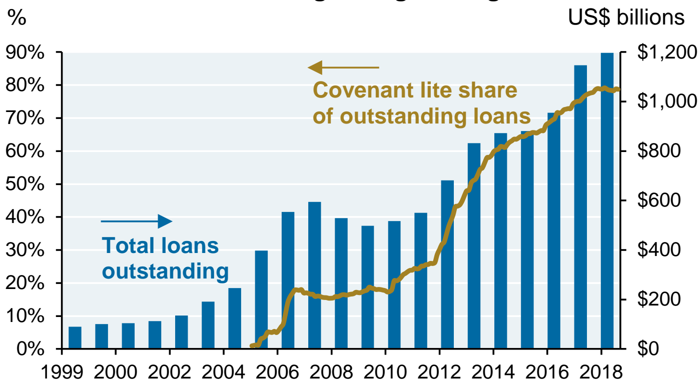
The food fight over covenant-lite leveraged loans

There are two food fights going on. First, there has been a mad scramble by investors racing to buy them, as they now represent 80% of the $1.2 trillion US leveraged loan market. Leveraged loan performance has been welcome at a time of low Fed policy rates: 5% leveraged loan annualized returns since 2010, which is 2/3 the return of high yield bonds, and with commensurately lower volatility.

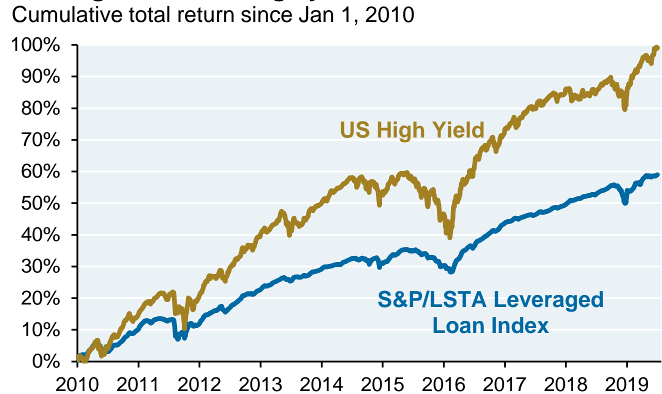
The second and equally important food fight is over whether cov-lite loans are a harbinger of doom for investors. Moody's broad-based assessment of loan covenants shows that they're at their weakest level on record[1], with a Moody's covenant specialist writing earlier this year that "our scores reflect weaker protections on a year-over-year basis in nearly every risk category we assess. Given the breadth and depth of covenant weakness, existing loans are in uncharted territory"[2]. All things considered, a decade of easy Fed policy and aggressive loan underwriting argue for materially lower loan recovery rates in the next recession. In this special *Eye on the Market* section, we explain why.

Cov-lite loans dominate a growing leveraged loan market



Source: S&P Global Market Intelligence, LCD. June 2019.

Leveraged loan and high yield returns



Source: Bloomberg. July 9, 2019.

Loan investors waving the white flag: Moody's loan covenant quality score is the weakest on record

Source: Moody's. Q4 2018.

Moody's: the last bastion of creditor protection is fading away

Loan covenants historically stipulated that borrowers could only use carve-out clauses to engage in certain corporate actions if they were not in default and had not experienced an "event of default". This protection is becoming rarer as more loans weaken/eliminate this requirement, increasing the possibility of a "Hail Mary" transaction at the 11th hour.

Moody's: "When borrowers can make restricted payments, investments, junior debt prepayments or incur new debt **even after default**, all lenders can do is hope for a satisfactory outcome". June 27, 2019

