What's Market: 2016 Year-End Trends in Large Cap and Middle Market Loan Terms

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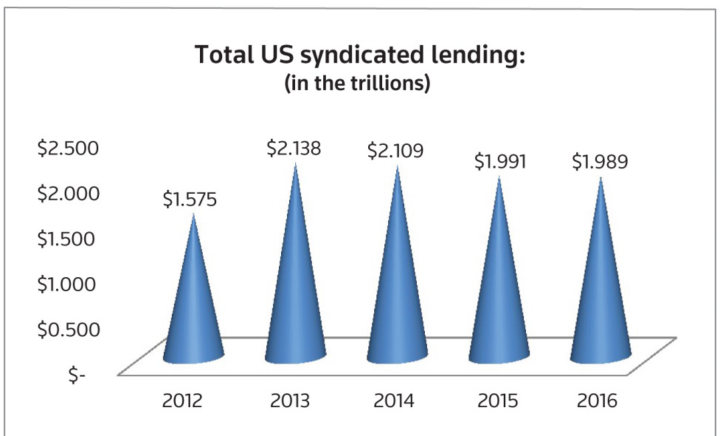
A review of trends in large cap and middle market loan terms for 2016.

Total syndicated lending in the US loan market for 2016 matched the performance of 2015, reaching $1.989 trillion in 2016, a 0.01% decrease from the previous year. Activity was anything but evenly spread throughout the year, however. In the first quarter, the market got off to a slow start, with syndicated lending down 19% year-over-year and the market experiencing a surge in defaults. In the second half of the year (and in particular, after Labor Day) the market saw robust deal flow and higher levels of leveraged loan issuances, refinancings and dividend recapitalizations (dividend recaps). In the third quarter, the improved market sentiment started to wane with investors' concerns about the impact of the US election, the Federal Reserve's policy on interest rates and the UK's withdrawal from the European Union, but by the end of the year the market had stabilized.



Leveraged lending for 2016 increased to $875 billion, a 12% increase from the volume seen in 2015. Sponsored leveraged loan volume was up 32.7% to $378 billion, due in part to leveraged buyout (LBO) volume of $88 billion, a 20% increase, and a 40% increase in non-LBO volume, which reached $279 billion.

Meanwhile, investment grade lending held steady, dipping just 1% from 2015 levels at $861 billion for 2016.

Issuance of collateralized loan obligations (CLOs), the biggest buyer of leveraged loans in the secondary market, continued to slow during the second half of the year. CLO issuance totaled only $72.42 billion, down by 26% from 2015, the lowest it has been in the last five years, according Thomson Reuters LPC.

Large cap totals, standing at $1.85 trillion, remained flat year-over-year from 2015, while middle market issuance edged down by 2%, standing at $138.81 billion for 2016.

M&A loan issuance was down overall in 2016, but was still the second highest annual total on record.

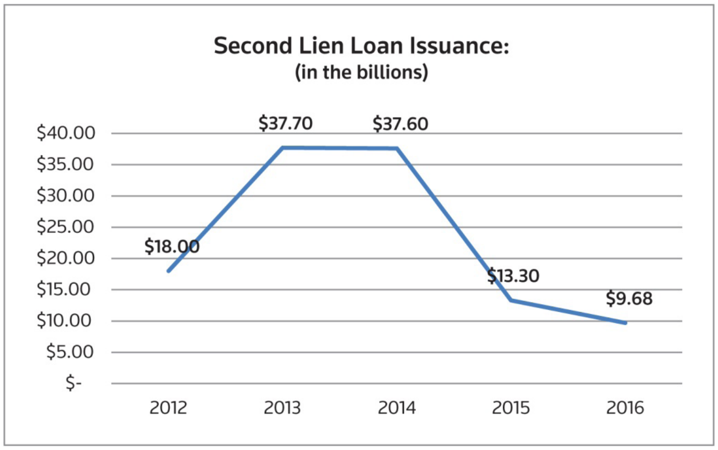
At $478.41 billion, M&A loan volume was down by 12%, which included a 17% decline in non-LBO loan issuance and a 20% increase in LBO volume. However, M&A loan volume in 2015 was skewed higher by a few jumbo M&A deals. While 2016 did not have as many mega deals, major M&A deals with significant bank financings included AT&T Inc. and Dell International (see AT&T Inc. Credit Agreement Summary and Dell International Credit Agreement Summary). M&A volumes overall continue to be stymied by high valuations for acquisitions, which chills investor interest.

For at least two quarters during 2016 (the second and the fourth quarter), the US loan market was dominated by refinancing activity, even though annual refinancing loan volumes only grew by 1% from $1.25 trillion in 2015 to $1.26 trillion in 2016.

