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Market Intelligence

Covenants continue to scrape new lows as investors cede more ground

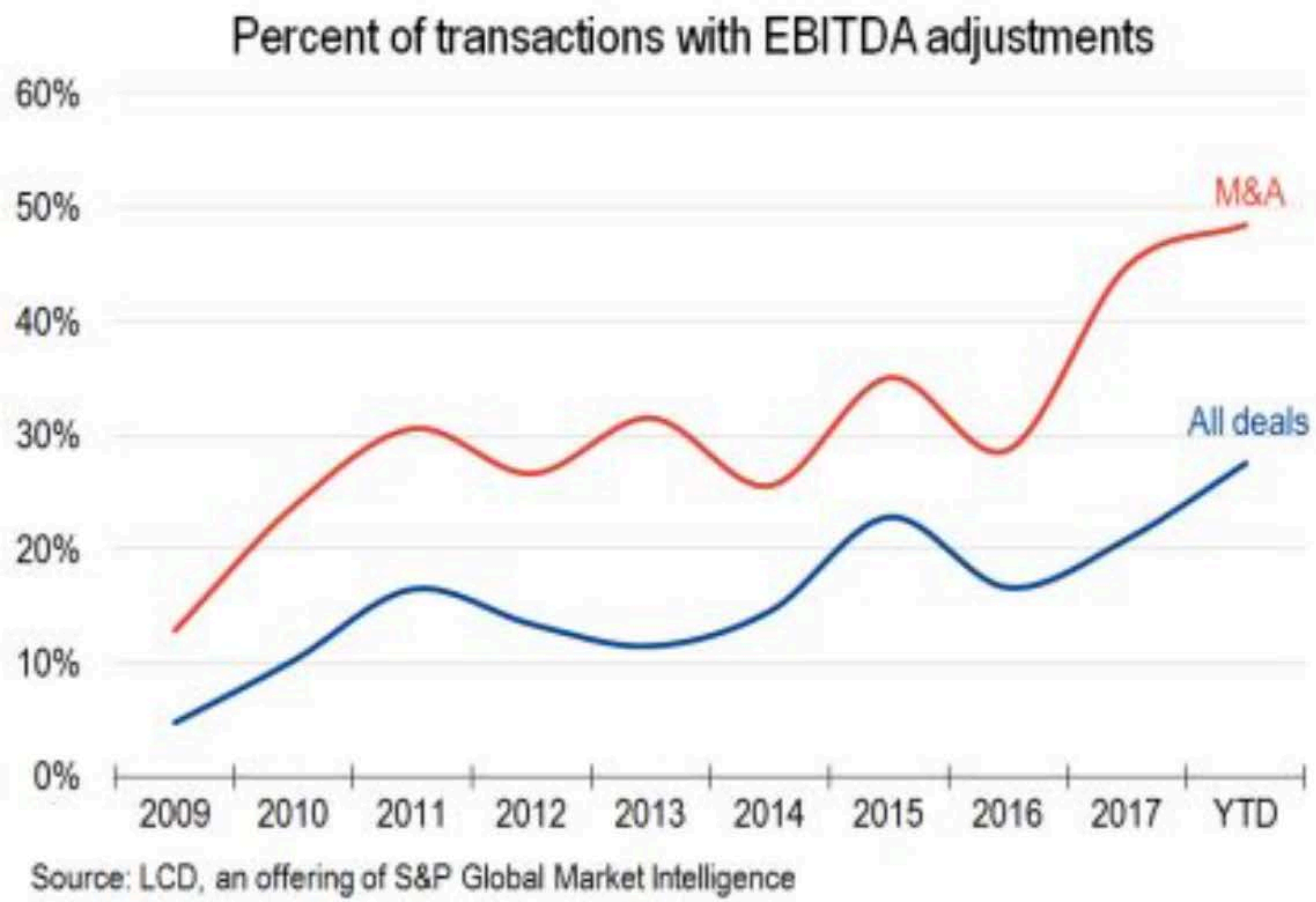
Private equity firms are continuing to find new ways to potentially seize assets from first-lien debtholders, and as investors fail to push back en masse, fears are growing that these new lows in investor protections could become more commonplace.

Investors have been concerned over covenant dilution for going on two years now, of course, but the aggressive way private equity firms have been pushing the envelope behind the financing of some of the year's largest LBOs—whether for Blackstone's giant $20 billion LBO of the former Thomson Reuters Financial & Risk business or KKR's $9.9 billion buyout of Envision Healthcare—once again has thrust covenants into the spotlight.

