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Covenant-Lite Loans: Leveraged Lending in the Syndicated Loan Market

Analyzing Elements and Structuring Provisions of Cov-Lite Loans for Borrowers and Lenders

THRUSDAY, MAY 30, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Paul | Weiss

Covenant-Lite Loans

Eric Goodison

May 30, 2013

Paul | Weiss

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What are Covenant-Lite Loans?

- **What are Covenant-Lite Loans?**
  - Borrower-friendly type of loan facility, often with high-yield bond style incurrence covenants.
  - Terms vary, but key feature is **absence of financial maintenance covenants** requiring the borrower to satisfy regular (monthly or quarterly) performance tests.
  - Common types of financial maintenance covenants include:
    - <u>Maximum Leverage Ratio</u>. Typically restricts the borrower from exceeding a specified ratio of debt to EBITDA. May apply to a borrower's total debt, secured debt, senior debt or first lien debt.
    - <u>Minimum Interest Coverage Ratio</u>. Typically requires the borrower to maintain a specified minimum ratio of EBITDA to interest expense.
    - <u>Minimum Fixed Charge Coverage Ratio</u>. Typically requires the borrower to maintain a minimum specified ratio of EBITDA to fixed charges (such as scheduled debt service, capital expenditures and rental expenses).

What are Covenant-Lite Loans?

- **Why have Financial Maintenance Covenants?**
  - Financial maintenance covenants serve as an early warning system for lenders.
    - Required levels are set based on financial projections.
      - Represents the lenders' expectation of how well the borrower will perform, plus a negotiated cushion to allow some room for error.
    - Breach of a financial covenant may indicate that the borrower is not performing as expected.
    - Allows lenders to take action before underperformance materializes into a payment default or bankruptcy. Upon breach, lenders can:
      - Accelerate the loans.
      - Terminate ongoing commitments to lend.
      - Exercise remedies against collateral.
      - Seek to negotiate adjustments to loan terms, using the prospect of the above remedies as a hammer.
    - Without financial covenants, lenders may have no choice but to stand by as borrower's financial condition deteriorates.

What are Covenant-Lite Loans?

- **Why Borrowers Prefer Covenant-Lite Loans**
  - Compliance with financial maintenance covenants may be beyond the borrower's control.
    - For example, the borrower cannot directly prevent a drop in its EBITDA, or a rise in the interest rates on its floating-rate debt, either of which can result in a financial covenant default.
  - Absence of financial maintenance covenants significantly reduces the borrower's potential for default.
  - Without maintenance covenants, the borrower can ordinarily avoid taking actions (or omitting to take actions) that will result in default.

Current Market Conditions

Current Market Conditions

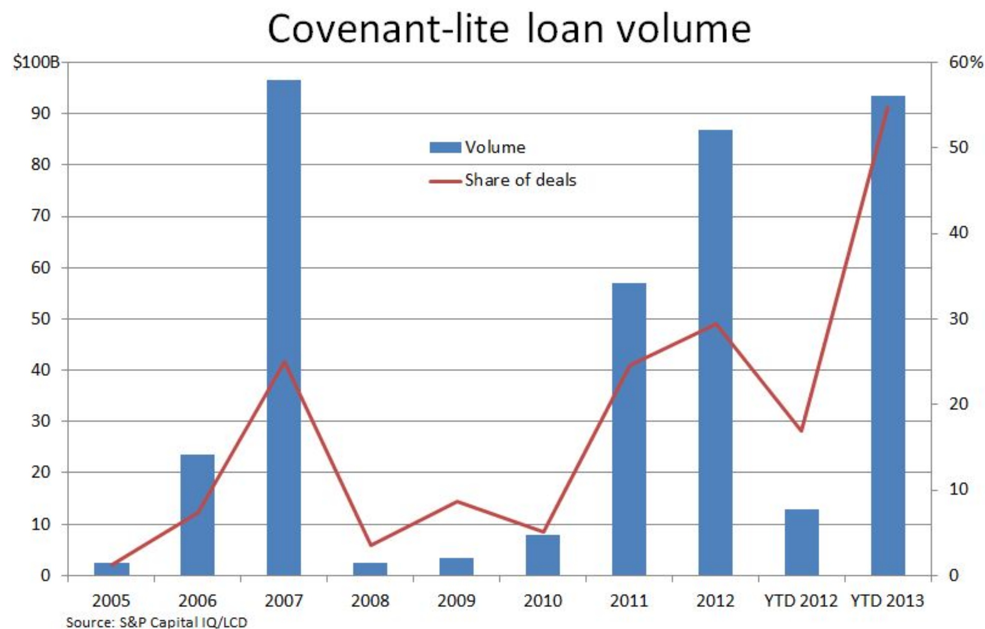
- **Return of Covenant-Lite Loans**
  - After all but disappearing during the credit crisis, covenant-lite loans have made a big comeback.
    - During peak of the market in 2007, covenant-lite loan issuance reached $97 billion (25% of total loan issuance), according to Fitch Ratings.
    - Then, during the years of the credit crisis, covenant-lite loan issuance virtually dropped to zero.

