PLCFINANCE
STATUS: Maintained • JURISDICTION: USA

Middle Market Lending: Overview

Online Contents

This Practice Note from our website provides an overview of financings in the middle market, including the key differences between the middle market and the large cap market, typical middle market loan providers and the various lending structures. It also highlights noteworthy recent changes in the middle market.

Cassandra G. Mott and Scott J. Moore, Jones Day

Loans and other extensions of credit to companies in the middle market (MM) comprise a large segment of the overall debt market. Thomson Reuters LPC estimates that MM issuances totaled $182 billion in 2011.

The MM is generally defined by either the size of the borrower (annual revenues of less than $500 million or annual EBITDA of less than $100 million) or the size of the loan (less than $500 million). The MM is typically further divided between large MM loans ($100 million to $500 million) and traditional MM loans (less than $100 million).

This Note provides an overview of the MM loan market and highlights noteworthy recent changes that have been occurring in this market.

KEY DIFFERENCES BETWEEN THE MIDDLE MARKET AND THE LARGE CAP MARKET

The MM is typically different from the large cap market (or the more broadly syndicated market, as it is also referred to) in several important ways. For example:

- MM lending tends to be more relationship driven than in the large cap market.
- Lender groups in the MM tend to be smaller and more concentrated than in the large cap market. MM lenders are more likely to hold loans through maturity than their large cap counterparts who trade loans as investments.
- In MM deals, pricing flex or changes in other purely economic terms by lenders are less likely to "save" a deal that receives a cool reception in syndication than they would in the large cap space. Instead, to achieve successful syndication, MM deals are commonly flexed in other important structural ways, often with a requirement for increased equity contributions.
- MM deals are more commonly private deals.
- Except for those in the larger end of the MM, MM transactions are unlikely to include high-yield debt or institutional term loans. MM

deals are more likely to use other financing options, such as unitranche loans, asset-based structures and junior debt.

- MM deals are almost always secured in contrast to large cap deals which are sometimes unsecured.

MIDDLE MARKET LOAN PROVIDERS

In the traditional MM and lower end of the large MM, lending is largely provided by banks and finance companies. Lending in this area remains highly relationship driven. As a result, regional and community banks, which are typically very customer focused, play an especially important role. These loans are often single lender deals or "club" deals (consisting of a small group of lenders arranged by the lead lender to share the loan exposure), and the lenders typically intend to hold the loans through maturity. The focus of these lenders is to build ongoing relationships with borrowers and to expand the scope of fee generating services they offer to their borrowers, such as treasury management, trust and retirement and wealth planning services.

As competition for deals in the MM has increased among banks, lenders have been increasing their hold levels, further shrinking the extent to which these loans are syndicated and concentrating the number of banks with which a borrower has its relationships. In addition, MM sponsors often utilize the same banks or clubs (as well as mezzanine lenders) on a repeat basis to:

- Wield more influence as a customer.
- Exact more favorable terms.
- Develop a course of dealing to speed execution.

Because traditional MM loans are smaller, generally less global in nature and are being held by an increasingly concentrated group of relationship minded investors with a long-term hold view, loan terms are driven primarily by borrower and industry fundamentals as opposed to macroeconomic issues and market fluctuations.

By contrast, the large MM has typically been served by money center and super regional banks and, in the higher end of the market, by institutional investors, such as pension funds, issuers of collateralized loan obligations (CLOs), hedge funds and insurance companies. These loans are usually broadly syndicated and the providers, particularly in the term loan and second lien market, view their financings as investments, focusing more on return, valuation and liquidity than on the relationship with the borrower or issuer of the debt. This term debt is traded among investors and, as a result, this market has become increasingly correlated and susceptible to general market forces and economic influences that are not necessarily related to the borrower or its industry.

While borrower and industry fundamentals obviously play a role in determining the loan terms in any given transaction, the terms in these large MM deals are generally based on the

prevailing market at the time for similarly positioned and rated borrowers. The influence of these broader factors has led to some unusual market conditions, such as those in the third quarter of 2011, where some loans in the traditional MM for smaller, less creditworthy borrowers were pricing lower than those for larger borrowers in the large MM and broadly syndicated markets.