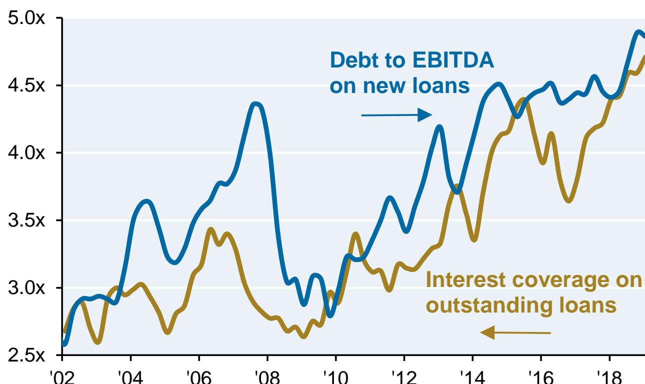
[1] **Loan investors wave the white flag**. Covenant assessment scores by Moody's and Fitch analyze leverage and interest coverage maintenance tests, most-favored-nation provisions, mandatory prepayments from asset sales, exceptions to negative covenant restrictions, restricted payments clauses, definition and scope of allowable EBITDA adjustments, leakage of assets from the collateral pool, caps on investments in or transfers to unrestricted subsidiaries and affiliates, the ability to add senior pari-passu or priority debt, lien dilution by non-guarantor subsidiaries, etc. **In other words**, the means by which lenders try to prevent issuers and their legal counsel from diminishing lender rights and protections. **These are the protections that loan investors are now surrendering at a record pace.**

[2] Moody's, "*North American loan covenant quality hits new record-worst in Q3 2018*", January 24, 2019. Moody's reported back in 2016 that **loan covenants were already weaker than they were in 2007**, before the crisis.

A. Leveraged loan **interest coverage** looks good, but there are some caveats. First, average leverage is rising as well. Second, coverage and leverage measures are artificially boosted by increasing use of "**EBITDA add-backs**[3]". This refers to the practice of companies adding back non-recurring expenses and assumed merger synergies/cost savings to earnings, thereby **artificially enhancing any measure derived from EBITDA**:

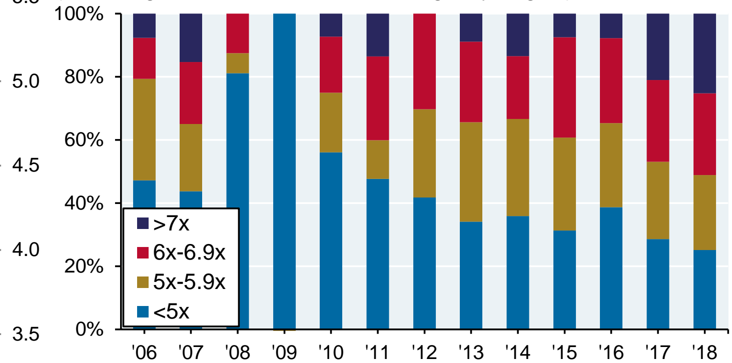
- According to S&P, the use of EBITDA add-backs has increased from 10% of all deals to around 30%. In terms of magnitude, S&P reports that such add-backs range from 10%-15% of unadjusted EBITDA. However, according to Moody's, some deals allow add-backs up to 20%-30% of unadjusted EBITDA, and some deals have no caps at all
- Fitch's Covenant Review reports that 35% of middle-market loan issuers used EBITDA add-backs. While assumed synergies were usually capped at 10%-15% of unadjusted EBITDA, in some cases there were also no caps, just as Moody's reported
- According to S&P, around half of all M&A loan issuance in 2017 and 2018 had leverage above 6.0x once the benefits of assumed synergies are excluded (second chart below)
- Moody's analyzed how successful European companies have been in achieving assumed cost savings. They found that only 45% of EBITDA add-backs were achieved on average, and that nearly 20% of issuers didn't achieve any of their projected add-back targets

Rising interest coverage, but rising leverage as well



Source: S&P Global Market Intelligence LCD. 1Q19.

M&A loan leverage trends using unadjusted EBITDA
(excluding the benefit of assumed merger synergies)



Source: S&P Global Market Intelligence LCD. 2018.

B. Some see the increase in cov-lite as a reflection of a loan market now dominated by **larger, more well-known issuers** (loans less than $300 mm were 50% of the loan market in the year 2000, but now represent just 10% of the market). Since 2017, these larger cov-lite loans have been issued with *tighter* spreads than fully covenanted loans. Whatever; I don't believe investors need less covenant protection simply because the companies issuing them are larger and better known. After all, they are still mostly non-investment grade (junk) credits. If anything, the loan market has become a little more "junky": since 2016, the % of the loan market rated below split BB has risen from 50% to 60%.

