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Spot-lite on Cov-lite (First of a Series)

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Our story last week of the hundred-year old fruitcake captured readers' attention. Tributes to this underappreciated treat poured into the *Lead Left* mailbox. "It's believed there's only one fruitcake in existence," one friend wrote. "It gets passed around during the holidays from family to family. Now we all know where it came from."

There's also been a fair amount of passing around in the leveraged loan market. Like the fruitcake, the same covenant-lite package is being incorporated for almost every borrower. Regardless of size.

As we detailed earlier this year in our special series, *Why Covenants Matter* [link], $50 million has been the unofficial bright ebitda line between middle market companies and their larger, more liquid issuers that have historically earned incurrence-only tests.

But thanks to the proliferation of pro forma adjustments and add-backs that are now routinely part of ebitda calculations, what masquerades as a $50 million company may actually be significantly smaller before all the analytic gymnastics.

Why the ebitda fuss? Private equity sponsors have raised so much capital that competition for properties has driven purchase price multiples to double-digits – even for sub-optimal businesses. To make exit returns work, buyers are working hard to lower entrance multiples. One approach is to boost going-in ebitda numbers.

Lenders cooperate with this arrangement because of their own pressures to put investment dollars to work. Occasionally credit buyers will push back on the more egregious adjustments. Still most transactions make it through the market, perhaps with modest pricing or structural concessions.

At the arranger level, competition for lead managed deals and underwriting fees is fierce. Existing relationships are defended at any cost, even if that means jettisoning maintenance covenants for otherwise undeserving midcaps.

The convergence of these factors has created a peculiar effect. Since covenant-lite is ostensibly for the best credits, a borrower coming to market *with* a covenant is viewed with suspicion. As one credit head was quoted recently saying, "You do have to think twice when you see a loan with a covenant these days."

In their defense, middle market loan arrangers point to the so-called "covenant-wide" or "covenant-lame" trend that prefaced this recent rash of cov-lite deals. As one originator put it: "What's the difference between a maintenance test that has a ridiculously wide cushion from the projected budget, and no test at all?"

The answer is…maybe a lot.

Over the next few weeks we'll dig deeper into the nuances of cov-lite loans in today's market. And what can happen if you own one.