These market dynamics may be working to change the MM landscape somewhat. Institutional investors have historically not been active players in the traditional MM and lower end of the large MM. However, the volatility in the syndicated loan markets resulting from the gyrations of the world and US economies is reportedly luring some of these investors down market into the MM, seeking (although at the expense of liquidity):

- Less price volatility.
- More stable yields.
- Lower leverage.
- More robust covenant packages.

Conversely, some traditional MM players are moving up market, seeking higher yields and more liquidity. This repositioning by lenders and investors, if it continues, will likely present both opportunities and challenges in arranging and structuring financings in the future.

Other capital providers common in the MM space include finance companies, CLO issuers, business development companies (BDCs) and mezzanine and second lien lenders. The banks and these other providers often provide a mix of senior, second lien and subordinated debt designed to maximize the amount of credit available to a borrower or issuer while maintaining senior and total leverage at acceptable levels.

The depth and efficiencies of the MM loan market have proven resilient even through trying times, as evidenced by the deferral of a large portion of the so-called "refinancing cliff" out to 2015 and 2016. However, liquidity in the MM may face some renewed tests in the future. There still remains a significant dollar volume of maturities that needs to be refinanced in the near term. In addition, there is mounting pressure on private equity funds to:

- Sell existing seasoned portfolio assets.
- Put their capital to work by acquiring new assets.
- Realize gains from their existing portfolios (including by way of leveraged dividends).

All of these actions will also require financing. Unless the situation changes, CLO issuers and BDCs, historically a large source of MM liquidity, cannot be counted on to ease the funding burden. This is because the investment periods for most existing CLOs will expire within the next 18 months (and new fund formation has not kept pace) and the outflows from BDCs have rendered them virtually inactive.

Banks, while eager for business, are likely to face additional capital restrictions under new regulatory requirements. Many European banks are currently being forced to cut their lending exposure to the MM or exit the MM entirely. Further, the public equity markets remain closed as a funding alternative to most MM issuers. All of these factors may affect the capital provider landscape and the supply of liquidity for the MM in the future (see below *Convergence of Markets*).

MIDDLE MARKET FINANCING OPTIONS

As noted above, a MM debt financing often combines lending structures to provide additional funds to the borrower while maintaining acceptable financing metrics, such as leverage levels, for the various lender constituents. These structures may consist of a senior financing, a second lien loan, high-yield debt or term B loan and subordinated or mezzanine debt. Multi-tiered financings are common in sponsored transactions where sponsors are looking to maximize the leverage component and reduce the equity contribution required to facilitate a transaction. Regardless of the structures and debt combinations, it is typical for the senior portion of any MM financing to include a comprehensive security and guaranty package from the borrower, any direct parent, its domestic subsidiaries and, in some cases, its foreign subsidiaries.

The various types of financing transactions that MM borrowers and sponsors frequently use include:

- Cash flow loans.
- Asset-based loans (ABLs).
- Second lien loans.
- Mezzanine and subordinated loans.
- Term B loans and high-yield offerings.
- Factoring arrangements.
- Unitranche loans.

CASH FLOW LOANS

Loans made to companies based on their expected cash flows are commonly referred to as cash flow loans. These loans involve maximum loan thresholds or lending commitments that are not tied to a borrowing base or the value of specific collateral that secures the loans. While MM cash flow loans are often secured, cash flow lenders chiefly rely on their borrowers' ability to continue to operate their businesses in a cash positive manner. Borrowers must typically comply with various financial maintenance covenants (that is, financial covenants that must be met on an ongoing basis), such as minimum EBITDA requirements, fixed charge coverage ratios and leverage restrictions.

Before the financial crisis, cash flow loans were not uncommon across the MM, especially at the larger end. However, during the past few years, as many MM businesses contracted and their revenue streams became less predictable, ongoing covenant compliance became more difficult and defaults increased. In the current environment, the cash flow loan is predominately available only in the larger MM and in term loan or high-yield tranches of larger financings, ceding the majority of the rest of the MM to ABL and other asset-based structures.

