Heavy issues over covenant lite

SO-CALLED COVENANT-LITE CREDIT AGREEMENTS HAVE MADE AN IMPACT IN THE LEVERAGED FINANCE MARKET. **STEPHEN KENSELL** REVIEWS THEIR DEVELOPMENT AND OUTLINES THE COVENANTS TO BE FOUND IN THE TYPICAL HIGH-YIELD BOND.

The explosive growth of non-bank lenders in leveraged deals has significantly affected deal structures and documentation, particularly tax and security issues, public/private-side information and so-called syndicate management provisions such as 'snooze you lose' and 'yank the bank'. These provisions seek to address issues arising from having large syndicates where lenders aren't always sufficiently resourced to respond promptly to requests for consents or waivers.

If the main group of investors in a particular credit are funds that (a) don't always require non-public information used by banks to grant amendments or waivers, and (b) may not respond to requests for such changes, there may be good reason to use a covenant-lite package. Covenant lite is particularly appropriate where such funds are also frequent buyers of high-yield bonds and comfortable with the attaching covenant and default package. It is not the best option for all credits – a covenant-lite package may be unsuitable when large revolving credit facilities or capex lines typically provided by banks rather than non-bank lenders are involved.

Historically, the covenant package in a leveraged loan agreement has been fairly tight to meet financial ratios and limit the way in which the borrower group conducts business. For example, borrowings, disposals or acquisitions require lender consent, apart from agreed carve-outs. Restrictions imposed by the covenant package mean both borrower and lenders know that the borrower may need amendments or waivers permitting actions not envisaged at signing but still perfectly sensible. The borrower accepts restrictions for having a supportive bank group that responds quickly and positively to such requests.

By contrast, high-yield bond issues must offer more freedom. The issuer knows that obtaining a waiver or consent from bondholders is difficult, time-consuming and generally involves a consent fee. The covenant package must anticipate what the borrower may wish to do in the future, while giving holders the required protection.

The position on defaults has been similar. Leveraged loans contain a more comprehensive set of defaults than high-yield bonds and typically add a 'material adverse effect' event of default. Views differ on the significance of losing the material adverse effect default; it is an inadequate basis for triggering a demand and acceleration, but still useful as a drawstop. If, as with a typical high-yield bond, the credit agreement is fully drawn at the outset, dropping the material adverse effect event of default makes little difference in practice.

Over the past year, given available liquidity and the negotiating strength of financial sponsors, traditional leveraged credit agreements have become looser. The result has been more headroom in financial covenants, the inclusion of equity cure rights and, in some deals, disappearance of the fixed-charge cover ratio and the removal of the amortising 'A' loan.

In any deal, the parties must agree whether they want to 'flip' to a covenant-lite package or use a traditional, but looser, covenant package. If the borrower uses high-yield bonds as well as senior debt, it makes sense from its perspective to have identical covenant packages for both credits. If no high-yield bond finance is involved, the parties must decide how closely to follow the high yield-style package.

Calling this kind of package covenant 'lite' misleads; it is actually 'heavy' with the lengthy and detailed covenants or, more particularly, carve-outs needed to anticipate the future. Borrowers get extra room to manoeuvre, but the covenant is fairly closely defined.

Europe's fledgling covenant-lite market lacks any standard

Executive summary

- As *The Financial Times* recently noted: "American hedge funds and other non-bank credit investment groups now hold just over 50% of all lending to risky European companies – pushing banks into a minority role in this sector for the first time." The resulting covenant-lite credit agreements include a covenant and default package similar to those used in high-yield bonds, which follow the standard pattern used in traditional banking covenant and default packages for leveraged credit agreements. This doesn't minimise the fact that individual covenant and default packages are individually negotiated. Transactions aren't always based on the classic bank package or covenant-lite package; they can fall midway – what might be called covenant loose, or hybrid. Even if the package looks familiar and uses similar defined terms, the actual definitions can vary, making it essential to understand the detail.

approach to documentation. Some, based on a traditional senior bank deal, add covenant-lite elements such as removing maintenance-type financial covenants and instead limiting the ability to incur extra ratio debt. Others reflect the high-yield model, with undertakings heavily based on its package.

