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Navigating the 'new normal': Cov-lite lending and beyond

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The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

Where past performance is included, please note that this is not a guide to future performance.

The European loan market has reached a new level of maturity in the last three years. This evolution has brought some unwelcome features including the dilution of structural protections, like maintenance covenants. It has also brought some benefits, like the advent of multi-billion corporate issuers and an active secondary market. Assuming that a loan manager is alive to the robustness of the borrower's credit profile and the inherent protections of seniority and security – and assuming efforts to push for excessive documentation flexibility can be successfully resisted or declined – there remains a strong rationale to invest in this relatively stable, high income-generating part of fixed income, despite the late-cycle position of developed markets.

Evolution of the loan market

Leveraged loans benefit from security over assets and/or equity of the issuing companies, as well as seniority in the capital structure. This means that if an investment does not perform as expected, then lenders are first in line to be repaid, ahead of unsecured debt holders and equity. Together with seniority and security, loans incorporate additional features that can provide comprehensive protection for an investor.

What is the difference between covenanted and cov-lite loans?

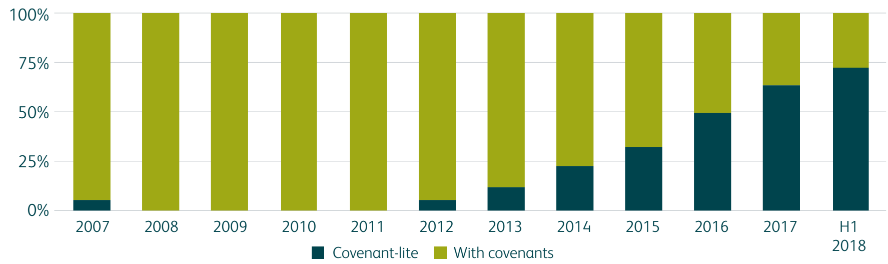
A borrower promises – or covenants – certain things to lenders in its loan documentation: not to make disbursements to junior stakeholders unduly; to provide regular, meaningful information to lenders; not to pledge assets in favour of any other party. Such promises are hardwired for life and remain commonplace in all loans. In addition, there will routinely be at least one financial covenant with which a borrower must comply, typically a leverage ratio (a debt/EBITDA cap) that must not be exceeded.

Whereas this limit once applied at all times (requiring a borrower, proactively, to prove to lenders that it was maintaining compliance), more typically in today's loans, that test becomes live only when a borrower attempts to raise new debt. In this way, the financial covenant may no longer be described as 'maintenance', but rather as 'incurrence' and essentially takes the form of a high yield bond covenant. When this is the case, the loan is described as 'cov-lite'.

Though endemic in the US for years, since 2015, there has been a proliferation of covenant-light, or 'cov-lite', leveraged loan issuance in Europe too. This has been due to the change in the market's investor constituency, the rise of global issuers and the liquidity of the secondary loan market.

Cov-lite loans made up around 70% of total issuance in Europe in the first half of this year, broadly in line with the US. This is unprecedented. Even at the height of the credit expansion phase, in 2007, cov-lite loans accounted for just 5% of total loan issuance in Europe, disappearing again before gaining ground from 2012.

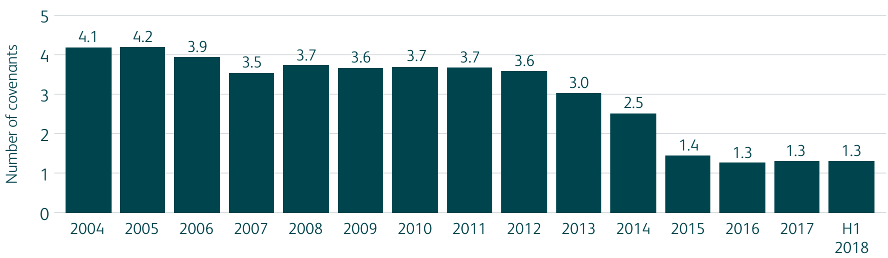
Figure 1: The proliferation of cov-lite loans



Source: S&P Capital IQ LCD, 30 June 2018 rolling 3-month leverage, institutional covenant-lite volume as a % of total issuance

Even when maintenance covenants *have* been preserved, they have typically been reduced from the once-standard four to a single (leverage) test as may be seen below.

