. As a result, we expect to continue to see the terms that cleared the market over the past few months brought to market through the second half of 2017.

Flex rights remain a hot topic in loan negotiations. In what ways have you seen flex rights being exercised so far in 2017, and what do you expect to see in the second half of the year?

Our financing commitments have indeed included an increasing number of flex items in early 2017, in part due to the aggressive nature of much of the new technology, which had not generally been asked of lending syndicates prior to this year. Many of today's terms were groundbreaking only a few months ago, and committed lenders agreed to present these innovations to the market while retaining the ability to revert to the previous norms if needed.

We saw syndicates accept new, more aggressive most favored nation (MFN) carveouts, basket growers for nearly all covenant carveouts, even including restricted payments, reclassification rights, and expanded incremental debt flexibility without the need to exercise all of that flex. However, we sometimes saw pushback on pricing terms.

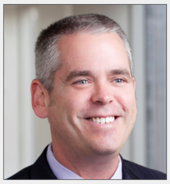
In recent months, we have observed repeat flex events that include a few extra basis points (bps) of interest margin, a few extra months of soft call protection, and reduction of 75 bps MFN protection back to its previously settled 50 bps norm. Some of the innovations the market addressed in earlier rallies are now once again subject to negotiation, for example, a 12-month MFN sunset or a step-down to 50% in an otherwise standard 100% asset sale proceeds sweep, and might be taken to market now to succeed or be flexed out based on the strength of the specific company, or the timing of marketing.

Some borrowers have successfully argued for the inclusion of retroactive default cures in their loan agreements, although these might be strongly resisted by some arrangers. What are the main points of negotiation for lenders and borrowers regarding these provisions?

We have seen a few sponsors and their portfolio company borrowers raising this as an issue in recent months. Our experience generally has been anecdotal, and we have not seen the market as a whole include these retroactive default cures as a routine matter, whereby a later action by a borrower can essentially "undo" the existence of the initial default. We have seen strong resistance from lenders and arrangers in some cases, and in other cases compromises have been reached, particularly pertaining to the knowledge of the borrower's officers of the events surrounding or comprising the default in the first place.

For example, some discussions have centered on the requirement of an agent to deliver default notices in order to start a grace period, which in turn hinges on the delivery by the company of its own standard default notice requirement. Market participants have previously focused on the ability to cure certain defaults in other contexts, such as during the rise of SunGard-style closing provisions, and more recently in a trend that allowed certain misrepresentations to be cured during a delineated time period. In our experience, those surgical provisions which address a very clearly defined scenario are more likely to be found acceptable to a syndicate.

Experts' View



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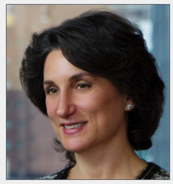

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Andrew, Jane, and Alfred discuss direct lending and its growing role in the US corporate loan market:

What is direct lending?

Direct lenders raise capital from investors to make leveraged loans directly to borrowers in deals sourced by the direct lenders themselves. Direct lenders use the capital raised from investors to fund a large portion, or the entirety, of a loan without syndicating it out to the institutional loan market.

Direct lenders have evolved from working primarily on simple club deals executed on a best efforts basis, serving family offices and middle market sponsors in sub-$50 million EBITDA companies, into influential market players that handle leading committed deals for top-tier sponsors and public companies.

Similar to balance sheet banks, direct lenders focus on achieving a return on actual *lending* as opposed to *distribution*. However, because direct lenders are unregulated non-banks, they do not need to adhere to the Leveraged Lending Guidance and can provide financing for the more difficult parts of the capital structure.

In what ways do direct lending deals differ from traditional bank deals?

Direct lending deals differ from traditional bank deals in the following key ways:

- There is typically limited or no syndication. If syndication does occur in a direct lending deal, it is often limited to a targeted strategy of pre-identified lenders.
- The marketing period receives little or no emphasis in direct lending deals, leading to speedier execution.
- Unlike committed syndicated deals where much of the focus is on flex in syndication, committed direct lending deals feature limited or no flex, and no concept of "Successful Syndication." This results in certainty of pricing and of terms, in contrast to traditional lending deals that include the risk of pricing at the caps.

other brick-and-mortar stores are struggling against their e-commerce competitors in a growing digital environment.

Debtor-in-possession (DIP) financing levels reached $2.7 billion through May 2017. Compared to $2.2 billion for the same period in 2016, this represents a 22.7% increase.

Refinancing activity continues to dominate the market. Accounting for the bulk of lending so far in 2017, refinancing activity topped $680.4 billion through May 2017, as issuers continue to take advantage of market technicals to cut spreads. Compared to $443.8 billion for the same period last year, this represents a 53.3% jump. Repricings increased as well, especially in the beginning of the year.

