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Covenant-Lite Loans Rise Again


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So-called "covenant-lite" loans have long been a presence in the syndicated lending market. Total issuance in 2007, just before the credit markets came to a standstill, was approximately $100 billion.[1] But although covenant-lite loans receded, along with general lending, during the Great Recession, contrary to the predictions of many market observers, they have since resurged, with $151 billion in issuance in the United States in the first seven months of 2013,[2] after $29 billion was issued in the first seven months of 2012[3] and $86 billion was issued in all of 2012.[4] Covenant-lite loans have represented about 23 percent of total leveraged loan issuance in the United States so far in 2013 and about 37.6 percent of loans held by institutional investor lenders.[5]

While the growth of this sector has largely followed the increase over the years of leveraged buyouts and the expanding influence of private equity sponsors, as further discussed below, there are other factors contributing to a rise in the frequency of appearance of covenant-lite structures. In addition, while covenant-lite loans have traditionally occupied one particular segment of the loan markets, namely acquisition or leveraged buy-out financing for high-credit quality borrowers, covenant-lite characteristics have begun to surface in loan facilities for middle-market borrowers as well as in traditional working capital facilities.

Covenant-lite loans have been viewed by many, including regulators, as too borrower-friendly and a possible destabilizing force in the credit markets. Others have suggested that this shift towards less restrictive and fewer covenants has given distressed borrowers the time and flexibility needed to keep jumpy lenders at bay, and successfully restructure and avoid bankruptcy.[6]

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Today we will explore the characteristics of covenant-lite loans, their expanding role in the marketplace and their effect on the credit markets generally.

What Is Covenant-Lite?

The term "covenant-lite" has been used to describe a wide variety of loan agreements with borrower-favorable covenants. However, covenant-lite is generally understood to refer to loans that contain incurrence-based rather than maintenance-based financial covenants. Specifically, in traditional bank loans, financial tests such as leverage ratios, fixed charge coverage ratios and interest coverage ratios are typically measured periodically, usually on a rolling four quarter basis. In covenant-lite loans, on the other hand, such financial tests will generally be measured only on the occurrence of a specified event, such as the issuance of new debt, the payment of dividends or the making of an acquisition or other large investment.

Structure and Documentation

Covenant-lite loans are most commonly found in the leveraged loan market (i.e., the segment of the market lending to borrowers with higher than average debt). Syndicated loan facilities in this market tend to be quite sizable, given that they are generally for large corporate borrowers, with participation by commercial lenders as well as institutional investors.

Syndicated leveraged loans typically include a paired revolving credit facility and term A loan (or term loan A) facility. Oftentimes they will also include a pari passu term B loan (or term loan B) facility. While both term A loans and term B loans are amortizing loans, term A loans must usually be repaid through regular periodic payments over a period of five to seven years. Term B loans, on the other hand, tend to amortize over a longer period of time, have a bullet maturity (meaning the periodic payments have not fully amortized the unpaid principal by the final maturity date), and bear a higher interest rate than the term A loans. The lenders in the paired revolver and term A loan facilities, often referred to as "pro rata" loans because the same lenders generally participate on a pro rata basis in both facilities, tend to be commercial banks. The term B loans (often referred to as institutional loans) are usually held by institutional investors, including CLOs, loan mutual funds and hedge funds. While the pro rata loans can be covenant-lite, it is typically the term B loans that have these characteristics.

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In the case of borrowers with a mixture of pro rata and term B loans, in some cases the pro rata lenders have the benefit of testing the financial covenants as of the end of each fiscal quarter and in others the covenants are tested only on a springing basis based upon a minimum percentage of the revolving facility being drawn at quarter-end. In either case, the loan documents typically provide that only the pro rata lenders have the ability to exercise remedies in the case of a financial covenant default, including acceleration of principal, foreclosure of collateral and invocation of default interest rates, and, likewise, lenders holding a majority of the pro rata facilities have the ability to amend the financial covenants and their components or to waive a default. The borrower would only be in default to the covenant-lite lenders if the pro rata lenders accelerate their loans, and the covenant-lite lenders have no voting rights with respect to the financial covenants.

The absence of financial maintenance covenants is the most prominent feature of a covenant-lite loan. However, the growing tendency of these loans to more closely resemble high yield bonds is evidenced by the increasing presence of other borrower-friendly characteristics. For example, certain facilities have fewer and, even in certain circumstances, no financial covenants. Negative covenants common to loan agreements prohibiting (subject to limited exceptions) such actions as debt incurrence or asset acquisitions instead permit them to occur subject to pro forma satisfaction of a single financial test, such as maximum leverage or minimum fixed charge coverage. Borrowers are often being given the ability to buy back their term loans on a non-pro rata basis, either on the open market or via reverse Dutch auctions for which all lenders are invited to participate, and to refinance their term loans without receiving any approval of existing lenders. Events of default involving financial covenants sometimes have the benefit of grace periods and events of defaults arising from defaults under other unrelated indebtedness of a borrower may additionally require acceleration of such other indebtedness (i.e., a cross-acceleration rather than a cross-default).

