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The Continuing Evolution of Middle Market Lending

Proskauer Rose LLP

Sandra Lee Montgomery

Generally, the leveraged loan market is often bifurcated into two markets: the large cap market and the middle market. For the past five years, The Private Credit Group at Proskauer Rose LLP has tracked deal data for private, middle market loan transactions. The data reflects that, as those sponsors that have historically focused on large cap transactions have increasingly undertaken transactions in the middle market, the middle market has been forced to incorporate financing terms and conditions that were once only found in large cap financings. While middle market lenders have resisted the inclusion of the full slate of large cap financing terms, the increasing competition for deal origination has resulted in the selective inclusion of certain large cap financing terms, albeit with a middle market orientation. While large cap terms assume a profitable and durable business model, as deal sizes get smaller and business models less able to withstand adverse economic results, middle market lenders have reacted to the introduction of large cap term with incremental conditionality. Middle market lenders' appetite for certain of these large cap financing terms differ not only based on institutional biases, but also based on the size of the borrower's consolidated EBITDA. As a result, the evolution of these large cap financing terms can be traced, in certain respects, to the size of the borrower's consolidated EBITDA, resulting in the middle market becoming further fragmented into the "lower middle market", "traditional middle market" and the "upper middle market". The evolution of certain of these terms in the subdivided middle market is discussed below.

Debt Incurrence

One of the most transformative structural changes to make its appearance in the middle market is the flexibility given to sponsors to incur additional debt either within or outside the applicable loan facility.

Incremental Facilities and Incremental Equivalent Facilities

Leading the way in providing greater flexibility to sponsors is the evolution of incremental and incremental equivalent loan facilities. An incremental facility (also commonly referred to as an "accordion") allows the borrower to incur additional term loans or revolving loan commitments under the existing credit agreement within certain limitations and subject to certain conditions, without the further consent of the existing lenders. Incremental equivalent debt has the same features of an incremental facility except that the debt is incurred as a separate facility outside the existing credit documentation either pursuant to a separate credit facility or through the issuance of notes (which could be issued in a public offering, Rule 144A or other private placement).

The migration of these additional debt facilities into the middle market can be stated as follows: the upper middle market will generally accommodate both the incremental facilities and the incremental equivalent facilities, while the traditional middle market transactions will generally only accommodate incremental facilities (subject, however, to very strict conditions, as discussed below) but will rarely allow for incremental equivalent facilities. Lower middle market deals generally do not provide for incremental or incremental equivalent facilities.

Incremental amount

- In large cap transactions, the existing credit facility may limit the incremental facility to both a fixed amount (known as a "starter basket" or "freebie") and an unlimited amount subject to compliance with one or more leverage ratios. The fixed amount will generally be no greater than 1.0× of consolidated EBITDA and may even have a "grower" component (see discussion on Grower Baskets below). The unlimited amount will generally be subject to compliance with a leverage ratio and depending on whether the original transaction is structured as a first lien/second lien credit facility or senior/mezzanine credit facility and what type of incremental debt is being put in place (i.e. debt *pari passu* to the first lien or senior facility, debt that is subordinate to the first lien or senior facility but *pari passu* with the second lien/mezzanine facility, or unsecured debt), the type of leverage test will be different (i.e. first lien leverage test *vs*. secured leverage test *vs*. total leverage test). In these larger deals, the level of the ratios will often be set at the closing date leverage multiple. The upper middle market often follows the larger deals in terms of how the incremental amount is limited except that, originally, the leverage ratio for the incurrence of the unlimited incremental amount would sometimes be set at the closing date leverage multiple less a setback (often 0.25× of EBITDA). Our data has shown, however, that setting back the closing date leverage multiple has become rare.

  Unlike the upper middle market, the traditional middle market differs greatly in that it will rarely allow both the starter basket and the unlimited amount. In the traditional middle market, it is common for the incremental amount to be unlimited but subject not only to an incurrence leverage test but also to *pro forma* compliance with the maintenance financial covenants. In instances in the traditional middle market where the incremental amount is subject to a fixed cap amount, our data also shows that its incurrence will also often be subject to an incurrence leverage test and *pro forma* compliance with the maintenance financial covenants.