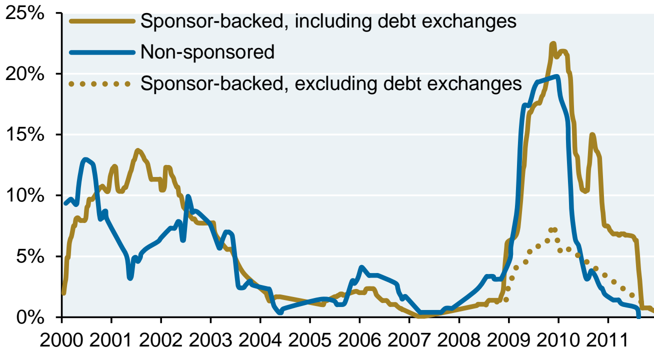
C. There's not a lot of history on **recovery rates** of defaulted cov-lite loans vs fully covenanted loans, since cov-lite loans were only a small fraction of the total market during the prior credit cycle. Since 2010, a period of very low overall corporate default rates, only 13 cov-lite loans defaulted. Their recovery rates were 56%, compared to 80%-85% for all bank loans and senior secured bonds.

[3] EBITDA is a proxy for cash flow and refers to earnings before interest, taxes, depreciation and amortization

D. Some argue that **financial sponsor** (private equity) firms will support their loans during a period of economic stress using resources of their funds. I don't buy it, unless there are clear financial advantages to the private equity firm for doing so. While sponsor-backed loan default rates were lower than for non-sponsor loans during the credit cycle 10 years ago, once debt exchanges are included (corporate actions which frequently entail large losses for lenders), sponsor-backed loan default rates look the same, if not slightly worse. Examples of large debt exchanges from the 2009/2010 period: TXU, Harrah's, Freescale, Realogy, Intelsat and Hexion.

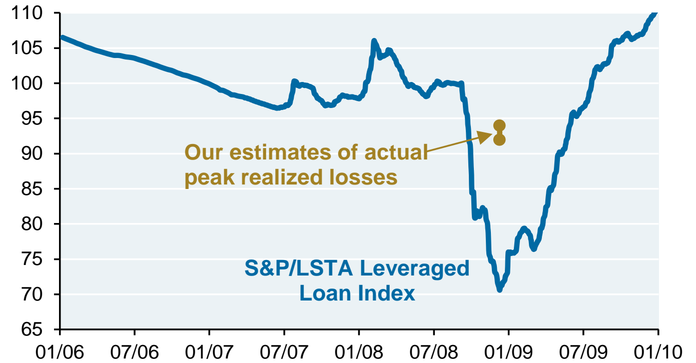
When thinking about default rates, remember that there's an important difference between **market pricing and realized losses.** The chart on the left shows peak loan default rates of 20%-22% in 2010. If recovery rates averaged 65%-70%, peak realized losses would have been around 6%-8%. However, as shown on the right, peak declines in the loan total return index (e.g., market pricing) were closer to 25%-30%. In other words, in the fog of recession, investors didn't know exactly which credits would default and which wouldn't, driving pricing lower across the entire loan market at a time of falling dealer liquidity. In a milder recession than 2008 but with lower loan recovery rates, I can imagine the loan total return index declining by roughly 7%-10%. **Bottom line: loan investors sometimes have to ride out periods of market declines that are well in excess of ultimate realized losses**. Over the last few years, this hasn't been a problem, since loan default rates have averaged 1%-2%.