ABLs

An ABL in its simplest form is a loan sized as a percentage of and secured by certain assets of the borrower. These assets are most typically inventory, accounts receivable (A/R) and, in some cases, property, plant and equipment (PP&E). Depending on the borrower and its industry, the lendable assets may also include intellectual property, investment property and other assets. Borrowing availability and capacity is limited to a percentage of the realizable value of these assets meeting defined eligibility criteria and other limitations (such as sublimits and overall commitments) and reduced by various reserves established by the lenders. Because lending exposures should always be supported by adequate collateral, ABLs as a class generally produce favorable risk-adjusted returns both in the primary and secondary markets as compared to cash flow loans.

The ABL structure offers several features that borrowers, big or small, may find advantageous in more difficult financial environments. Most notably, ABL structures typically require fewer and less onerous financial covenants (including, in some cases, covenant-lite structures). In many cases, these financial covenants are "springing" covenants that become operative only upon the occurrence of certain conditions, such as an event of default or excess availability falling below a pre-determined amount. These relaxed financial covenants can be especially beneficial to companies that have seen their

EBITDA fall to levels that would make compliance with ongoing maintenance covenants focused on or determined by reference to profitability difficult or impossible to meet.

However, one disadvantage of an ABL is that lenders require frequent and detailed collateral reporting requirements (such as borrowing base certifications and A/R aging reports, inventory and other appraisals and frequent field examinations) in addition to the usual financial reporting associated with other lending structures.

While an ABL is often one of the only lending options available to smaller and mid-sized companies, in the current environment it is also becoming a preferred option for larger companies facing a significant downturn in the availability of cash flow loans at covenant and pricing levels that are sustainable or sensible. Many of these borrowers have converted or refinanced existing cash flow loans to ABLs or have chosen to bifurcate their financings to accommodate both an ABL and a high-yield debt component.

SECOND LIEN LOANS

A second lien loan is a secured financing where the second lien lender's security interest in a borrower's assets, but not its rights to payment of its debt, ranks behind the senior lender's security interest. A second lien lender's rights to enforce against and receive and apply proceeds of a borrower's collateral are restricted pursuant to an intercreditor agreement. Typically these loans are provided by finance companies or funds looking for enhanced yields with collateral protections. These loans are often term loans or "stretch" revolvers, providing incremental availability on the collateral package supporting the senior revolving loan.

Like subordinated and mezzanine financings, second lien loan amortizations are typically heavily backweighted, and there is often an annual excess cash flow sweep. However, unlike those financings, interest in a second lien financing is predominantly cash pay as opposed to being capitalized (known as payment-in-kind or PIK). While these loans are pricier for borrowers than first lien loans (due to the second lien lender's subordinate collateral position and practical lack of control over the shared collateral), they are generally less expensive than mezzanine loans, equity financings or high-yield offerings.

The second lien market has been active during the last year or so, as senior lenders have been tightening senior leverage ratios while lenders lower in the capital structure require enhanced security to entice them into transactions at reasonable pricing. Second lien loans have proven a useful and popular alternative to mezzanine financing and high-yield debt, especially in the sponsored sector.

MEZZANINE AND SUBORDINATED DEBT

Probably the most common way for MM borrowers and sponsors to maximize permissible leverage is through the use of mezzanine and subordinated debt. This debt is subordinated in right of payment to the prior payment in full of the senior financing and, if secured, the liens are similarly subordinated to those of the senior lender. However, the debt is not included in calculating senior leverage ratios used in evaluating and sizing the senior debt portion of a financing. In MM transactions, both types of financings are most often provided by funds seeking higher returns associated with the higher risk financings. Sponsors frequently have ongoing relationships with specific mezzanine and subordinated debt providers, using them on a recurring basis for their funding needs.

Mezzanine and subordinated loan structures have many similarities. For example:

- Amortizations are typically structured at *de minimus* levels before maturity (often 1% per annum).
- Interest is structured as a combination of cash pay and PIK.
- Maturities are set outside of the senior facility's maturities (typically no less than 90 days).
- Covenants and defaults are offset from those under the senior facility (a cushion of typically 5% to 15%).

Mezzanine financings are generally unsecured, especially in cases where equity or warrants are required by the lender. Other subordinated debt financings may be secured or unsecured depending on the outcome of negotiations among the senior lenders, the subordinated lenders and the borrower.