  The use of different leverage tests creates significant flexibility to the sponsors and the borrowers in that it allows the borrowers to incur multiple layers of debt in excess of the overall total leverage test originally used as the leverage multiple. For example, in computing total leverage, the indebtedness included in such a calculation would typically include all funded indebtedness of the applicable credit parties and those subsidiaries included in the financial metrics of the credit parties. The indebtedness included in calculating first lien leverage would only be funded indebtedness subject to a first lien on the assets of the credit parties. As a result, a borrower could first incur unsecured indebtedness up to the required total leverage ratio and still incur additional first lien indebtedness even though such additional debt would bust the total leverage ratio because the test applied for the first lien leverage ratio would not include the unsecured indebtedness incurred by the borrower. This flexibility, although provided in the upper middle market, is often rejected in the traditional middle market transactions. Traditional middle market deals will usually only apply a total leverage test for all types of incremental loans.

- In large cap and upper middle market transactions, sponsors will also seek the ability to (i) use the ratio-based unlimited incremental amount first, (ii) reclassify (at their discretion or automatically) incremental debt which was originally incurred in the fixed amount as incurred under the ratio-based unlimited amount (thereby reloading the fixed amount), and (iii) in instances where an incremental loan is incurred based on both the fixed amount and the unlimited amount, not take the fixed amount into account when testing leverage. In the instances where a traditional middle market financing allows for both a fixed starter basket and a ratio-based unlimited incremental amount, the middle market lender will most likely require that the fixed amount be used first and reclassification would generally not be permitted.
- In large cap and upper middle market transactions, the incremental amount may also be increased by an amount equal to: (a) in the case of an incremental facility that effectively replaces any existing revolving commitment terminated under the "yank-a-bank" provisions, an amount equal to the portion of such terminated revolving commitments; (b) in the case of an incremental facility that serves to effectively extend the maturity of the existing facility, an amount equal to the amount of loans and/or commitments, as applicable, under the existing facility to be replaced with such incremental facility; and (c) all voluntary prepayments of the existing term loans, previously incurred incremental term loans and refinancings of the existing term loans and voluntary commitment reductions of the revolving facilities (except to the extent funded with the proceeds from an incurrence of long-term indebtedness (other than revolving indebtedness)). The incremental amount limitations will be the same for incremental equivalent facilities provided that the establishment of an incremental facility or the incurrence of incremental equivalent debt will result in a dollar-for-dollar reduction of the amount of indebtedness that may be incurred in the other facility. In this regard, the upper middle market is generally consistent with the larger deals. However, the traditional middle market will again differ in that if any additional amounts increase the incremental amount, it will be limited to the voluntary prepayments of indebtedness or commitment reductions of the revolving facilities. The traditional middle market will rarely allow the incremental amount to be increased as described above.

Rate and maturity

- Generally, incremental term loans: (a) cannot have a final maturity date earlier than the existing term loan maturity date; (b) cannot have a weighted average life to maturity shorter than the weighted average life to maturity of the existing term loans; (c) rank *pari passu* with the existing loans or junior in right of payment and/or security or are unsecured; (d) are not secured by any additional collateral or guaranteed by any additional guarantors than collateral securing or guarantors guaranteeing the existing term loans; (e) participate *pro rata* or less than (but not greater than) *pro rata* with the existing term loans in mandatory prepayments; and (f) have covenants and events of default substantially similar, or no more favourable to the lenders providing such incremental term loans than those applicable to the existing term loans, except to the extent such terms apply only after the latest maturity date of the existing term loans or (sometimes) if the loan agreement is amended to add or conform to the more favourable terms for the benefit of the existing term lenders. Some sponsors in larger deals have been pushing for a carve-out from the maturity requirement which would allow the borrower to incur incremental term loans with earlier maturities, up to a maximum amount governed by a fixed dollar basket.

These terms have generally been adopted in the upper middle market. The traditional middle market does not contain significant variations with an exception, as the traditional middle market sometimes allows only the incurrence of incremental debt that is *pari passu* debt. Although it seems that allowing the borrower to incur either lien subordinated or unsecured subordinated debt instead of *pari passu* debt would be beneficial to the lenders, the traditional middle market's resistance to allowing different types of debt stems from a desire to maintain a simpler capital structure especially in credit transactions where there are no other financings.

