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Global Finance

Loan Market Update: Q1-Q3 Recap, Trends & What's Next

By The Global Finance Practice

From Q1-Q3 of 2023, the U.S. loan market was marked by novel deal patterns and uneven market activity. Initially, the bulk of deals were portfolio work, including amend & extend transactions, covenant relief amendments and LIBOR transition amendments. With respect to new issuances, private credit deals continued to outpace syndicated transactions and recurring revenue financings increased in frequency and quantum. Beginning this summer, deal volume began to pick up, even if it has not yet quite returned to the levels seen in late 2020 into the first half of 2022. Pricing pressures were front and center as reference rates (one-month Term SOFR) rose to over 5.25% (just as USD LIBOR ceased publication at the end of Q2), which abated slightly when the Federal Reserve declined to raise rates in September. At the forefront of deal term negotiations beyond pricing were MFN protections, financial covenant structures, and leakage & uptiering protections.

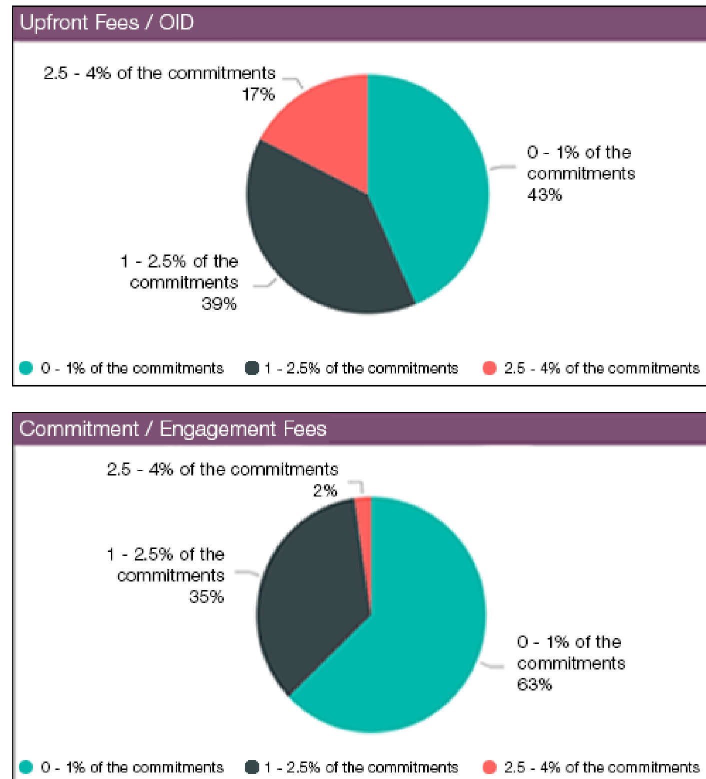
1. Recent Trends[1]

A. Pricing Developments

Over the course of 2023, margins have declined in both large cap and middle market credit facilities, and in both broadly syndicated and direct lender-led deals. Some of this decrease in margin is likely attributable to rising reference rates through Q2 and, into Q3, improving market conditions. Compared to the beginning of 2023, margins in Q3 thus far declined by: (1) for broadly syndicated deals, approximately 50 basis points (bps), (2) for upper middle market (with borrower EBITDA > $20MM), by nearly 40 bps, and (3) for lower middle market (borrower EBITDA ≤ $20MM), by almost 50 bps. In middle market deals, margins are still higher than they were just over a year ago as of the end of the second quarter of 2022. However, margins in broadly syndicated deals were down nearly 115 bps from Q2 of 2022.

	Margins (first lien/senior secured term loans; in bps)		
	Broadly Syndicated	Upper Middle Market	Lower Middle Market
2022 – Q2	500.7	516	542
1Q23	415.5	585	589
2Q23	411.2	583	581
Q23 (to 9/22)	385.8	548	563

With respect to fees (by tranche, for new issuances), original issue discount (OID) in 2023 returned to more "normal" levels (ranging from 97-99 in the lion's share of deals) following record high OID in the second half of 2022 (when some deals included OID in the 80s). Otherwise, commitment, engagement, and other comparable fees were down slightly as compared to late 2022 (~168 bps), averaging around 140 bps in sponsor-backed deals closed in 2023 (through 09/22/2023).



