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The Case for Covenants (Part Three)

THE LEAD | June 6, 2017

At a recent debt conference we did what most of our direct lending colleagues are doing these days: complain. Speaking with one long-time practitioner, we mentioned a middle market transaction which was both cov-lite and ebitda adjustment-heavy. “Yeah, it’s ridiculous,” he said. “But it’ll get done.”

Therein lies the problem. As we discussed last week, loan arrangers are pushing cov-lite for middle market loans because they can. Insatiable investor appetite and less-than-robust buyout flow have combined to produce issuer-friendly conditions. “Getting it done” refers not to winning a great asset, but getting it off your books.

Direct lenders have built sizeable war chests to accommodate larger holds. But as competition has heated up and deal terms have become increasingly aggressive, arrangers have pivoted from holding loans to distributing them.

At the same time, investors are eager for the premium yield middle market loans enjoy relative to their broadly syndicated cousins. Agents are accordingly betting that any deterioration of terms will be offset by the thirst for assets. So far, it’s worked.

In the case of cov-lite, investors say they’re willing to accept debt incurrence-only tests on a “case-by-case” basis. Those cases appear to have three common denominators. First, borrowers have demonstrated solid free cash flow characteristics through a cycle. Second, private equity sponsors are committing significant capital to the transactions. Finally, businesses are on a strong growth trajectory.

We would have added a fourth condition: ebitda is at least $50 million. But that barrier has been breached; $40 million seems to be the new $50. And with ebitda adjustments on the rise (see *Chart of the Week*), cov-lite is being applied to $30-ish million ebitda issuers which are then adjusted up to meet the $50 million benchmark.

If the company fails to realize cost saves or revenue enhancements built into the pro-forma figures, investors are left with a very leveraged borrower and no mechanism short of a payment default to bring the sponsor and company back to the table.

A big difference between the broadly syndicated and middle markets is the path investors in each asset class have in a distressed scenario. If a large liquid credit misses its numbers, or even if there’s a *worry* it will stumble, holders can proactively trade out of their position at or close to par.

In the middle market, secondary trading is “by appointment only.” A quick sale of a stressed name is rarely an option. Lenders generally need to stick around and work things out. Even if they could find a buyer at some price, chances are it would be to a distressed fund whose interests may not be aligned with other lenders or the sponsor.

While cov-lite structures provide sponsors with the allure of structural flexibility, in the long run they introduce variables that could significantly inhibit value creation.

Next week we discuss the issue of defaults and recoveries for cov-lite loans