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The Case for Covenants (Last of a Series)

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“When things are good, people don’t pay attention to covenants, but when things go sour, covenants are their only line of protection.”

So said one head of credit research of a large asset manager in a recent Bloomberg article. He was referring to bond covenants, but the lesson applies equally to loans. And things have certainly been good. But how long will good last?

It’s clear some managers are betting conditions will be constructive for credit for a while. Cash continues to flow into the broadly syndicated market via retail funds and new CLO vehicles, as well as the middle market from managers’ fundraising. Interest rates remain low, default rates modest, and the economy steady, if uninspiring.

But as we outlined last week, loan structures are deteriorating in the face of keen competition among arrangers for deal mandates. Not just cov-lite creeping into the middle market, but loosening of terms across the board. “In that respect,” one loan manager told us, “things are worse than 2006. Credit agreements are one-sided.”

We’ve noted before in frothy times bankers behave as if anything worth doing is worth overdoing. Faced with losing an existing relationship to a more aggressive lender plus the relentless demand to put money to work, there’s no end to corners being cut.

This goes for underwriting standards beyond simple erosion of terms. One shop reportedly told a sponsor, “We don’t need separate due diligence. We’ll just piggy-back off yours.” Another handed out a list of transaction criteria like pricing and leverage, with a pre-commitment for any transactions meeting those characteristics.

It’s one thing for large cap firms to encourage such nonsense knowing market appetite will absorb anything right now. But why are some middle market lenders, armed with big hold levels, taking this stuff down for their own account?

What kind of havoc will cov-lite wreak on portfolios in a real downturn? Since 2013 the universe of institutional loans has been dominated by cov-lite issuers. When payment defaults happen among these vintages, they will happen with very little ability of the lenders to affect the outcome.

While defaults are still modest in number, the pattern is clear. S&P’s year-to-date default rate (by issuer count) for cov-lite loans is 0.78%. That compares to a cov-heavy rate of 0.34%. With only 290 cov-heavy credits tracked versus 640 cov-lite, that translates to five cov-lite issuers defaulting for every one cov-heavy issuer.

For experienced managers, this movie is familiar. No recession repeats exactly, but downturns affect large and small borrowers alike. The reason middle market lenders have been allergic to cov-lite for so long is they know underwriting midcaps is a high-touch proposition. With their hands firmly on the wheel going into a credit, the last thing they want, if problems arise, is to find themselves in a driverless car.