- In large cap and upper middle market transactions, additional tranches of incremental revolving loan commitments are permitted whereas the traditional middle market allows only increases to the existing revolving loan commitments and may be combined with an extension of maturity of the existing revolving facility. If additional tranches of incremental revolving loan commitments are provided, these additional revolving commitments usually are required to have substantially the same terms as the existing revolving loan commitments, other than pricing, fees, maturity and immaterial terms that are determined by the borrower and the lenders providing such incremental revolving loan commitments.
- The interest rate provisions applicable to incremental facilities customarily provide some form of pricing protection that ensures that the all-in yield of the existing credit facility would be increased to match (less 50 basis points) any new incremental facility whose all-in yield was greater than 50 basis points above the existing credit facility. These provisions are generally referred to as the "MFN (most favored nations) provisions". In large cap and upper middle market transactions, the MFN provision is often no longer applicable after a period of 12 months to 18 months (some with sunset periods as short as six months). The sunset provision, however, may be eliminated altogether or flexed out, depending on marketing conditions. As the ability to designate incrementals with different payment and lien priorities (or as incremental equivalent debt) has become commonplace in large cap and upper middle market transactions, sponsors have been soliciting additional accommodations that have the effect of further eroding the MFN provisions, including (i) additional carve-outs to the calculation of all-in yield for amounts that do not clearly constitute "one-time" fees (for example, OID and upfront fees), thereby making it easier to remain below the MFN trigger threshold; (ii) applying the MFN provisions only to incrementals (or incremental equivalent debt) that is *pari passu* in claim and lien priority to the existing credit facility; and (iii) limiting the application of the MFN protection to the term loan facility originally issued under the credit facility.

The traditional middle market takes a somewhat consistent approach to the upper middle market's treatment of the MFN provision. For the most part, *pari passu* debt issued in reliance upon the incremental provisions is subject to the MFN provisions. However, middle market lenders may also require that the impact of the MFN provisions apply to all debt outstanding under the credit facility, including incremental loans previously funded. Also, traditional middle market lenders rarely allow sunset provisions to apply to the MFN provisions.

- Finally, in large cap and upper middle market transactions, sponsors sometimes request that debt incurred in reliance upon the starter basket amount and other incremental incurrences used for specific purposes (i.e. permitted acquisitions) should be excluded from the MFN provisions. Without adding further protections, allowing the incurrence of an incremental loan based upon the starter basket amount to be free of the MFN protection has the potential of eliminating the MFN treatment altogether in deals where the borrower has the ability to redesignate starter amount incrementals as leveraged based incrementals because the borrowers are able to, in certain circumstances, reload the starter basket amount.

Use of proceeds

- In large cap and upper middle market transactions, proceeds from the incurrence of incremental and incremental equivalent debt may generally be used for any purpose not otherwise prohibited by the original credit facility. In contrast, the traditional middle market restricts the use of proceeds to very specific purposes such as acquisitions, or capital expenditures. Our data shows a clear migration of the large cap and upper middle market flexibility with respect to the use of incremental proceeds filtering down to the traditional middle market. Increasingly, middle market lenders are, in some deals, permitting incremental proceeds to be used for general purposes, including for restricted payments such as dividends and payment of junior debt but subject to stricter leverage tests.
- Sponsors have also been pushing to permit contemporaneous voluntary prepayment of existing debt with proceeds of an incremental. By permitting contemporaneous voluntary prepayment of existing debt, a borrower can use incremental debt to refinance existing debt, which may occur if the debt being incurred does not qualify as "refinancing indebtedness", or when the borrower is using the incremental to refinance non-consenting lenders in connection with an "amend and extend" transaction.

