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

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The notion that covenant-lite loans are bestowed on only the best and brightest borrowers has been pretty banged up. Cov-lite and other leveraged lending terms are now hostages in the front-line battle middle market arrangers are waging for business.

Competition is no longer just among the midcap lender themselves. For companies in and around the $50 million ebitda mark, the larger investment banks have become increasingly frequent sources of capital. This is particularly true when sponsors seek to eke out the last 25 bps in pricing or the last quarter-turn of leverage.

For new buyouts in the larger middle market space, private equity buyers have at least two options. They can select an underwriter to distribute paper in the broadly syndicated market at the most issuer-favorable terms. That party will hold none of the paper itself. Or they can go the club route – pick a handful of relationship lenders to each hold a big chunk of the financing, and elect one as agent to organize the effort.

In the former case, depending on the market, the underwriter can impose aggressive terms on loan buyers. “If you don’t take this, somebody else will,” is the implicit message. The appetite for yield and assets is so strong today that funds will bow to whatever terms the agent dictates. The underwriter (if an investment bank) expects to sell their position to zero, leaving no portfolio issue if the credit falters down the road.

For club executions, the risk to lenders is clear. If the borrower’s performance hiccups, then each member of the club is stuck with a sizeable problem loan on their books. That propect will powerfully concentrate the minds of the lenders’ risk analysts.

Is it a coincidence that middle market arrangers are loathe to go the club route with cov-lite deals? The good news is that sponsors are learning that the syndicated cov-lite option has real consequences.

For one thing, you end up with lenders that are focused solely on the asset as a piece of meat – some yield, a secured position, and better than cash. Not much of a relationship there. If you need to tweak the structure for whatever reason, it’s easier with lenders who have aligned incentives with you. Finally, if the agent can flex to a covenant anyway, you’ll end up with the “worse” structure and non-aligned lenders.

What’s surprising about the trend towards looser structures in the middle market is not that credit is competitive. Or that larger banks are coming down-market in times of froth. Or that cov-lite and *faux* ebitda are prevalent. The surprise is that midcap players should know better. We’ve seen structuring fads come and go. We’ve been trained that sound credit fundamentals don’t change. We know from experience that just because “the market” allows certain terms, doesn’t mean it’s good for investors.

Direct lenders, particularly in the middle market club, have always demanded covenants. Without them, you can only watch as borrowers spiral towards payment defaults. To pretend that “now it’s different” risks hurting the middle market’s reputation for credit stability and performance it has enjoyed for decades.