New money deals, on the other hand, have had a rough start this year. Through May 2017, total new money loan issuance posted $244.2 billion, representing a 10.9% decrease from $274.2 billion for the same period in 2016.

Overall, middle market issuance has been relatively strong so far this year, with lending totaling $57.8 billion through May 2017, a 21.2% increase from the $47.7 billion recorded at this time last year. Of this volume, approximately $46.1 billion was large middle market issuance (deals valued over $100 million) and approximately $11.8 billion was traditional middle market issuance. Middle market new money issuance reached $29.6 billion, while refinancing activity was valued at $28.2 billion through May 2017. By contrast, middle market new money issuance totaled $22.9 billion for the same period in 2016, while refinancings reached $24.8 billion.

Lending in the large cap market posted $866.7 billion through May 2017, compared to $670.3 billion for the same period last year, an increase of 29.3%. Of this volume, new money issuance reached $214.6 billion through May 2017, compared to $251.3 billion through May 2016, a decrease of 14.6%. Large cap refinancing activity levels grew to $652.2 billion through

- Smaller direct lending deals often have no ratings or use private or shadow ratings that provide cost savings to the borrower. In smaller deals, the sponsor relies almost exclusively on shadow ratings. Larger deals (greater than $300 million) often include some form of syndication, and therefore private (or sometimes public) ratings are obtained.
- Direct lending deals place a stronger emphasis on underwriting at the commitment stage. Accordingly, lenders provide sponsors with certainty that terms will be executed on.

What key terms are direct lenders focused on?

Direct lenders expect, and often receive, better terms than borrowers are required to provide in the institutional market. In general, direct lenders are still reluctant to forgo financial covenants or adopt more bond-like covenant packages and basket structures. Direct lenders typically get higher indicative pricing. Additionally, because no market check is performed, direct lenders do not need, and will not have the opportunity, to sell syndicated paper at the best possible market clearing price. The price is agreed to at signing, and the sponsor does not benefit if the market improves during the interim period. Conversely, there is no price flex to adjust if the market deteriorates.

As sponsors have become more sophisticated and the need to compete with other arrangers in auction situations has increased, direct lenders have had to agree to terms that converge with large cap deals, such as run rate EBITDA cost savings adjustments, bleeding edge revenue side adjustments, incurrence-based covenants, reclassification rights (in some deals), and underwriting the terms contained in precedent credit agreements. Nonetheless, direct lenders continue to exhibit their middle market attributes, including through:

- Disqualified lender list fall-aways in default.
- Delivery of fourth quarter and monthly financials.
- Quarterly lender calls and/or MD&A.
- Deposit account control agreements (DACAs) and other collateral perfection steps typically not required in large cap deals.
- Specific positions on earnouts.

What do you see as the future of direct lending?

The role of direct lenders will continue to grow. Direct lending platforms are expanding to cover larger deals with top-tier sponsors, as direct lenders become more sophisticated and more aggressive in their marketing.

Direct lenders are now developing effective syndications and capital markets teams that have growing track records of syndicating upper middle market first lien/second lien deals. The ability to effectively execute on a syndicated option and also show willingness to hold an anchor order on terms within the caps (often by pivoting to a unitranche offering of similar size) if the market turns during syndication makes their offerings particularly attractive to sponsors looking at marginal credits that could go either way in volatile credit conditions.

Search Expert Q&A on Direct Lending for the complete, online version of this Experts' View.

May 2017 from $419.0 billion for the same period last year, a 55.7% increase.

Sponsor-backed leveraged loan issuance amounted to $272.2 billion through May 2017. Compared to $81.6 billion through May 2016, this represents a significant increase of 233.6%.

US borrowers have increased issuance of euro-denominated loans, reaching $13.8 billion through May 2017. Compared to $11.5 billion through May 2016, this represents an increase of 20%.

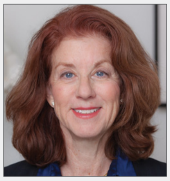
This year has also seen a significant uptick in second lien loan issuance, amounting to $9.8 billion at the end of May 2017, a surge of 326.1% over the $2.3 billion for the same period in 2016. Second lien new money issuance posted $8.5 billion, while refinancings reached $1.3 billion through May 2017. By contrast, for the same period in 2016, second lien new money issuance totaled $1.8 billion, and refinancings reached $530 million.

Dividend recap volume has also picked up this year. Following a strong performance in April 2017, issuance reached $18.0 billion through May 2017, a staggering 309.1% increase compared to $4.4 billion at this time last year.

Collateralized loan obligation (CLO) issuance totaled $37.5 billion through May 2017, a 92.3% increase compared to $19.5 billion for the same period last year. Refinancing activity in this area drastically increased, reaching $80 billion from 179 deals, an astounding 3,536.4% increase compared to the $2.2 billion from 10 deals recorded through May 2016. Most CLO refinancings were driven by deals under the Crescent no-action relief letter, which states that CLOs issued before December 24, 2014 meeting certain specific requirements can refinance without being subject to the new risk retention requirements.