Ratio Debt

In addition to the incremental and incremental equivalent facilities described above, large cap and upper middle market transactions often include additional debt incurrence capacity through the inclusion of so called "ratio debt" provisions, provisions that can be traced back to the "high-yield" bond market. Ratio debt allows the borrower to incur additional indebtedness so long as the borrower meets the applicable leverage or interest coverage ratio test. Traditional and lower middle market transactions generally do not provide for ratio debt. To the extent ratio debt provisions appear in traditional middle market transactions, the incurrence of such debt is often conditioned on such debt being subordinated in right of payment to the credit facility (and is not otherwise permitted to be secured). Additionally, in those rare instances where the traditional middle market allows for ratio debt, it requires that any applicable MFN provisions be applied to any ratio debt that is *pari passu* to the credit facility obligations. Notably, this middle market term has migrated up market as upper middle market deals have increasingly adopted this protection in respect to ratio debt.

Acquisition Indebtedness

Generally, credit agreements will allow the borrower to incur certain indebtedness in connection with a permitted acquisition or investment. Not surprisingly, the larger deals will commonly allow the borrowers the most flexible formulation and permit the incurrence of any acquisition indebtedness to the extent such indebtedness was not incurred in contemplation of such acquisition or investment and is only the obligation of the entity or its subsidiaries that are acquired. The upper middle market takes a similar approach to the large cap market but will sometimes place certain restrictions by providing that after giving effect to the acquisition indebtedness, the borrower must be in *pro forma* compliance with the financial covenants and/or meet a leverage test (i.e. closing date leverage). Although it is not uncommon for this type of indebtedness to be permitted in the lower middle market, it will be subject to additional limitations. These limitations may be in the form of required subordination terms, dollar caps or require the assumption of debt incurrence exceptions otherwise provided for in the credit agreement. This formulation neuters the acquisition indebtedness exception because, generally, there will be no other form of permitted indebtedness (such as ratio debt) other than the general basket that would be applicable in the lower middle market or traditional middle market deals.

Limited Condition Transactions

One of the best known outcomes of the loosened credit markets in 2005 was the "certain funds provision" technology instigated by sellers who gave preference to those potential buyers who had financing locked down. Certain funds provisions (also commonly known as the SunGard provisions) provided that, except as expressly set forth in a conditions annex, there could be no conditions precedent in the definitive loan documentation to the close and funding of the credit facility, and it limited the representations required to be true at closing to material representations set forth in the acquisition agreement and a narrow set of additional "specified representations". It also limited the actions required to be taken by the borrower pre-closing to perfect security interests in the collateral. These limits were designed to assure buyers and sellers that so long as the conditions to closing under the acquisition agreement were met, the lenders would not have an additional "out" beyond the narrow set of conditions in the conditions annex.

Acquisition financings in general, regardless of the market, have generally adopted the SunGard provisions which require that the only representations at closing that are conditions to funding are specified representations and the representations set forth in the acquisition agreement. All other representations and warranties in the credit agreement are made at closing, but are not conditions to close, so even if such representations and warranties are not true, the lender will still be required to close the financing with a default immediately following the closing. In some more aggressive deals, the sponsor will seek to limit the representations and warranties made only to the specified representations and the acquisition agreement representations so that even if the other representations are not true, the borrower will not have a default post-closing. The upper middle market has generally followed the larger deals in this respect but not without objection especially in first lien and second lien financing transactions where the second lien lenders will not benefit from a regular bring down of the representations through advances made under a revolver. The traditional middle market, for the most part, continues to resist the requirement that only specified representations and acquisition agreement representations should be made at close.

As borrowers and sponsors continued to push for greater flexibility in credit documents, the certain funds provisions continued to evolve, widening its applicability to include future acquisitions contemplated by the borrower financed from the proceeds of incremental loan facilities. Through the broader applicability of the certain funds provisions, the limited condition acquisition provisions were developed where sponsors have succeeded in limiting conditionality for incremental debt incurred primarily to finance an acquisition, thereby diminishing financing risk for follow-on acquisitions. In larger deals, sponsors have been successful in extending this "limited condition acquisition" protection to all acquisitions using an incremental, regardless of whether there is a financing condition in the underlying acquisition documentation.

