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What's Market: 2022 Year-End Trends in Large Cap and Middle Market Loan Terms

by Practical Law Finance

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An Expert's View: Developments in the Large Cap Loan Market

Michelle Kilkenney of Kirkland & Ellis LLP discusses developments in the large cap market in 2022 and what the market can expect in 2023.

During 2022, did you see a change in financing structures to finance M&A in the face of syndicated market challenges?

While syndicated loan and high yield bond market dislocation in 2022 made access to debt more difficult and expensive, sponsors and borrowers found creative approaches to finance new M&A opportunities and increase leverage. These strategies included:

- Use of seller financing.
- Use of both money center banks and direct lenders to provide first lien financings.
- Use of term loan As (TLA) to reduce the size of a syndicated term loan B (TLB) tranche.
- Use of holdco PIK tranches or preferred tranches to stretch leverage beyond leverage levels available in the TLB market.
- Use of minority stakes transactions to avoid triggering change of control provisions to retain existing target debt.
- Executing all equity transactions and obtaining financing post-closing.

In addition, I expect direct lenders to continue to play a significant role in financing large LBOs (albeit with greater selectivity and, in some cases, reduced hold sizes) as they seek to deploy dry powder and showcase private credit's advantages over the syndicated market (chiefly, certainty and speed), particularly in times of market dislocation.

With regular-way syndicated market LBO activity not expected to pick up again this year until the end of the second quarter or early in the third quarter, when hopefully bulge bracket and money center banks are likely to have resumed a risk-on stance after unloading some of the underwritten deal overhang, I expect to continue to see sponsors and borrowers find creative approaches to finance new M&A opportunities.

How do you think the pressures of the current economic environment may impact large cap borrowers during 2023?

Macroeconomic conditions (including rapidly rising rates, rampant inflation, and geopolitical uncertainty) led to uneven syndicated loan and high yield activity in 2022. Meanwhile, private credit providers used the disruption in the syndicated market to their advantage and stepped in to bridge the financing gap by funding some of the largest LBOs of the year, including by purchasing large portions of underwritten hung LBO bank debt. The lack of new supply and the scale of the hung loans in the broadly syndicated market led market participants to actively focus on OID and pricing dynamics.

I would expect to see the full impact of rising rates, including increases in company leverage ratios and compression of coverage ratios over the next 6 to 12 months. The amount of stressed or distressed activity centers on the degree of earnings deterioration and the total increase in debt servicing costs, particularly for highly levered capital structures. While many borrowers have only yet lived through several quarters of the new normal with higher interest rates, costs remain elevated ongoing supply chain disruptions" and orders down for 2023. Unlike 2021 and 2022,

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many companies may struggle to continue to increase prices to offset these cost increases.

In addition, many borrowers are not able to withstand 5% SOFR for sustained periods of time. Companies may be forced to consider a variety of options in light of underlying limitations inherent in their credit facilities, including cutting costs and selling non-core assets to boost EBITDA. Companies may consider finding ways to reduce cash paying debt burden (especially with interest paid in kind, or PIK interest). For sponsored companies, sponsors may be asked to provide equity capital during this period of margin compression and liquidity constraints.

Yet, many levered borrowers have greater documentary flexibility than in the Great Financial Crisis, which for some may allow a long enough runway at this crucial point in the business cycle to avoid problems at least until the Fed begins to cut rates. This reality, along with some form of sponsor equity support, may help these companies survive through to the point when the Fed begins to cut rates, hopefully late in 2023 or in 2024.

Given most large cap debt is covenant lite, market observers expect the real focus in this earnings downturn is likely to be on maturity and liquidity. For middle market borrowers, the reality may be more complex, which is where I expect to see the majority of stressed and distressed amendment activity in the first half of 2023.

Are there particular issues in covenant negotiations in large cap loan deals that you think will demand increased attention in 2023?

For new loan issuance activity, the reality of reduced loan market liquidity and volume (driven by a lack of opportunistic financings, as companies are holding on to their cheaper legacy pricing in existing credit facilities) is expected to continue to drive higher spreads, lower leverage levels, higher amortization, longer call protection, decreased add-backs to EBITDA, and decreased covenant cushions.

In recent weeks, borrowers in certain sectors have been increasingly approaching lenders for financial covenant holidays (sometimes with minimum EBITDA or liquidity testing, or both, throughout). Other borrowers are hopeful that lenders will agree to temporarily increase the dollar/percentage caps in EBITDA rather than reset financial covenant levels for future quarters.

Given margin compression and earnings deterioration, borrowers are also beginning to ask for interest relief in the form of PIK interest. The responses to these requests reportedly vary across direct lenders, but some have been willing to PIK interest for six months to a year, while others will only allow borrowers to PIK the increased portion of interest implemented as part of a relief amendment (for example, if adding 50 bps to the highest level of pricing grid, the borrower is permitted to PIK the 50 bps). In some cases, direct lenders have been unwilling to agree to PIK interest at all.

In the current climate, interest or covenant relief may be difficult to obtain without the sponsor contributing additional equity. This reality was not necessarily the case in the immediate post-COVID period. Borrowers are also increasingly focused on potential going concern qualifications, which may lead to an increase in amendments to permit certain types of exceptions to standard requirements for delivery of clean annual audits. Ultimately, borrowers will need to thoughtfully balance what lenders are willing to provide (such as, PIK relief, new money, financial covenant relief) against what they may demand in return (such as, tighter baskets, sponsor equity and amendments focused on limiting liability management opportunities) given current macro factors and market dynamics.