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Covenant-Lite Loans: Borrowers Are Running the Show

From the Experts

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During the past three years, so-called covenant-lite—or “cov-lite”—loans have come roaring back in the leveraged loan marketplace. In 2013, financial institutions issued more than \$381 billion worth of these borrower-friendly loans, more than triple the amount issued in the gangbuster, pre-recession days of 2007. This year looks just as promising: According to data tracker Dealogic, loan issuances recently hit \$83.6 billion over 82 deals, up 41 percent from the same period in 2013 (\$59.4 billion over 68 deals).

Favorable lending terms have now become ubiquitous in the leveraged loan market, with the trend trickling down from the bulge bracket to the middle market. In addition, this phenomenon is not only expanding throughout the U.S.—it is also going global, with European companies backed by private equity now beginning to tap in.

While the name “covenant-lite loan” might itself be a mouthful, the friendly terms of these loans, including less-restrictive or no financial covenants and greater flexibility to transact business, are far easier for borrowers to swallow. The convergence of surplus debt capital, a lower volume of completed deals and lenders in search of higher yields has created a robust and growing demand for such loans, and the borrowers—particularly those backed by top-tier private equity sponsors—are increasingly calling the shots.

For instance, McGraw-Hill Education LLC recently borrowed \$688 million through a loan instrument light on financial covenants, in turn agreeing to pay the lender an interest rate of 5.75 percent. That compares with the current 3-month rate of 0.23 percent for the benchmark London Interbank Offered



Rate. Other recent cov-lite borrowers in the news include Epicor Software Corp., Univision Communications Inc. and SuperValu Inc. Awash in cash and faced with an economy providing few other opportunities for high-yield investments, investors are willing to accept fewer restrictions on the borrower in return for a higher interest rate.

What Are “Cov-lite” Loans?

Leveraged loans, which carry greater credit risk than investment-grade loans, traditionally contain an array of restrictive financial maintenance covenants—such as leverage ratios, interest coverage ratios and fixed charge coverage ratios—which borrowers generally must test on a monthly or quar-

terly basis. Lenders rely on those covenants to provide them with greater protection in case of trouble with the borrower, and the loan, down the road. In the case of a default or breach of a financial maintenance covenant, lenders may take enforcement actions against the borrower to ensure repayment of their loans, including increasing the interest rate, accelerating the loans, charging amendment and restructuring fees, and engaging in other means of recourse, including foreclosure on the assets that secure the loans.

What separates the friendlier loans currently pervading the marketplace from traditional leveraged loans is the absence of financial maintenance covenants under a term loan credit facility and the springing

nature of the financial maintenance covenants under a revolving credit facility. Similar to high-yield debt, cov-lite loans utilize incurrence-based covenants, which are tested only upon the occurrence of an event, as opposed to traditional financial maintenance covenants, which are tested at regular intervals. Incurrence-based covenants require a borrower to take affirmative action before they can be breached. Thus, by refraining from a particular action, a borrower can control the triggering of the covenant.

Most revolving loans are still subject to a financial maintenance covenant, which “springs” into existence if the revolving credit facility utilization exceeds a specified percentage.

Benefits to the Borrowers

This new generation of cov-lite loans allows for greater flexibility to make restricted payments, incur additional debt, prepay subordinated debt and consummate acquisitions. Instead of being subject to fixed-dollar baskets, borrowers now can engage in these transactions if they satisfy certain incurrence-based covenants

These loans also present less default risk for borrowers and provide more control over their businesses, particularly during strained financial times, by restricting the ability of lenders to force them into workout scenarios. For example, whereas a traditional borrower may be subject to a maximum leverage ratio tested on a quarterly basis, that same borrower with a cov-lite loan would instead have to comply with a maximum leverage ratio test only prior to incurring debt, making restricted payments, consummating an acquisition or prepaying subordinated debt. In the latter scenario, the borrower can avoid default by not engaging in a transaction, whereas a traditional borrower would violate its credit agreement for simply exceeding its maximum leverage ratio.

By lowering the risk of borrower default, these new loans restrict the ability of lenders to step in and meddle with a company's business operations. Thus, cov-lite loans ultimately preserve the ability of a company to operate unhindered and to recover, if need be, without going into bankruptcy.

Benefits and Risks to the Lenders

In exchange for looser credit terms, borrowers are willing to pay a premium, and lenders can therefore earn a higher yield in

the current low interest rate environment. Because lenders do give up early warning trip-wires, which are often tied to corporate debt levels or a borrower's ability to service its debt, they may be unable to reprice credit risk, request their money back or restructure a problematic loan upon a breach of a financial maintenance covenant.

Some market analysts have suggested that the recent covenant-lite trend may signal a bubble that could leave investors vulnerable in a market downturn. However, historically the default rates for these loans have been lower than those of loans with traditional financial maintenance tests. As reported by the S&P Capital IQ, since 2008 cov-lite loans have defaulted at a rate of 14.0 percent (compared to a 17.6 percent rate for cov-heavy loans). Borrowers who qualify for these friendly loans generally have solid financials, and in a recent report, money manager Loomis Sayles stated that from a lender's perspective, owning a good covenant-lite loan is better than holding a bad credit with a financial maintenance covenant.

Recent Trends

These less restrictive loans first originated in the bulge-bracket market, where lenders have traditionally provided looser restrictions to large-cap borrowers with healthy balance sheets and strong earnings profiles. However, with interest rates at an all-time low, an oversupply of available funds and increased investor demand for higher returns, lenders are ever-more willing to offer such loans to high-quality borrowers in the middle market.

The borrowers' power in the middle market is further buttressed by the fact that covenant-lite is trickling down into the lower-middle market. For example, Learfield Communications, a middle market company in Jefferson City, Mo., with under \$40 million of EBITDA, obtained a \$330 million cov-lite loan from Deutsche Bank and GE Capital in October of 2013. Similarly, Sprint Industrial Holdings and Hemisphere Media Group Inc., both companies with annual EBITDA around \$40 million, also closed covenant-lite loans in 2013.

This borrower-friendly phenomenon not only is expanding in the U.S. middle market, but also on a global scale, though mostly still with a decidedly American character. European companies backed by private equity have increasingly negotiated loans with lighter fi-

ancial covenants in recent years, but mostly they have tapped U.S. and European investors for the loans rather than marketing only to their own region's investors, who have historically demonstrated a greater resistance to such loans. While these cross-border transactions continue to make up the majority of European cov-lite issuances, more of these loans are being originated and syndicated in Europe only, including recent financings completed by Ceva Sante Animale and Continental Foods. According to a report by Forbes, as of May 31 a whopping 35 percent of all institutional loan volume syndicated to European investors carried no financial maintenance covenants whatsoever—a record high and more than double the share of such loans in the marketplace from the same time period a year ago.

The Bottom Line

With borrowers now running the show, lenders are under the proverbial gun to continue issuing debt on terms. Accordingly, borrower-friendly leveraged loans are, and will continue to be, in vogue so long as the supply of debt capital remains high and lenders compete for higher yields. Although borrowers will pay a premium for these favorable terms in the form of higher interest, cov-lite loans more than pay for themselves by allocating less managerial time to covenant management. Such loans allow a borrower's business to focus on doing what it is meant to do—operate without interruption to generate profits for its equity holders.

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