Lead Left Interview – Jessica Reiss and Justin Forlenza (Part 2)

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This week we continue our conversation with Jessica Reiss and Justin Forlenza, attorneys with Covenant Review. Begun in 2006, Covenant Review is the world's first boutique research firm focused on bond and loan covenants. ***Second of two parts – View part one***

The Lead Left: MFN is triggered if the company raises debt priced 50 bps from the existing debt.

Justin Forlenza: That's correct. Lenders are always asking if prospective financings are subject to MFN.

Jessica Reiss: Another example of term erosion is something called "re-classification." For covenants and incremental debt facilities it's common on bond documents to have a ratio, for example, 2.0x interest coverage, above which the borrower can issue any debt. However, if the company has *dollar-based* baskets, they can go up those levels even if the interest coverage is less than 2.0x.

JF: The catch is even if the company has no access to the ratio basket, they can retroactively apply it later after they use it, and still have the dollar-based baskets free and clear.

JR: In the past two weeks, we've seen three deals where this has made its way into accordion baskets. Incremental debt under the credit agreement is ok, but if the company incurs side-car debt, you'll often have a different set of lenders. You don't know if they'll be on the same page with you. Incentives may not be aligned.

TLL: What's your perspective on covenant-lite loans?

JR: It's a continuum. At one end is when both the RC and TL have maintenance covenants. Then the TL can have a springing covenant, in which the RC has a maintenance test, but it's subject to the RC being 35% drawn. If there's an ABL in the capital structure, the TL may not have a maintenance covenant.

If you're in the institutional tranche with a maintenance covenant, you get a quarterly test, but only for the RC. The TL gets some derivative protection, but TLs can waive a breach or call a breach on their own. You can't charge a fee, etc.

JF: If you have a maintenance covenant, there may be an indirect benefit to the company meeting their ratio, but you get dragged along with no rights. Of course, the borrower still has to deliver its financial statements and other obligations.

JR: Lack of maintenance covenants is not the worst thing. There are other flexibilities that go along with covenant-lite. For example, debt incurrence tests where they get more room. There are things under the company's control, such as incurring debt vs. having a covenant triggered because your cash flow falls below a certain level.

JF: It's a fact of aggressive markets that for broadly syndicated loans, those with covenants are suspect. It would be interesting to run recovery rates on covenant vs. cov-lite deals.

TLL: What are the hidden traps lenders should look for?

JF: MFN protection has gotten a lot of attention. Not just for the accordion, but also other incremental debt. For example, permitted debt for acquisitions allows for additional *pari passu* first lien debt. The existing lenders did not get the benefit even though pricing was over the 50 bps test. If it's under the ratio basket, the MFN usually applies. Debt incurred under a sidecar applies. But under the permitted acquisition basket, the MFN isn't always there.

TLL: Why not?

JR: No one noticed. We've seen it in a number of deals. Even with a sidecar, if it's a bond, you can do first lien secured bonds and the MFN won't apply.

JF: Or the company can call the incremental debt a "note purchase agreement" and since it's not technically a TLB, MFN won't apply.

TLL: How about the middle market?

JF: We don't look at the middle market, but it depends on the sponsor. The large cap sponsors will push through large cap terms to smaller companies. Sometimes in the $50-75 million ebitda range you can't tell the difference between terms for a middle market borrower and one with $500 million ebitda.

TLL: What about the unitranche trend?

JR: We don't see a ton of unitranche. There was a big unitranche in the news recently; that one was the biggest we've seen. It's more a supply/demand dynamic.

JF: It's a very appealing product for the borrower; a blended rate and one lender. It's very convenient. Where it will go remains to be seen.

TLL: What's been the biggest surprise for both of you in terms of covenant trends?

JF: Things were decently steady in terms of a pipeline earlier in the year, but the last couple of weeks have exploded, especially going into the summer. That was very surprising to see.

JR: Is this the look of things to come? Or are we headed for a new cycle? We are certainly seeing more defaults. We've had a ton of questions on oil and gas bonds. Will they file?

JF: There's lots of money out there. It makes sense there's an uptick in refinancings and new buyout business. It does seem it could continue, but for how long? One month, six months?

Contact:
Justin D. Forlenza
jforlenza@covenantreview.com

Jessica Reiss
jreiss@covenantreview.com