Customarily, as noted above, conditions to incremental debt incurrence have included material accuracy of representations and warranties, absence of default or event of default, and in certain areas of the market, either a *pro forma* compliance with the existing financial covenant (if any) or meeting a specific leverage test, each tested at the time of incurrence of the incremental debt. The limited condition acquisition provisions debuted in the larger deals enabling the borrower to elect the date of the acquisition agreement ("acquisition agreement test date") as the relevant date for meeting the required conditions. As a result, if the borrower made such an election then the combined conditions to accessing the incremental loans and making a permitted acquisition (which may have included accuracy of representations and warranties, no events of default, and leverage tests) would be tested at the time the acquisition agreement is executed and the borrower would have the ability to include the financial metrics of the target entity (i.e. EBITDA) at the time of such testing. Although the middle market was not able to fully resist the introduction of the limited condition acquisition protections, the middle market was nonetheless able to counter the effect of limiting the conditionality of the incremental debt by requiring that the acquisition close within a specified time frame (usually not longer than 120 days (the "120 Days Limitation")). As a result, in the event the acquisition does not close within the agreed upon time frame, the limited conditionality is eliminated and the borrower would have to comply with all the conditions at the time of the incurrence of the incremental loan. The lower middle market has generally resisted the limited condition acquisition provisions.

The representations and warranties, events of defaults and leverage tests are treated and limited as follows:

- <u>Representations and Warranties</u>: In the larger deals and in upper middle market deals, for the most part, the incremental debt incurred primarily to finance an acquisition is conditioned on a bring-down of only the acquisition representations and the specified representations (see discussion above) at the time of signing the acquisition agreement.

  In the traditional middle market, the alternative approach is to require a full bring down of the representations and warranties at the time of signing the acquisition agreement and require only the acquisition representations and the specified representations at the time of closing the acquisition. This alternative is becoming harder to impose even in traditional middle market deals especially in light of the fact that the 120 Days Limitation may be in place which sponsors argue should be sufficiently protective to the lenders.
- <u>Events of Default</u>: In the larger deals and in upper middle market deals, the absence of the defaults condition is, for the most part, limited to the absence of payment or bankruptcy default at the time of signing the acquisition agreement.

  As an alternative, in the traditional middle market, some incremental facility provisions provide for testing of the absence of all defaults condition at the time of signing the acquisition agreement and an absence of payment or bankruptcy default at closing of the acquisition.
- <u>Leverage Test</u>: The limited conditionality provision permits a borrower to elect the date of the acquisition agreement (instead of the closing date) as the date of determination for purposes of calculating leverage ratios in order to test ratio-based incremental debt capacity. Testing of the leverage ratio at signing eliminates the risk of a decline in EBITDA of the borrower and the target between signing and closing (the period between execution of the acquisition agreement and closing date referred to as the "Intervening Period"), when the ratio otherwise would be tested. This risk is of special concern in deals involving a lengthy delay between signing and closing due to regulatory approvals.

  As the leverage test is intended to include the financials of the acquisition target on a *pro forma* basis, sponsors have further requested that any other incurrence-based leverage test (required in connection with any other investment, incurrence of debt, restricted payment, etc.) that is tested during the Intervening Period include the financials of the acquisition target on a *pro forma* basis. Generally, the markets have responded to this request in three different ways:
  - <u>Most sponsor-favourable</u>: In very large deals, any leverage test required during the Intervening Period will be tested after giving *pro forma* effect to the acquisition. In the event the acquisition does not close, any leverage test applied during the Intervening Period will be deemed to be valid regardless of whether the borrower would have failed to meet the leverage test without giving effect to the acquisition target's EBITDA. The upper middle market has not yet fully embraced this calculation of the leverage test.
  - <u>Most lender-favourable</u>: Any leverage test required during the Intervening Period will be tested on a stand-alone basis. The traditional middle market and the upper middle market (but less frequently) will generally take this approach.
  - <u>Compromise</u>: The maintenance financial covenant and any incurrence leverage test pertaining to the payment of restricted payments are tested on a stand-alone basis but the remaining incurrence leverage tests are tested giving *pro forma* effect to the acquisition. Another compromise is to test all maintenance financial covenants and incurrence leverage tests on both a *pro forma* or stand-alone basis. This application of the leverage test is often seen in the upper middle market.

