Covenant-Lite Loans: Credit Quality Is Still the Dominant Factor

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As portfolio managers for bank loan products at Loomis Sayles, we are often asked about “covenant-lite” bank loans, and in particular whether they represent a dangerous trend that suggests loans are overheated and should be avoided. This paper describes our views on what covenant-lite loans are and are not; it is based more on reasoning and experience than proof, because covenant-lite loans have not been offered over a long enough period to establish a meaningful fact pattern.

What is a “Covenant-lite” loan?

Senior secured loans are governed by a contract between borrowers and lenders called a credit agreement. The credit agreement spells out the obligations of borrowers and lenders as well as the terms of the loan. Included in those terms are covenants, which come in three forms: positive, negative and financial.

Positive Covenants	Must be done, such as provide financial statements to lenders.
Negative Covenants	Must not be done, such as dividend too much money to equity owners, or sell collateral without compensating lenders. The negative covenant list can be lengthy.
Financial Covenants	Financial Covenants come in two forms: incurrence tests and maintenance tests. **incurrence tests** say that the company must not take an action that pushes a financial ratio beyond a specified level. For example, the company must not borrow so much money that pro forma interest coverage becomes less than two times. The exact incurrence tests are a matter of negotiation between lenders and the borrower and are not standard from deal to deal. **Maintenance tests** say that the borrower must maintain at all times a certain financial ratio; for example, senior leverage may not exceed four times cash flow, or the company will be in violation of the covenant. Unlike an incurrence test, which prevents a borrower from taking an action that results in a violation, a maintenance test may fail just because cash flow declines due to weak business results.

A covenant-lite loan will typically have many covenants, positive, negative and possibly incurrence, but they lack even a single maintenance financial covenant. Note that a “covenant-heavy” loan might have only a single maintenance financial covenant. Covenant-lite, therefore, is commonly understood to mean that a loan lacks one specific type of covenant only, not that a loan completely lacks covenants.

What happens when a borrower violates a covenant?

Violating a covenant puts a borrower in technical default, which may sound scary but usually is not. A violated covenant gives the senior loan holders power because they may call the loan (demand immediate repayment) if they wish to do so. The vast majority of the time, in our experience, the loan group has no interest in calling the loan because the credit quality remains satisfactory. Therefore, they usually waive the covenant violation for a small fee or sometimes an increase in the rate of interest (coupon) paid by the borrower. The greater the need for change, the greater the compensation required by the loan group. Sometimes future covenants are reset to reflect the likely path of financial results over subsequent periods. But the important factor to keep in mind is that covenant violations give the lenders the power to get the changes they want

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or call the loan, which in turn might force a borrower into bankruptcy court if alternative financing cannot be arranged.

Why do borrowers ask for "covenant-lite" credit agreements?

Borrowers do not want to give their loan syndicate the power to call the loan or get concessions just because future results may be weak. Management and owners want to figure out the best way to handle the implications of weak results without lenders threatening bankruptcy or pushing for changes that do not help the firm's value.

For example, the owners might wish to pursue an out-of-court exchange with the bondholders in the structure to reduce debt without the financial burden of bankruptcy. Or the owners might want to work through a couple of weak quarters without permanently increasing the cost of their loans. For example, if a borrower, who has a hypothetical $500 million loan outstanding, violates a covenant and is forced by the lending group to raise its coupon 100 bps (1%) to cure the violation, the result would be an extra $5 million in interest expense annually for the borrower until the loan is repaid. Not surprisingly, borrowers would rather do something else with that kind of money.

Why do senior lenders like having a maintenance financial covenant?

Senior lenders get two potential benefits from having a maintenance financial covenant: the possibility of fees and/or a higher coupon on violation and greater influence on company actions if the credit becomes weak.

Is it important for lenders to be protected by a maintenance financial covenant?

In our opinion, most of the time, the answer is no. This is a point that the financial press arguably misses when some infer that covenant-lite loans reflect a significant deterioration in lending standards. Our view is that a high-quality credit might not be impacted by a maintenance financial covenant because it would not likely have violated the covenant even if it had one. We feel that from the perspective of a lender, it is more desirable to own a good covenant-lite loan than hold a bad credit with a maintenance financial covenant. Therefore investors in loans should be far more interested in the credit skills of their managers than the proportion of covenant-lite loans in a portfolio.

How about less favorable credits? There are two ways for a maintenance financial covenant to be important: if it leads to greater income for lenders, or if it allows lenders to avoid greater losses by getting control of a deteriorating situation earlier. The first of those two is the more likely to occur, in our experience. Some proportion of loans in any portfolio will probably violate a maintenance financial covenant at some point and that might lead to fees and/or a higher coupon. That proportion multiplied by the potential improved terms equals the most visible value of covenant-heavy loans.