Figure 2: Average number of covenants per transaction has fallen



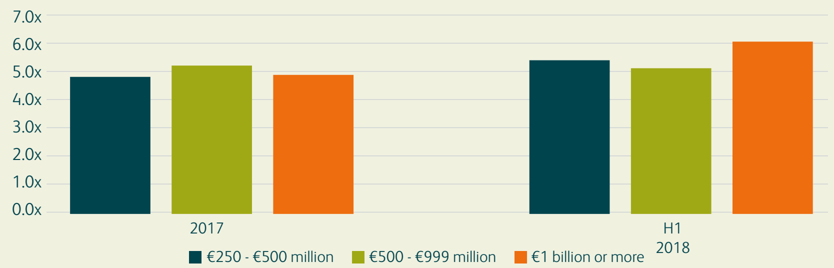
Source: S&P Global Market Intelligence, LCD quarterly leveraged lending review 2Q 2018

What has been driving the increase in cov-lite lending in Europe's leveraged loan market? The search for yield has undeniably been one of the main drivers of increased investor appetite for the asset class in the years following the financial crisis. Institutional investors – rather than banks – currently make up around 80% of the European loans market. This in turn, has given borrowers the upper hand to dictate loan terms, pushing for similar terms to US borrowers or high yield bond issuers.

Trends in cov-lite lending: Cov-lite driven by larger transactions

Covenants remain typical only in 'small' leveraged loans; ie, sub €250 million (an informal definition that fell from €350 million over 2017). According to Fitch, medium-sized borrowers with debt between €200-500 million have increasingly adopted cov-lite structures, which is a concern given that leverage is also rising for deals of this size. On the other hand, leverage has slightly fallen for larger deals – typically sized between €500 million to €1 billion – an area we see as a 'sweet spot' in which to invest, cov-lite nature notwithstanding.

Figure 3: Average senior debt / EBITDA by deal size



Source: S&P LCD, 30 June 2018. Senior debt includes first lien, second lien and senior notes. Analysis excludes amendment and add-on transactions

Beyond cov-lite: What else is happening to loan documentation?

In addition to the removal of maintenance covenants in loan documentation, attempts by private equity firms, underwriting banks and law firms further to weaken documentation have not gone unnoticed. We highlight some of the specific changes that have crept into loans over recent years and why lenders need to be cautious when evaluating each loan.

The importance of covenants

The type and level of covenants are structured and set at the beginning of the transaction and serve to provide the lender with early warning signs of any deterioration of income, earnings or liquidity. Covenants create control, so a lender can engage with a borrower if things start to go off track during the life of the investment.

As the actual performance of a business can be very different from what is initially anticipated, setting covenants requires care and expertise to provide sufficient protection for lenders while not putting the borrower under undue pressure. Covenants should afford a borrower some headroom but not an inappropriate amount, undermining their worth.

Covenants permit risk repricing in the event of a covenant breach and provide a lender with actionable recourse before significant credit deterioration occurs. If a borrower cannot repay enough of the loan to satisfy the breach, lenders may have 'enforcement' rights to ensure value protection – such as calling in the entire loan.

Information provision and disclosure – moving the goalposts

We have seen some companies reporting on a quarterly basis instead of monthly and dropping the requirement for an annual meeting with lenders in which the company would usually present its full-year results, the budget for the upcoming year and any other relevant themes for the period ahead. It is essential for lenders to maintain close relationships with the management team and the private equity owner to permit full credit monitoring and to pursue remedial action should problems arise.

Dividend-taking

The permissive use of so-called Restricted Payments clauses to allow cash to be paid out of a business – for example, to pay owners a dividend – is being enabled to a greater degree than before. Not all companies will exercise this option, but lenders need to be careful to ensure this does not creep into documentation excessively. Behaviour by sponsors is hard to predict but could be to the detriment of lenders.

Example: Corporate carve-outs – beware the Trapdoor

From time to time, documentation can be weakened such that key assets, initially pledged, can be transferred out of the lenders' security package. Since being senior and secured are core tenets, this constitutes an unacceptable undermining of a first lien lender's position that should be resisted.

PetSmart, the US pet superstore, recently reportedly disclosed to its lenders that it had transferred equity ownership of 36.5% of Chewy, an online retailer it purchased in 2017 for $3 billion. It gifted 20% of the shares (in the form of a dividend) to the private equity owner of both companies and moved the remaining 16.5% of shares to an 'unrestricted subsidiary' of PetSmart. Consequently, Chewy will no longer act as collateral for PetSmart's debt and, given a lack of clarity around the documentation, there are concerns that the owner could still have ability to transfer more collateral away from lenders under its debt covenants.

