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The Case for Covenants (Part Four)

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It's not surprising so much fuss has been made about the proliferation of cov-lite structures in the leveraged loan market. After all, what was the exception even among larger issuers has become the rule (see our *Chart of the Week*).

Indeed this trend has been growing since 2013 when almost 60% of loan volume lacked maintenance covenants. That share grew to 68% in 2014, 74% in 2015, and 75% last year. Compare that to the height of the leveraged loan boom in 2007 when only a paltry 25% of issuance was cov-lite.

Our "Case for Covenants" series led one reader last week to ask us: "To what degree have covenants been weakened since 2008? And is there an expectation of default percentages, impact on pricing and expected recoveries?"

As we noted earlier in this special series, pre-crisis cov-lite was the province of only the best, most liquid, corporate credits. Investors felt comfortable that risks of payment defaults were low and expected recoveries were high. According to S&P, cov-lite loans historically possessed the highest recoveries among loan asset classes.

But that was before loan arrangers began to bestow cov-lite on this most recent crop of middle market issuers. It's unclear how these smaller companies, some of which with leverage well over six times ebitda, will fare in a downturn. And that's after almost nine years of economic "growth." What happens when the cycle finally turns?

Even for broadly syndicated cov-lite loans, some disturbing statistics have emerged. A May 23rd Moody's report on corporate defaults and recoveries showed debt cushions for cov-lite little differentiated from non-cov-lite. Overall, however, pre-crisis loans had 33% debt below them, sporting only a 22% cushion last year.

But this focus diverts attention from other developments in terms of large publicly rated loans. Fund managers are reporting increased deterioration of covenant quality across a wide spectrum of risk elements.

This is confirmed by the Moody's report which cites envelope-pushing in "aggressive" incremental facility provisions, "excessive" asset sales, "weakened" mandatory prepayments, and "diluted" prepayments with proceeds of asset sales. In short, any non-financial covenant capable of being stretched for the issuer is being stretched.

Of course while lenders are complaining about terms, they have no one to blame but themselves. That's why credit managers are praying for a correction: "market conditions" are an easier excuse to structuring sanity than simply saying no. Particularly since a big enough market crack ensures competitors won't gain the upper hand.

In the meantime, as our faithful reader concluded, "It seems that underwriters with better, more detailed processes with risk mitigation are the ones to partner with."

Next week we wrap up our series by considering the outlook for covenants