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Covenants in the Coal Mine (First of Two Parts)

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By the time you read this, the UK will be voting on its long-awaited referendum on whether or not to leave the EU. Polls show the contest too close to call. Whether “Remain” or “Leave” prevails, the Brexit outcome will undoubtedly impact international politics and the global economy for years to come.

Despite turmoil in the UK, along with the Fed’s inaction on rates, observers of US capital markets noted the relative calm surrounding both public equities and fixed income. While the Dow is down just under 2% since it reached a near record high of 18,005 on June 8, the industrial average slipped only modestly for the week.

Similarly the high-yield bond market continues to see issuance proceed apace. Though steep fund outflows ($1.8 billion) were recorded last week, new junk volume rang up $5.2 billion (per S&P LCD) for the period. That comes on the heels of $12 billion of deals the week before – a level not seen since last November.

Broadly syndicated loans are also shrugging off Brexit phobia, at least until the vote. While institutional volume is down 7% from last year’s activity, pricing and terms seem to reflect an enduring confidence that overall conditions will remain seller-friendly.

That trend is also mirrored in increasingly aggressive covenant packages. In our *Lead Left Spotlight* this week and next, Covenant Review’s co-heads of Leveraged Loan Research, Justin Forlenza and Jessica Reiss, discuss how arrangers are once again testing the limits of broadly syndicated loan and high yield bond buyers.

Like the proverbial canary in the coal mine, covenants provide lenders with early warning that a borrower’s performance might be off-plan. Until the recent market snapback, lenders got the covenants they wanted, successfully resisting incurrence tests and “free and clear” baskets (a starter kit of debt not included in initial tests).

The quick recovery from the first quarter’s doldrums surprised participants. Now large cap lenders find themselves under familiar pressure to push the envelope on terms.

As Forlenza and Reiss outline, another example is asset sales sweep language. In the prior market 100% of proceeds from an asset sale were going to repay debt. Today step downs to 50% subject to a leverage test are common; if leverage falls low enough, the company may be able to do whatever it wants with the proceeds.

Pricing trends have also reversed. As we said last week, MFN sunset provisions are beginning to shorten from 12-18 months, to six months. Indeed, the share of borrowers asking for a sunset has more than doubled from 21% earlier this year to 43%.

Whether this issuer-friendly environment will continue remains to be seen.

Next week, we’ll look at what middle market players are reporting on the covenant side of leverage lending, and how that compares with the broader markets.