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A Year in Review (Third of a Series)

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"How's your pipeline?" we asked the head of one of the leading middle market arrangers in December. He shook his head. "The quality-adjusted deal flow is down."

That distinction resonated with a number of our middle market brethren. Complaints centered around ebitda adjustments, over-liberal debt allowance baskets, and covenant-lite (or covenant-wide) structures. "High leverage *per se* is not the problem," one lender fretted. "It's the fictional ebitda the leverage is built around."

Some of this structural erosion is attributable to sponsors trying to bring large cap terms down market. The same credit document that the PE firm used for a $250 million ebitda issuer is being rolled out for the $50 million borrower.

Another culprit is the hyper-competitive auction climate for buyers. To justify double-digit purchase price multiples, particularly for otherwise run-of-the-mill businesses, sponsors are pushing the envelope on what defines true ebitda. "We draw the line when pro forma adjustments effectively double actual cash flow," a mid-cap fund manager said. "Those deals don't even make it to committee."

Of course, competition among loan arrangers is a driver of sell-side friendly features. One leading indicator is the number of covenant-lite loans for larger middle market companies. $50 million ebitda remains the unofficial minimum for cov-lite, though smaller issuers occasionally sneak through. "It's all a matter of market flex," one bank underwriter reported. "If you can flex to a leverage test when investors balk, you may be willing to risk it. Otherwise, you could get stuck holding the paper."

But for buy-and-hold non-banks, the worry is less syndication, and more portfolio quality. "A lot of these cov-lites are broadly syndicated credits that have performed well through the cycle," the head of capital markets for one arranger told us. "And they've often been owned by multiple top-tier sponsors. Frankly, even *with* a covenant, if the cushions are too wide the test is meaningless. You get better protection from tight debt baskets."

Where debt-to-ebitda tests undergo envelope-pushing is unitranches. In many cases Day One leverage for larger borrowers is already north of six times. Add a reasonable covenant cushion, and the trigger could approach 9x. And that's before analyzing the rationale for add-backs and adjustments.

Another sell-side element is to eliminate or significantly slow leverage stepdowns. There's a defensible rationale for issuers with *de novo* growth strategies, but sometimes it's just the sponsor seeking to optimize flexibility. In the latter case, the argument is that a sizeable enough equity checks and/or strong free cash flow characteristics should give senior secured lenders sufficient comfort.

Next week we conclude our series with the behavior of middle market loan yields