At the same time, new money issuance totaled $723.68 billion, 2% down from 2015.

At $24.95 billion, dividend recap loan volume increased by 23% year-over-year. A high volume of dividend recaps is unsurprising in a challenging environment for M&A transactions as sponsors unable to sell portfolio companies turn to dividend recaps as a means to obtain funds from their investments to make a return to their investors.

Similar to the loan market overall, the first lien/second lien loan market bounced back and forth during 2016, but overall, second lien loan issuance declined for the second consecutive year reaching only $9.68 billion, a 29% decrease from 2015.



During 2016 the credit quality of borrowers remained a concern among market commentators. Even though lenders faced greater market liquidity and greater demand for assets, deal flow was limited, leading to more issuer-friendly terms, with looser structures for weaker credits. On the other hand, lenders shrugged off credit quality concerns based on strong market technicals for certain borrowers.

In the first half of the year, there was a significant increase in institutional loan defaults, which were up 27.5% year-on-year through the end of May. As the year came to an end, the number of defaults leveled off. Overall, loan default volume in 2016 totaled $17.5 billion up from $16.4 billion in 2015, only a 6.7% increase. The trailing twelve month loan default rate fell to 1.8% by the end of 2016.

Overall, DIP financing levels in 2016 grew significantly totaling $7.5 billion, a 700% increase from 2015. As DIP financing levels have increased, lenders have pursued more roll-ups of prepetition debt into post-petition facilities. DIP financing arrangements have also become more complex and face more scrutiny. For more information about highly negotiated DIP provisions and related court rulings, see An Expert's View: Trends in Debtor-In-Possession (DIP) Financing (w-002-7607).

Analyzing the leveraged loan market by industry, the technology and healthcare sectors continued to perform strongly in 2016 and were the most active sectors in the loan market.

Predictably, the oil and gas sector continued to struggle under the weight of low oil prices, particularly in the first half of the year. As of December 14, 2016 there were 70 oil and gas producer bankruptcies in 2016, a 59% increase from 2015. There were 71 bankruptcies in the oil services sector in 2016, a 82% increase from 2015. For more information on the performance of the oil and gas industry during 2016, see Legal Update, Oil & Gas Update: 2016 Year in Review (w-005-3860).

REGULATIONS & DIRECT LENDING

In the large cap market, banks have grown more accustomed to working within the constraints of the Leveraged Lending Guidance (LLG). With this growing comfort, in 2016 the closing date leverage ratio for broadly syndicated loans (LBOs only) increased slightly from 5.99x to 6.08x. This uptick may also be attributed to EBITDA add-backs and the negotiation of the leverage calculation. Unadjusted leverage may not be decreasing because EBITDA with negotiated add-backs, as a measure, is becoming more future-driven and less historical. For more information, see Covenants.

In the middle market, when traditional banks cannot underwrite deal terms as competitively due to regulatory constraints, direct lenders, such as Blackrock Capital Investment Corporation, Ares Management L.P. and Antares Capital are a growing source of financing.

The current regulatory regime threatens the speed and certainty that sponsors and borrowers seek. Traditional banks continue to face heightened regulatory scrutiny over leveraged lending. Capital constraints and shareholder activism continue to put pressure on publicly traded business development companies (BDCs). CLO issuance has also been depressed because of risk retention regulations. Against this backdrop, direct lenders, alternative debt capital providers that extend loans directly to borrowers, are becoming an important source of capital.

Direct lenders may have certain advantages over bank lenders because:

- They have flexibility to provide capital at different levels in a borrower's capital structure.
- They can work quickly to close deals because they are a one-stop shop.
- Many are willing to invest in more complicated or "messier" deals.

Traditional banks are not ceding market share to direct lenders without a fight and in some deals will go head to head with direct lenders. Many banks are willing to make exceptions to the LLG in particular circumstances, such as where there may be:

- A borrower with a longstanding relationship with the lender.
- New deals in the pipeline, such as an acquisition financing or business expansion.
- Cash management services and other bank products, such as swaps.
- Significant and credible deleveraging in the borrower's business plan.

For example, if a company wants to refinance at a time when its leverage would not pass under the LLG, its existing lender may be willing to refinance if structural changes can be made to the deal, for example, tighter baskets and additional collateral.

Top tier sponsors still enjoy significant negotiating leverage and often seek commitments from multiple lenders, including banks and non-bank lenders. In 2016, practitioners observed "sponsor arranged syndications" in the middle market, such as where an arranger seeks commitments for the first lien tranche of debt in the capital structure and the sponsor arranges a group of lenders, increasingly direct lenders, to provide a second lien or junior tranche of debt. The arranger may agree to discount its fees to reflect the sponsor's role in arranging the second lien tranche of debt, though the sponsor may have a limited window to find the club. The result is that there may be two or three holders of the junior tranche meaning that no single lender controls consent rights and amendments regarding that tranche of debt, giving the sponsor greater leverage.