Current Market Conditions

- **Historical Trends**
  - Covenant-lite loans became popular in the heyday of the market in 2006 and 2007, due to increasing bargaining power of borrowers and intense competition among banks for syndicated lending opportunities.
  - Covenant-lite lending ended abruptly with the onset of the credit crisis.
    - Credit markets virtually shut down altogether in 2008-2009.
    - As credit markets recovered in 2010, tightened lending standards reemerged.
      - With decreased appetite for risk and greater market power, lenders refused to lend on covenant-lite terms.
  - Despite market watchers' predictions that covenant-lite loans would not return for many years, covenant-lite terms started to reappear in late 2010.
    - Since 2011, there has been a huge resurgence in covenant-lite loan volume, with record-setting levels being issued today.

Current Market Conditions

- Covenant-lite loans began reappearing in the syndicated loan market in late 2010/early 2011. According to Fitch Ratings:
  - $52 billion issued in 2011 (25% of total loan issuance)
  - $87 billion issued in 2012 (over 30% of total loan issuance)
  - **$78 billion** issued in **Q1 2013 alone** (over **50%** of total loan issuance), surpassing previous quarterly record of $48 billion set in Q2 2007.



Current Market Conditions

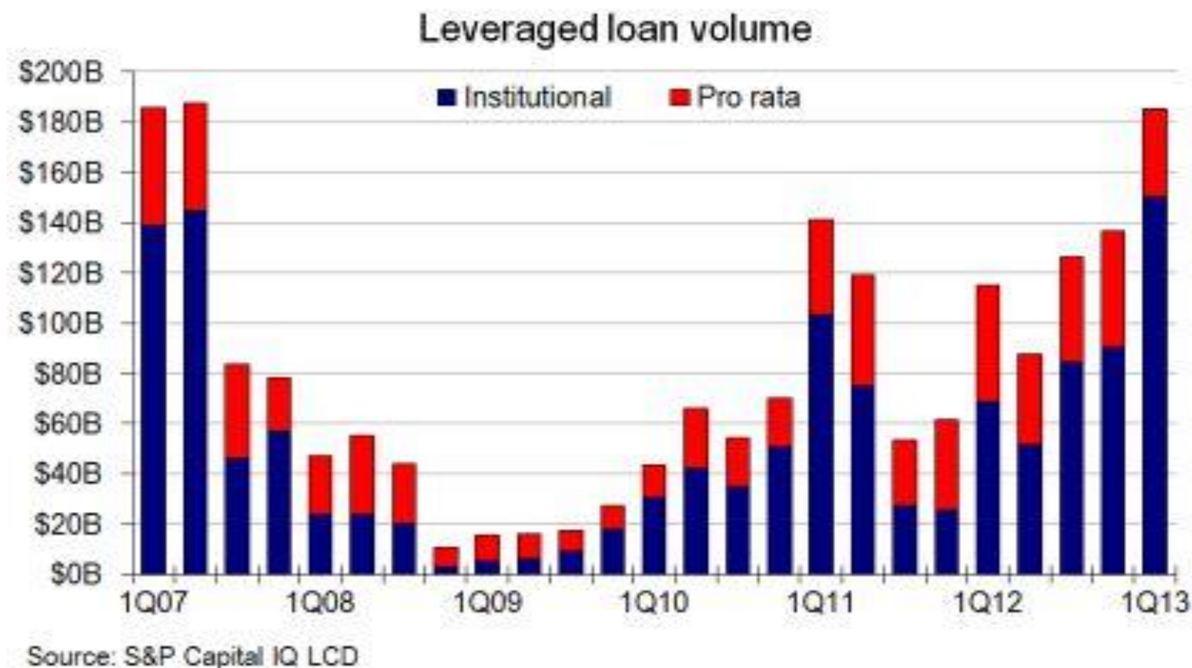
- Before the credit crisis, covenant-lite loans were used to finance takeovers and acquisitions (often backed by private equity sponsors), in addition to refinancings and other general purposes.
- Unlike pre-credit crunch deals, most covenant-lite activity today consists of **opportunistic** (not committed) financing, unrelated to M&A/LBO transactions.
  - Refinancings
    - Borrowers are replacing existing debt with new credit facilities which have improved economic terms and more favorable covenants, including covenant-lite structures.
  - Repricings
    - Borrowers are taking advantage of low interest rates to seek downward price adjustments and loosening of covenants with existing lender groups.
  - Dividend recapitalizations
    - Trend of private equity sponsors taking a large dividend in connection with refinancing their portfolio companies' debt.

