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# "Covenant-Lite: The Rise Of A Fallen Angel"
## Seminar: 06/11/2104: Article Part 1

*As part of the White & Case "Risk In A Recovering Market" autumn seminar series on 6 November 2014, Stephen Mostyn-Williams, Chairman and founder of DebtXplained collaborated with White & Case bank finance partners, Jake Mincemoyer, Justin Wagstaff and Lee Cullinane, in a discussion on the various issues that may arise when structuring, negotiating and investing in covenant-lite leveraged loans in both the US and European market.*

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## What Is A Covenant-Lite Leveraged Loan?

Although meaning different things to different people, a cov-lite loan is usually understood to be a loan which has no financial maintenance covenants applicable to any term loan but which has a "springing" covenant for the benefit of the revolving lenders (nearly always based on leverage) and often including some elements of a high yield bond-type negative covenant package.

The tables below summarise how cov-lite, covenant-loose (i.e. up to two financial maintenance covenants (e.g. leverage ratio and/or interest cover ratio and occasionally high yield style negative covenant flexibility) and traditional covenant packages are spread across 2014 European leveraged deals according to total commitments and by covenant type.

| *Data as at 4 November 2014* | **Covenant Package Distribution Across Deal Sizes (Euros)** | | | | **Total** |
|---|---|---|---|---|---|
| | 0-250 million | 250-500 million | 500-1,000 million | 1,000+ million | |
| **Covenant-lite** | 0% | 25% | 45% | 30% | 100% |
| **Covenant-loose** | 9% | 37% | 27% | 27% | 100% |
| **Traditional** | 38% | 62% | 0% | 0% | 100% |

| *Data as at 4 November 2014* | **Covenant Package Distribution Within Deal Sizes (Euros)** | | | **Total** |
|---|---|---|---|---|
| | Covenant-lite | Covenant-loose | Traditional | |
| **0-250 million** | 0% | 40% | 60% | 100% |
| **250-500 million** | 28% | 44% | 28% | 100% |
| **500-1,000 million** | 60% | 40% | 0% | 100% |
| **1,000+ million** | 50% | 50% | 0% | 100% |



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## The Transatlantic Journey Of Cov-Lite Provisions

Cov-lite is the current standard for private equity deal leveraged term loans in the US, the so-called "Term Loan B" or "TLB". Cov-lite is well entrenched in the US market so negotiations of US TLBs now focus on (and end up in) the gradual loosening of the various established terms, rather than in the broader structural aspects of the loan.

It is estimated that institutional investors consist of approximately 90% of the US cov-lite investor base. Institutional investors have historically been the principal investor base for the high yield market, and so it comes as no surprise that these investors, when initially entering the cov-lite loan market, were not unduly concerned with participating in loans incorporating high yield terms. And those looser terms have stayed.

Recently, European borrowers have looked to access the US market for various reasons, including its depth of liquidity and the ability to access more favourable terms than the terms the European market has traditionally offered.

Alongside the borrowers' search for looser terms has been the growth of the institutional investor base in Europe, consisting of approximately 60% of European investors; as a result, the ability for European borrowers to obtain looser terms in a home market has grown.

In addition, liquidity growth in the European investor base has meant they have had to be more accepting of looser covenant packages to keep attracting borrowers who might otherwise syndicate into the US.

As well as the supply and demand dynamics, the human element should not be underestimated. Importation of US cov-lite terms into European deals has also been in part due to the increase of dedicated debt teams within sponsor entities, populated with ex-bankers fluent in deals on both sides of the Atlantic. Certain well placed law firms representing both sponsors and arrangers also span the Atlantic which has assisted the importation of terms.

However, the importation of US terms into Europe has not been wholesale; certain terms have been adapted or ignored or resisted completely. We highlight these below.

