Restructuring the next wave of cov-lite debt

With cov-lite financings at record highs, debt holders will need to be proactive in maximising recoveries

Will the last person leaving please turn out the lites?

Cov-lite loans can leave lenders with limited restructuring options, but creative lenders will still find ways to bring debtors to the table, partners **Ian Wallace** and **Christian Pilkington** of global law firm White & Case LLP explain

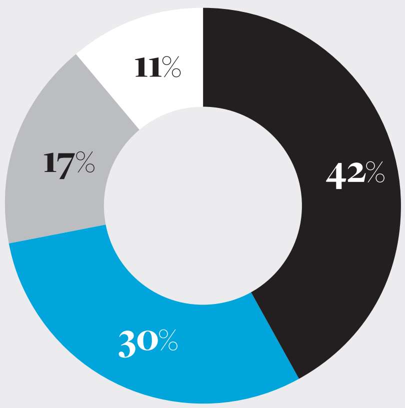
Recent data shows that investor protection in loan documents has fallen to its lowest point ever. And yet, leveraged loans continue to be issued with no or minimal covenants, and considerably reduced protections for lenders generally. The bond market is in a similar position, with ever-weakening terms for bondholders.

Market conditions remain relatively benign from a debtor's perspective, so the issuance of cov-lite loans continues—in many ways reminiscent of conditions in 2005 – 2007 immediately prior to the credit crunch. The current raft of loans lack even the basic financial covenant protection that existed in the mid-2000s. These covenants were key leverage points for lenders in a number of restructurings in 2008 – 2010. So what will happen if there is some sort of forced market correction, and a substantial number of these cov-lite loans become distressed?

Historically, financial covenants have been viewed as a form of 'early warning system' for lenders, enabling them to initiate restructuring discussions before the debtor's business irretrievably declines. The absence of meaningful covenants in recent deals greatly restricts lenders' ability to compel a borrower to take action when its business hits the rocks. To make matters worse, lenders' ability to exit the loan has become restricted, due to the increasing use of blacklists, whitelists and tighter consent rights on transfers.

When this happens, what options do lenders have? Are they simply left in limbo, unable to mitigate their losses, waiting for the inevitable default on the repayment date while the borrower's business deteriorates? Or are there options that lenders may be able to turn to in order to encourage earlier restructuring discussions, even in the absence of covenant default?

Figure 1. Post-credit crunch restructuring triggers



Source: European restructuring report 'Default, Restructuring and Recoveries in 2008 – 2010', *Debtwire*

72%

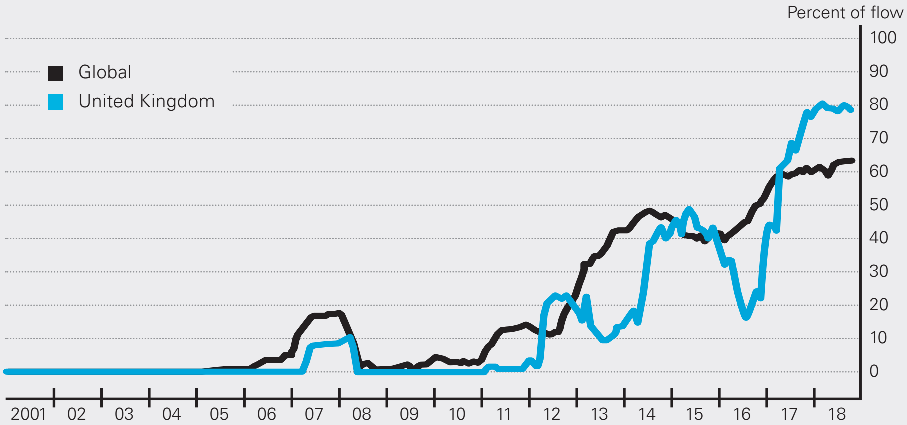
of restructurings in 2008 – 2010 were triggered by an actual or potential covenant breach

Source: European restructuring report 'Default, Restructuring and Recoveries in 2008 – 2010', *Debtwire*

> **The current raft of loans lack even the basic financial covenant protection that existed in the mid-2000s**

Figure 2. The share of covenant-lite leveraged loan issuance has reached record highs