Current Market Conditions

- **Why is Covenant-Lite Back?**
  - Current market conditions generally favor borrowers:
    - Historically low interest rate environment.
      - Investors are searching for yield, turning to the leveraged loan market.
    - Leveraged M&A activity has not kept pace with debt investor demand.
      - Results in more capital competing for fewer deals.
      - Lenders are therefore under pressure to offer borrower-favorable terms.

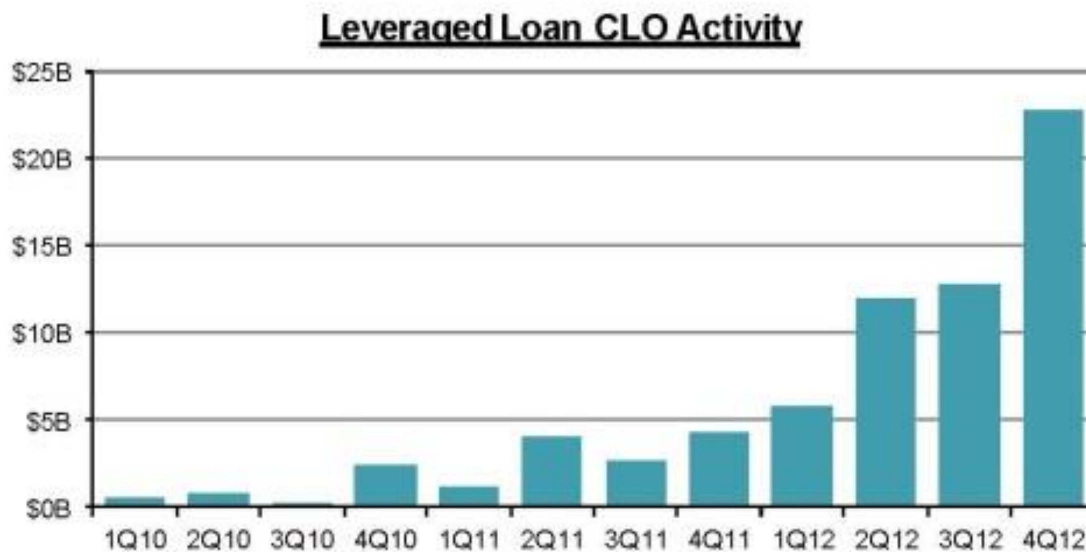
Current Market Conditions

- Credit markets remain robust.
  - Record levels of syndicated lending activity in general, fueled by opportunistic refinancings and dividend recaps.



Current Market Conditions

- **CLOs** have become major players in the leveraged loan market.
  - Level of investment in syndicated loans by CLOs is approaching pre-credit crunch levels. According to S&P Capital IQ, CLOs captured **60.4%** of the primary market during Q1 2013.
  - Overall CLO issuance levels have skyrocketed since the credit crisis.



Source: Standard & Poor | Leveraged Commentary & Data

Current Market Conditions

- CLO investment limitations on covenant-lite loans have tracked the resurgence of covenant-lite loans in the market. According to a Wells Fargo Securities report:
  - In early 2012, CLOs typically had restrictions limiting investment in covenant-lite deals to 30-40% of assets.
  - Today, 50-60% is more common, with some CLOs having the ability to invest up to 70% of their assets in covenant-lite loans.