In recent years, it was predicted that direct lenders would replace traditional banks, but this has not been the case and in many instances they complement one another. Practitioners report that in first lien/second lien deals and senior/subordinated deals, banks take the role as the arranger of the first lien debt and multiple direct lenders may take second lien lending roles. Direct lending has created a level of disintermediation in the market as loans are increasingly negotiated between a borrower and a lender or a small group of lenders.

The rise of direct lenders has also created more competition which means more choice for borrowers. As in the past, large cap sponsor terms are finding their way in to middle market loan documentation, along with the continued practice of sponsor's counsel drafting term sheets. Surprisingly, it has been observed that unlimited incrementals and unrestricted subsidiaries are being requested at the lower end of the middle market.

LOAN STRUCTURE: UNITRANCHE FINANCING AND AALS

Unitranche loans are now an established part of the loan market for middle market companies. Unitranche loans combine separate senior and subordinated debt financings into a single debt instrument. For information about the characteristics and uses of unitranche financing, see Practice Note, Unitranche Loan Financing (6-503-7571).

Unitranche structures are becoming more complicated and some even provide for multiple, separate unitranche facilities.

In the Agreement Among Lenders (AAL), the market seems to be moving away from listing any event of default as a waterfall triggering event. However, the list of waterfall triggers is growing more complex and bespoke by deal or sponsor.

More complex voting arrangements are being seen in some AALs, sometimes only effective after certain events of default or only if the tranche without a blocking position would be adversely impacted. For deals with complicated voting positions, some permit the buyout of the position of any lender blocking a desired vote.

AALs are also becoming more complex regarding remedial arrangements and rights of inside lenders.

The volume of unitranche deals also continues to grow outside of the US, including in Canada and Europe.

For more information about current trends in unitranche financing, including recent cases and information on Europe, see Article, Developments in Unitranche Financing (2016) (w-002-6841).

LOAN DOCUMENTATION

A nascent trend observed in loan documentation in certain large syndicated deals involving a few investors each taking large positions in the credits was the omission of the commitment letter stage, where the parties moved directly to full loan documentation. Although this practice is not uncommon in bilateral or club deals where the parties have longstanding relationships, it has not traditionally been adopted in large syndicated credits. This trend may be encouraged by the fact that commitment letters have grown in length and complexity in recent years and it may be better suited to deals following an agreed precedent. For an example in which this approach was followed, see AT&T Inc. Credit Agreement Summary.

INTERCREDITOR AGREEMENTS

In large syndicated deals, intercreditor terms are relatively settled. However, in "buy and hold" deals, practitioners have reported lenders are paying more attention to the rights of second lien holders in the wake of recent court cases. Courts are construing turnover provisions in intercreditor agreements extremely narrowly against secured creditors.

Previously there were concerns that that bankruptcy courts may not enforce the terms of intercreditor agreements because the lenders party to them were not in bankruptcy. More recently, the trend is clearly for bankruptcy courts to enforce them strictly and literally. 2016 saw a few developments in the area of intercreditor agreements.

Professional Fees

Professional fees are typically included in the definition of first lien obligations. However, in recent years practitioners have questioned whether professional fees should count against first lien debt cap. If the first lien lender does not want the second lien lender opposing reimbursement of the first lien lenders' expenses or other adequate protection, it must be stated in the intercreditor agreement.

Make-Whole Premiums

A recent spate of bankruptcy court decisions calls into question the payment of make-whole premiums under intercreditor agreements. In *In re MPM Silicones, LLC* (Momentive), the US Bankruptcy Court for the Southern District of New York denied payment of a make-whole claim on the automatic acceleration of debt caused by the debtors' bankruptcy filing (2014 WL 4436335, at *13 (Bankr. S.D.N.Y. Sept. 9, 2014), aff'd, 531 B.R. 321 (S.D.N.Y. 2015); see Legal Update, In re MPM Silicones: SDNY Bankruptcy Court Denies Make-whole Claim and Approves Cramdown of Secured Creditors with Below-market Replacement Notes (1-580-3268)). The Momentive decision continued a trend of denying make-whole provisions after automatic acceleration unless clearly and unambiguously provided for in the governing documents.