TERM B LOANS AND HIGH-YIELD OFFERINGS

Larger MM borrowers are increasingly looking to the high-yield and term B loan markets for term financing. Often these deals are coupled with a bank facility, which includes a revolving facility, possibly a term loan facility and sometimes, especially where the financings are to be used for an acquisition, a bridge facility used to "stop the gap" until a high-yield deal closes. These facilities are often secured on a "cross-over" basis, with the banks being secured by a first lien on current assets and a second lien on all other assets and the high-yield or term loan facility being secured by liens of opposite priority.

In addition, some MM borrowers may pursue pure high-yield offerings without an accompanying bank loan. For large MM companies in particular, the high-yield bond market has helped to fill the void left by the contraction in the conventional bank financing market and the departure of CLOs and other leveraged credit funds from the syndicated term loan market. The high-yield market and deal structures are far more market driven than the conventional bank loan market, which tends to focus on the attributes of individual borrowers.

While the initial costs associated with a high-yield note issuance in a private placement, public offering or term B loan offering can be high in comparison to the costs associated with negotiating and closing a more traditional bank loan, the high-yield market is attractive for eligible issuers because of:

- Favorable overall yields.
- Longer tenors.
- Flexible covenants.
- Speed of execution.

However, this market is susceptible to market fluctuations and can cool or close without warning.

FACTORING

Similar to the growth of the ABL market, the tight credit markets have fostered a resurgence in factoring. Unlike a secured loan, where a lender takes a lien on the assets of a borrower to secure repayment of a loan, the factor actually purchases A/R from the borrower, taking on the risk of loss on the receivable (subject to minimal recourse). The sales are priced at a discount, which is usually higher than the comparable rate of interest on a loan secured by those assets, to account for the:

- Risk of loss on the receivables (without full recourse to the borrower/seller).
- Time value of money.
- Costs of capital, overhead and profits.

The higher cost factoring solution is primarily used by MM borrowers that do not have access to cheaper financing options. These borrowers are typically smaller, more cyclical businesses or businesses "with a story" for which the conventional banking market remains closed. Factoring is sometimes characterized as funding of last resort and in some areas may carry a stigma that a borrower is financially unstable. However, for companies in need of financing, factoring provides a solution to speed up cash flows and provide financing to carry on operations.

UNITRANCHE

The unitranche structure arose out of the desire to provide borrowers with a one-stop solution to their financing needs and offer speed of execution, certainty of closing and, for the lenders, enhanced fundings and returns. These facilities combine senior and subordinated tranches of debt into one facility with a blended rate of interest. This blended rate of interest is often less than the combined rate a borrower would pay for two separate facilities. The unitranche loan is divided into first and second lien components, with priority issues handled through a payment waterfall.

The primary advantage of the unitranche facility for a borrower is that it simplifies the financing process and eliminates costly and time consuming intercreditor issues. The unitranche market is served primarily by specialty funds and, to a lesser extent, some regional and community banks and is predominantly used by smaller MM borrowers.

THE DEAL PROCESS

The MM deal process is similar to that of large syndicated bank loans. After a borrower, its advisors and lenders work out the financing structure, they:

- Begin the due diligence process (for more information, search Due Diligence: Lending on our website).
- Negotiate:
  - the commitment letter (for more information, search Commitment Letters Overview: Lending on our website);
  - the fee letter (for more information, search Fee Letters Overview: Lending on our website); and
  - if applicable, the salient intercreditor terms (for more information, search Intercreditor Agreement Between First and Second Lien Lenders: Overview on our website).
- Negotiate the loan documents (for more information, search Loan Agreement: Overview, Security Agreement: Overview and Guaranties: Overview on our website).

>> For more detailed information on the principal phases of a typical loan transaction, search Lending: Overview and Closing a Loan Transaction on our website.

THE MAKE UP OF A MM SENIOR LOAN

Most MM senior loans include revolving and term loan facilities and often include a letter of credit facility.

REVOLVING FACILITIES

The revolving component included in most MM senior loans is typically used to provide liquidity to run the business and, in some cases, to provide financing for acquisitions, dividends, stock buybacks and other projects. A revolving facility provides the borrower with a maximum amount that may be borrowed, repaid and re-borrowed over a specified period of time (usually three to five years). The borrower pays a commitment fee of typically between 37.5 and 50 basis points (significantly less than the interest rate on drawn funds) on the unused portion of the revolving commitment.

