Why Credit Standards Matter (First of a Series)

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Much attention has been paid to regulators' concerns over banks pushing leverage and other risk elements. What goes missing in these discussions is what lenders, including non-banks, think about the credit environment we're currently in. Specifically, regardless of what the Fed, OCC, and FDIC (the Big Three) are doing with their Leveraged Lending Guidance, the real question is, what are debt originators and investors thinking about credit standards? Are they being eroded, and if so, what can be done about it?

For the next several weeks, this column will devote itself to these questions. With the help of some of our friends in senior credit positions around the industry, we'll take a look at financial covenants, debt baskets, amortization, cash flow sweeps, projection models, risk ratings, valuations, and other components of credit agreements being scrutinized by market players today.

We'll also take a look at some basic, tried-and-true credit parameters that may have escaped notice of some parties as conditions in the leveraged lending market have heated up in the five years since the end of the Great Recession.

Let's begin with a look at financial covenants. In a conversation we had recently with the credit chief of a leading middle market shop, we asked what he thought of the direction financial tests were headed, given where leverage has migrated.

It's not the test themselves that are the problem, he explained. In a more normal market, lenders would get 15-20% cushions off a reasonable base case. Today covenants are being built off a sandbagged case with 30% or wider cushions. If the borrower has been demonstrating double-digit revenue growth for the past five years, why show 3% growth going forward? It's not a matter of being conservative, it's being realistic.

Another key metric is capital expenditures. Our risk pro noted the growing lack of capex tests, either in the cash flow definition or as a stand-alone covenant. And forget about a minimum Ebitda test. Incremental debt, either associated with acquisitions or restricted payments such as dividends, is allowed with increasingly liberal terms.

Sponsors ideally want to incur debt without necessarily going back for approval of the lenders. Or in the case of acquisitions, provide for cash going to earn-outs alongside debt repayment. That's fine, says our credit officer, but show how you will pay for it. Tough for a $12 million Ebitda business that models a $10 million payout over two years.

Equity cures – the right of the sponsor to put cash into the borrower without having to repay debt – has been a feature in the middle market for a while and remains a hot topic among lenders. PE firms are willing to inject new equity dollars to fix a troubled credit, but aren't fans of proceeds simply reducing lenders' exposures. Cures are heavily negotiated, our friend reports. Lenders want to be back at the table in the case of a melting ice cube.

So-called "builder baskets" allow borrowers to increase restricted payments based on a cumulative excess cash flow test that builds over time. Lenders more easily tolerate this in the context of an otherwise reasonable covenant package.

Next week: our series on credit standards continues with further color on covenants