Covenant-lite loan levels also increased this year, amounting to $295.7 billion through May 2017, representing a surge of 407.2% over $58.3 billion from the same period last year.

An Expert's View



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Alexandra represents corporate borrowers, financial institutions, private equity sponsors, and asset managers in a wide range of domestic and international financing transactions.

Alexandra reviews loan market trends:

Borrowers have become more aggressive in their requests for EBITDA add-backs in loan agreements. How have these adjustments to EBITDA changed in recent deals, and what regulatory concerns do EBITDA add-backs raise?

More loan agreements are featuring aggressive EBITDA add-backs for expected cost savings and synergies. Traditionally, borrowers could add back projected cost savings from acquisitions and other transactions realized within a certain time period (often 12 months), capped at a fixed amount or a percentage of EBITDA (15%-20%). Recently, this add-back has become more flexible. The borrower may be able to add back projected cost savings for any operating change, cost savings, or similar initiative that it projects will result in cost savings, even if unrelated to the transaction. Many deals now require only that actions have been or are expected to be taken within a time period (often 24 months) after the event or initiative expected to result in cost savings. The cap on the amount of this add-back has increased (frequently to 25% of EBITDA) or has been eliminated, more notably in sponsor deals. The concern over high leverage expressed in the Leveraged Lending Guidance (specifically total leverage exceeding 6.0x) has increased sponsors' reliance on EBITDA add-backs to reduce leverage levels. In response to this practice, regulators criticized the use of add-backs to dramatically increase EBITDA in several deals in 2016.

What loan agreement provisions do you predict might become the subject of increased negotiation in the second half of 2017?

We expect sponsors to continue to push for maximum flexibility for borrowers to incur additional debt, both within and outside the loan agreement.

Sponsors are aiming to increase incremental debt capacity and diminish traditional protections for existing lenders under incremental debt provisions. Both the size of free and clear incremental tranches relative to EBITDA and use of an EBITDA grower component have increased recently, with arrangers relying on flex to reduce the size and drop the grower. Many deals now include a prepayments tranche composed of the amount of voluntary prepayments of loans and pari passu incremental equivalent debt, as well as buybacks of this debt (at actual cost), in each case not debt financed. Incremental capacity

Unitranche loans, which combine separate senior and subordinated debt financings into a single debt instrument, were once again a solid presence through May 2017. Market observers are optimistic that unitranche loans will continue to be at the forefront of middle market lending this year and play an important part in the continued development of direct lending.

Search Unitranche Loan Financing and Developments in Unitranche Financing (2016) for more on the characteristics of, uses for, and recent developments involving unitranche financing.

Blockchain is a database that uses distributed ledger technology to create copies of aggregate blocks of transactions. The copies created can be kept and maintained by many people or organizations, and no copy serves as the master or lead. Market observers believe blockchain has the potential to transform the way the financial sector does business and that market participants might seek to expand the use of this technology in their operations.

Search Expert Q&A on Blockchain Technology in Banking and Financial Services for more on blockchain technology and its implications for the banking and financial services industries.

In the acquisition financing context, market observers have recently seen increasing instances of escrow funding in the term loan B (TLB) market. In contrast to the use of escrow funding in the bond context, which may be driven by uncertainty of timing for closing or an issuer's desire to take advantage of favorable market conditions, a TLB escrow funding is typically intended to permit the initial committing lenders to, in effect, replace their funding commitments by syndicating a funded TLB to institutional and other investors before the closing of the acquisition and expiration of the long-dated commitment period.

also includes a ratio-based tranche using a maximum leverage test (typically first lien leverage for pari passu debt). The ability to use the ratio-based tranche first, and to reclassify incremental debt incurred under the free and clear or prepayments tranche as ratio debt if the leverage test is later satisfied, is accepted in large deals but negotiated more in the middle market. Middle market lenders prefer to see fixed dollar baskets used first and limited to one time use rather than being refreshed by a performance improvement that may only be temporary.

With sponsors pushing for aggressive terms, there is negotiation around existing lender protections under incremental debt provisions. Sponsors aim to exclude some amount of incremental term loans from the condition that these loans not mature earlier or have a shorter weighted average life to maturity than existing term loans. Often MFN pricing protections for existing lenders are diluted so that one or more of the following does not trigger the MFN:

- Incremental term loans incurred under the free and clear tranche.
- Specified amounts of incremental term loans.
- Incremental term loans incurred to finance an acquisition.
- Incremental term loans maturing more than two years (sometimes one year) after the latest existing term loan maturity date.

Relative to 2016, more deals have closed this year with MFN sunsets intact, mainly in the large cap market, as middle market lenders still resist MFN sunsets. There is tension between lenders resisting MFN carveouts and sunsets and seeking MFN protection for sidecar pari passu loans, and sponsors trying to limit the scope of MFN protection.