Lenders may refuse to fund under a revolving facility if certain conditions are not met. These conditions generally include:

- The delivery of a borrowing notice.
- The absence of a default or an event of default.
- The bring down of representations and warranties in all material respects.
- In the case of an ABL, a borrowing base that equals or exceeds the aggregate amount of outstanding loans.

The conditional nature of a revolving facility subjects the borrower to some risk that the funds will not be available in the future.

LETTER OF CREDIT FACILITIES

A letter of credit facility is a sub-facility under a revolver. Letter of credit facilities share equally in the collateral and any other credit support, such as guaranties. Typically one or more lenders in a facility agree to issue and front the letter of credit, but all lenders share in the risk pro rata, with any letter of credit reducing availability under the revolver dollar for dollar. Letter of credit facilities can be a challenge for MM loans that do not include traditional banks as part of the lender group because either these non-bank lenders cannot issue letters of credit or these letters of credit are not accepted in the market.

TERM LOAN FACILITIES

MM senior loans (and almost all other forms of MM loans) usually include a term loan component. Term loans are typically drawn in full on the closing date (unless the term loan facility includes a delayed draw term loan for certain events, such as contemplated acquisitions, dividends or stock buybacks) and, unlike revolvers, provide a certainty of funding (provided, in the case of delayed draw term loans, that the enumerated conditions are met). Term loan facilities may be further divided into:

- Term A loans (usually maturing in three to five years) with:
  - regular monthly or quarterly amortization payments;
  - the all-in yearly amortization rate increasing over time (generally 5% in year one increasing up to 20% in later years); and
  - interest rates generally equivalent to the revolver's.
- Term B loans (usually maturing in six to seven years) with:
  - low amortization payments (as low as 1% per year) and a balloon payment at maturity;
  - interest rates generally higher than the revolver's;
  - a fairly standard prepayment penalty at least in the early years (term B lenders are usually looking for a long-term return on their investments and do not want prepayments); and
  - an option for the term B lender to refuse prepayments.
- Term C loans (usually maturing in seven to eight years), which are similar to term B loans but are less common, with:
  - no amortization payments and a balloon payment at maturity;
  - interest rates even higher than the term B loans'; and
  - an option for the term C lender to refuse prepayments.

CONVERGENCE OF MARKETS

The MM has historically been dominated by a relatively small group of lenders who desired to hold on to the loans for the entire term or to put together a club deal with like-minded lenders. Although this limited a borrower's financing options somewhat, the MM was also fairly well insulated from macroeconomic conditions. However, as traditional large cap lenders are being drawn into the MM, it has become more susceptible to the volatility caused by macroeconomic conditions, such as:

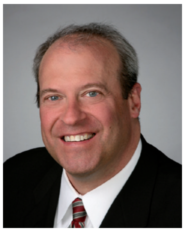
- Economic turmoil in Europe.
- Budget issues in Washington.
- General instability of the US economy.
- Uncertainty related to regulatory and tax reform.
- The upcoming US presidential election.
- Heating and cooling of the high-yield debt market.

For borrowers, this convergence of the large cap market and the MM is a double-edged sword. Although MM borrowers may benefit from a larger pool of lenders, MM loans have started to experience the volatility that is more typical of large cap or more broadly syndicated loans. Although MM and large cap loans have historically been different in many key ways, this convergence very likely may impact other aspects of the MM lending landscape.

//AUTHORS

Cassandra G. Mott
PARTNER
JONES DAY

Cassandra represents capital providers and borrowers in a broad range of secured and unsecured commercial finance transactions, including acquisition and leveraged buyout financings, general working capital facilities, investment grade credits, multijurisdictional and multicurrency facilities and syndicated facilities.



Scott J. Moore
PARTNER
JONES DAY

Scott has broad experience representing agents, lenders, borrowers and other market participants in a wide variety of commercial financing transactions, including secured and unsecured financings, securitizations, multicurrency financings, acquisition and leveraged buyout financings, and workouts and restructurings.