Available Basket Amount

Once the leveraged financing markets revived following the downturn of the financial markets in 2009, the concept of builder baskets or the "available basket amount" seen in "high-yield" bond deals migrated into, and became prevalent in, the middle market. It is worth noting, however, that the lower middle market is still resistant and often rejects the inclusion of available basket amounts. An available basket amount is also commonly referred to as a "cumulative amount" or a "builder basket". The purpose of an available basket amount is to give the borrower the ability to increase certain baskets in the negative covenants (i.e. investments, dividends and payment of junior indebtedness) without asking for a consent from the lender. The rationale behind lenders conceding to an increase in certain baskets in the negative covenants was an attempt to recognise and reward an increase in the borrower's profitability by permitting the borrower to not only deleverage its debt, but also to permit the borrower the ability to increase baskets in the negative covenants that generally restrict cash outflow.

The available basket amount will be generally constructed to be the sum of the following:

- <u>Starter Basket Amount</u>: a starting amount (commonly referred to as a "starter basket amount") which, unlike the incremental starter amount, is not necessarily based on a percentage of the borrower's EBITDA but is, instead, generally determined on a case-by-case basis (which amount may be further increased by a grower basket in the larger deals). Upper middle market deals and traditional middle market transactions (but less frequently) will often include a starter basket amount.

- Retained Excess Cash Flow or a Percentage of Consolidated Net Income: typically in larger deals, the available basket amount will include a percentage of consolidated net income over the retained excess cash flow because the borrower will have quicker access to the consolidated net income especially in those transactions that close in the first half of a fiscal year since the borrower will not be able to build retained excess cash flow until the end of the following fiscal year. Upper middle market transactions will often use either retained excess cash flow or a percentage of consolidated net income. In contrast, the traditional middle market deals will more often include retained excess cash flow which, in addition to having limited accessibility, will most likely be defined in a manner that results in as little actual excess cash flow as possible since the borrower will be required to make a mandatory prepayment in an amount equal to a percentage of such excess cash flow. As a result, the borrower is incentivised to minimise the amount of excess cash flow generated.
- Contributed Equity: if the available basket amount is included in the financing, then having it increased by the amount of equity contributions will be common regardless of the size of the deal. It is also commonly accepted that equity contributions made in connection with equity cures will be excluded from the available basket amount.
- ROI on Investments Made With the Available Basket Amount: larger deals and upper middle market deals will commonly increase the available basket amount by the amount of returns in cash, cash equivalents (including dividends, interest, distributions, returns of principal, profits on sale, repayments, income and similar amounts) or investments. However, not all traditional middle market deals will include returns in cash, cash equivalents or investments in the available basket amount. If included, they will only be permitted to the extent such investments were initially made using the available basket amount.
- Declined Proceeds: declined proceeds from mandatory prepayments required to be made by the borrower will commonly be included in the calculation of the available basket amount regardless of the size of the deal.
- Debt Exchanged for Equity: in larger deals, to the extent that any debt owed by the borrower is converted into equity, such amount will be included in the available basket amount. The upper middle market will often adopt this formulation while the traditional middle market has, for the most part, resisted the addition of debt exchanged for equity in the calculation of the available basket amount.
- Redesignation of Restricted Subsidiaries: in larger deals and often in the upper middle market transactions, in the event an unrestricted subsidiary is redesignated as a restricted subsidiary, the fair market value (generally determined in good faith by the borrower) of the investments in such unrestricted subsidiary at the time of such redesignation will increase the available basket amount so long as such investments were originally made using the available basket amount. The traditional middle market continues to resist this component of the available basket amount.