Proforma EBITDA and add-backs

The ability to base financial tests on 'proforma', rather than 'actual' EBITDA to comply with covenants, is now commonplace. The impact of using proforma earnings needs to be considered fully, requiring lenders to be fully confident that outlined future synergies and cost-savings are credible and achievable within a reasonable timeframe. This has coincided with the inclusion of EBITDA 'add-backs' eg; for 'one-off' items that allow borrowers to take on more leverage. Lenders therefore need to be cautious when analysing new transactions, making any required adjustments to get to a 'true' leverage level.

According to a Moody's study[1], the EBITDA adjustments made by new loan issuers were accurate in 81% of cases, compared with only 53% for bonds. That said, loan issuers tended to achieve more adjustments across different categories than bond issuers.

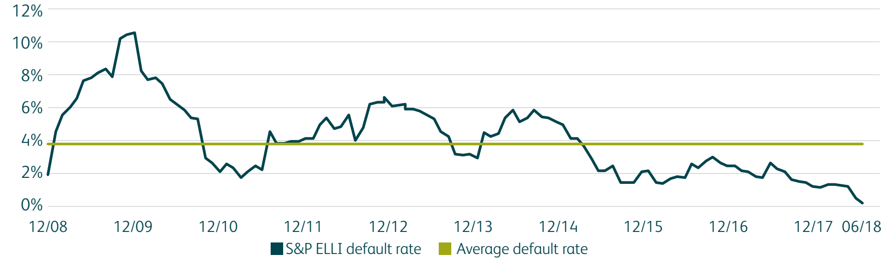
[1] Moody's Investor Service, "Speculative-grade non-financial corporates – EMEA", 27 June 2018

Cov-lite loan default risk and recoveries

As cov-lite lending becomes more prevalent in the market, there are concerns that investors will be more exposed to losses, through lower recoveries, when the credit cycle turns.

For now, the European loan market continues to be underpinned by solid market fundamentals: corporate performance is strong, the outlook for M&A-related issuance remains very supportive, and loan defaults are very low.

Figure 4: Loan default rates in Europe

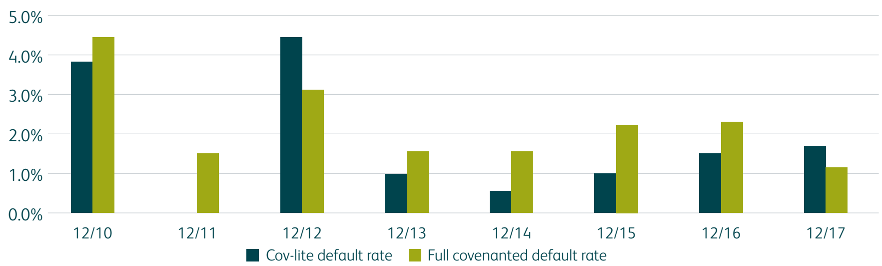


Source: S&P Capital IQ LCD, as at 30 June 2018

The average default rate (by value) for the European loan market was 3.8% in the period from 2008 to 2018, based on historical data on default rates for the S&P European Leveraged Loan Index (S&P ELLI).

The loan default outlook is benign for now but the question of how cov-lite will affect the next default cycle remains. This is sub-investment grade lending to leveraged companies, so over time, some credit deterioration, leading to downgrades and even defaults, is likely to occur. Defaults could increase due to several factors; for example, weaker credits that have been artificially propped up by cheap and abundant capital, could be vulnerable to a less-accommodative refinancing environment.

Figure 5: Historical US loan default rates – cov-lite versus covenanted



Source: Credit Suisse, "CS Credit Strategy Daily Comment", 13 March 2018

Default rates for the US loan market have been slightly lower on average for cov-lite deals historically,1.7% versus 2.0% (not shown in the chart), and certainly in the years since the financial crisis, but as Figure 5 shows, this is not routinely the case in each individual year.

Sectors with higher idiosyncratic risk, such as the oil and gas sector, may be vulnerable to extreme cyclicality creating a lack of liquidity and default. This was the case for the US credit markets in late 2015 and early 2016, as oil and gas companies faced a sharp decline in crude oil and natural gas prices, in turn triggering a wave of defaults. Similarly, the retail sector can see fast insolvencies should the confidence of trade credit insurers be lost and their ability to contract with suppliers made difficult. In other words, a maintenance covenant breach is not always a prelude to payment default.