More recently and seemingly at odds, in *Delaware Trust Co. v. Energy Future Intermediate Holding Co., LLC* (In re Energy Future Holdings Corp.), the US Court of Appeals for the Third Circuit reversed the holdings of the US District Court for the District of Delaware and the US Bankruptcy Court for the District of Delaware disallowing the noteholders' claims for make-whole premiums, ruling that the relevant indenture provisions support payment of the make-whole amounts (2016 WL 6803710 (3d Cir. Nov. 17, 2016)). For more information on the In re Energy Future Holdings Corp. decision, see Legal Update, In re Energy Future Holdings Corp.: Third Circuit Reverses and Requires EFIH to Pay Make-Whole Claims (w-004-8130).

The Third Circuit's opinion departs from the rationale regarding make-whole premiums that the SDNY Bankruptcy Court set out in Momentive. However, the court's decision was based only on its interpretation of the specific contractual provisions before it. Therefore, the question of whether make-whole premiums will be enforceable in other bankruptcy cases will depend on that court's interpretation of the contractual language in the governing documents. The decision serves as a reminder of the importance of careful drafting and the need to include explicit language in loan agreements and intercreditor agreements concerning the parties' intentions to enforce or avoid make-whole premiums after acceleration.

LOAN TERMS AND CONDITIONS

EU BAIL-IN PROVISIONS

On January 1, 2016, financial institutions regulated by the European Economic Area (EEA) and other EEA loan market participants became subject to bail-in requirements, which include the insertion of an Acknowledgement and Consent to Bail-In of EEA Financial Institutions (Contractual Recognition Provision) in certain documents to which they are a party.

The European bail-in rules are required to be issued by member states within the EEA to implement Article 55 of the EU Bank Recovery and Resolution Directive (BRRD). Designed to address "too big to fail" concerns, Article 55 is intended to prevent taxpayers from having to come to the rescue of banks in the event of another financial crisis. European regulatory authorities can instead resolve the problem and recapitalize a failing EEA financial institution by having the option to deal with unsecured liabilities in certain ways, including modifying shareholder interests and compromising the claims of unsecured creditors, rather than resorting to a bail-out through the use of public funds.

EEA institutions that are affected by the BRRD are required to give notice to their contractual counterparties that the unsecured liabilities of the EEA institution arising under certain agreements with the counterparty entered into or amended on or after January 1, 2016, may be subject to compromise in the event a bail-in is initiated at the election of the applicable European regulatory authority. Affected EEA institutions must have their counterparties' express consent and acknowledgement that the obligations are subject to an EEA regulator's exercise of bail-in powers. They must also accept the terms of any bail-in as they apply to the contractual obligations.

For more information on EU bail-in rules, see Article, Additional Expert Q&A on Applicability of the EU Bail-In Rules in the US dated June 1, 2016 (w-002-5556) and Article, Expert Q&A on Applicability of the EU Bail-In Rules in the US dated November 4, 2015 (w-000-7350).

The US loan market has responded by adopting the bail-in provisions recommended by the LSTA. Based on a statistical analysis by Practical Law Finance, most loan agreements contain a Contractual Recognition Provision. Practical Law analyzed 130 publicly filed credit agreements from 2016 and reached the following conclusions:

- Of the 130 credit agreements, 72% (94 deals) included a Contractual Recognition Provision.
- Of the 94 credit agreements that included a Contractual Recognition Provision, 89% (84 deals) also included bail-in language in the defaulting lender definition.
- Of the 94 credit agreements that included a Contractual Recognition Provision, 39% (37 deals) inserted a reference to the Contractual Recognition Provision in the fronting exposure and reallocation provision.

For more information about Practical Law's analysis of the 130 credit agreements, see Practice Note, What's Market: Analysis of EU Bail-In Rules (w-002-3514).

For examples of credit agreements that include a Contractual Recognition Provision, a defaulting lender definition modified to include EU lenders covered under the bail-in rule, and a fronting exposure and reallocation provision that references the Contractual Recognition Provision, see Arthur J. Gallagher & Co. Credit Agreement Summary and Campbell Soup Company Credit Agreement Summary.

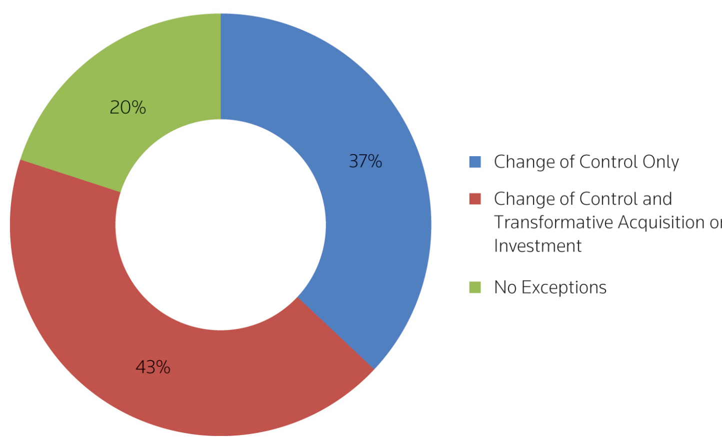
For additional credit agreements with EU bail-in provisions, see Practice Note, What's Market: EU Bail-In Rules (w-003-6629).