## The "Available Amount" Or "Cumulative Credit" Basket

The "Available Amount" (otherwise called the "Cumulative Credit" or "builder" basket) is an amount based on either a percentage of consolidated net income ("**CNI**") or retained excess cashflow, plus certain equity contributions and returns on investments made using this basket, or some variation of this common formulation. It is a "floating basket" in the sense that it can be used to pay dividends, repay subordinated debt and make general investments.

Although initially inspired by high yield bonds, it differs in that a bond "builder" basket is more uniformly based on 50% of CNI (plus other additions). As in US TLBs, it can also be used to pay dividends, repay subordinated debt and make general



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investments, however, this is usually subject to being able to incur an additional $/€1 under the 2x fixed charge cover ratio debt basket and other conditions.

The "Available Amount" basket is very common in US TLBs but its incorporation into European deals shows no pattern as yet; many deals have this basket alongside the more traditional leverage-based "Permitted Payments" basket or other "Permitted Payment" baskets with a hard-cap etc. Other European deals only have the traditional leverage-based "Permitted Payments" basket.

## The "101" Soft Call Provision

Over time, US investors have received some reassurance that they will remain invested at the initial price for a minimum period of time through the introduction of a "101" soft call provision. This protection has migrated into the European leveraged loan market, although there is a greater deal of variety on the use and level of the fee.

The "101" soft call is a prepayment premium which is payable on a voluntary prepayment of term loan principal using cheaper debt, or a refinancing of the term loans by the same term lenders at a cheaper price, in each case often defined as a "repricing event" in the loan documentation, with the premium set at 1% of the principal prepaid or refinanced (the standard percentage and hence the "101"). It is "soft" because the prepayment is at the borrower's option and does not apply to all prepayments (hard call protection would mean that generally all prepayments would attract a prepayment premium, usually for a stated time period, and is not typically seen in the leveraged loan market for first lien secured debt). It is a "call" because the term has been taken from bonds, where the issuer "calls" the notes in for redemption; here the borrower simply prepays the debt, but the term has remained as coined in the bond market.

75% of English or other European law deals reviewed in 2014 ("**2014 Deals**") which were cov-lite provided for a soft call on the occurrence of repricing event.

Investors should note whether the soft call fee is limited to refinancings using senior facility debt only or whether its scope is wider and includes any debt, focusing on the fact of the refinancing itself and not the source and ranking of the refinancing debt.

## EBITDA Cures Of The "Springing" Leverage Covenant

**Use of the "Springing" Leverage Covenant**

A "springing" leverage covenant is the norm in US cov-lite deals and is for the benefit of revolving lenders. The "springing" covenant is an instance of a "wholesale" importation of a US cov-lite term into the European market.

When first introduced in the US, the leverage covenant commonly "sprang" when 10% of revolving commitments were drawn; this has since risen to 25-30% in both the US and Europe. Although varying from deal to deal, frequently a specified amount of letters of credit will be excluded (if not all); this is also the case in the European market.



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For more information, see our research paper entitled Negotiating The "Springing" Leverage Covenant.

**The EBITDA Cure For The "Springing" Leverage Covenant**

The EBITDA cure for the "springing" leverage covenant is standard in the US; it is not typically negotiated and restricts the borrowers' ability to "over cure", i.e. contributing more than required to cure the breach.

EBITDA cures have been accepted to some extent in cov-lite deals; 62% of 2014 Deals which were cov-lite provided for an EBITDA-based equity cure.

It is interesting that this degree of acceptance of the EBITDA cure in European cov-lite deals has not been seen in traditional European deals, where it remains rare; if European investors can get comfortable with the EBITDA cure in a cov-lite deal, it would be contradictory to resist it on principle for a maintenance leverage covenant in traditional European loan as the same risks are present. However, market sentiment plays a strong part in maintaining this barrier between cov-lite and traditional loans and it looks unlikely to tumble given its persistence to date in a gradually loosening market.