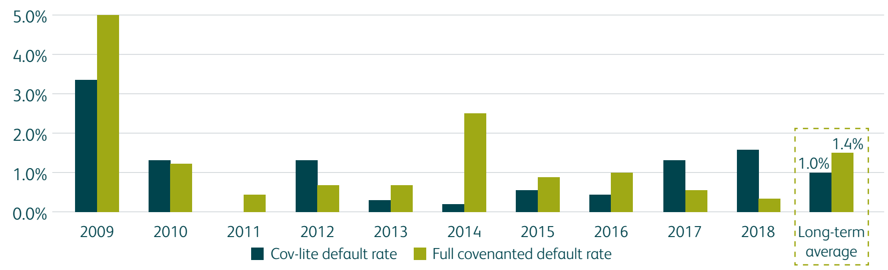
Determinants of recovery rates

To determine what cov-lite means for ultimate recovery in a default scenario, once again turning to the default and recovery experience of the US loan market – being well-established for several decades – could help us to make useful assumptions about Europe.

Several historical US loan recovery studies (spanning different time periods) have shown that the differential between average recoveries of cov-lite loans relative to full covenanted loans, ranges from 10% to 15%. While it may be reasonable to take the same differential and apply it to the current loan market, there is uncertainty about how relevant historical default and recovery rate data may be when making assumptions for future recovery rates. This is particularly true in the European market where restructurings will typically be idiosyncratic, privately-negotiated affairs.

An April 2018 research paper from Credit Suisse[2] finds that average recovery rates for defaulted loans with financial covenants since 2009 tend to be higher than those without, but ultimate loss rates over time[3] are superior for cov-lite loans versus full-covenanted. On average, the population of covenanted loans suffered 1.4% in total default loss over a cycle versus 1% from the cov-lite cohort as can be seen in Figure 6. The implication is that the population of cov-lite companies returned to a higher enterprise value (EV) than those with covenants over time.

Figure 6: Lower default losses for cov-lite loans over time



Source: Credit Suisse, "CS Credit Strategy Daily Comment", as at 27 April 2018

Similar to Credit Suisse, S&P Global LCD data shows that fully covenanted senior loans had, on average, a 10% higher recovery rate than cov-lite ones (based on emergence from bankruptcy between 2014 and 2017), but the agency cautions that more needs to be taken into consideration than the covenant (or lack of one).

[2] Credit Suisse, "CS Credit Strategy Daily Comment", as at 27 April 2018

[3] This is equal to the loss given default (1 - the recovery rate) multiplied by the default rate

Investors may therefore need to treat 'average' historical statistics with some caution and take a nuanced view of the determinants of recoveries on defaulted loans:

Not all loans are created equal – It is important to understand that cov-lite and fully covenanted loans are not alike in terms of quality or size. Until 2017-2018, there has been greater incidence of cov-lite structures for larger, more liquid deals and higher-rated borrowers. Only now is there evidence of increased pressure for investors to consider cov-lite for smaller companies. Not all loan managers will be tempted to invest in small, cov-lite loans.

Equally, not all cov-lite loans will behave the same way in a downturn and certain cov-lite loans – in the right businesses with the right loan managers – should shake out better than average in a default scenario.

Quality of the business and management focus –The sheer size of the companies in today's borrowing population is higher than that of five years ago and can consist of major industry players or best-in-class companies. The quality of the businesses may be more important than covenants in determining the value of the business in distress and thus the recovery. This encourages investors to dig deeper into a company's fundamentals and management strategy – for example, to ascertain whether it is a cash-generative business with a 'reason to exist'. There is an argument to be made that, when management is focused on running a company to meet covenants, its focus on growth is lacking, with excessive energy being expended on lurching from one covenant test-date to another without the ability to run the company for the longer term.