CALL PROTECTION

"Soft call" provisions applicable to first-lien term lenders continue to be highly negotiated. However, the triggers for soft call protection, a repricing or a refinancing, are not the main focus of negotiations, which often center on exceptions to soft-call protections. Practical Law Finance performed a statistical analysis of deals from August 2015 to August 2016 with soft call provisions. Of the deals with soft call protection, 31% required a call premium to be paid on the occurrence of a repricing only, while 69% required a call premium to be paid on the occurrence of a refinancing and a repricing.

Lenders typically define "repricing" and "refinancing" transactions as those for which the primary purpose is lowering interest, with exceptions for certain transactions, such as change of control, initial public offerings and other material transactions. Borrowers commonly argue for exceptions for repricings in the context of transformative acquisitions or repricings with junior debt. Based on Practical Law's statistical analysis, of the deals with soft call protection, 37% included a change of control exception, 43% included a change of control exception and a transformative acquisition or investment exception and 20% did not include any exceptions.

Call Protection Exceptions

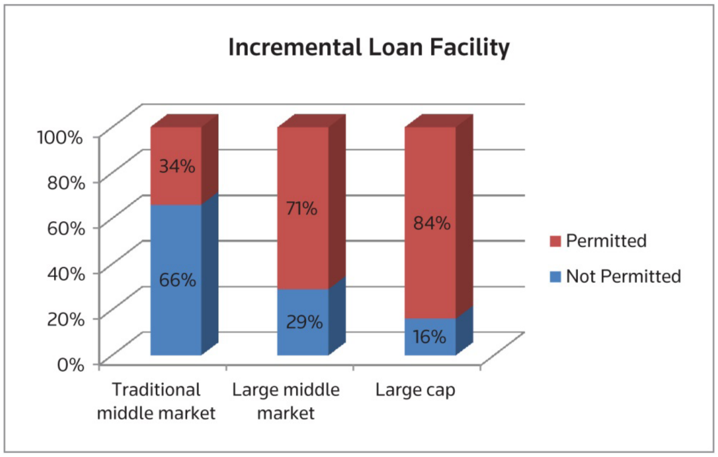


For more information on trends in call protection provisions, see An Expert's View: Trends in Loan Agreement Provisions (w-002-7607). For more information on Practical Law's statistical analysis of call protection provisions, see Practice Note, What's Market: Current Trends in Call Protection (as of August 2016) (w-003-1234).

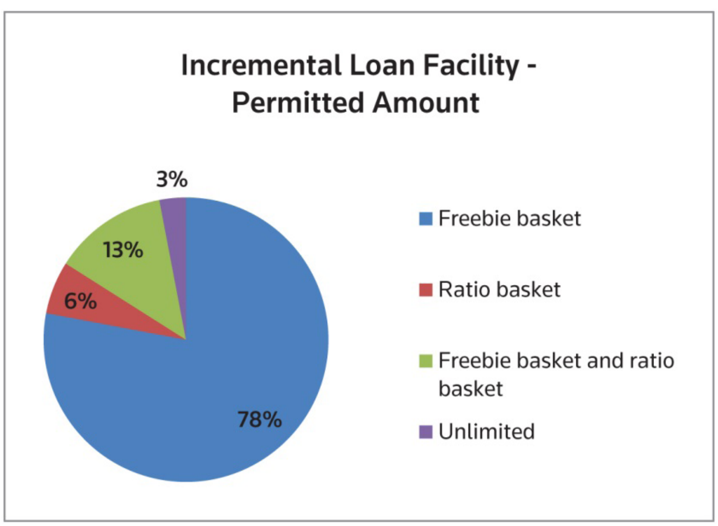
For examples of credit agreements with soft call exceptions for change of control and transformative acquisitions, see Cavium Inc. Credit Agreement Summary and AdvancePierre Foods, Inc. Credit Agreement Summary.

INCREMENTAL LOANS

Incremental loan provisions, which are now largely customary in large cap deals, have become more prevalent in the middle market (except for club deals). Based on Practical Law Finance's statistical analysis of 188 credit agreements from November 2015 to November 2016, incremental loan facilities were permitted in 34% of traditional middle market deals (loans under $100 million), 71% of large middle market deals (loans between $100 million and $500 million) and 84% of large cap deals (loans over $500 million).



