WHISTLING PAST THE COVENANT-LITE GRAVEYARD

A SANITY CHECK IN PRACTICAL & PHILOSOPHICAL TERMS

SUMMARY

The recent shift in common wisdom with respect to covenant-lite loans hearkens the warning to be careful of changing opinions in the face of unchanging facts and steadfast opinions. Many general partners bemoan the incidence of covenant-lite loans, but others do not. Some market participants have come to support covenant-lite loans. Their opinions appear to have changed when, we believe, the underpinning need for them has not changed. This brief note will summarize the pro–covenant lite positions articulated to us and point out their weaknesses.

In general, there are four arguments in favor of tolerating covenant-lite loans. They are best summarized in the following assertions:

- They DO have covenants! Incurrence covenants!
- Only the best borrowers get covenant-lite loans and only the worst need covenants.
- A covenant trip doesn't result in bankruptcy, so we don't think defaults will rise.
- You can't enforce covenants these days; there are too many lenders to generate a consensus.

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THEY DO HAVE COVENANTS! INCURRENCE COVENANTS!

Incurrence-only covenant packages used to define covenant-lite loans because their protections of creditor rights were "light" compared to the vast majority of historic new issuance. There were no "covenant-heavy" loans; just loans and covenant-lite loans. The "covenant-lite" moniker defined an exception, not the norm that we have today in the syndicated loan market. To point to these weak terms as evidence of creditor protection is to redefine "covenant none" as "covenant lite" and to make the former exception the new rule. This claim is an example of a change in the opinion that creditor rights are not as necessary in the current environment. Might the next assertion offer insight into changes in facts justifying the change in opinion?

ONLY THE BEST BORROWERS GET COVENANT-LITE LOANS AND ONLY THE WORST NEED COVENANTS.

According to Leveraged Commentary & Data, more than 80% of new issue loans are covenant-lite in the United States. Let us ponder this proportion in both absolute and relative terms. Does anyone really believe that eight of ten borrowers represent the best credit risk available? This sounds like the proverbial middle school class where every student raises a hand when asked: "Are you above average?" By this logic, a decade ago, the "best" borrowers represented two of every ten borrowers. Either the weaker credits are no longer accessing the leveraged loan markets, or the entire US corporate sector is dramatically less exposed to poor management, competition, input prices, technological disruption, regulation, lawsuits, the national economy, and the myriad other causes of financial distress. There is little evidence that today's borrowers have immunized themselves against these threats. Consider the second half of the assertion that only the worst borrowers get covenants. This may be true in the current environment. But this doesn't preclude the possibility that borrowers that have bad management, are subject to technological disruption, or are otherwise exposed to near-term financial stress can obtain covenant-lite loans.

Even more importantly, this observation, and many of the others, interpret covenant-lite narrowly, ignoring the term's broader recent significance that includes general weak terms, such as starter and builder baskets, heavy EBITDA add-backs, steep haircuts in setting covenants, and the narrowing net of unrestricted subsidiaries. Reading this assertion with the broader definition of covenant-lite makes it even more dubious. Are there really companies so strong that lenders can exclude certain subsidiaries that generate meaningful cashflow or that house important assets as borrowers?

Finally, this assertion assumes that arrangers of loans act as arbiters of credit quality or that buyers of these assets respond solely to the incentives of risk/return. The first assumption is clearly untenable. Arrangers act in the best interest of their clients, the issuers, endeavoring to secure the most borrower-friendly terms, of which covenant-lite loans are the friendliest. Loan buyers surely have an eye toward risk-adjusted returns, balancing terms with credit risk. But they are also susceptible to salesmanship and the temptation of asset gathering to generate lucrative fees. These competing interests can distract loan buyers from pure credit analysis.

A COVENANT TRIP DOESN'T RESULT IN BANKRUPTCY, SO WE DON'T THINK DEFAULTS WILL RISE.

