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What's Market: 2023 Mid-Year Trends in Large Cap and Middle Market Loans

by Practical Law Finance

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Experts' View: Erin Simmons and Neal Kaminsky, Haynes and Boone, LLP

Erin and Neal discuss current trends in middle market lending and highlight issues for borrowers to consider in the current credit environment.

What is your assessment of the current state of middle market lending and how does this impact borrowers?

In recent months, there's been a confluence of events that have slowed the pace of middle market commercial lending transactions. Economic indicators paint a picture of uncertainty about the direction of the economy. Recent surveys suggest a significant number of credit managers still believe the US economy will face challenges through the end of 2023 and into next year. Uncertainty about the economy has been a damper on money-center national banks' appetite to lend for a while, but until recently we didn't see this having the same effect on regional banks. However, the bank takeovers in the first half of this year may have encouraged regional banks to scale back on lending activity, like their larger competitors. Adding to the pressure within the sector, the Federal Reserve, worried about bank failures, announced at the end of July proposed rules to increase capital requirements on large banks and apply capital rules to a larger pool of banks. Implementation of the rules may be some way off, but the announcement may have further limited banks' appetites for loans. On the borrower side, a slowdown in M&A activity fueled by a disconnect between would-be buyers and sellers over business valuations has resulted in fewer leveraged buyouts. Moreover, the steep rise in interest rates since March 2022 – with the Fed benchmark rate now standing at a 22-year high – has deterred some borrowers from taking on new debt, and an increase in pricing has deterred borrowers from refinancing existing debt.

These forces are playing out in a variety of ways in the middle market space. It's been harder to get deals through credit committees. More lenders are simply saying no to deals they might have done in the past, and in deals that do move forward lenders are imposing stricter covenant packages on borrowers and increased pricing. Lenders tell us that they are reluctant to take deals to their credit committees if they don't involve clear wins. In this environment, a "win" for a lender is a transaction that comes with significant deposits, fee income from ancillary business and is straight down the fairway in terms of risk profile. There is a heavy focus by lenders on the overall returns a relationship will generate. For their part, borrowers under existing facilities are hesitant to request changes to their deal terms since the resulting amendments may involve higher pricing and fees. Given the tighter credit conditions, borrowers worry that by seeking an amendment to their loan agreement they may prompt some lenders to exit the facility.

There are a couple of bright spots in the middle market. One is asset-based lending (ABL), which hasn't seen quite the slowdown that the middle market cash flow-driven loans have seen. In uncertain times, the relative safety of an ABL loan, with its reliance on the borrower's assets and greater control over them, can be appealing to lenders, and its popularity brings additional

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liquidity to the market. The other bright spot is direct lending. Direct lenders aren't implicated by the bank takeovers or subject to regulation by the Fed, so those drags on market activity haven't weighed on them. As a group, direct lenders also have a lot of "dry powder" available, meaning they have significant amounts of investment capital to put to use by making commercial loans. Since borrowers already expect to pay more when going to a direct lender, the increased focus on return in direct lending deals is viewed by many borrowers simply as a cost of doing business with a direct lender.

What would you say to a borrower that is looking for financing in the middle market right now?

If you are a middle market borrower coming to the loan market, you probably already know that credit is tighter than in the recent past. However, even in the present climate, there are things a middle market company can do to increase the likelihood of closing a successful financing:

- Come to the market with realistic expectations. Credit supply is tighter in the middle market than it has been in the recent past, and you can expect to pay higher pricing than even a short while ago, and for it to take longer and be harder to get a deal done.
- Shop around, particularly if you are considering a bilateral loan. Different lenders have different credit sensitivities. It is important to remember that each bank's credit committee has its own peculiarities about what it views as desirable or not. A bank's decision whether or not to do a particular deal is driven by a host of factors, some of which the borrower cannot control, such as the bank's internal risk management concerns about over-exposure to particular segments of the market in its portfolio.
- Be prepared when discussing your needs with your lender. Focus on your must-have business items. Be prepared to provide a business case for having them.
- Plan for a longer closing timetable. Banks may look to club-out deals that in the past they would have done on their own, and this can slow the closing timetable. For new syndicated transactions, the agent may have a harder time putting a bank group together than would have been the case only months ago. If refinancing is a must, keep in mind your existing maturities and don't wait too long to act, since deals are taking longer to get done.
- Be realistic when considering your existing bank group. If you are seeking a refinancing, be aware that some existing lenders may need to leave the facility if the overall return isn't high enough going forward to meet current credit approval conditions.
- Consider waiting. If you can wait, it may be better to wait and see if the lending environment becomes more borrower friendly. Having a conversation with your current lender or potential lender may provide you insight into whether they think you should wait.
- Be open to other financing solutions. An ABL deal, which suits some asset-rich companies, might be an attractive source of funding. We are seeing greater interest from lenders to do ABL loans with middle market companies. However, ABL is a different financial product and it is important for borrowers to understand how living with an ABL loan is different from living with a cash-flow based loan. Generally, you can expect fewer financial covenants, but additional reporting requirements. Another financing option for some borrowers might be a short-term facility. We have seen an increase in loans maturing within a year. There is a less stringent regulatory burden on banks underwriting these short-term facilities and we are seeing more of them in the market. For a borrower it could be a chance to "kick the can down the road" as far as seeking longer-term financing is concerned, but it is important to understand the ramifications for the business of a one-year facility. Finally, if a borrower goes the direct lender path, they can expect more flexibility on covenants, as well as greater deal certainty and shorter timeline to closing. But as a borrower in a private credit deal, you pay for what you get in the form of higher interest rates, call protection, and in many middle market deals we see equity kickers as part of lenders' overall returns.

In the deal terms themselves, unlike in the looser covenant packages that we had become used to seeing over the past few years, borrowers should now expect there will be less "leakage" available to them under their negative covenant baskets. You see many examples of this in loan agreement negotiations. Borrowers can also expect tighter EBITDA definitions with fewer addbacks, particularly the more speculative addbacks around business synergies and efficiency gains from operational improvements. We are also seeing a greater focus by lenders on amortization and excess cash flow sweeps in their deals, with lenders looking to be paid back sooner.