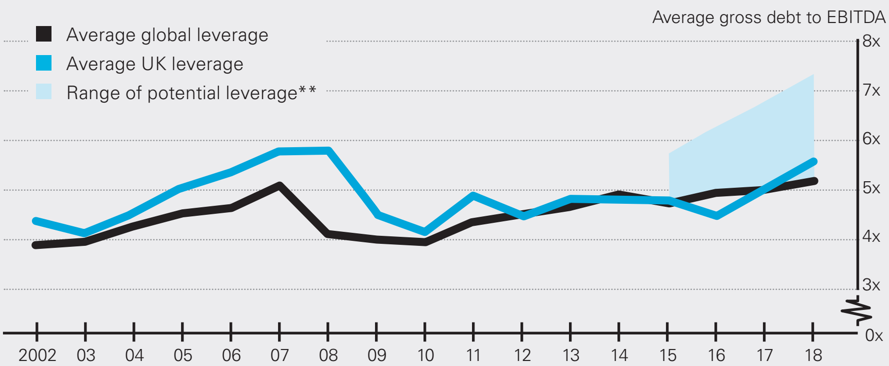
Share of covenant-lite leveraged loan issuance globally and in the UK



Source: *Financial Stability Report*, November 2018, Bank of England

Figure 3. The average leverage of issuers has reached pre-crisis levels and could be even higher than reported

Average leverage of global and UK issuers for new leveraged loans*



* Granular data on add-backs only available from 2015

** The greater the proportion of add-backs which are not realised, the higher the actual leverage will be relative to the reported leverage. The top range assumes none of the add-backs are realised. The bottom of the range assumes all of the add-backs are realised.

Sources:
Covenant Review, LCD, an offering of S&P Global Market Intelligence and Bank calculations.
https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2018/november-2018.pdf

The current market: A self-fulfilling prophecy?

Inevitably, the preponderance of cov-lite debt has led many commentators to draw analogies with 2008. In its November 2018 *Financial Stability Report*, the Bank of England has raised concerns about the loosening of underwriting standards in the leveraged loan market, and has specifically compared the current leverage lending market with the US subprime mortgage market of 2006.

The percentage of cov-lite loans has reached record highs in 2018 (see Fig. 2), and the average leverage of issuers has reached pre-crisis levels and could potentially rise even higher (see Fig. 3).

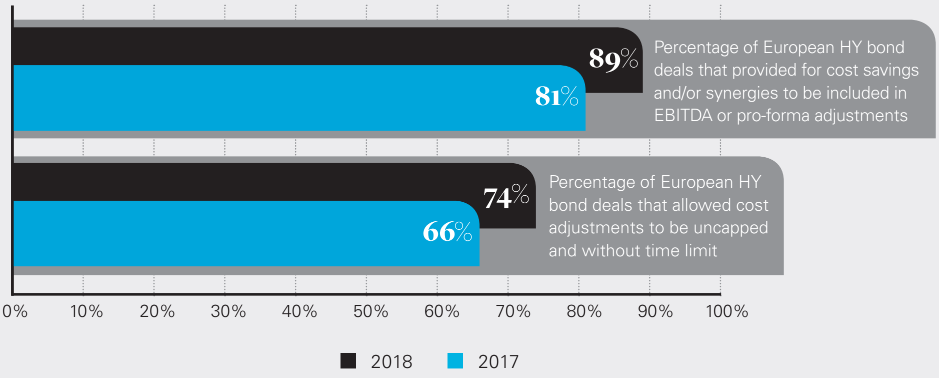
When is leverage not leverage?

One of the increasing market trends recently has been the use of EBITDA adjustments when the loan is written that assume future improvements in earnings. These 'add-backs' could result in substantial overstatement of EBITDA and, as a result, substantial understatement of leverage. Fig. 3 shows very clearly the potential impact on leverage, if some or all of the add-backs are not, in fact, realised. The leverage of issuers of cov-lite loans suddenly appears far higher, potentially already exceeding pre-crisis levels.

The EBITDA add-backs also have a couple of additional key effects. One is potentially to permit transfer of assets from the borrower group or the incurrence of new debt or security, at a time when the 'real' EBITDA of the group would not support it. Another effect—when there is a maintenance covenant—is to delay the time when a covenant breach could occur, potentially resulting in a default occurring under the loan before the lenders are aware of the borrower group's distress. When combined with the other weaknesses in debt documentation, the Bank of England's comparison between the leveraged loan market and the US subprime mortgage market in 2006 seems prescient.

Figure 4. EBITDA add-backs in the European high yield bond market

Research shows that EBITDA add-backs are becoming increasingly prevalent in the European high yield bond market



Source: *Debt Explained Market Update 'Aggressive Terms in European High Yield 2018'*, 22 January 2019

New 'cov-lite' raises lender concerns

It seems clear that these EBITDA add-backs, and their ability to water down leverage protection and obfuscate the availability of incurrence baskets, are a potential problem for lenders in any upcoming downturn. However, they are not the only terms in the latest wave of cov-lite loans and bonds that could be of concern to lenders in future distressed scenarios.

