

Covenantive Easing (First of a Series)

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Much attention was paid over the past few weeks to a dramatic series highlighting the struggle between two powerful forces, a dizzying game for world domination, with the outcome hanging in the balance and viewers on the edge of their seats.

Of course we're talking about our recent series on valuations ("Why Valuations Matter" [\[link\]](#)). Seems it struck a chord with our subscribers. Based on your feedback, the trends we identified have indeed been experienced by both credit users and providers.

One particular question from lenders, though, has arisen in multiple conversations at conferences and other settings; namely, how does the element of asset valuation figure into covenant packages and how they are being negotiated?

It was thus fortuitous that attorneys from Morgan Lewis dropped in last week for a credit agreement teach-in, with a special emphasis on covenants. We decided to expand that discussion with them in this space for the next few episodes.

First, for those distracted by the *Game of Thrones* finale build-up who missed our main drivers of valuations, here's a quick summary:

Sponsors today are challenged more than ever to establish platforms to maximize future shareholder value. In part, that's because purchase price multiples are at record highs, making the "buy-low, sell-high" increasingly complicated.

Also, the competition for good properties is fierce. Buyers are being forced to execute "add-ons" more rapidly than ever. Finally, the time frames for auction processes have been greatly compressed. That leaves more due diligence discovery for post-closing.

As we've remarked previously, the credit agreement should mirror the sponsor's blueprint to grow the business. Given the pressures outlined above, it's no wonder private equity buyers insist on as much wiggle room as possible to execute that plan.

It is a balancing act. Lenders don't want to relinquish control on terms that protect their own investment within the borrower's capital structure.

So now where's that line between too much control, and not enough? We've covered some of the basics in a prior [Lead Left](#) white paper ("Why Covenants Matter" [\[link\]](#)). But the tug-of-war between issuers and lenders has only heightened since.

Over the next several weeks, we'll look at the creation of a sound credit agreement, from development of the commitment papers, the evaluation of financial covenants, as well as such topics as unrestricted subsidiaries (e.g. PetSmart and J. Crew), negative covenants, incremental facilities, and baskets.