In the case of pro rata loans that are tested only on a springing basis, lenders in some cases are allowing letters of credit to be excluded from the calculation of revolver usage. Additionally, in sponsor deals lenders are permitting equity cure mechanics whereby the sponsor is permitted to make an equity contribution in order to reduce revolver outstandings for purposes of this calculation.[7]

Growth in Covenant-Lite Loans

As noted above, the emergence of covenant-lite loans can be attributed to a number of factors, but primarily the growing involvement in syndicated loan facilities of both private equity sponsors and institutional investor lenders. Institutional investors, as traditional consumers of high yield bonds, have increasingly turned to the leveraged loan market for returns as interest rates in the bond market continue to remain relatively low. Private equity sponsors, accustomed to the looser borrower covenants of the public debt markets in financing leveraged buy-outs, have pressured lenders to tailor their agreements to more closely resemble high yield bond covenants and, with institutional investors, have found a constituency more receptive to this approach than bank lenders.

Another reason for the increased popularity of covenant-lite loans is the acquisition of these loans by collateralized loan obligations, or CLOs. These portfolio investors have become a driving force behind the demand for term B loans. To respond to growing investor demand for high yield instruments, some CLO managers have been negotiating higher percentage limitations on holding covenant-lite loans in their portfolio as well as narrowed definitions of covenant-lite in their investment guidelines,[8] thereby freeing themselves to invest a greater portion of their portfolios in these products. While in 2012 CLOs' limits on covenant-lite holdings were between 30 percent and 40 percent, the limits are trending upward this year, toward and exceeding 50 percent.[9]

Effects of Covenant-Lite Surge

As dollars in ever greater numbers have flooded into term B loans, borrowers' bargaining power has steadily grown and they have accordingly been pressing for favorable terms. Investors, eager to find yield in new places, have been more than happy to comply. Moreover, in addition to being an element of the large facilities for the most credit-worthy borrowers, covenant-lite features have been appearing in large middle market transactions. Here the perils presented to lenders by the covenant-lite approach to loan documents are magnified by the greater credit risk posed by the less financially stable borrowers in the middle market sector.

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As a result, covenant-lite loans are being made available to borrowers with weaker credit quality than ever before[10] and an increasingly high number of risky companies have credit facilities from lenders who may not be able to call a default and have a "seat at the table" in early stages of the companies' declines. While default rates are generally at their lowest in many years,[11] history shows that it is not likely to remain this way forever. Typically when companies' results turn sour, financial covenants are tripped and lenders are able to work with borrowers to restructure their balance sheets when doing so is still possible in order to retain a relatively high level of value. In covenant-lite loans that lack that early tripping mechanism, lenders may be stuck sitting on the sidelines as companies' financial situations worsen and enterprise value continues to drain. By the time a default occurs it may be too late to avoid bankruptcy and significant loss of value for these companies. The more covenant-lite loans are issued into the market, the less likely it is that lenders will be able to stem the next downturn by negotiating out-of-court restructurings. Investors, including CLOs, are increasingly being exposed to this risk as the covenant-lite market expands, which could have implications for the broader economy in the years to come. Standard & Poors, among others, has already raised this concern and pointed out that recoveries may become more challenging for CLOs and other investors.[12]

Regulatory Concerns

Regulators have also been clear in their concerns regarding covenant-lite loans. In their guidance on leveraged lending activities issued in March 2013, federal regulators noted the increased use of covenant-lite structures. They observed that since the issuance of the 2001 guidance debt agreements have frequently included features that provided relatively limited lender protection, including, but not limited to, the absence of meaningful maintenance covenants in loan agreements. They further noted that, while these types of structures may have a place in the overall leveraged lending product set, they recognized the additional risk in these structures and confirmed that the agencies will closely review such loans as part of the overall credit evaluation of an institution.[13]

Conclusion

Investors' hunger for yield in the post-recession years in U.S. financial markets has led to a number of trends, and as many leveraged lending lawyers can attest, the big one in 2013 has been the proliferation of covenant-lite institutional term loans. It remains to be seen how long this market will remain hot, whether regulators will take steps to reign it in or what effects it could have on the economy if default rates rise in the future.

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