Free and clear or "freebie" baskets (based on a half-turn or a full turn of EBITDA) have been observed across market segments. Grower components based on EBITDA and unlimited permission baskets (also known as leverage ratio baskets) based on closing date leverage were also observed. The latter two are more common in large cap deals, but are also making their way into middle market deals. In certain mainly large cap deals, hardwired into the agreement was the ability to use the free and clear basket while simultaneously using the leverage ratio basket, with the free and clear tranche not counting towards leverage levels.



(See, Article, Trends in Incremental Facilities (2016) (w-001-5004).)

In 2016, there has been some evolution in the way that most favored nations provisions (MFNs) are applied. In some deals, a MFN only applies:

- if the incremental loan matures before the initial maturity date;
- if the borrower issues pari passu or ratio-based debt;
- if the incremental debt is above a certain threshold; or
- if the incremental debt is broadly syndicated.

Practitioners have also reported attempts to circumvent MFNs by syndicating deals during the MFN period but having those deals take effect after the MFN period expires. In this environment where many M&A deals are add-on acquisitions, MFN sunsets or the absence of MFNs is also becoming more important because MFNs affect the ability of the borrower to add on debt without their lenders' consent.

COVENANTS

As in prior years, during 2016, certain loan terms continued to move in a more borrower-friendly direction. Those terms include MFNs, negative covenants and caps on EBITDA adjustments for financial covenants.

In the large cap market, unlimited baskets for debt and restricted payments (subject to a leverage test) are more commonplace and have also been observed in some middle market deals. According to practitioners, negotiations for these provisions now center on the leverage test.

It has also been reported that some borrowers are negotiating for the ability to incur debt and liens (or make investments, restricted payments, or junior debt prepayments) under ratio baskets without taking into account the borrower's use of their fixed dollar basket under the agreement or the amount drawn under the revolver.

Another trend in the large cap market is for borrowers to seek the ability to use their fixed dollar basket and then, once the borrower's financial performance improves, later reclassify these transactions such that they are deemed to be incurred or made under an unlimited leverage-based basket instead. This frees up availability under the dollar-capped basket. Lenders do not want to grant borrowers the unlimited ability to reclassify between dollar baskets and ratio baskets. This reclassification may be permissible in the context of the debt and investment covenants. However, lenders are uncomfortable with automatic reclassification and reclassification of junior debt prepayments and restricted payments. For more information on reclassification among baskets in negative covenants, see An Expert's View: Trends in Loan Agreement Provisions (w-002-7607).

Other developments in loan agreement covenants include:

- In the large cap market, some sponsors are now pursuing step-downs on asset sales sweeps. For example, levels may start at 100% and go down to 50% once the borrower has achieved a particular leverage ratio. For an example of a credit agreement with asset sale sweep step-downs, see CDW LLC Amended and Restated Loan Agreement Summary. For an example of a commitment letter setting out an asset-sale sweep step down, see Columbus McKinnon Corporation commitment letter.

- Typically, negative covenants are subject to some cap or other type of governor. Practitioners have reported that grower baskets based on EBITDA are now routine. A grower basket has a cap based on a percentage of some variable (for example, total assets and consolidated income.). For examples of credit agreements with EBITDA growers, see e.l.f. Cosmetics, Inc. Credit Agreement Summary and Amplify Snack Brands, Inc. Credit Agreement Summary.
- Relatedly, another issue subject to increased negotiation is how EBITDA is defined and how the credit agreement deals with add-backs. EBITDA is a historical measure of the borrower's performance, which is indicative of the cash flow generating capacity of the borrower. However, in some deals EBITDA is becoming more future-driven, which shows the borrower's expected performance based on changes due to anticipated events. Through permitted adjustments to EBITDA, Borrowers are essentially telling lenders what EBITDA is rather than reporting historical results. There has been a shift in pro forma calculations to allow unlimited add-backs over the prior 18 to 24 month period. This shift is concerning in a market where the ability to add incremental debt has become standard.
- In contrast to more borrower-friendly developments, lenders are negotiating to limit the creation and usage of unrestricted subsidiaries. A concern is that borrowers use unrestricted subsidiaries to complete transactions that would not be permitted under the loan agreement. In response, lenders seek to limit unrestricted subsidiary designations to ensure that unrestricted subsidiaries are formed for their intended purpose, establishing single-purpose entities, regulated subsidiaries, or joint ventures without adversely affecting the borrower's credit profile. For an example of a credit agreement that limits unrestricted subsidiaries to special purpose entities, regulated subsidiaries or joint ventures, see CIT Group, Inc. Second Amended and Restated Credit Agreement Summary.