The start of 2018 had seen the occasional deal with the more traditional three or four maintenance covenants, albeit without ratio-based debt incurrence restrictions. However, by Q4 2018, all of the syndicated European leveraged loan deals were cov-loose (with one or two maintenance covenants, or just leverage maintenance) or cov-lite (with only a springing leverage covenant). The *Debt Explained European Leveraged Loan Market Update Q4 2018* reported that more than 80% of deals fell into the cov-lite category. Most commonly in 2018, the springing leverage covenant would only apply when the RCF in the deal is drawn to 40%—a relatively 'loose' trigger potentially open to manipulation by a debtor that can time its cashflows to avoid springing the covenant in the first place.

89%

of European HY bond deals in 2018 provided for cost savings and/or synergies to be included in EBITDA or pro-forma adjustments

Source: *Debt Explained Market Update: Aggressive Terms in European High Yield 2018,* 22 January 2019

Even when maintenance covenants do remain, the standards applicable to equity cures have loosened over recent years. It is now common not to include restrictions on the number of cures or the amount by which a breach can be cured. It is also becoming increasingly common for the cure to be used in prepayment of outstanding RCF commitments, which removes the future application of the springing leverage covenant.

The same trends can be observed in the European high yield market—a sector that traditionally offers far less covenant protection than loans anyway—as high yield bond issuers have continued to achieve favourable terms in their documentation. EBITDA add-backs have been equally prevalent in high yield deals, and both the Restricted Payments basket and the covenants on Affiliate Transactions have become increasingly more aggressive.

> **"The remit of transfer restrictions has been extended to cover sub-participations, preventing a bank from offloading its exposure and control while remaining lender of record**

Other debtor-friendly amendments to loan documentation

Extension of transfer restrictions

One advantage that lenders had in 2008 was that they were able to exit the loans they were holding. This flexibility for par lenders to trade out enabled these original lenders to focus on larger problems, which in many cases included their own balance sheets, and allowed distressed debt investors to buy in at a substantial discount and effect a more 'root and branch' restructuring. While a number of 'zombie' companies did continue for some time, there would arguably have been many more if par lenders, with an understandable desire to limit substantial impairments to their loan portfolios, had not been able to trade out, and focused instead on 'amend and extend' short-term solutions.

In contrast to the pre-credit crunch position, all of the newly issued European syndicated leveraged loans in Q4 2018 contained a 'whitelist' of permitted transferees, and an ever-increasing number contained both a whitelist and a 'blacklist' of prohibited transferees. Over time, the remit of transfer restrictions has been extended to cover sub-participations as well, preventing a bank from offloading its exposure and control while remaining lender of record.

When borrower consent is required, an overwhelming majority of deals provide that the consent requirement only falls away in the event of a payment or insolvency default. Fewer than 30% of European leveraged loans in 2018 had a consent right that was disapplied on any other event of default.

Prevalence of 'light touch' security packages

Historically, lenders have expected share and asset security—and subsidiary guarantees—from all material group companies, but recent years have seen a number of limitations or exclusions to the lenders' security package being introduced. This can encompass the exclusion of certain jurisdictions

85%

of all leveraged loans in the UK were cov-lite by the end of 2018

Source: Leveraged Data & Commentary unit of S&P Global Market Intelligence

Voting thresholds

One key change to loan documentation is the lower thresholds for majority lender and super majority lender definitions. These have been watered down to New York law bond levels, with more than half of all loan deals setting the 'Majority Lender' level at 50.1%, in contrast to the traditional 66 $^2/_3$% requirement. The 'Super Majority Lender' threshold has survived a little more intact, with thresholds mostly in the region of 80%.

The threshold for 'non-major' changes in the European high yield bond market was already a simple majority (more than 50% of outstanding bonds). However, as *Debt Explained* reported in "Voting Thresholds: When Security is not so Super", it is the 'super majority' threshold for release of collateral and/or security that has been reduced—in this case to 66 $^2/_3$% of holders—in the majority of 2018 deals. This is in contrast to the more traditional 90% or 100% required for other 'Super Majority' decisions, which continue in the European high yield bond market.