Current Market Conditions

- **Expanding Reach of Covenant-Lite**
  - Covenant-lite terms have primarily been available in large-cap deals (≈ $300M plus) often involving borrowers backed by top-tier private equity sponsors and large leveraged companies.
  - However, there are signs that covenant-lite is becoming more widespread in the marketplace. It has been reported that:
    - Private equity firms facing scarcer large M&A opportunities are casting a wider net for deals, bringing large-cap structures—including covenant-lite loans—to middle market deals.
    - Lenders competing for deals due to oversupply of capital are starting to make covenant-lite terms available to middle market companies and borrowers with higher leverage.

Overview of Covenant-Lite Provisions

Overview of Covenant-Lite Provisions

- **Incurrence Tests**
  - Instead of maintenance covenants, covenant-lite loans often contain **incurrence-based financial covenants**, which are tested only if the borrower takes certain actions (e.g., incurring debt or making dividend payments).
  - Covenant-lite structures may also have "springing" financial covenants, which only apply (or spring into effect) if certain criteria are met.
    - ABL – minimum availability trigger.
    - Cash Flow Revolver – certain facility usage trigger.

Overview of Covenant-Lite Provisions

- **Other Covenant-Lite Terms**
  - In addition to lack of financial maintenance covenants, covenant-lite loan facilities may contain high-yield bond style negative covenant packages.
  - These looser covenants often allow the borrower to take otherwise restricted actions if specified incurrence tests are satisfied.
    - Debt incurrence – the borrower may be permitted to incur an unlimited amount of debt, as long as a specified incurrence test is met after giving effect to the incurrence of the new debt.
      - Applicable incurrence test is commonly a maximum leverage ratio or a minimum interest coverage ratio.
    - Lien incurrence – the borrower may be permitted to grant an unlimited amount of additional liens on its assets, as long as a specified incurrence test is met after giving effect to the granting of the additional liens.
      - Applicable incurrence test is commonly a maximum leverage ratio calculated with respect to the borrower's secured debt or first lien debt.

Overview of Covenant-Lite Provisions

- Restricted payments – the borrower may be permitted to make dividends and distributions up to an amount equal to a specified percentage of net income or EBITDA.
- Acquisitions – the borrower may be permitted to conduct an unlimited amount of acquisitions, as long as a specified incurrence test is met.
  - Applicable incurrence test is commonly a maximum leverage ratio, calculated with respect to the borrower's secured debt or total debt.

- In traditional credit facilities, rather than incurrence-based tests, each of the above activities would generally be limited to a fixed dollar cap (if permitted at all).
- In covenant-lite facilities, negative covenants may also contain "builder baskets."
  - Allows the borrower to allocate a portion of its excess cash flow for use towards:
    - Investments;
    - dividend payments; or
    - repayments of junior debt.

Overview of Covenant-Lite Provisions

Covenant-Lite Financing Structures

- Cash Flow Loans
  - A common structure for covenant-lite loans is for two or more credit facilities to be provided under a single credit agreement, consisting of:
    - a term loan or series of term loans, and
    - a cash flow-based revolving credit facility.
  - Generally, all facilities are subject to the same covenants, mandatory prepayments and events of default, except with respect to financial covenants.
  - Sometimes there are no financial maintenance covenants applicable to any of the facilities.
  - Other times, there could be financial maintenance covenants that **apply only to the revolver**.
    - In these cases, typically there will be a single financial covenant, such as a maximum leverage ratio.

Overview of Covenant-Lite Provisions

- Breach of financial covenant will create a default under the revolver, but with respect to the term loans the breach will either:
  - never result in a default, or
  - result in a default only if the revolving lenders have not waived the default by the end of a specified standstill period (typically 45-90 days).
- Revolving lenders will have the exclusive ability to amend the terms of the financial covenant or waive a default in respect of the financial covenant.
- Revolving lenders will also have the exclusive ability (until the expiration of the standstill, if there is one) to exercise remedies in respect of the default, including:
  - terminating the ongoing commitments to lend.
  - declaring the outstanding loans immediately due and payable.
  - exercising remedies against the collateral.