B. Financial Covenants

From late 2020 through the first half of 2022, financial covenant levels in some credit facilities (almost exclusively sponsor-backed) reached record highs with levels set at double-digit leverage ratios (including both those with covenant-lite/springing financial covenants and those with maintenance financial covenants). Beginning in the second half of 2022 and continuing into 2023, most new issuances have not included quite such generous leverage tests. Overall, the initial leverage testing level is very deal dependent, based on the size of the company, strength of sponsor, closing leverage, and other factors. Over the course of 2023, initial post-closing covenant levels in sponsor-backed private credit facilities have most often ranged from 5.75x-7.75x for the initial (or sole) EBITDA-based leverage level. In lower-middle market and corporate borrower credit facilities from this period, these were most often set at 3.50x-5.00x.

In covenant-lite/springing-covenant deals in 2023, where there is a single, fixed covenant level, tested only upon triggering the testing condition, this threshold has usually been based on 30-40% of the revolving credit facility (RCF) being drawn down (subject to certain exclusions & credit for unrestricted cash) as compared to late 2020 to first half of 2022, where deals sometimes included more generous triggers of 50+% (even up to 75-85%!).

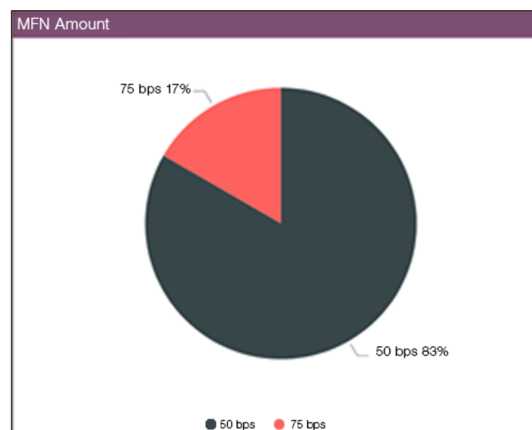
In deals with a financial maintenance covenant (that is an EBITDA-based leverage covenant) from this period: (1) most deals include at least 1-2 step-downs once financial covenant testing commenced (step-down increments of 0.50x-1.00x were most prevalent), (2) step-downs typically began at least 4 full fiscal quarters (FQs) after testing commencing, with step-downs occurring at intervals most often between 4-8 FQs (and potentially at equal, subsequent intervals thereafter), (3) large cap/strong sponsor-backed deals were most likely to include a single, fixed covenant level with no step-downs, (4) some lower middle market deals included step-downs on a quarterly (or every other quarter) basis (such step-downs are generally 0.25x each), and (5) in recurring revenue-based deals, step-downs in recurring revenue based leverage covenants were typical (step-downs in toggle deals, after the flip to EBITDA-based covenants, were typically more limited or not included post-toggle).

Most cash-flow EBITDA credit facilities in 2023 that included a maintenance financial covenant (over 67%) only included a single EBITDA-based leverage financial covenant. Multiple financial covenants were more common in: (1) recurring revenue loans, (2) asset based loans (ABL), (3) lower middle market credit facilities, (4) corporate borrower credit facilities, and/or (5) distressed credit facilities. Where additional financial covenants were included, liquidity covenants (or minimum EBITDA/recurring revenue covenants) continued to be most common. Some deals (predominantly ABLs) instead included fixed charge coverage or interest coverage covenants, and, less frequently, guarantor coverage tests. Occasionally, credit facilities additionally, or instead, included maximum capital expenditures or similar financial covenants.