This change to documentation is a double-edged sword. It is clearly useful for lenders to be able to avoid holdouts—and the unnecessary loss of value to those lenders holding out—when agreeing changes to the documents, or a more extensive restructuring of the debt. Equally, though, lower voting thresholds make it easier for a debtor to push through amendments that might have been more difficult to achieve previously.

Figure 5. Summary of changes in loan document protections over time

Loan document protections	2003	2007	2019
Existence of covenants	Prevalent – both maintenance and incurrence	Both maintenance and incurrence covenants, but subject to substantial relaxation and reset during 2008 – 2010	Few maintenance covenants; most deals just with incurrence covenants
Strength of covenants	Strong – acted as effective early warning system	Still effective – relaxation in equity cure rules and many covenant resets after the credit crunch	Loose/lite – lots of flexibility, especially around calculation of EBITDA. Difficult to actually calculate leverage of business
Security package	Strong – substantial share and asset security, and guarantees from material group companies	Strong – little meaningful change from 2003	Weakening – more reliance on share security and single point of enforcement. Less asset security and fewer guarantees
Transfer restrictions	Strong – no blacklists/whitelists. Sometimes no borrower consent; if it existed, fell away on default	Strong – little meaningful change from 2003; if any change, lenders' position stronger on transfer	Weak – prevalence of blacklists and whitelists. Stronger borrower consent rights; often don't fall away until payment default

Strong	**Weakening**	**Weak**

altogether, for example, not requiring security to be granted where it is particularly expensive or cumbersome to do so.

Both security and upstream guarantees can be restricted when there are issues relating to financial assistance, corporate benefit, thin capitalisation, etc.—issues that arise under the laws of certain Western European jurisdictions, and beyond. However, the market trend is to introduce further exclusions, with the asset-level security limited only to 'material' assets of the borrower group, or even for lenders to rely simply on share pledges over the key companies in the group—as a single point of enforcement—and do not take asset-level security at all.

While these measures were introduced to provide operational flexibility for the borrower group, the limitations to the security package—and ability for the borrower group to require the release of such security—clearly carry risks for lenders in the eventual enforcement, and have the potential to reduce recoveries in a worst-case insolvency scenario.

Lenders still have options

There seems to be no indication that investors will stop making finance available on these terms, unless there is some external economic or political trigger with an impact akin to the collapse of the US subprime market in 2007. At some stage, lenders will have to address the documentary inadequacies of these loans. What will they be able to do?

Given the weaknesses in debt documentation, there are clear limitations on lenders' rights under the loans. The biggest risk is that lenders are unaware—or are aware but unable to take any action—until a borrower defaults on a payment due under the debt. At that point in time, any anticipated recovery will have been dramatically reduced. But it's not all doom and gloom, and lenders still have options.

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> **Lenders need to understand the debtor's business, and be aware of the key commercial and legal pressure points available to them as leverage**

Carrot and stick: New money/waivers in return for resetting documents

Improving weaknesses in existing documentation is a priority. A clear example is if the borrower group needs any formal consents under the documents, or if there is a new money requirement. In those circumstances, lenders should seek to reinstate covenants, relax transfer restrictions and restore as much lender power to the documents as possible, as the quid pro quo for acceding to the borrower's request. Given that such opportunities are by no means guaranteed—due to the inherent lack of protection in the documents—it is critical that lenders seek to be proactive and organised.

Two-stage restructurings

While the balance of power has shifted under the debt documentation, it is still open to lenders to approach borrowers with constructive proposals prior to a default. For example, lenders could offer new money, a payment holiday or even specific sector expertise, in return for improved credit support, an equity injection or revised loan terms that provide earlier triggers. It would also be worthwhile for lenders seeking to improve liquidity in the loan to remove or soften the borrower's veto on transfers, and remove any blacklists or whitelists in the documentation. Those amendments would enable lenders who want or need to exit the loan to do so, and enable activist distressed investors to become involved.

$452bn

in new cov-lite issuance was added to the global market in 2018

Source: Leveraged Data & Commentary unit of S&P Global Market Intelligence

Early engagement, and taking a constructive and creative approach, will be the key to maximising future recoveries. While human nature is to defer difficult conversations until strictly necessary, getting a seat at the table with the borrower and/or its private equity sponsor, rather than simply sitting there waiting for the doomsday scenario, is the best approach.

Improving the documents at this relatively early stage can enable a 'two-stage' restructuring to take place, with the credit improvements instituted in the first stage, allowing a sensible and collaborative restructuring to be put in place, if needed, at a later date.