For unsecured ratio debt, there is negotiation as to the use of a high yield fixed charge or interest coverage test instead of a total leverage test. For ratio debt incurred to finance an acquisition, there is negotiation as to whether the borrower can satisfy, in lieu of the specified ratio test, a test that the transactions be leverage neutral.

There is an increased focus on asset sale prepayments, with borrowers requesting leverage-based step-downs from the typical 100%, with retained proceeds included in the "available amount" that can be used for restricted payments, investments, and junior debt prepayments. Borrowers aim to exclude more types of asset sales, increase thresholds for proceeds not subject to prepayment, expand the length and scope of reinvestment rights, and use proceeds to ratably prepay pari passu debt. Often only the unlimited dispositions basket triggers the mandatory prepayment, even as the dispositions covenant has expanded to include baskets for sales of non-core assets, specified product lines or businesses, and assets that are not collateral.

Sponsors seek flexibility to pay dividends, while lenders are concerned about leakage of cash. Restricted payment baskets in fixed dollar amounts (often with EBITDA growers) without satisfying a financial ratio test (through both the "starter" portion of the available amount and a standalone basket) are more accepted in large deals but resisted in the middle market. Also subject to negotiation is the ability to make unlimited restricted payments, investments, and junior debt prepayments based only on a leverage test that requires some deleveraging from closing date leverage.

Search Escrow Funding in the Term Loan B Market for more on TLB escrow funding and common issues for parties to consider when implementing TLB escrow funding arrangements.

The US House of Representatives, in a 233-186 vote, recently approved the Financial CHOICE Act of 2017 (CHOICE Act), which would make significant changes to US financial regulation, including repeal or replacement of key parts of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). Among other things, the CHOICE Act renames and restructures the Consumer Financial Protection Bureau, which was originally created to protect against fraudulent lending, abolishes the Volcker Rule, which limits trading activities by banks, and repeals the Department of Labor's controversial fiduciary rule. Although the bill still needs to be considered by the Senate, the House's actions might be the first step in a dramatic overhaul of the Dodd-Frank Act.

Search Financial CHOICE Act Approved by House for more on the CHOICE Act.

Following a promising start to the year, market observers anticipate that leveraged loan volume will remain relatively healthy as 2017 continues, although regulatory uncertainties present a significant concern.

2017 MID-YEAR LOAN TRENDS

Trends that were seen in the large cap market and the middle market through May 2017 include:

- An increase in aggressive EBITDA add-backs for projected cost savings and synergies, including a shift from requiring that these expense reductions are accomplished within a particular time period to a showing that substantial steps have been taken (for examples of credit agreements containing cost savings EBITDA add-backs with a good faith determination, search REV Group Credit and Guaranty Agreement and CDW LLC Second Amended and Restated Credit Agreement in What's Market).

- Negotiation around incremental debt capacity to include a prepayments tranche containing voluntary prepayments of loans and pari passu incremental equivalent debt, as well as buybacks (for an example of a credit agreement with these more aggressive incremental facilities, search Global Eagle Entertainment Inc. Credit Agreement in What's Market).
- Exclusions to the mandatory prepayments provision, with borrowers negotiating for leverage-based step-downs from the usual 100% of asset sale proceeds (for an example of a credit agreement with a step-down threshold for asset sale prepayments, search Emerald Expositions Holding, Inc. Amended and Restated Credit Agreement in What's Market).
- Increased focus on flex rights in credit agreements involving incrementals, soft call protection, and reclassification rights (for examples of credit agreements with these provisions, search REV Group Loan and Guaranty Agreement (MFN sunset), Belden Inc. Amended and Restated Credit Agreement (reclassification rights), and Lantheus Medical Imaging, Inc. Amended and Restated Credit Agreement (soft call protection) in What's Market).

Additionally, this article highlights some key issues in direct lending, a rapidly growing field in the US corporate loan market.

A LOOK AHEAD

Given the heavy levels of refinancings so far this year, activity is likely to remain strong throughout 2017. Another wave of repricings is also expected, considering that the call premiums for a high number of loans will expire in the next few quarters.

Lenders will continue to watch the Trump administration closely for any potential easing of regulation, including reform of the Dodd-Frank Act. Additionally, if Senator Toomey is successful in his bid to recharacterize the Leveraged Lending Guidance as a rule, Congress might invalidate it, thereby easing restrictions on banks and potentially changing the regulatory landscape.

Market observers are also keeping an eye on blockchain, which has the potential to bring technological transformation to some aspects of loan market operations. Direct lenders are expected to continue their reach into large, top-tier sponsor deals and play an aggressive role in the market.

The market statistics cited in this article were provided by Thomson Reuters LPC.