Covenantive Easing (Third of a Series)

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As we continue our special series on covenants, we've noted how lenders and sponsors are pushing envelopes to deal with an increasingly competitive landscape. This includes areas of the credit agreement that might otherwise appear innocuous.

Take financial statements. Quarterly numbers are typically due within 45 days after fiscal quarter-end, and annuals within 120 days after fiscal year-end. Borrowers are often asking to stretch out these deadlines for at least the first few periods after an LBO: 60 days for quarterlies and 150 days for annual audits. Yet even with these extensions, it's surprising how often deliveries are missed.

Indeed, experienced lenders note that late delivery of required financials is often a sign of credit problems. For that reason, lenders may require smaller middle market borrowers to deliver monthly numbers. Sponsors of larger midcap LBOs resist this, usually successfully.

Of equal importance to lenders is the company's annual budget. But here again, sponsors may seek to delay delivery until the annual numbers are sent. 150 days into the fiscal year is almost half the year gone! Tough for a lender to judge performance vs. budget at that late date.

Other affirmative covenant erosions include limitations in ongoing security and guaranty provisions. According to Matthew Schernecke of Morgan Lewis, these covenants are getting pared back in credit agreements. "This weakening of lenders' collateral and credit support packages is based on 'excluded collateral' and 'excluded subsidiary' concepts, in which a significant amount of collateral and credit support may be definitionally excluded" he said.

"Another development is that, due to recent tax law changes, obligors may, in some cases, not be negatively impacted by providing foreign collateral and guarantees. Even with these changes, we find sponsors are mostly successful in retaining the traditional limitations of 65% of a foreign subsidiary's voting stock subject to an equity pledge and no foreign guarantors/collateral. Many lenders have not pushed aggressively for tighter provisions here unless significant offshore collateral value prompts it."

What about incremental facility provisions? Why do they matter? "These provisions provide for the incurrence of additional debt within the existing credit agreement or in 'incremental equivalent' notes or similar offerings," Schernecke said. "They include pre-agreed modifications so that broader lender consent is not required to incur the debt. Various baskets are also included in these provisions."

"'Free and clear' baskets – based on a percent of EBITDA – for example, aren't subject to a leverage test. There's also often a basket for voluntary prepayments of debt that provides for dollar-for-dollar increased incremental debt availability as debt is prepaid.

"Another example," Schernecke continued, "are ratio-based baskets. These baskets provide for an unlimited amount of incremental debt to be incurred based on a pro forma leverage ratio. There can be multiple tests for different tranches of debt outstanding, including senior and total leverage tests, with permitted netting of unrestricted cash in these calculations."

Not surprisingly, pricing is also subject to borrower pushback. "Most-favored nation (MFN) provisions protect existing lenders from 50 bps higher all-in pricing on other debt," he said. "But sponsors are pushing to raise that threshold to 75 bps. Finally, sponsors are seeking to have MFN protection disappear ('sunset') after 12-18 months for larger deals. We do not view this as common for the traditional middle market… at least for now," Schernecke concluded.