The market will continue evolving before any standard emerges, and the suitability of a particular approach will reflect other elements of the deal's capital structure. For example, if a deal has a high-yield bond, sponsors will be attracted to having a senior bank piece with a consistent covenant package. In other cases, the size of revolving credit and capex facilities require other solutions to ensure bank market liquidity remains available for undrawn parts of the deal.

Covenant lite represents another step in the converging loan and bond markets, made possible by the leveraged loan market's changing investor base and the strong distribution focus of leading debt arrangers. The attractions for sponsors – freedom from maintenance covenants and the ability to incur additional debt on the upside – suggests more covenant-lite deals will come to market while sufficient liquidity remains in the institutional investor base. There are variations on the covenant-lite theme, but further deals should see a European market standard emerge for documentation.

The rest of this article sets out a brief overview of a typical high-yield bond covenant package as it applies to a covenant-lite deal.

RESTRICTED AND UNRESTRICTED SUBSIDIARIES What characterises the typical high-yield bond covenant package applied to a covenant-lite deal? Most high-yield deals have the underlying concept of a 'restricted' group – the borrower, designated restricted subsidiaries and the remaining 'unrestricted' subsidiaries. There may be a requirement that subsidiaries accounting for at least a defined percentage of EBITDA or assets be restricted. The idea is fairly straightforward, with a core group of restricted companies (including the borrower), whose financial position forms the basis of any financial ratio test. Subject to conditions, the borrower may designate a subsidiary as unrestricted.

The financial ratio used as a basis will be the fixed charges coverage ratio (EBITDA to interest expense and dividends) or the leverage ratio (debt to EBITDA).

What goes into EBITDA? Typically, the borrower can disregard exceptional, unusual and non-recurring items for defined EBITDA, providing scope for designating expense items that allows it to maximise the figure. The definition of debt or, more particularly, the types of debt incurrence to be disregarded, also offers considerable freedom. It is essential to understand the definitions and how they are used.

DEBT INCURRENCE Borrowers don't want a fixed-charges cover ratio or a leverage ratio tested constantly – a 'maintenance' covenant exposing them to potential default if, for example, EBITDA declines due to trading conditions or delayed delivery of the sponsor's business plan.

High-yield bonds use an 'incurrence' covenant, under which the borrower cannot incur debt (as defined) unless the chosen financial ratio is below a stated level. As EBITDA rises, the ability to borrow increases. Conversely, the covenant isn't tested unless the borrower seeks to incur further 'ratio debt'. If the borrower lists out all possible incurrences of debt and provides for them to be disregarded, it may be some time before the covenant is tested – if at all.

The treatment of any revolving credit or capex facility is key. Institutional investors have limited appetite for undrawn facilities, so they must be structured to attract sufficient liquidity from the bank market. Sometimes a quarterly maintenance covenant applies to these facilities; for others an incurrence covenant represents a condition to any drawdown. Both solutions offer additional comfort to bank lenders, but dilute the benefit of a covenant-lite deal for borrowers. One remedy has been to grant 'super priority' status to the revolving credit and capex facility, trading maintenance covenant protection for a higher ranking in a workout or enforcement.

The use of the chosen ratio effectively restricts other actions such as making restricted payments unless there is headroom under the ratio to incur an additional nominal amount of indebtedness.

NEGATIVE PLEDGE AND ADDITIONAL SECURED DEBT In unsecured high-yield bond deals the negative pledge means no security is given to other lenders (apart from the senior credit facility and certain limited carve-outs) unless equal and rateable security is given to bondholders. If the other secured obligations are discharged, the security for the note holders is discharged too. A borrower can focus on raising additional debt if the debt incurrence ratio allows. To do so, it will probably have to grant security for the additional debt. So more carve-outs are needed to the negative pledge, allowing the borrower to raise unsecured, second-secured or equally secured debt. Amounts are limited by its ability to meet a pro forma ratio; sometimes, different ratios are set for the unsecured, second-secured and equally secured amounts.

Security is another consideration – how will the new money benefit? The most straightforward way is to share in the security already held by senior lenders, hence the inclusion of 'accordion' facilities within the senior credit agreement. These can be

uncommitted lines, or mechanics facilitating the incorporation of additional facilities at a later date.