The conditions around the usage of the available basket amount vary greatly and the traditional middle market takes a very different approach than its larger counterpart, the upper middle market. As noted, the purpose of the available basket amount was to increase the basket pertaining to cash leakage such as investments, dividends and junior debt payments. The upper middle market deals often place few conditions around the usage of the available basket amount. Such conditions may be further distinguished as follows. In very aggressive upper middle market transactions, conditions for accessing the available basket amount will usually apply in respect to a dividend or junior debt payment basket to the extent such amount is being increased from the component of the available basket amount pertaining to the starter basket amount or retained excess cash flow or a percentage of consolidated net income. More specifically, these conditions will typically be no payment or bankruptcy events of default as well as a specific leverage or fixed charge coverage test. It is important to note, however, that the leverage or fixed charge coverage test will generally apply only in instances where the component of the available basket amount pertains to the retained excess cash flow or a percentage of consolidated net income. In the more conservative upper middle transactions and the traditional middle market deals, the approach will be to place conditions for the usage of the available basket amount irrespective of which component of the available basket amount is being accessed. For the most part, these conditions may include a *pro forma* leverage ratio test as well as a no events of default condition. In the traditional middle market, it is also not uncommon for the available basket amount permitted to be used to be subject to an additional capped amount. Additionally, in respect to the payment of dividends or junior debt, there will be an additional leverage ratio test that will be well within the closing date leverage (by as much as 1.0× to 2.0×).

Grower Baskets

Akin to the available basket amount, the "grower basket" is intended to provide the borrower with the flexibility of automatically increasing certain basket amounts based on the growth of the borrower's EBITDA or total assets. As the larger deals adopted the grower baskets with ease and in light of the sponsors' continued demands on the lenders, the middle market was forced to respond in kind. While the upper middle market and, to a lesser extent, the traditional middle market have generally adopted the grower basket provisions, the lower middle market continues to resist the inclusion of grower baskets as much as it continues to resist the available basket amounts.

Grower baskets are intended to be utilised at any time a hard capped amount is implemented by formulating it as being the greater of a capped amount and a percentage of either the total assets or EBITDA of the borrower. As such, grower baskets will be used in connection with the free and clear amount in incremental debt provisions, the starter basket amount in the computation of an available basket amount and other amounts set out as exceptions to negative covenants.

Unlike the available basket amount, which represents an additional level of flexibility within the investments and restricted payment covenants by providing for an additional performance-based covenant exception, a grower basket is the addition of a growth component based on a percentage of EBITDA or total assets that corresponds to the growth of company. Utilisation of the grower basket will not be subject to any conditions such as there being no events of default or a leverage ratio test unless the exception for which the hard capped amount relates originally included any such condition.

Choosing between EBITDA or total assets is not exclusively beneficial to either the lender or the sponsor. While EBITDA is better to measure the performance of companies that are not asset rich but are instead cash flow-centric, the downsides are that it can be volatile and, depending on the industry, very cyclical. Total assets, on the other hand, are better suited for companies that are asset rich. However, the downside is that there may be certain assets that are difficult to value such as intellectual property and goodwill.

Unlike available amount basket, which will uniformly build with a percentage of consolidated net income or retained excess cash flow, there is no established rate by which particular grower baskets are set. Instead, the parties will negotiate the hard capped amount and set the percentage of either the closing date EBITDA or total assets to the equivalent hard capped amount.

Unlike the calculation of the available basket amount which, once increased, would only decrease to the extent utilised, because grower baskets are formulated based on a "greater of" concept, if the growth component fluctuates in size, the quantum of the basket will also fluctuate (but limited down to the hard capped amount). Note, however, that since grower baskets are generally included in incurrence-based exceptions utilisation, if a grower reduces in size, any prior usage of the basket at the higher level will not trigger an event of default.

Looking Ahead

With each passing year, The Private Credit Group data has shown that the terms relating to debt incurrence, limited condition transactions, available basket amounts and grower baskets as adopted in the middle market have continuously evolved due to sponsors' continuing success in obtaining greater flexibility in their transactions. Constantly evolving markets, economy and access to debt markets should, in certain instances, impact the sponsors' ability to continue pushing for flexibility in their transactions. However, as a particular sponsor-favourable provision is adopted in the middle market, the middle market lenders' ability to unwind such change is, for the most part, limited. The inability to back out of such provisions is due, in some part, to the growing use by sponsors and middle market lenders of credit documents for a prior transaction as the basis for the documentation of a new transaction. Although taking back a particular provision may be difficult to achieve, changes in the market will most likely still impact the dividing lines of where these issues fall in either the lower middle market, traditional middle market or upper middle market.

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