Overview of Covenant-Lite Provisions

- Financial maintenance covenants in these structures are often springing in nature, applicable only if specified thresholds are met.
  - Typically the trigger is based on revolver usage – if the borrowings exceed the specified threshold, the financial covenant is tested.
  - Allows borrower to avoid financial covenant testing by managing timing of revolving borrowings and paydowns.
    - If borrower is not confident in its ability to satisfy the financial covenant, borrower can pay down outstanding amounts (and/or avoid new drawdowns) under the revolver before the covenant testing date in order to reduce usage below the threshold trigger (assuming the borrower can afford to do so).

Overview of Covenant-Lite Provisions

- Asset-Based Loans
  - It is becoming increasingly popular for working capital facilities to take the form of **asset-based loans (ABLs)** rather than cash flow revolvers.
    - Total amount of funds available to borrower is limited based on the underlying value of specific classes of assets serving as collateral.
    - ABL lenders focus primarily on the value of the collateral package rather than the borrower's credit profile or earning potential.
    - ABL provides enhanced lender protection in that ABL lenders should theoretically never be undersecured, because borrowings cannot exceed collateral value.
  - Borrowings under ABL facility are limited by a **"borrowing base"** formula.
    - Borrowings are limited to a specified percentage of the value of the assets included in the borrowing base that meet specified eligibility criteria.
    - Accounts Receivable and Inventory are usually key components of the borrowing base.

Overview of Covenant-Lite Provisions

- Unlike cash flow deals, where term lenders and revolving lenders share a pari passu lien in the collateral, term lenders and ABL lenders have different rights in the collateral.
  - Both sets of lenders typically have liens on substantially all assets.
  - Differing priority in the lien on the shared collateral:
    - ABL lenders usually have first priority lien over working capital assets (receivables, inventory and cash), and second priority lien on property, plant and equipment.
    - Term lenders have reverse priority: first lien on PP&E, second lien on current assets.

Overview of Covenant-Lite Provisions

- Typically, covenant-lite deals having this structure will include a cash flow term loan under one agreement, and an ABL revolver under a separate credit agreement.
- Because the term loan and ABL are provided under separate credit agreements, different sets of covenants apply to each.
  - Covenant-lite deals will have no financial maintenance covenants in the term loan agreement.
  - ABL usually has a **springing minimum fixed charge coverage ratio**, applicable only if borrowing availability under the ABL falls below a specified threshold.

Overview of Covenant-Lite Provisions

- Events of Default in the term loan agreement are structured to prevent the term lenders from indirectly benefiting from the financial covenant in the ABL facility.
  - **Cross-acceleration**, rather than cross-default, to the ABL in the term loan agreement.
  - Term loan lenders cannot exercise remedies in respect of a breach of the ABL financial covenant unless ABL lenders have accelerated the ABL facility.

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EVERYTHING MATTERS

COVENANT-LITE LOANS

MARKET DYNAMICS, MARKET RESPONSE AND ELEMENTS OF COVENANT-LITE LOANS POST-CREDIT CRUNCH

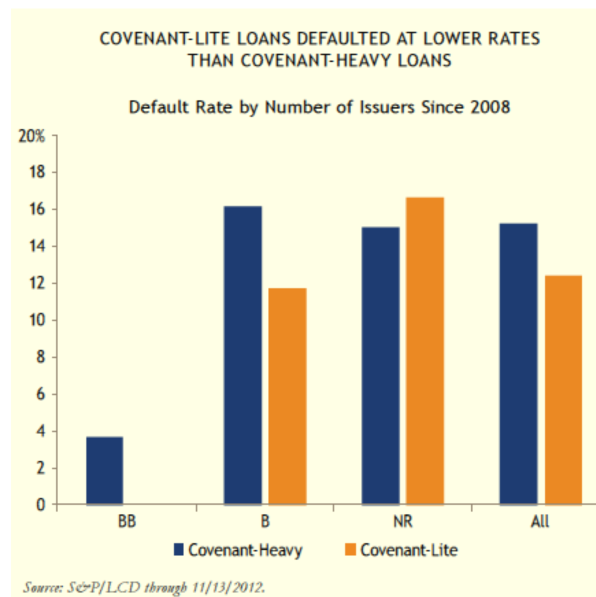
Jamie Knox, DLA Piper LLP (US)

May 2013

Market Dynamics

DLA PIPER

- Covenant-Lite Loans have had a strong resurgence since the credit crunch
- The Credit Crunch did *not* show that Covenant-Lite Loans always put lenders in a substantially worse position



- BUT These are default rate statistics—Are they meaningful in this context?