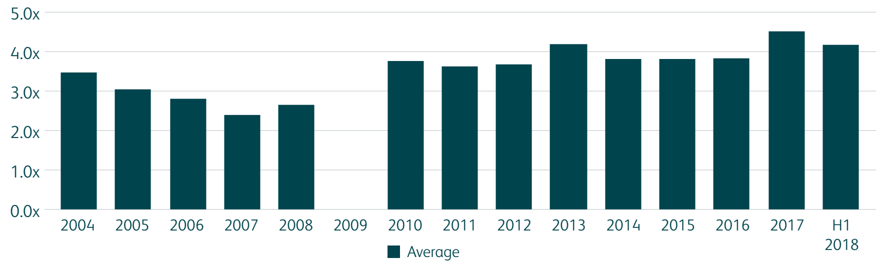
Recoveries are complex especially in Europe – Restructurings are usually privately negotiated in Europe, unlike the well-trodden Chapter 11 route in the US, and can often be complicated and lengthy albeit with similar ultimate outcomes in recovery rate terms. This feature of European restructurings may become particularly important in the era of cov-lite defaults. As the variability of restructuring outcomes widens, we believe that the dedication of specialist restructuring resources is ever more crucial to the management of distressed situations and performance.

The quality of the business, followed by the secured status of the first lien lender is more important, in our view, than covenants in determining the ultimate value of the business and thus the ability to protect capital in a default. However, covenants influence the *timing* of when a lender can take action and it is acknowledged that 'the sooner the better' is typically the maxim for best outcome. Furthermore, in Europe, cov-lite loans may be more likely to stay in the hands of original or 'par' lenders until a company has a liquidity crisis. The ability to provide funding at such a time is a critical part of controlling and protecting future value too.

Key features of the European loan market

Despite the dilution in investor protections, lender discipline and regulators have inhibited structural aggression. Total new issue leverage remains contained and interest coverage ratios (ICRs) are notably higher, compared to pre-crisis levels.

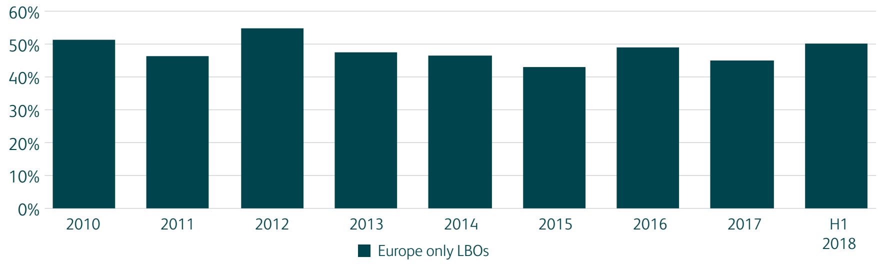
Figure 7: Higher coverage ratios (x)



Source: S&P Global, LCD European Leveraged Buyout Review: 2Q18. Interest cover is EBITDA to cash interest cost

Average equity contributions in the typical leveraged buyout (LBO) have also increased – 50% compared to 32.5% in 2007 (not shown in Figure 8) – helping to mitigate the effects of the cov-lite rise in Europe.

Figure 8: Average equity contribution to LBOs – bigger equity cushion in transactions



Source: S&P Global, LCD's Quarterly European Leveraged Lending Review: 2Q18

Europe is a market more commonly populated by private equity-owned companies and there is reputational risk associated with a default scenario that could impact future fundraising activity. This may encourage private equity sponsors to negotiate with lenders even without a formal trigger like a covenant breach. It is important to remember too that directors have duties not to run a company whose impending liabilities exceed its assets. Assertive, experienced lenders will not be slow at reminding directors of their responsibilities, engaging with the company as soon as any issues come to light.

Lenders have an iterative, vibrant relationship with a portfolio company and its owner. The direct, contractual nature of a loan creates more frequent contact between the parties. Not only does this permit engagement – to a greater extent than is the case between bondholder and issuer – but lenders can more easily proffer a solution of use to a company encountering difficulties or when performance is deteriorating, even without a covenant breach.

Recent loans will likely contain transfer restrictions on sales to 'loan-to-own' funds, meaning that original lenders with experience are likely to remain holders in a downturn; which is not the case with bonds, where the investor community may have changed considerably by the time the company encounters problems.

How to approach cov-lite lending in Europe

We think it is important that lenders remain eternally vigilant, but worrying about whether a loan is cov-lite or not may be a false anxiety, assuming that it is made to a strong, large, high-quality company and that the lender has an unassailable priority position in the capital structure, according to the documentation.