COVENANT QUALITY

In 2016, covenant-lite loan volume reached $335.1 billion, which is a 47% increase over 2015. This increase may be attributed to a strong demand from investors for leveraged loan assets. According to Thomson Reuters LPC, many issuers and sponsors have taken advantage of this demand by repricing loans, pushing out maturities and taking out dividends, all while maintaining the loose structure of covenant-lite loans. For an example, see Vantiv, LLC Second Amended And Restated Loan Agreement Summary. For most covenant-lite loans, it has been reported that springing financial covenants have become standard and the biggest negotiation point is around the trigger event.

Even middle market borrowers are pushing for covenant-lite facilities, particularly borrowers that are backed by private equity sponsors.

According to Moody's Investors Service, the covenant quality of US leveraged loans in 2016 was worse than it was in 2007, the year before the credit crisis, in which underwriting standards are regarded as having been at their loosest in the previous cycle. Protections restricting borrower activities, providing warning of deteriorating financial circumstances and triggering enforcement rights have all eroded as covenant carve-outs have expanded, leaving lenders with less covenant protection. Specifically, in 2016 lenders faced increased risks in lien and structural protections due to lien dilution and structural subordination. Especially notable is the decline in lien quality, given that lenders rely on their collateral to preserve their rights ahead of other creditors in a default scenario.

Consistent with the trend towards more borrower-friendly provisions, in the middle market, it has been observed that financial covenants have become more of a "check-the-box" item, set at ceiling levels so high that the covenants are unlikely to be triggered unless the borrower suffers significant and rapid deterioration in its financial performance. Deals with these types of financial covenants are termed "covenant-wide" or "covenant-loose." It is reported that in a covenant-wide deal the leverage test may run as wide as 30% to 40% of closing date leverage, when the default trigger is typically between a variance of greater than about 25% to 30%.

NEGATIVE LIBOR

Concerns about negative interest rates and fears that LIBOR could fall below zero have largely been allayed by market developments. While interest rates were low in 2016, forward LIBOR is trending upward, decreasing the likelihood of LIBOR in the US becoming negative. Even though negative US LIBOR is unlikely, lenders continue to add zero LIBOR floors to their loan agreements.

Zero LIBOR floors protect the applicable margin from being eroded by negative LIBOR rates and address the theoretical possibility of lenders having to pay the borrowers to lend them money.

For more information on negative interest rates, see Article, Expert's View: Q&A from Practical Law's 2016 Loan Trends Webinar (w-001-5106) and Practice Note, What's Market: Eurodollar Rate/LIBOR Interest Rate Provisions (8-385-8146).

A LOOK AHEAD

In 2017, the US syndicated lending market may have to contend with uncertainties arising from policy changes implemented by the new US administration, the UK's departure from the EU (Brexit) and Federal Reserve policy, as well as economic and political events in the wider world. Market observers predict that the syndicated loan market is likely to be stable in 2017, while some lenders speculate that the market may become more unpredictable.

Active sponsors, borrower-friendly lending environments and reduced volatility in valuations cannot overshadow the unknown post-election effects, including changes to various aspects of the existing regulatory framework. Lenders are aware that potential changes to the Dodd-Frank Act could affect the US leveraged loan market, especially if risk retention rules for CLOs are changed. However, some commentators predict that the new administration is not likely to change these regulations, but may instead reduce enforcement.

The short-term view on middle market volume is optimistic for 2017. It is predicted that the biggest uncertainty facing the middle market concerns interest rates, which market participants predict are likely to increase. If interest rates increase slowly, middle market lenders (for example pension funds and insurance companies) are likely to continue to make middle market loans.

The market statistics cited in this article (unless otherwise stated) were provided by Thomson Reuters LPC.

AN EXPERT'S VIEW: LARGE CAP LOANS

Jeffrey Katz, Scott Zimmerman and Sarah Gelb of Dechert LLP review developments in large cap loan deals:

DURING 2016 WHAT WERE THE MAIN AREAS OF FOCUS FOR SPONSORS AND LENDERS IN LARGE CAP LOAN COMMITMENT LETTER NEGOTIATIONS?

Commitment letters continue to be long and detailed, with sponsors generally taking advantage of this stage of the transaction, when their leverage tends to be greatest. Often a particular sponsor precedent financing transaction will be identified under the term sheet's Documentation Principles, with an agreement that, unless otherwise specifically set forth in the term sheet, the terms of the current transaction will be no less favorable to the sponsor / borrower than those contained in the precedent transaction. When the timing of finalizing commitment documentation is very tight, as it often is, arrangers are under significant pressure to understand all the terms of any such identified precedent, so that they can deal with any objectionable terms either in the term sheet or as potential flex items in the fee letter. As arrangers continue to try to accommodate their sponsor clients in respect of terms and timing, this trend and pressure on arrangers is likely to accelerate.

