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The Case for Covenants (Part Two)

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An astute *Lead Left* reader appreciated the first part of our special series on covenants. He alerted us to a ironic development Friday in the high-yield bond market. According to Bloomberg, bondholders of the commodities trader, Noble Group, saw values drop below 50 cents on the dollar on a negative earnings surprise. Apparently the bonds had been sold in March with only investment grade covenants.

Unlike junk bonds with incurrence tests, Noble's securities only had a change of control and negative asset pledge. No asset sale or dividend limits. Let's call it "cov-lite-lite." One analyst put it, "When things are good, people don't pay attention to covenants, but when things sour, covenants are their only line of protection."

Attaching IG covenants to non-IG borrowers is like having incurrence-only tests for middle market companies – migrating looser terms to issuers of lesser credit quality puts investors in a less-defensible position.

So why are loan arrangers pushing cov-lite for smaller loans? In part, argue some managers, "cov-lite" is the natural evolution from the "cov-wide" trend (or as some dub it, "cov-lame"). That's where the cushion between the financial covenant test (say, debt to ebitda) and the projected ratio is so large that it becomes meaningless.

Say the borrower has $250 million debt and $50 million in ebitda, for 5x total leverage. But if the covenant is only tested at 7x, the company's cash flow could deteriorate almost 30% to $36 million and still not be triggered. If the leverage test steps down over time, at least that cushion won't get worse. But occasionally these covenants are set at closing and remain there permanently as a static test.

From the sponsor's perspective, the attraction to such flexibility is obvious. Why not have maximum optionality in managing the borrower's balance sheet? With purchase price multiples at all-time highs, PE firms are pouring more equity capital into buyouts. They are using add-ons, bolt-ons, and other complex strategies to drive growth. Why add another unknown with a bank covenant? What's the upside?

Unfortunately lenders may overreach when companies trip a test, extracting high fees or making other onerous demands to amend defaults. That reinforces the negative perception that covenants are how bankers try to hold sponsors hostage. Even straightforward negotiations are time-consuming and require management attention.

While the Great Recession certainly created some bad lender/borrower dynamics, these tended to be rare. The truth is covenants are not designed to be punitive. They serve as early warnings to alert lenders when a borrower's performance goes off plan.

Rather than boxing sponsors into a corner, covenants are guard rails that provide impetus for all parties to sit around the table and review financial performance. The sponsor and borrower can then outline what steps they will take to remedy the situation. That in turn allows lenders to provide thoughtful, constructive solutions, including more time and capital.

Next week we examine why loan investors are accepting cov-lite structures.