Hypothetically, if 20% of a portfolio eventually incurs a problem (that estimate may be high) and the coupon on those loans were to be raised by 100 bps (which is on the high side) to waive the violation, that would equate to 20 basis points (bps) or 0.20% of potential annual income foregone from having no maintenance financial covenant. If this portfolio yielded 5% and was entirely covenant-lite, it might be missing the opportunity to earn 5.2% annually for some portion of the portfolio's life because it did not have covenant- heavy loans.

What kind of value can be preserved in a truly distressed credit by giving the loan group more influence earlier? That is unknown, but our view is that it is less than what many people imagine. In our experience, loan groups are no better (and may be worse) at maximizing value for themselves and other lenders than the business owners (the borrowers), who after all have the most incentive to keep their businesses viable.

If the owners can improve their operations or extract value from bondholders below the bank loan holders in the capital structure without dragging lenders through bankruptcy for a couple of years, that is good for the bank loan holders (they could save time and resources and end up with a similar outcome). Indeed, bank loan holders who push for taking too much money off the table too fast may increase the odds of bankruptcy. In our view, it is a misplaced notion that granting control to wise lenders will save bad owners and managers from driving their companies off a cliff. There might be some merit to that belief when dealing with small borrowers that have less experienced and savvy managers. With larger, more established companies and experienced sponsors, we think the lending group is likely to be well protected most of the time by their position in the capital structure and the support of collateral, rather than the potential for earlier intervention in a declining credit.

If "covenant-lite" is so unimportant, why do so many seem so concerned by it?

The elimination of any particular contractual protection could be a sign of easing credit conditions, and, all things held equal, lenders (including Loomis Sayles) would choose more protection over less if it were "free." We would like to see maintenance financial covenants on our loans because of the potential to earn additional income. But if the choice is to

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have covenant-lite loans or not to have access to the loan asset category, our choice is easy, particularly given our confidence in our proprietary credit research.

Part of the stigma of covenant-lite (besides the label, which we think implies more than reality) is that the rating agencies warned[1] about the potential dangers of covenant- lite before the last downturn. As it turned out, covenant-lite loans did relatively well versus covenant- heavy loans over the course of the global financial crisis (see charts to the right). In fact, the agencies admitted as much, but could not let go of the concern and warned that maybe next time it will be worse[2]. Maybe, maybe not. We think covenant-lite loans did relatively well in the recent global financial crisis largely because they tended to originate from larger companies with major sponsors who understood how to work the levers of value preservation further down the capital structure, benefiting the senior lenders in the process. Will there be lots of smaller covenant-lite loans with inexperienced sponsors issued over the next cycle? We do not know, but suggest that borrower size and sophistication may be more important attribution factors in the end.

Covenant-lite loans have had better recovery rates than covenant-heavy loans

Recovery rates	Covenant-lite	Covenant-heavy
First lien loans that emerged from default between Q4 2008 and Q1 2011	89.6%	81.5%

Source: Moody's "Covenant-lite Defaults and Recoveries: Seeing Where It Hurts", June 7, 2011.

Conclusion

Covenant-lite loans are not covenant free. In our experience, covenant-lite loans have more covenants than high yield bonds. They lack at least one maintenance financial covenant (and in that alone they resemble most high yield bonds). The lack of maintenance financial covenants reduces the expected value of a loan to an investor by the amount of fees/coupon that could have been extracted by lenders upon violation of the covenant, if it were to occur. On a portfolio basis, that value can be estimated based on probability of occurrence multiplied by value of the violation; the estimates we have seen have been quite small. Generally, the more conservative the portfolio, the lower the value lost from a covenant-lite measured on an ex-ante basis. In addition, there is some potential for a lending group to retain more value (generally capped at par plus accrued interest) by getting earlier control of a deteriorating situation, but we are skeptical of that value under most circumstances for large syndicated loans.

Ultimately, our view is that good credit quality is far more important for investors than a single covenant eliminated from among the many that still go into a loan credit agreement. Covenant-lite is a cyclical reality and potentially an annoyance for lenders, but it is only a small part of the much bigger credit picture and therefore should not have a major effect on risk and return in the category. In our opinion, investing wisely still comes back to fundamental credit analysis.

Endnotes

[1]S&P Capital IQ "The Leveraging of America: Covenant-Lite Loan Structures Diminish Recovery Prospects" July 18, 2007.

[2]S&P Capital IQ "Reshuffling the Debt: US Credit Markets Were Covenant-Lite and Dividend Heavy in the First Half of 2011" August 4, 2011.

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