For example, Blackstone, on the Thomson Reuters Financial & Risk LBO, now called Refinitiv, can pay itself up to a $1 billion dividend or 40% of its own pre-defined EBITDA via an unrestricted dividend basket, according to analysts at Moody's.

Normally there are different maintenance tests the private equity sponsor must meet, usually in the form of a leverage test, before it can access a builder basket to repay debt, pay itself a dividend, or make additional investments into the company. The allowance usually starts as a fixed amount, and in recent indentures it has been allowed to approach up to 50% of consolidated net income.

Yet, even with those tests in place, the widespread use of adjusted EBITDA add-backs has already watered down the effectiveness of those tests, sources say.



“[September] became quite ludicrous…. One such deal, which shall rename nameless, had so many adjustments to EBITDA that when the first covenant compliance hits sometime in 2019, the company could be bleeding cash and still be well in compliance,” Drew Sweeney, Senior Vice President in the Fixed Income group at TCW wrote on Oct. 11.

But that’s not all. Blackstone’s LBO of Refinitiv is noteworthy because of its ability to use three years of future cost savings in its own calculation of EBITDA, the analysts at Moody’s added. Ultimately, those analysts gave the Refinitiv financing “the worst-possible score” across its six different criteria for covenants.

“These loans should be called collateral-lite, not covenant-lite,” Patrick Daugherty, President and Chief Investment Officer of Glacier Lake Capital Advisors, said.

The Moody’s analysts have also found striking covenant packages in Envision (KKR), Laureate Education (KKR), **Party City** (Thomas H. Lee), **Atkore** (Clayton Dubilier & Rice), and **Sabre GLBL** (TPG & Silver Lake).

Assets: Now you see them …
It seems that investors have already ceded the ability to prevent a private equity sponsor from transferring valuable assets that they have claim to onto other entities, to where they hold no claim as loan investors. Sources now estimate that up to 80% of recent issues have such ability.

Of course, this was originally seen in **J. Crew**—over a year ago—where sponsors TPG and Leonard Green were able to use a trap door in its credit facility to transfer intellectual property assets to an unrestricted subsidiary. In addition to that, up to $787 million in dividends have also been paid out since its LBO.

Since then, BC Partners and Ares Management have made similar moves by making special dividend payments to unrestricted subsidiaries on **PetSmart** and **Neiman Marcus**, respectively. And there is rumbling that Revlon may follow.

Very slowly, then all at once
How did investors start to cede their rights and protections?

