

The Case for Covenants (Part One)

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It's a fact of life in leveraged lending that terms are market-driven. During periods of excess liquidity – when loan demand exceeds supply – structures become issuer-friendly. When investors pull back, for any reason, terms swing in favor of lenders.

When concerns about China and commodities roiled markets in August 2015, the Dow dropped 2000 points in two weeks. But by the spring of 2016 things began to normalize. The market then entered its current issuer-friendly cycle, with structures continuing to erode. Absent another correction, we see no end to this trend.

A good barometer for sell-side exuberance is prevalence of covenant-lite structures in the middle market. As our [Chart of the Week](#) shows, the share of cov-lite has shrunk and swelled over time. Today cov-lite loans less than \$250 million are 27% of total volume, less than the 40% for loans above \$250 million (and less than \$350 million).

What causes this effect? Why are loan arrangers pushing cov-lite for smaller loans? And why are loan investors accepting it?

To answer these questions, let's go back to the origin of these structures. As we've discussed in past commentaries, cov-lite emerged from broadly syndicated loans. As that market became more institutionalized in the 1990's, large investment bank sales desks found bond buyers were developing an appetite for floating rate assets. Since bonds only had incurrence covenants (triggered when issuers brought on more debt), why not strip out the maintenance covenants (tests issuers had to meet quarterly)?

While such cross-over funds (buyers of both bonds and loans) were accustomed to sailing along with little between them and a payment default, other accounts balked. For years cov-lite was available to only the best, biggest, and most creditworthy companies that issued frequently in both bond and loan markets.

Over time, however, in the absence of other product, those same sales desks began to push cov-lite for smaller borrowers. Bankers sold sponsors on the concept, but left themselves an out: they would go to market without a maintenance test, but retain the right to flex to one if the market pushed back.

Because the banks were incented to distribute loans and not hold them, they had little to lose by dumping weak structures into the market. Sponsors were relieved to have one less credit parameter to worry about. And investors, desperate for paper when deal supply dried up, talked themselves into buying the loans.

At first, the unofficial minimum Ebitda for cov-lite borrowers was \$100 million. Then it crept lower, settling at \$50 million. There it stayed, with few exceptions. Until this year.

What's changed is that non-banks for the first time (as we highlighted last week) are employing the same strategy for distributing middle market paper as their investment bank competition used against them. They're fighting back. But at what cost?

Next week we examine why cov-lite is not suited for middle market loans.