This is technically true, although poorly articulated. An uncured or unwaived covenant breach can result in bankruptcy if the lender elects to accelerate the loan and the borrower is unable to repay it. A covenant trip itself is not meant to result in bankruptcy, although it can. This assertion fails because it defines the use of covenants according to the most extreme outcome and then rejects their importance based on the infrequency of that outcome. Furthermore, defaults of covenant-lite loans will likely not be higher than covenanted loans, but not necessarily because of the stated premise. The credit ratings agencies define three primary paths to default: non-payment of interest or principal, declaration of bankruptcy, and distressed exchange of an existing instrument for another to avoid the other two paths. The lender typically has the most influence over the last (it is up to the borrower to not pay interest or principal, or to file bankruptcy, typically). Robbed of rights by covenant-lite loan structures, lenders will have fewer opportunities to force distressed exchanges, greatly narrowing that path to default. Fewer paths to default could easily mean fewer defaults.

YOU CAN'T ENFORCE COVENANTS THESE DAYS; THERE ARE TOO MANY LENDERS TO GENERATE A CONSENSUS.

Recall that covenanted loans used to be the norm. Have broadly syndicated loans become syndicated too broadly to corral consensus? Was it historically easier to marshal lenders' attention when voting on covenant remedies? Are syndicates so unwieldy that it isn't even worth having covenants? Perhaps, but those making this assertion should offer evidence. Until then, it is probably safe to assume that broadly syndicated loans are syndicated just as broadly now as when covenanted loans were the norm. It is also very interesting to note that proponents of this view consistently fail to caveat this justification by calling for covenants in clubbed transactions, with their smaller lender groups and easier voting dynamics. No one seems to say, "covenants are pointless in large syndicates, but lenders should definitely insist on them in club deals with five or fewer lenders."

But we don't really need evidence to discard this assertion because it indefensibly justifies disenfranchisement on the basis of inactivity: the "use it or lose" argument. Approximately 50% of the US population usually votes in presidential elections. Should we bar the other half from voting? More than 80% of criminal cases in the United States are settled by plea bargain. Should we eliminate the right of jury trial? More likely than not, holders of common shares of issuers listed on the stock exchanges of the world infrequently attend annual meetings or vote on corporate actions. Should shareholder rights follow covenants to the exit?

The crucial error here appears to be the fundamental misunderstanding of covenants' purpose. For the most part they are there not to be enforced, but to give lenders the right to enforce their other rights. A lender can no more easily enforce a covenant than Rod Rosenstein can subpoena a telephone call. If declining EBITDA and rising leverage conspire to violate a time-sensitive covenant (and most financial covenants have a temporal element), it is simply impossible to go back in time and correct the

breach. Covenant breaches can be ignored, waived, or cured (either through pre-agreed terms or a negotiated settlement). Rights triggered by the breach are most commonly enforced. If supporters of covenant-lite loans believe that creditors should have rights, then they should support the triggers for those rights. If their complacency with covenant-lite loans belies an indifference to creditor rights, then it would be more straightforward, if more controversial, for them to simply state so.

These justifications are probably rooted in a lack of investment mandate flexibility that would permit the most active loan asset buyers from pivoting to another form of credit spread product. There are vehicles that must buy leveraged loans and must therefore paint the rosiest picture of the current trends.

Investors prefer loans to bonds because they have floating-rate coupons, offering an inflation hedge, and highly documented structures that should generate superior recoveries. Those superior recoveries rest on three pillars: priority liens, superior documentation, and shallower positioning in a capital structure. The last two differences are eroding as loan-only structures plumb greater cap stack depths and vanishing covenants mimic bond documentation. Today's buyers of covenant-lite loans are either betting that the remaining pillar will suffice in ensuring continued superior recoveries, or they have come to accept that the loan market is turning into the senior bond market (with respect to creditor rights). Our clients should make this bet after covenant-lite loans are tested. ■

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