The sanctity of being secured and senior is where some loan managers can lose out, but experienced, well-resourced lenders can provide investors with exposure to large, stable businesses, while also bringing diversification and liquidity benefits to a loan portfolio. There is also the secondary trading of large loans to provide options. For large-cap loans, there is a decently-liquid two-way market, with turnover of 30-40% per annum, according to Thomson Reuters and Loan Market Association statistics.

Getting paid for the risks

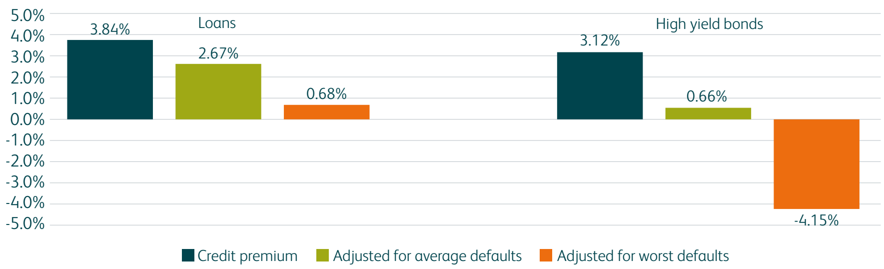
Lenders need to ensure that the expected return of each loan sufficiently compensates them for the risks being undertaken. Applying a rigorous research and analysis process to loan transactions, whether the loan has a full covenant package or not, can help to identify and mitigate potential risks before investing or indeed result in a decision to decline an investment. Investors are becoming more aware of the potential consequences of overlooking certain terms in documentation and need to ensure 'loopholes' are not placed in legal terms without knowledge.

When a new buyer becomes the owner of a company, we would seek to understand its own structure, history, aspirations for the target as well as its attitude to environmental, social and governance (ESG) issues. We count overly-aggressive documentation as a governance issue. Too many loopholes, for example, placed in the legal terms and irrelevant to the stated aims of management – including those that potentially threaten the future seniority or secured status of the debtholder – can raise concerns about integrity and the potential for future action, adverse to the interests of some stakeholders.

Selectivity on which loans make it into a portfolio is very important – the team has declined around two thirds of the loans that it has been shown over the past two decades, enabling it to demonstrate a much lower level of defaults than the overall market.

Looking at the default premia comparison of European leveraged loans and high yield bonds, we find that the loss-adjusted spread of loans is superior to high yield bonds, owing to higher loan recoveries, as the security position of loans protects the downside better than bonds. These outcomes, which are based on stressing both asset classes for the average and best defaults of the last decade, assume that this differential between loans and bonds can persist.

Figure 9: European loan and high yield bond spreads and default spread premia (%)



Source: M&G, BofA Merrill Lynch High Yield (HPIC) OAS and Credit Suisse W. European Lev Loan Index 4-year DM at 31 July 2018, S&P, Moody's default data for loans and bonds 2008-2017, Estimated recovery rate 40% bonds, 70% loans based on data from S&P, Moody's and M&G

Merits of being private-side

Europe is a relationship-driven market and therefore requires extensive, dedicated resources for successful long-term investing. Having well-established and stable relationships with key market stakeholders (such as private equity sponsors, issuers and banks) can give loan managers unrivalled access to assets and create an ability to be selective.

The onus is on lenders to perform the necessary due diligence of an investment opportunity as part of a robust credit process. This is best done by going private, in our view, as the chances of insulating future returns for investors and minimising default risk are highest. Lenders receive private information from issuers on a regular basis (formally and/or informally) through the life of the investment, often outside of the regular reporting cycle, which can help to flag any performance issues early on. So, even without covenants to offer contractual protection, there is still time for lenders to exit if they feel uncomfortable about the borrower's ability to service the debt it owes.

In the case that an investment does not perform as expected, having restructuring resources on hand can help to protect value. This is typically achieved by keeping the company as a going concern and, potentially, becoming an active shareholder for a period. At M&G, we are able to draw on the expertise of our in-house workout team, that incorporates legal and restructuring specialists, who can negotiate on M&G's behalf to seek the best possible recoveries.

Concluding remarks

Cov-lite lending is now the norm in both the US and Europe, but there are as yet few tests of the difference that may be felt in times of stress. Well-established lenders nevertheless understand that they need to exercise caution when evaluating each loan opportunity to ensure they are getting paid for the risks, including when the cycle turns. It is the ability of lenders deeply to analyse borrowers before investing – and to create access to a large range of lending opportunities from which to select the best, while preserving diversity – that is crucial to investing in leveraged loans today.

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