Covenant Lite: The Time Bomb that Wasn't

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The widespread adoption (85%) of cov-lite documentation in large, syndicated leveraged loans paired with the Covid pandemic in 2020 seemed like it should have been a dangerous combination for leveraged loan investors. Conventional wisdom suggested the pandemic would trigger widespread defaults of leveraged loans and the recoveries on these defaulted loans would be lower because of the "lite" covenants protecting investors. However, it did not turn out that way. Despite their widespread reputation as a "ticking time bomb"[1], in our opinion several covenant-lite loan provisions actually helped the loan market avert widespread defaults in 2020.

So, what happened? Why did we end up with so few defaults and losses? Why didn't the "time bomb" go off?

2020 Recap

A quick look at loan prices during 2020 helps tell the story. In January 2020, the S&P/LSTA Index was trading at a price of 97.3. When Covid lockdowns and related measures hit, the index plummeted to 76. At that time, 24%[2] of all leveraged loans were trading below 80, a level S&P deems to be "distressed." The situation looked dire. Operating incomes of leveraged borrowers plummeted, causing debt-to-EBITDA ratios to spike upward and interest coverage ratios to spiral downward. During the March – May period, S+P downgraded 31%[3] of all issuers in the leveraged loan index. At the same time, during the initial months of the pandemic, 1-year default expectations jumped in line with the rating downgrades, as 1-year default forecasts from S&P and Moody's ranged from 10% to 17%. Yet, the final 2020 default rate was just 2.61% for the 12 months ending April 30, 2021, which is **lower** than the long-term average of 2.9%[4].

Two Categories of Loan Covenants: Maintenance and Structural

Currently, 85% of loan origination is governed by covenant-lite documentation (vs. just 15% in 2010)[5]. Covenant lite takes many shapes and forms, but can broadly be separated into two categories: maintenance and structural. In regard to maintenance covenants, covenant lite loan agreements typically feature: (1) EBITDA add-backs; and (2) watered down or no maintenance covenants. In regard to structural covenants, covenant lite loan agreements can include

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[1] https://www.telegraph.co.uk/business/2018/09/02/ticking-time-bomb-could-blow-financial-crisis/
[2] S&P Global Market Intelligence. Leveraged Loan Index Default Rates. Published 5/31/2021.
[3] LCD. "Index/Default Rates".
[4] LCD. "LCD Default Survey: Defaults seen topping historical average in 2021".
[5] S&P Global Market Intelligence. LCD's Quarterly Leveraged Lending Review:1Q2021. Slide titled "Covenant/Security: First-Lien Leveraged Loan Covenant Statistics".

features such as: (1) collateral stripping and transfers of assets to unrestricted subsidiaries; (2) release of guarantees by subsidiaries; (3) elimination of asset sale proceeds prepayment; (4) sidecar debt structures; (5) maturity priming; (6) non-guarantor debt incurrence; and (7) erosion of call protection provisions and MFN protections.

Maintenance Covenants

The events of 2020 reconfirmed our view that, not only does the elimination of maintenance covenants do no harm to term loan lenders, it often helps them. We offer two arguments supporting this view.

First, as counterintuitive as it may seem, the financial flexibility offered by the lack of maintenance covenants in loan agreements was critical in enabling leveraged loan issuers to survive in 2020. The lack of maintenance covenants allowed issuers to keep running their businesses and avail themselves of much needed financing during the tough times. If maintenance covenants had been in place in Q2 2020, when EBITDA plummeted due to the Covid lockdowns, a large portion of leveraged loans would have automatically been deemed to be in technical default even though interest and other obligations were met. This would have resulted in costly, time-consuming workout negotiations with lenders to waive or avoid maintenance covenant default and would likely have resulted in higher interest expense, payment of fees and, potentially, additional maintenance covenants. The business activity of many leveraged companies might have largely ground to a halt while default remedies were hammered out, resulting in significant value destruction in our view.

It is also important to understand that, while term-loan lenders do not have the benefit of maintenance covenants in a cov-lite loan agreement, the smaller group of lenders in the revolving credit facility ARE usually protected by "springing" or "incurrence" covenants in cov-lite loan agreements. This is important because many of those revolver lenders had to provide covenant waivers during 2020 for borrowers to access additional liquidity. These covenant waivers were typically provided in exchange for additional or amended forward-looking maintenance covenants that the borrowers had to adhere to in order to access additional revolver drawdowns.

The result was a best of both worlds scenario: (a) the lack of maintenance covenants for term-loan lenders in cov-lite loans prevented an automatic, widespread series of technical defaults among leveraged borrowers when Covid struck, while allowing borrowers to access revolving credit lines as an important source of much-needed liquidity; and (b) newly negotiated maintenance covenants, held by the 1st lien revolver lenders, benefited both the revolver lenders and term-loan lenders.

Second, the secondary market for leveraged loans continued functioning through the most difficult periods of the recession, providing a better and timelier outlet for risk management than restrictive covenants could have provided. We have long held this view. In December 2019,

we issued a white paper[6] arguing that the emergence of a liquid secondary market for syndicated leveraged loans provided market-driven risk management alternatives that reduced the need for maintenance covenants. We wrote:

"Rather than having to rely on loan covenants, CLO managers can now simply sell loans with deteriorating issuer performance in a liquid, transparent loan market with reasonably tight bid-offer spreads to buyers who want to accept that loan risk at a market-clearing price that reflects the transfer of risk from seller to buyer. Moreover, the highly visible, real-time feedback in the form of a falling loan price arguably exerts more financial discipline on a company than covenants could because the market puts a visible price on a company's creditworthiness every day… Loans deemed more likely to default will simply flow over time from investors wishing to avoid that risk to investors willing to accept that risk at market-determined prices".