C. Debt Capacity & MFN Protections

Debt capacity, both with respect to the accordion/incremental and *pari* side car debt incurred outside of/separately documented from the loan documentation, has been scaled back overall over the last twelve month (LTM) period. Fixed incremental components in 2023 that have cleared the market have rarely included a multi-faceted grower component based on the greater of (x) closing EBITDA and (y) LTM EBITDA. Nonetheless, the fixed incremental amount in sponsor-backed deals has largely returned to amounts and growers equal to 100% of closing EBITDA versus late 2022 when some deals saw this reduced to 75-95% EBITDA. Broader limitations on debt incurred by non-loan parties have become more widely accepted following several high profile restructurings by issuers that previously consummated so-called “liability management transactions.”

In 2023, MFN pricing protections triggers continued to be set at 50 bps yield differentials in most credit facilities. However, a notable portion (~17%) of sponsor-backed new issuances and refinancings incorporated 75 bps MFNs (as reflected in the chart below, covering 230 sponsor-backed deals in 2023); 75 bps MFNs were largely absent from the U.S. loan market in the second-half of 2022. Carve-outs to MFN protections continue to appear in most sponsor-backed credit facilities, and are more prevalent in broadly syndicated deals, where MFN sunsets of at least 6-12 months are typical. With private credit capturing an ever greater market share during this period (including providing, increasingly larger credit facilities), MFN carve-outs that were often limited to the syndicated loan market have begun to gain traction in private credit deals. For example, in 2023 thus far, large cap, strong-sponsor backed direct lender-led credit facilities included inside maturity carve-outs in nearly 50% of such deals (up to dollar-amount equivalent and/or EBITDA grower ranging 50-100% EBITDA).



D. Leakage Protections

Drafting protections meant to address cash, collateral & value leakage (whether by restricting transfers of material assets, prohibiting automatic releases of guarantor subsidiaries upon ceasing to be wholly-owned by the loan parties, and/or limiting designation of unrestricted subsidiaries) have become not only non-negotiable for many financing sources, but also more broadly accepted by borrowers and sponsors. Most sponsor-backed credit facilities in 2023 (~70%), across the large cap and middle markets, included at least some variation of such protections. As these "leakage protections" have become essentially required terms, they have also become increasingly negotiated, and, in some case, materially diluted. One recent evolution in terms restricting transfers of material assets is an additional qualification that would permit dispositions of material assets in connection with any bona fide joint venture transaction or strategic transaction. This qualification, which had previously been limited to protections governing the automatic release of guarantor subsidiaries upon ceasing to be wholly-owned, may dilute this ostensible protection, especially if included in addition to other qualifiers such as materiality thresholds or only restricting transfers to unrestricted subsidiaries (versus all loan parties).

E. Uptiering Protections

Following several headline grabbing uptiering transactions in recent years, uptiering protections that require all/affected lender consent ("enhanced lender consent") in connection with priming transactions resulting in lien and/or payment subordination have become generally accepted in the U.S. loan market. In 2023 to date, some form of uptiering protections for amendments (1) to pro rata sharing provisions, (2) to the payment waterfall, (3) resulting in lien/payment subordination, and/or (4) permitting releases of less than all/substantially all of the collateral and/or guarantors have appeared in vast majority of credit facilities.

	Uptiering Protections (% frequency in 2023 sponsor-backed deals)		
	Large Cap	**Upper Middle**	**Lower Middle Market**
Pro Rata Sharing	95%	100%	100%
Payment Waterfall	64.3%	68.7%	75.1%
Lien/Payment Subordination	57.2%	78%	70.6%
Partial Releases (Collateral or Guarantors)	23.3%	49.5%	81.3%