Market Dynamics, continued

DLA PIPER

- Total return/recovery statistics
  - 2011 Moody's study data
  - Suggests the default rate statistics aren't misleading—covenant lite investors have not fared worse even in default cases

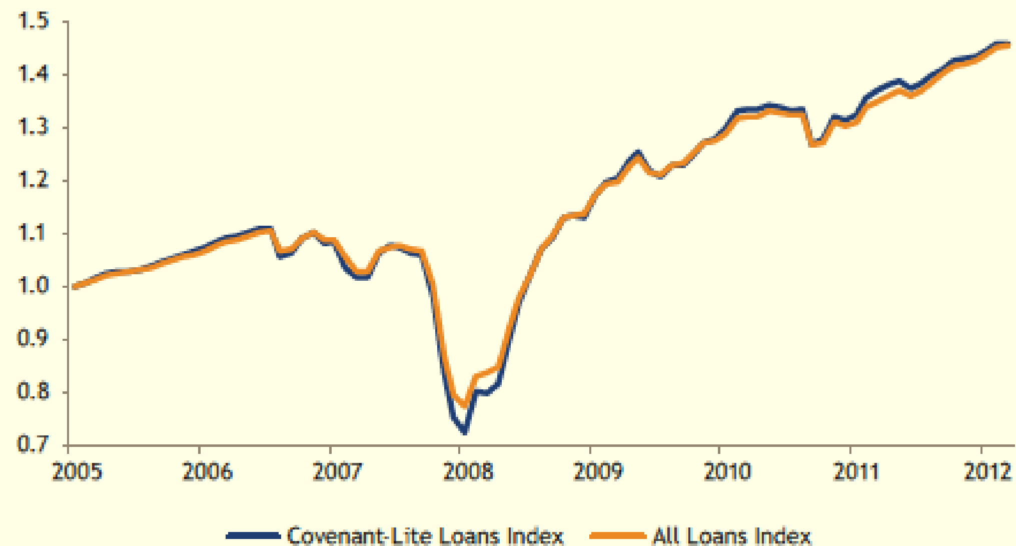
Instrument Recovery Rates

	Covenant-Lite Study	Hard Data for Hard Times II Study
First-Lien Loans (all cov-lite loans were first lien)	89.6%	81.5%
Subordinated Loans (Second Lien and Unsecured)	5.6%	29.3%
Senior Unsecured Bonds	47.2%	42.6%
Senior Subordinated Bonds	23.1%	27.6%

Source: Moody's Ultimate Recovery Database

Market Dynamics, continued

- In performing loan cases, statistics have been strong for covenant lite loans as well



Market Response

DLA PIPER

- In the face of fairly benign default and recovery statistics from the credit crunch, covenant lite issuance has surged back
- New CLOs are ready, willing and able to allocate substantial funds to covenant lite issuance
  - 6 of 10 largest 2012 CLOs permitted 50%+ covenant lite loans in the loan pool

TEN LARGEST CLOs OF 2012

CLO	Manager	Size ($mm)	Date	Cov-Lite Loans
Mercer Field CLO	Guggenheim Partners Investment Management	1,054	Dec-12	60%
Madison Park Funding X	Credit Suisse Asset Management	802	Nov-12	40%
OHA Credit Partners VII	OakHill Advisors	770	Oct-12	50%
Venture XII CLO	MJX Asset Management	750	Dec-12	40%
CIFC Funding 2012-II	CIFC Asset Management/Greensledge	748	Oct-12	40%
ALM VII	Apollo Credit Management	722	Oct-12	70%
Ares XXIV	Ares CLO Management XXIV	719	Aug-12	30%
OHA Credit Partners VI	Oak Hill Advisors	674	Apr-12	50%
Octagon Investment Partners XIV	Octagon Credit Investors	626	Nov-12	50%
Northwoods Capital IX	Angelo, Gordon & Co.	626	Nov-12	50%

SOURCE: S&P LCD. DATA AS OF DECEMBER 31, 2012. INCLUDES BROADLY SYNDICATED CLOs.

