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Terms of Endearment

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Despite continued strong deal flow this month, conditions in the leveraged loan market remain constructive for issuers. Yes, there’s been push-back on specific transactions, as we’ve been highlighting. But cash keeps flowing into retail funds and new CLOs keep ramping. That’s providing more fuel to the broadly syndicated financings fire.

The middle market is also in good shape coming into the last days of July. Direct lenders have raised plenty of dry powder in the form of credit funds, separate managed accounts, and middle market CLOs. Matching that demand has been a steady, if unspectacular, stream of new and refi business.

Of course, competition to lead financings remains keen, despite some market pushback on edgier transactions. Indeed, as hold levels expand, crowding out smaller lenders, the inventiveness of sell-side arrangers remains noteworthy.

Such is the case of “covenant-fade.” Unlike cov-lite, which is in the capital structure day one, cov-fade loans start out life with a covenant, then disappear when ebitda reaches a certain level. It’s not clear whether the covenant reappears if ebitda later falls below that level, but we suspect it’s a one-way street.

Other sell-side features, as highlighted by our friends at S&P LCD, include further deterioration in cash flow sweep step-downs, run-rate synergy add-backs, and grower baskets. While these terms are seen frequently in broadly syndicated loans, there increased occurrence in the middle market is indicative.

Some things might be more wish than reality. One example is the non-amortizating term loan. Granted, the typical term loan B structure is already pretty accommodating – mostly back-ended amort with minimal principal due until the last couple years. We have long remarked on how the loan and bond markets are converging. While we’re waiting to see a live example, this could be the next instalment.

Another structuring twist is the delayed-draw term loan that converts to a revolving credit if unused during the draw-down period. The risk clearly is that a facility designed for long-term purposes (such as add-on acquisitions) is added to the issuer’s short-term working capital availability. And with no scheduled term out.

One rumored provision that got our attention was allowing restricted payments while the borrower is in Chapter 11. Hard to feel good about a company filing for bankruptcy, then paying a dividend to shareholders as a reward for superior performance.

Finally, we’ve heard of a document containing unlimited cure provisions. The sponsor can remedy any number of covenant defaults by injecting more equity into the business. While more equity is usually a good thing, such a term postpones a reckoning with lenders, and prevents other operating or capital structure changes.

While some of these items remain gleams in sponsors’ eyes, credit managers are watchful that they don’t end up hard-coded into credit agreements before Labor Day.