LIMIT ON RESTRICTED PAYMENTS Essentially a dividend restriction, this controls investments in entities that aren't restricted subsidiaries or the retirement of debt subordinate to the bonds. The basic rule is that no dividends are paid unless:

- there is no event of default;
- after paying the dividend the borrower can still incur a nominal amount of indebtedness (triggering the debt incurrence test); and
- the dividend can be paid out of a defined cash and profit pool, comprising the aggregate of a specified percentage of net profits and disposal proceeds from specified assets (less any amount invested in specified assets). Cash for dividends and most investments comes from the pool.

LIMIT ON SALES OF ASSETS Permitted if the disposition meets certain criteria: a stated minimum percentage of the consideration must be cash, the value obtained must be fair value, and the proceeds must be used in a specified way to reinvest (often only in specifically allowed kinds of asset or investment) or pay down debt. How debt reductions apply between senior and junior debt will be defined.

LIMIT ON SELLING INTERESTS IN SUBSIDIARIES Apart from outright sale of a subsidiary (that complies with the covenant dealing with asset sales), the borrower cannot dispose of shares in subsidiaries unless it retains an interest above 50%.

LIMIT ON GUARANTEES Neither the borrower nor any restricted subsidiary can guarantee an unrestricted subsidiary's obligations. Guarantees of the obligations of the borrower or restricted subsidiaries are allowed provided the notes debt is guaranteed as well and that if the guaranteed debt is subordinated, the guarantee is also subordinated.

LIMIT ON RESTRICTIONS ON DISTRIBUTIONS BY RESTRICTED SUBSIDIARIES The borrower and its subsidiaries cannot enter into any arrangements that might restrict the flow of dividends up to the borrower from its subsidiaries.

CHANGE OF CONTROL In a traditional leveraged senior deal, change of control triggers automatic mandatory prepayment of all lenders. In a classic high-yield bond deal, the borrower must offer to prepay so that bondholders wishing to exit the credit may do so, typically receiving a premium of 1% of the amount prepaid. The difference between the two approaches is that in a classic senior deal the starting position is that the borrower has to prepay lenders, but seeks a waiver to avoid prepaying them all. In a bond deal it need only prepay those wishing to be prepaid. Covenant-lite deals have adopted the classic senior route.

LIMIT ON MERGER, CONSOLIDATION AND SALE OF ASSETS Consolidation and merger is allowed only if the successor company meets defined requirements, including one that a nominal amount of debt can be incurred to activate the incurrence ratio test.

LIMIT ON TRANSACTIONS WITH AFFILIATES Provisions designed to ensure transactions with affiliates are on arm's-length terms and, if exceeding certain amounts, are approved by the borrower's board or an independent financial adviser.

ANTI-LAYERING In senior subordinated deals, the borrower cannot layer in debt between the senior and senior subordinated debt. There may be requirements to bring newly incurred debt into an existing intercreditor arrangement. Otherwise, existing layering or subordination is maintained.

NO PAYMENTS FOR CONSENTS The borrower cannot make payments to lenders to induce consents unless it offers to pay the same amount to all lenders who consent in the time requested.

CHANGES TO BUSINESS ACTIVITIES There is often a limit on what business the borrower and its restricted subsidiaries can undertake, as in a typical bank deal.

CROSS-DEFAULT V CROSS-ACCELERATION Bank loan agreements classically include cross-default rather than cross-acceleration. A covenant-lite deal based on a high-yield package is likely to provide for cross-payment default, and cross-acceleration for other defaults.

ACHIEVING INVESTMENT-GRADE STATUS There may be provisions suspending a significant part of the covenant package if the obligations achieve investment-grade rating.

TRANSFERABILITY The covenant-lite package in a credit agreement aims to satisfy non-bank investors used to investing in high-yield bonds. Lenders want to ensure they can transfer their interests in the loans to that type of investor. But borrowers have sought to restrict transfers, to prevent distressed and other 'value' investors purchasing debt in a workout to obtain control of the borrower group. This sparks tension between borrowers who want covenants more acceptable to non-bank investors than traditional bank lenders while seeking to control the access of non-bank lenders to their lender groups. In a high-yield bond, there would be no restrictions on transfer.

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