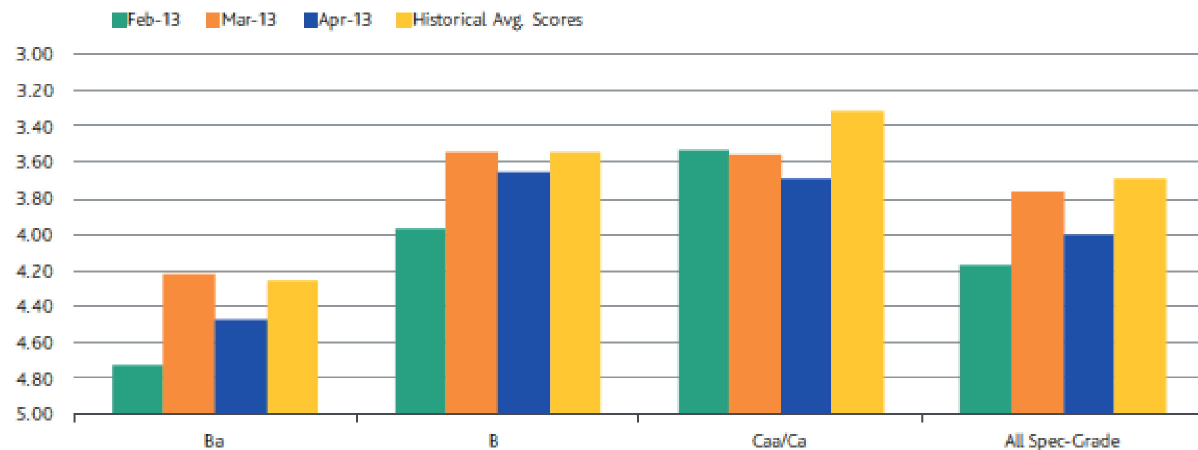
Market Response, continued

DLA PIPER

- As an asset class, covenant lite loans remain an attractive option relative to other speculative debt
  - January 2013 Guggenheim commentary:
    - "Moving up the capital structure from unsecured bonds into secured, floating-rate coupon, shorter-maturity loans with covenants only costs investors 30 basis points in yield."
  - In exchange, investors get protection from underlying interest rate increases, collateral coverage and a stronger covenant package

Market Response, continued

- Has the pendulum swung too far?
  - Moody's research published in the last week suggests April covenant protections were lower for new CCC loans than B loans—an inversion of the typical market dynamic



- Does this suggest an overheated market?

Loan Terms Post-Credit Crunch

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- Similarity of cov-lite terms pre-crunch and post-crunch
- Substantial convergence of term loan cov-lite structures with high yield bond indenture terms
  - Incurrence-based covenants
  - Flexible, growing negative covenant baskets
- Substantial convergence of cov-lite revolver terms with traditional ABL terms
  - Springing financial covenant(s)
- Reasons for Term Loan/Revolver differences
  - Who lends
  - When they lend

Case Study – TransDigm (Feb 2013)

DLA PIPER

- $2.2 billion term loans (Term B and C), $310 million revolving credit facility
- Maintenance Covenant
  - Solely for benefit of Revolving Lenders
  - 6.0x Consolidated Net Leverage Ratio
  - May be waived or amended by the Revolving Lenders acting alone
  - No Event of Default for Term lenders until Revolving lenders have accelerated their debt
- Refinanced existing credit facilities

Case Study – TransDigm (Feb 2013)

DLA PIPER

- Negative Covenants
  - Debt and lien incurrence
    - Pari passu secured debt permitted to 4.0x Secured Debt Ratio
    - Junior lien and subordinated debt permitted to 6.0x Consolidated Net Leverage Ratio
  - Investments and Restricted Payments
    - Unlimited, so long as Consolidated Net Leverage Ratio is 5.75x or less and unrestricted cash is at least $200 million

High Yield – Remaining Differences

DLA PIPER

- Leverage, rather than coverage, as key governor on Restricted Payments, etc. in covenant-lite loans
  - Note that the TransDigm RP covenant is potentially more permissive than a typical high yield bond “building basket” structure
- Economic Terms
  - Floating interest rate
  - Prepayment penalties
  - Amortization

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