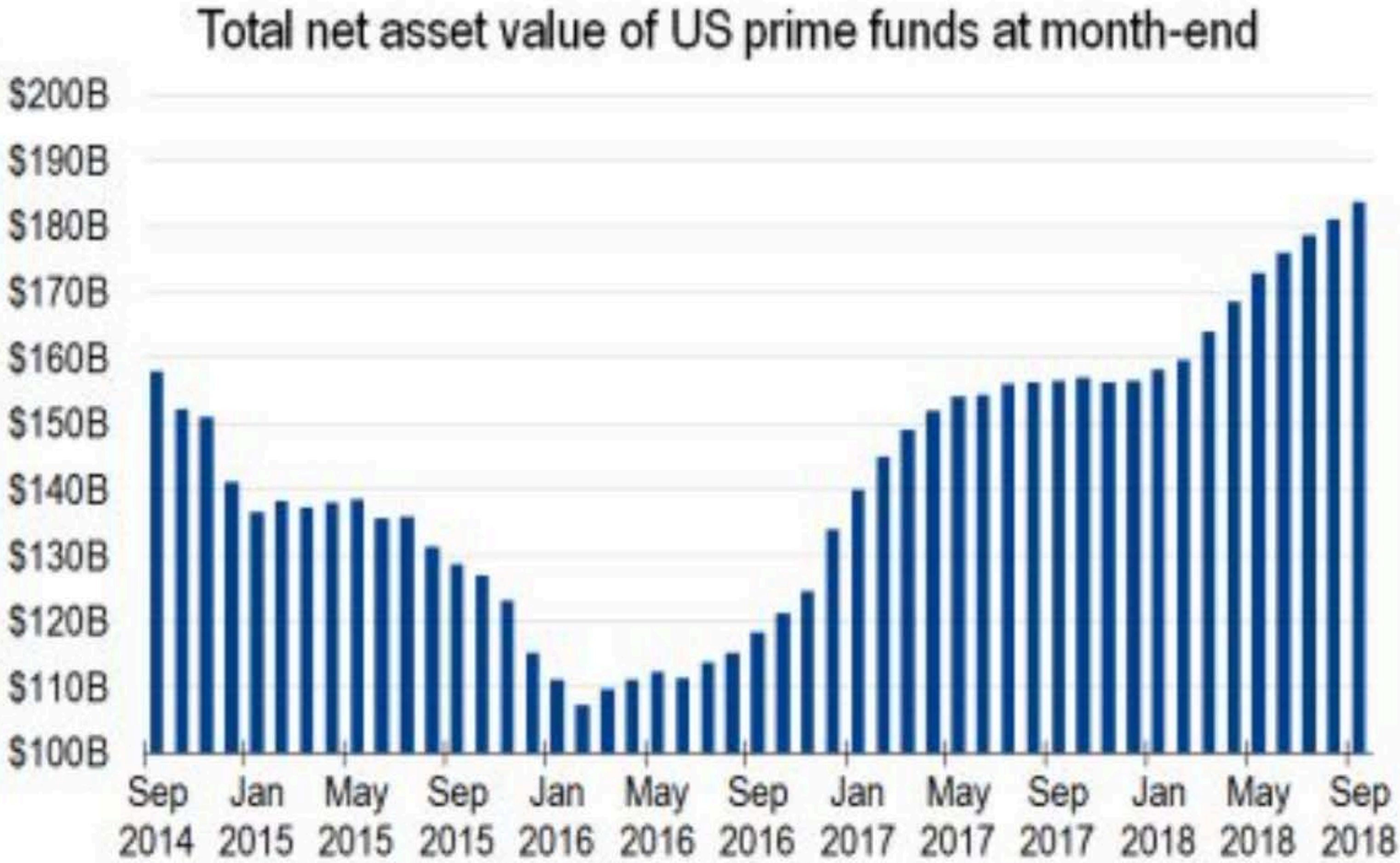
Sources point to a number of law firms that originally inserted some of the most aggressive terms in the documents, touting benefits such as additional flexibility to private equity sponsors.

But even when investors would find language that was unacceptable, a number have said that they would pass on those deals, only to find that the deal would still get done anyway.

With Refinitiv, both the bonds and loans were well oversubscribed, allowing pricing on the $6.5 billion in dollar loans to tighten to L+375, from L+400–425 price talk. This was the case despite a number of investors complaining during the marketing process about the EBITDA add-backs, unrestricted dividend capacity, the ability to move assets out of the restricted group in a distressed case, and the ability to pay down second-lien debt before first-liens.

Part of the blame might go to the rise of a less sophisticated but rapidly growing retail and overseas investor base, one that doesn't have the experience or ability to negotiate for tighter documents. But even more so, fund managers have been besieged with cash, and are paid to put that money to work. This onslaught of cash, allied to the negative carry of cash and the need to justify management fees, has led many to hold their noses when it comes to covenants, while it is also debatable that the entire market always knows what is it buying.

"Anecdotally, we have heard that massive amounts of money came into the loan market from overseas, in the form of SMAs. This money needed to be put to work, and was willing to buy loans at any level," TCW's Sweeney said in his September monthly commentary. "The result for the broader market was less positive, leading to weakened credit agreements, tighter spreads, and higher prices."



Sources: LCD, an offering of S&P Global Market Intelligence; Lipper FMI

Still, even after retail and other investors are accounted for, CLO managers collectively make up some 65% of the buyer base for new loans, accounting for the lion's share of demand, and a number of investors in market, including the managers themselves, place the blame there.

The main reason seems to revolve around the fact that CLO managers' primary line of business has become gathering assets as they collect a percentage of that total, those sources say. Once those CLOs are issued, managers are at the mercy of what the loan market offers them, in some cases having to resort to finding the "least worst" investment, as they are limited to how much cash and non-loan assets they can hold, sources added.

About those CLO assets: From 2014 to 2016 the CLO market grew by roughly 23%, versus the loan market, which grew by some 7%, according to analysts at Wells Fargo. Loan issuance has since picked up, growing 18.1%, but still lags the CLO market, which grew 19.3% in that same time period.