We concluded that some of the fears over covenant lite were largely overblown and that, in the next downturn, *"losses to any individual holder will usually be far smaller and far less concentrated than in the past due to the market's ability to price and transfer risk continuously".*

Structural Covenants

Structural covenant loop holes embedded in cov-lite documentation are by far the most dangerous cov-lite features for leveraged loan investors. These loop holes can be potentially exploited by bad actors to prime existing lenders and/or strip them of their collateral. So far, relatively few issuers have chosen to exploit specific "structural" cov-lite provisions designed to limit the rights of senior creditors. Prior to 2020, the most publicized cases of exploitative behavior included J. Crew, Neiman Marcus, Acosta and PetSmart; all examples of shareholders and/or distressed investors exploiting weak documentation to the detriment of 1st lien lenders. With the spike in distressed issuers in mid-2020, the list grew to include names such as Revlon, Serta Simmons, Boardriders, Trimark and Travelport. However, what is notable about all these situations is the legal fight put up by the term-loan lenders who, in cases such as PetSmart, J. Crew, Acosta, Neiman Marcus, Trimark and Travelport, forced (or in the process of it) varying degrees of compromise by the aggressors. In the case of Travelport, the term-loan lenders, led by several prominent CLO managers, threatened default and legal action against the sponsor, Elliott, to prevent the transfer of intellectual property collateral. As a result, the term-loan lenders forced an out-of-court compromise from Elliott. In the case of Trimark, litigation is ongoing but in August the plaintiffs received good news from the State of New York Supreme Court which is allowing their case to proceed.

Partly because of these legal battles, the Loan Syndications and Trading Association ("LSTA") formalized resistance to exploitative structural covenants in March 2021 when it published a series of documentation recommendations, including *"J. Crew" blocker provisions and "Serta"*

[6] Capra Credit Management, LLC. "Cov-Lites" paper. Published 12/11/2019.

protections. These protections are becoming more commonplace in today's leveraged loan documentation.

Cov Lite and Loan Recoveries

S&P Global Market Intelligence, in its fall 2020 LossStats research[7], cited deterioration in leveraged loan average recoveries over the past several years. In its study, S&P cites two contributing factors:

(1) the decreasing levels of unsecured debt in the capital structures; the paper states that the highest loan recoveries have been in capital structures with more than 75% of total debt represented by unsecured lenders, while the lowest recoveries have been in capital structures with less than 25% of total debt represented by unsecured lenders.
(2) Covenant-lite documentation.

Our own monitoring of loan recoveries in the CLO cohort of loans mirrors S&P's conclusion. However, we believe item 1 above to be far more responsible for decreasing loan recoveries than item 2. Our view on item 1 is supported by LCD's data tracking average debt cushion below 1st lien loans[8]. In 2007, the average was 29%. Today it has decreased to 18%, thereby reducing the amount of unsecured or subordinate lenders to support higher recoveries at the 1st lien level. The implication is clear - it is not as good to be a senior creditor when there are fewer junior creditors! Another less-cited factor has been the recent uptick in the amount of super-senior revolvers and Asset Based Lending facilities that are senior to 1st lien term loans. According to Moody's, the average amount of 1st lien term loans that are senior in the capital structure has decreased from 93% in the late 1990s to 80% today[9].

S&P's item 2 is overly broad in our view. As we argued above, we believe **covenant-lite documentation reduced aggregate default rates, and therefore aggregate losses, in 2020**. However, in a handful of cases, covenant-lite documentation (specifically, the weakening or outright elimination of structural covenants) did result in lower recovery rates when some borrowers chose to exploit the weak structural cov-lite provisions. Fortunately, those cases were met with spirited pushback. These cases helped catalyze the creation of the LSTA-recommended documentation that is now being adopted, with the intent of preventing or limiting the abuse of *structural covenants* going forward.

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[7] S&P Global Market Intelligence. "LossStats: As credit cycle ends, data point to lower recoveries" by Marina Lukatsky. Published 2021.
[8] S&P Global Market Intelligence. "As long-only issuance top records, debt cushions thin" by Rachelle Kakouris. Published 2/3/2020.
[9] Moody's "Favorable US Post-Pandemic Credit Conditions – Identifying Risks Ahead". July 14, 2021.

Conclusion

In summary, the frequently-published covenant lite gloom and doom headlines fail to unpack the numerous risk management components of cov-lite documentation and their impact on probability of default and loss given default. Specifically, it does not differentiate between the exclusion of maintenance covenants, which we view as innocuous at worst, and the potentially more harmful cov-lite features that target the structural integrity of the collateral and priority of term loan lenders. In addition, term loan investors have access to a liquid secondary market for leveraged loans thereby providing them with alternative risk management mechanisms in the absence of covenants. Lastly, term loan investors have pursued many successful legal remedies against investors attempting to exploit weak documentation. All these factors, when assessed together, are certainly enough to diffuse the 'ticking time bomb'.

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