For sponsors that will wish to continue pushing the envelope in terms of leverage levels on acquisitions, alternative arrangers , not subject to regulation under the Leveraged Lending Guidance, will continue to be attractive alternatives to traditional regulated arrangers. In connection with this, sponsors need to handle issues arising from working with alternative lenders. These often will include reduced flexibility regarding provision of revolving credit facilities, which alternative lenders are far less adept at providing than traditional lenders, as well as issues around letter of credit needs, since alternative lenders will ordinarily be unable to provide letters of credit. Because of the Leveraged Lending Guidance, the willingness of regulated lenders to participate in such facilities will depend on overall leverage levels, among other things.

In the current market, some lenders are attempting to take back some of the flexibility that large-cap borrowers were generally able to negotiate previously, including the extent of a borrower's ability to utilize its "free and clear" incremental debt basket without taking the related debt into account for purposes of its leverage ratio-based incremental facility and related debt baskets, as well as the general availability of covenant-lite loans. Yet many borrowers have been successful in pushing back and retaining these benefits. The state of the market will dictate whether there is a give-back of borrower-friendly terms.

WHAT ISSUES DO YOU THINK WILL BE THE FOCUS IN LARGE CAP LOAN AGREEMENT NEGOTIATIONS IN 2017?

Current issues in loan negotiations include the following:

- MFN on incremental loan issuance: There is tension between sponsors fighting for quick sunset on "most favored nation" provisions and arrangers pushing for long ones or no sunset; there is tension between arrangers fighting for applicability to sidecar facilities as well, however documented, and sponsors fighting for applicability only to similar types of financing facilities, if at all; and there is negotiation around calculation of the concept of "current all-in yield" when at least one incremental facility was already utilized.
- Debt incurrence: There is negotiation between using an indenture-style fixed-charge coverage ratio test or a loan agreement-style leverage ratio incurrence test.
- Unrestricted subsidiaries: There is discussion by arrangers as to additional limitations on unrestricted subsidiaries, including caps on the percentage of EBITDA that may be attributable to such subsidiaries, while sponsors continue to want to maintain flexibility.
- Reclassification among baskets: There is negotiation relating to the extent of a borrower's ability to reclassify debt, liens, etc. incurred under a general basket at a later time, when the borrower is able to meet the applicable leverage test set forth in a leverage-based basket.

A LARGE QUANTITY OF CORPORATE LOANS IS SET TO MATURE IN 2017 AND 2018. WHAT DO YOU THINK ARE SOME OF THE BIGGEST CHALLENGES FACING BOTH BANKS AND NON-BANK INSTITUTIONS AS THEY CONTINUE TO INCH CLOSER TO THIS MATURITY WALL, AND HOW DO YOU PREDICT THEY WILL RESPOND?

This challenge will become exacerbated in the event that overall lending capacity in the market diminishes between now and these upcoming maturities. In this event, aggressive sponsors may attempt to opportunistically refinance portions of existing facilities via the flexibility afforded by allowances under their existing credit documentation for incremental and refinancing facilities and the like. This could translate into fewer traditional one-time refinancings of entire existing facilities than has traditionally been the case.

Due to the degree of convergence of loan agreement and indenture covenants in the large-cap space, and the corresponding overall loosening of loan agreement negative covenants under many existing large-cap loan agreements, lenders could face aggressive moves by sponsors / borrowers, some of which may be unprecedented, taking advantage of less restrictive provisions and possibly attempting to push the envelope on movement of value to unrestricted subsidiaries, selling assets without prepaying outstanding loans (under aggressive readings of prepayment exceptions, such as for capex), and through other methods of removing cash or assets from the priority of the senior credit agreement lender group under gray areas of existing credit documentation.

Against the backdrop of these impending maturities, the new administration in Washington, DC has promised to loosen regulatory capital requirements and other regulations applicable to traditional lenders. These changes may have the effect of increasing liquidity in the market, thus forestalling the effect of the so-called maturity wall. At this time, there is little detail in terms of how far the applicable regulations may be rolled back, if at all. In any event, these changes could in turn exert pressure on alternative financiers to retain their recently gained position in the market, potentially incentivizing them to differentiate themselves in other ways, to the extent their regulatory advantage will be diminishing. Only time will tell how this will play out and what its effect, if any, on large-cap loan terms will be.