Pressure on directors

One of the most well-trodden paths by lenders seeking engagement with a reluctant borrower is putting pressure on the borrower's board of directors, and reminding board members of their duties.

Directors' duties vary materially by jurisdiction, but many local laws have some form of trigger, ranging from the requirement for directors to act in the interests of the company's creditors, rather than its shareholders, when in the 'zone of insolvency' in England or compared to the compulsory insolvency filing rules that exist in Germany. Equally, it may be possible to take advantage of the differing rules on directors' duties across jurisdictions of companies in the borrower group, to put more pressure on the directors of certain guarantors. In particular, a reminder of the directors' personal liability, if applicable—civil and criminal, depending on jurisdiction and the action being taken—will inevitably have a more substantial impact.

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Early engagement with borrowers, coupled with lenders’ constructive and creative approach, is the key to maximising future recoveries

A period of 12 months is considered the ‘foreseeable future’ for going-concern sign-off

It would also be sensible for any reminder of directors’ duties to be coupled with an express reservation of rights regarding any conduct of the group that the lenders or bondholders consider inappropriate or potentially in breach of the debt documents. Lenders should ensure that such reservation of rights is as robust as possible.

Balance sheet insolvency test (if applicable)

A number of jurisdictions, including the UK, have a balance sheet insolvency test in their legislation, along with the more prevalent cashflow test. If the liabilities of a company exceed the value of its assets, the balance sheet test will deem that company insolvent. The laws of some jurisdictions, particularly in Europe, contain restrictions on the limitations on guarantees that can be given by a company, based on the value of their assets. However, these rules do not apply in all jurisdictions, which makes balance sheet insolvency more likely.

To some extent, this is a corollary to the directors’ duties, because directors’ duties only become relevant when a company is at least prospectively insolvent. If the borrower group has companies in jurisdictions with a balance sheet insolvency test, it may be helpful to increase pressure. In addition, the balance sheet insolvency test may be an event of default under the debt documents—in addition to the ‘cashflow test’ of whether a company can pay its debts as they fall due. Default based on balance sheet insolvency may be more palatable for lenders rather than, for example, material adverse change.

Audit sign-off

One clear red flag for lenders—and potentially an event of default under the debt documents—is the inability for any company in the borrower group to achieve sign-off by its auditors of its accounts, on a going-concern basis. A period of 12 months is considered the ‘foreseeable future’ for going-concern sign-off.

While this is clearly out of the lenders’/noteholders’ control, they should be aware of the timing and process. As it is management’s responsibility in the first instance to consider whether a going-concern basis is appropriate, any pressure that can therefore be brought by lenders/noteholders to show that the group will have cashflow issues and/or need to materially curtail operations in the following year will inevitably put pressure on the borrower/issuer group to engage.

MAC

Material adverse change (MAC) or material adverse effect (MAE) is the clause that no lender really wants to rely on to assert a default. It is notoriously difficult to prove what is ‘material’ in terms of the impact of the event on the borrower group, its ability to perform its financial obligations or the effectiveness of the lenders’ security package. However, if there are no other events of default available to lenders—not least because the covenants in the agreement are so ‘lite’ that they do not trigger a default—it may be worth exploring the ambit of the MAC clause. It may be possible, at least for the purposes of seeking engagement with the borrower group, to consider its usefulness, even if the lender group would still prefer not to call a default on the basis of a MAC clause alone.

With no ‘early warning systems’, lenders need to be proactive

While some commentators disagree on whether the market should be concerned about the prevalence of cov-lite debt, there can be no doubt of the very substantial amount of debt that has been written in recent years, with minimal ‘early warning systems’ for its financiers.

Will these cov-lite issuances run into trouble? It’s impossible to tell. But with the issuance of cov-lite debt at record highs, and the average issuers’ leverage at levels not seen since before the financial crisis of 2007/08, a market correction is likely. And when it happens, holders of cov-lite debt—whether bank debt or bonds—will need to be proactive to ensure that they maximise all available recoveries.

In the years leading up to the financial crisis—irrespective of the leverage in the system at the time—lenders had the benefit of the ‘early warning system’ of robust financial covenants. These covenants gave an indication of the troubles suffered by a distressed business and provided lenders with a clear route to a ‘seat at the table’ in restructuring negotiations. That benefit no longer exists in loan documentation.

Today’s lenders need to understand the debtor’s business, and be aware of the key commercial and legal pressure points available to them as leverage. Being proactive and organised will be crucial if lenders are to overcome the documentary deficiencies and achieve meaningful restructurings while avoiding material impairments.

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