## Asset Disposals

In US cov-lite deals, the disposal covenant follows the high yield bond formulation by permitting any asset disposals in an unlimited amount as long as certain conditions are satisfied, such as receiving 75% of consideration in cash or cash equivalents and certain restrictions on the use of proceeds. Mandatory prepayment requirements and reinvestment rules, however, follow the traditional bank (not high yield bond) approach.

In 65% of 2014 Deals, the traditional disposal covenant is still present. It requires all disposal proceeds to prepay the term loans, subject to an agreed *de minimis*, the carve-out of certain disposal baskets and reinvestment rights, with Europe seeing over the last eighteen months a gradual rise in more extensive carve-outs of disposal baskets. 45% of 2014 Deals show an influence from either the US TLB or high yield bond markets. At one end of the spectrum, some deals only deviate from the traditional European formulation by containing a 75% cash or cash equivalent consideration requirement for certain capped permitted disposal baskets. At the other end of the spectrum, some deals follow a high yield bond formulation and allow proceeds to go towards prepayment of other debt without any *pro rata* sharing of the disposal proceeds with the leveraged term loan lenders.

## Unrestricted Subsidiaries And The Restricted Group

Again, US cov-lite deals follow high yield bonds in dividing borrower group members into two, the restricted subsidiaries and the unrestricted subsidiaries, with only the restricted subsidiaries being bound by the covenants and supporting the credit.

On the one hand, this provides operating, investment and financial freedom to the unrestricted subsidiaries but on the other, makes interactions between the restricted



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and unrestricted group a key point to control for investors to ensure there is no adverse value leakage from the restricted group to the unrestricted group. US credit documentation treats unrestricted subsidiaries like third parties.

This is one aspect of US cov-lite that has not taken firm hold in Europe (except the odd deal here and there), where covenants continue to bind the borrowers, guarantors and each group member. Of course, as has always been the case, each European deal needs to be checked individually to see whether there are any material companies that are carved-out from the definition of “group”.

## Uncapped Acquisitions

A US cov-lite deal will seldom cap acquisitions, except for an aggregate cap in respect of targets that do not become guarantors or assets that do not become collateral for US insolvency law reasons, as they are seen as a positive for the business and so not to be constrained. This is not true of the European market where acquisition caps are common. Of the 2014 Deals, only 10% followed their US counterparts with no cap, whereas 30% had a hard-cap, 40% had an acquisition ratio test acting as a cap and 20% had a hard-cap and acquisition ratio test applying in the alternative or as a double cap.

## Summary

The return of cov-lite to Europe has been concerning for European investors, who have had little power to resist its return in the current low yield environment. However, cov-lite has not overrun the European market and where it has returned, it is not simply a smaller version of the US TLB market, just rolling-out the same terms and conditions as in the US but for a few tweaks here and there. Certainly some terms are wholesale imports; however, the majority are not. Savvy investors will understand the differences between US and European cov-lite and be able to make a more considered analysis about the different risks that arise in each case, enabling them to make a more informed investment decision.


## Know the Market: DebtXplained Representative Loan Terms Database

*Representative Loan Terms allows for over 300 loan covenant provisions to be searched on a non-confidential basis across up-to-date transactions ranging from €50m-€1bn+*

**Why You Can’t Thrive Without RLT**

- RLT provides, for the first time ever in the European market, a comprehensive and statistical breakdown of the terms of new and historic loan transactions.
- It enables Term Sheets to be constructed with reference to all the latest provisions going through the market.
- It ensures that our clients are never caught out in term negotiations by not having worked on a deal.
- It guarantees that our clients offer their clients the best market terms.





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**Why DebtXplained is the Partner You Need**

- Our databases have been used for over 3 years by tier-1 investment banks, law firms and financial advisors with 100% renewal rates.
- They ensure our clients have complete purview of market terms, are never caught out in negotiations and can guarantee the best structures for their clients.
- No other provider has comparable systems.
- No other provider has such a strong team of lawyers.
- No other provider delivers with such reliability.
- This is why DebtXplained is the market leader and is used by the market leaders.

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