2. New & Expanding Deal Terms

A. Leveraging Acquisitions/Transactions

Some credit facilities may permit a temporary reset of the financial covenant back to the initial EBITDA-based leverage testing level (or a prior, more generous/cushioned leverage level) following certain material transactions, such as material acquisitions and, less often, other material permitted investments and/or dispositions. Such mechanics may allow the financial covenant levels to be reset for 4-8 FQs following such event and may require that such transaction be funded (in part) with available delayed draw term loan (DDTL) commitments (or at minimum specified amount thereof). This "leveraging acquisition/transaction" construct had been relatively rare, even at the height of market flexibility in late 2020 through mid-2022. However, with borrowers facing rising rates and leverage continuing to increase, leveraging acquisition/transaction constructs began to be more frequently requested by borrowers and sponsors. At first blush, leveraging acquisition/transaction constructs may seem to be unappealing to existing lenders; however, ostensibly, this construct is included to facilitate growth and expansion of the loan parties' business without requiring a refinancing and/or covenant relief amendments during the initial

growth/adjustment period following such material transaction(s).

B. Permitted Material Asset Dispositions

The advent of leakage protections has meant that credit facilities are more likely to restrict dispositions of material assets. However, in 2023, a small, but growing portion of credit facilities have begun to include provisions expressly permitting dispositions of material assets, such as material intellectual property. Such terms typically allow the material asset disposition subject to restrictions on the purpose of the transaction and the counterparty. One such provisions permitted any disposition of so-called “Material IP” so long as such transaction would not be “(i) undertaken to facilitate a financing (including a debtor in possession financing) or a Restricted Payment, (ii) undertaken in connection with a liability management transaction, or (iii) entered into with an Affiliate of the Borrower (other than Holdings or its Subsidiaries).”

C. Expanded/Additional “Lender Sacred Rights”

This year has been marked by several new and/or expanded “lender sacred rights” appearing in at least some credit facilities. Beyond the most commonly requested enhanced lender consent items, some credit facilities have included leakage protections as “lender sacred rights,” such as requiring all/affected lender consent to release material assets and/or permit designation of additional unrestricted subsidiaries. With a heightened focus across the U.S. loan market on the use of open market purchase provisions as a means by which loan parties may effect uptiering transactions, some additional “lender sacred rights” have prohibited non-pro rata term loan buybacks and/or debt exchanges without all/affected lender consent.

D. Double-Dipping

Recent loan market industry news headlines have declared the rise of proverbial “double-dip” transactions. In double-dip transactions, creditors providing new money to a company seek to maximize recoveries by creating at least two separate claims against the company with respect to its organizational and capital structure. As an example, (1) first, a company with existing credit facilities could create a new/spun-off subsidiary, (2) next, the double-dip creditor could provide financing to this newly created/spun-off subsidiary, which would be guaranteed by a restricted subsidiary of the company, and (3) finally, the proceeds of double-dip financing would be used to provide an intercompany loan from the new/spun-off subsidiary to the company (with such intercompany receivable pledged to secure the double-dip financing). Under this structure, the creditor would then have claims against: (1) the restricted group via the guaranty and (2) the company via the pledge of the intercompany loan, which creates the “double-dip” structure. Although recent industry news coverage suggests such structures are novel, examples of double-dips (and allegedly, “triple-dips”) by creditors seeking to improve their recoveries can be found in various liability management transactions and Chapter 11 proceedings.

3. What’s Next for the U.S. Loan Market

With Q4 on the horizon, it seems the U.S. loan market is finding its new rhythm. The most flexible terms from mid-2020 through mid-2022 appear to be in the rearview, even if there does not appear to be a tightening of terms across the board to the levels seen at the end of 2022. Lender protections for leakage, uptiering and otherwise are certainly becoming more “standard,” but remain highly negotiated, and, as such, will continue to evolve in the near term. Into the end of 2023, the uptick in loan market activity appears poised to continue (and hopefully to increase), with respect to both the syndicated loan market and private credit market, the latter of which will likely retain a greater portion of market share than it did pre-2020.

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[1] Unless otherwise indicated, data analytics are based on publicly available and proprietary data for: (1) from 2023, over 500 sponsor-backed credit facilities and (2) from Q2 of 2022, nearly 150 sponsor-backed credit facilities.

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