But there's one more reason. CLO creation has also been spurred, ironically, by the Dodd-Frank risk retention rule that was once believed could nearly wipe out a portion of managers who would not have the capital to hold at least 5% of each new CLO. Instead, several billion have been raised through risk retention funds, and must now be put to work into those managers' new issues, whether or not the economics of issuing CLOs makes sense, sources said.

The upside down

There are also questions regarding the clarity of drafting, and the level of due diligence being undertaken by some on the buyside. This is especially so on the increasingly thorny issue for first-lien investors, where proceeds from asset sales can pay down second-lien debt holders before them, a seeming inversion of the normal payment priority.

Atkore, **Sabre**, and **Refinitiv** all feature asset sale step-downs, where sponsors can reduce how much from asset sales go toward repaying senior debt, or are reinvested in the business once certain leverage goals are met, going against first-lien lenders' typical expectations that they are first in line in a delevering.

This issue has already arisen in the Refinitiv deal, where junior debt can be paid back before more-senior debt. In light of news that Blackstone may be looking to sell off a number of operations, investors on the deal have also started to realize how little control they have over those ensuing proceeds, given the lack of clarity in the documents usually governed by a restricted payments covenant.

For instance, one major loan investor trying to figure out how much of the $3 billion sale of FXall Blackstone it would be entitled to consulted with the legal counsel for three different banks involved in the buyout, only to get three completely different answers, ranging from nothing to $2 billion.

This comes as first-lien debtholders have been caught off guard by incremental pari-passu debt getting tacked on, for instance to repay second-lien debt, and having a maturity before existing facilities. For accounts to be caught off guard, however, raises questions as to the level of due diligence being undertaken, albeit on increasingly lengthy, opaque, and complicated indentures. That additional debt had typically been limited to a fixed-amount free-and-clear tranche, but has more recently become limitless, capped only by leverage ratio tests, which have also been diluted by the use of adjusted EBITDA.

Such leeway in the tests also allows private equity sponsors to sell assets when the businesses come under distress, as the full extent of the decline in EBITDA can be concealed by the adjustments, sources said.

First-lien investors had previously been somewhat protected—at least economically—by the most-favored nations clause, which states that a higher margin on the incremental loan must then be met with the original loan's margin being adjusted to closely match.

But here too the envelope has been pushed. Provisions are now being included where the MFN applies only to incremental term loans coming from the free-and-clear tranches, and specifying a fixed rate of incremental loans that can be issued before triggering the MFN provision, according to lawyers at Skadden, Arps, Slate, Meagher & Flom.

Of course, this follows the addition of MFN sunsets, where the MFN no longer applies 12–18 months after the original deal's closing, a time frame that is now growing even shorter.

All about recoveries ...

The increasing degradation of investor rights and claims to assets will unquestionably lead to lower recoveries when defaults pick up. Already, sources expect recoveries on senior secured first-lien loans to fall below the historical average of roughly 70%. Indeed, the move to cov-lite removes the early warning system and the ability for lenders to get to the table early. Now, the dilution of incurrence covenants leaves owners with leeway to strip value from the company, to the detriment of lenders.

And we might not be at the end of this particular road.

“The sizable amount of capital raised by the largest PE firms suggests LBOs will continue to be an attractive structure for the firms, and we can continue to expect deteriorating credit quality and covenant protections given current investor demand," the analysts at Moody’s wrote, adding further caution, saying, “the longer the favorable credit environment persists, the more ranks of low-rated companies will build, expanding the potential number of defaults and credit losses in the next downturn.”

A number of current and former public officials have also taken notice. Former Federal Reserve Chairman Janet Yellen, for one, recently told the *Financial Times*, "There has been a huge deterioration in standards; covenants have been loosened in leveraged lending," adding that she was worried about the systemic risks stemming from such loans.

Across the Atlantic, the Bank of England has chimed in as well: "The [Financial Policy] Committee discussed the extent to which the growth in leveraged loans had parallels to the growth in the U.S. subprime mortgage market before the crisis. The ... market was larger than the U.S. subprime mortgage market had been in 2006. As with subprime mortgages, underwriting standards had weakened."

But the BOE acknowledges some key differences between leveraged loans and subprime, namely that banks are not holding them on their balance sheets unless they are stuck with deals, and that there is less reliance in short-term wholesale financing for them, as well as the fact that the loans are more diversified across different industries, and that there are fewer synthetic derivatives and securitizations being issued on them. — Andrew Park