Sponsored vs non-sponsored default rates
%, 2000-2012



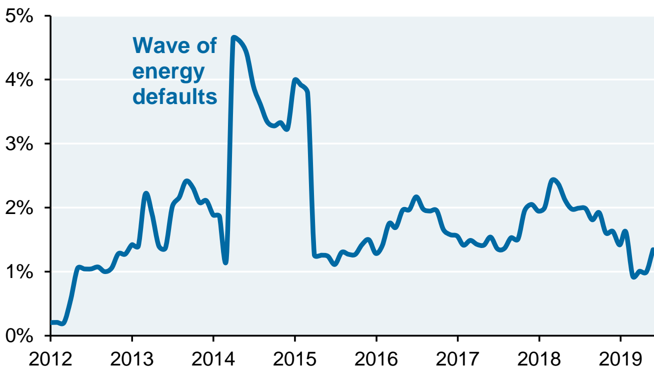
Source: S&P Global Market Intelligence LCD. 2019.

Leveraged loans: market pricing versus realized losses
Index, 9/15/2008 = 100



Source: Bloomberg, JP Morgan Asset Management July 12, 2019.

Leveraged loan default rates
%, 2012-2019



Source: S&P Global Market Intelligence LCD. June 2019.

E. Following on point D on financial sponsors, I would go further and say that in some cases, they can substantially *increase* risk on leveraged loans. There are recent reported cases of "**collateral stripping**" in which sponsors transfer collateral beyond the reach of senior creditors[4]. They have been infrequent so far, but when/if the economy turns, this kind of activity could increase due to the laxity of "restrictive payment" and other covenants outlined in footnote 1 on page 3, which should be **required reading** for loan investors.

- In 2016, as J.Crew was on the verge of bankruptcy, sponsors TPG and Leonard Green extracted intellectual property behind the brand name from collateral pledged to existing creditors. In 2017, they offered this IP as collateral to new creditors, and borrowed $300 mm of new money. Sponsors used proceeds to reinvest in the business, and so far, consequences for loan investors have been positive; but if J Crew were to fail, original creditors would lose out due to dilution of collateral
- In 2017 PetSmart transferred stakes in Chewy.com (which PetSmart had bought for $3.4 billion) to a special subsidiary and a holding company that would be hard for bondholders to reach in case of bankruptcy. Sponsors BC Partners convinced lenders to limit future litigation over these actions; Chewy has since gone public, with none of the proceeds used to pay down Pet Smart's $8 bn debt
- In Sept 2018, Neiman Marcus (struggling with $5 bn in debt, some of which traded at 45 cents on the dollar) disclosed that it was transferring its online luxury fashion e-commerce site MyTheresa to a holding company owned by sponsors Ares and the Canadian Pension Board. This would move MyTheresa out of reach of Neiman Marcus creditors in case of a bankruptcy filing

This kind of activity was notable enough to be mentioned in an October 2018 speech on leveraged loan risks by a Senior Director at the Federal Reserve[5]. There are competing signals coming from the official sector: while the Fed has been raising red flags regarding risks in the loan markets, the OCC has been lowering them by softening the EBITDA leverage guidance that it put in place in 2013[6].

One last comment on financial sponsors: many of them instruct banks arranging their syndicated loans as to which law firm the *bank* should use as it own counsel, a practice known as "**sponsor-designated counsel**". Given all the lender-issuer tradeoffs required to negotiate a set of covenants, I would not be surprised if people ask questions about this when/if the cycle turns.

All things considered, these trends don't argue for higher default ***rates***, those will be determined by the depth of whatever recession occurs, and I believe it will be a much milder one rather than in 2008; the Fed is also now pushing out the timing of a recession by easing. But in my view these trends argue for lower loan ***recoveries*** on defaults that eventually occur. Historically, loan recoveries averaged 70% compared to 40% for high yield. The midpoint of 55% is where loan recoveries may end up next time around. In the covenant food fight between issuers and lenders, issuers are winning, hands down.

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[4] Sources: Bloomberg July 19, 2019; DigitalCommerce360.com; WolfStreet.com

[5] "*Perspectives on Leveraged Lending*", Todd Vermilyea, Federal Reserve, October 2018.

[6] While loan examiners are in practice still tracking highly leveraged loans, particularly those that amortize less than 50% over 7 years, they do not explicitly prohibit them, and highly leveraged loans with unadjusted debt/EBITDA over 6.0x-7.0x are still commonplace, as described on the prior page.

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