PRACTICE NOTE

An Expert's View: Marisa A. Sotomayor, King & Spalding LLP

by Practical Law Finance

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Marisa discusses the middle market lending environment and highlights several trends in EBITDA adjustment negotiations.

What is your assessment of the current state of middle market lending and how does this impact borrowers? What practical guidance would you offer to borrowers looking for financing in this corner of the market?

Middle market lending is facing many of the same headwinds as the broadly syndicated and large-cap markets. These include ongoing geopolitical uncertainty, macroeconomic pressures and the interest rate environment, continued stress in certain software and technology sectors, highly publicized BDC and credit fund redemptions, uneven asset quality, and a significant volume of upcoming maturities. While the market remains open and active, these dynamics have contributed to greater lender selectivity, higher pricing, and more pronounced differentiation among credits.

Conditions also vary considerably across the middle market. The upper middle market remains highly competitive, largely due to stronger credits and abundant lender interest (plus, arguably, competition from the broadly syndicated market). The core middle market has generally held steady, demonstrating anecdotal resilience, although appetite and performance remain highly industry-specific. The lower middle market sees fewer transactions, but a history of disciplined underwriting has created opportunities for lenders willing to pursue more tailored or creative financing structures. Although the middle and large-cap markets have converged significantly over the last decade as large direct lenders moved down-market to deploy capital, covenant-lite structures remain largely reserved for the strongest sponsors and credits. At the same time, documentation has tightened meaningfully from the borrower-friendly terms characterizing the 2020 and 2021 vintages.

For borrowers, the key is to be both realistic and opportunistic. Businesses with stable cash flows, recurring or sticky revenue streams, and exposure to more resilient sectors generally remain well positioned in the current environment. By contrast, technology-focused businesses and sectors perceived as vulnerable to AI-driven disruption may face heightened scrutiny, although regional and commercial banks have shown increasing willingness to pursue those opportunities. Borrowers should begin financing processes early, anticipate more extensive business and legal diligence, and expect occasional starts and stops as lenders assess risk. They should also focus negotiations on structural flexibility that is genuinely needed for the business rather than pursuing expansive baskets and exceptions that may not ultimately prove meaningful in practice. Finally, borrowers should not overlook traditional bank financing sources, including revolving facilities, pro rata and term loan A facilities, first-out/last-out structures, and asset-based facilities, as regulated lenders continue to compete aggressively to regain middle-market market share.

Ultimately, this remains a lender-friendly but highly competitive market. Capital is available for well-positioned borrowers, but financing is no longer as abundant, inexpensive, or flexible as it was in prior years. In a crowded market, capital will gravitate toward borrowers that present the most compelling investment case by clearly demonstrating the strength of their business and financial profile.

Takeaway: In today's middle market, capital is available, but it is more selective, and the winners will be borrowers that can clearly differentiate their credit story and execute a disciplined financing process.

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In your practice, what are some of the key issues practitioners have been focusing on when negotiating EBITDA add-backs in their credit agreements? What issues are driving those discussions and what do you predict to see in the second half of 2026?

EBITDA add-backs remain among the most heavily negotiated provisions in credit agreements. The principal areas of focus continue to be run-rate cost savings and synergies, including, where applicable, revenue synergies arising from acquisitions or integration initiatives. Negotiations typically center on the scope of permitted adjustments, the applicable realization period, whether the projected benefits must be "reasonably identifiable and factually supportable," and the existence and calculation of any caps. A recurring point of contention is whether those caps are measured before or after giving effect to the relevant add-back or to all add-backs collectively.

Revenue-oriented adjustments, including new contract and similar revenue-synergy add-backs, also continue to generate meaningful debate. Discussions often focus on the duration and quality of the underlying contracts, customer churn assumptions, supporting evidence, and the appropriateness of any caps, assuming lenders are willing to entertain such adjustments in the first instance.

Looking to the second half of 2026, we expect lenders to continue exercising discipline and scrutinizing EBITDA adjustments. Borrowers and sponsors with credible alternative financing options, particularly those with access to the broadly syndicated market, will continue to push for greater flexibility. At the same time, both sides increasingly recognize that the focus should extend beyond individual add-backs to the overall quality of EBITDA and its effect on credit metrics. Empirical evidence suggests a correlation between aggressive EBITDA adjustments at closing and subsequent performance shortfalls, making careful diligence around EBITDA quality just as important as the negotiation of any individual add-back or adjustment.

As a result, we continue to focus on uncapped extraordinary, unusual, and non-recurring expense add-backs, expansive restructuring and business optimization adjustments, and broad, uncapped Regulation S-X-style adjustments. Sponsor precedent often includes a lengthy list of generic, non-tailored add-backs and adjustments, but the most effective approach remains a balanced one: preserving reasonable flexibility for borrowers while grounding EBITDA in demonstrated cash generation and supportable adjustments. Perhaps most importantly, EBITDA negotiations are no longer simply debates over financial definitions. EBITDA drives leverage capacity and covenant flexibility throughout a credit agreement. Every dollar of incremental EBITDA translates into additional capacity for debt incurrence, investments, asset transfers, and other value-leakage transactions. In an environment where liability management and structural flexibility continue to dominate market attention and headlines, practitioners remain focused not only on whether an add-back is appropriate in isolation, but also on the incremental (pun fully intended) flexibility that adjustment may create elsewhere.

Takeaway: As liability management transactions continue to garner attention, the real debate is not what EBITDA is, but what an inflated EBITDA number permits a borrower to do.

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