This article was first published in **Debtwire**, 30 May 2019

Docs disguised as large cap as sponsors cherry pick – Mid Market Chatter

By Mariana Valle *(Editor at Debtwire)*

When some funds decided to disintermediate the banks and create what is now the rather mature direct lending market, the promise was of bespoke financing and attractive yields with robust documentation. Just a few years ago that was still true, but the rapid erosion of lenders' rights in the syndicated market in the last few years, coupled with increased competition, has created a dramatic change that is spilling over into the mid market, where documentation today has a distinct large cap feel, according to several market participants.

To start with, flexibility around EBITDA add-backs is plentiful, allowing borrowers to adjust not only for synergies, as was common before, but for a variety of initiatives, with the definition of uncapped exceptional items ever expanding. The period in which synergies can be accounted for has also increased to 18 or even 24 months, from 12 months before, with the cap on those increasing to 20% instead of 10%.

"This brings the flexibility to manipulate EBITDA through projected cost savings and synergies (that may — or may not — ever be realised) largely in line with what we are seeing in the European large cap syndicated market, where 20% EBITDA caps on such adjustments and 12- to 18-month look forward periods are commonplace," said Christine Tognoli, senior covenant analyst at *Xtract Research*.

Some more aggressive docs also allow borrowers to run-rate EBITDA from new sites on expected returns, and EBITDA cures are now commonplace.

The EBITDA definition flexibility also means borrowers are much less likely to breach covenants, which are now commonly down to just one leverage covenant. Meanwhile headroom has ballooned to 35%–40% based on fully drawn RCFs, and a small number of deals also allow the RCF to be drawn without counting as debt under the definition of leverage, allowing sponsors to dip into the facility ahead of an expected breach. That is considered an aggressive feature even in the large cap market.

"In 2015 you'd see leverage, cashflow cover, interest cover and capex expenditure restriction, traditionally set at much lower headroom. Now you have just a leverage covenant on a fully drawn RCF set at a much higher headroom, and a low assumption of cash. Plus you have addbacks so the cumulative effect is covenants with little teeth," said Stuart Brinkworth, European head of leveraged finance at Mayer Brown.

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It is what is now being defined as cov-less — a cov-loose deal with a very loose covenant. A double whammy.

And even when businesses breach covenants, lenders are finding that their ability to sell out is also being impaired, although they are willingly giving up control.

A few years ago, if an event of default occurred, all bets were off. Now, that is limited to a financial event of default, and even then some documentation restricts transferability to loan to own/distressed or competitors when an event of default occurs.

Companies' ability to relever above opening leverage is becoming a lot more common, which includes incurring third party debt, incremental facilities, acquisitions and for dividends. This means a sole lender in a deal could find themselves sharing security over the asset with another debt provider, which is a particular headache for direct lenders.

Incrementals in general are now usually uncapped, and are linked to opening leverage or permitted indebtedness caps, and are available all the way to maturity. Whereas before existing lenders would get a first look or right of refusal if the company raised additional debt, it is no longer included in the documentation, although it remains common practice.

Another large cap feature finding its way into the mid market is freebie baskets, although these are usually simplified to opening leverage plus half a turn of freebie basket.

Grower baskets are also on the up, and they are no longer limited to acquisitions. Now, they are commonly expressed as a percentage of adjusted EBITDA, and grow as EBITDA grows, and are used on an incurrence basis with any unspent amount on annual baskets carried forward.

Prepayment fees are becoming more second lien-like, with 102, 101 call protection. Sponsors also go fee-free on an early prepayment if they IPO the business or if the existing lender rolls into the new deal.

Another interesting feature that is creeping in is the ability to toggle some of the interest, which is becoming more and more common.

How have these terms infiltrated the mid market so quickly? Just like in the larger end of the market, sponsors secure terms on a deal, and then use that as a precedent for their next deal.

The now ever-present — and much hated — grid is combined with a precedent facility agreement in many cases, which locks in terms even before lenders are mandated. From that point on there is not much room to manoeuvre.

"Sponsors are keeping even tighter control over the documentation process than they have previously, giving lenders little or no room to negotiate outside of the term sheet," said Brinkworth.

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Sponsors are also picking and choosing from the high yield bond and syndicated loan markets, as well as from the US market, which creates the ideal borrower-friendly environment. In the US, documentation is loose but lenders have much more leeway when it comes to transferability language. But sponsors are only doing what makes sense in a heated market, where competition for good assets drives innovation on the documentation.

"The result is the best or worst of both worlds, depending on your view point," said Brinkworth.

"Convergence of (and cherry picking of the most favourable terms from) the US and European leveraged loan markets and HY bond markets has been a common theme over the last few years in large cap European deals. We also frequently see stronger sponsors indiscriminately apply their precedent documentation from large deals to deals for much smaller credits," added Tognoli.

One key example of how innovation becomes the norm is the delay fee on the undrawns. What started as a an enticing feature that lowers the cost for the borrower on day one, allowing sponsors to just pay half of the fee upfront and the other half when the undrawns are drawn, has caught on across the market after making its way from the US and is now common practice in the mid market too.

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