Loan Covenants in a Borrower-Friendly Environment

The concept of a loan is a familiar one, an agreement between a borrower who needs money today and a lender who is happy to provide it and collect interest over the term of the loan. Most people are familiar with the borrowing side of the picture, be it for a mortgage, student loan, auto loan, or a personal loan of any kind. The other perspective, that of the lender, is important to consider for any who may be considering investing in senior loans.

For prospective loan investors, there are a number of concepts that may not be familiar to those who have only participated in loans as a borrower. One thing that investors should be aware of when evaluating an investment in loans is the status of the covenants: Are the loans structured with traditional maintenance covenants or are they considered covenant-lite?

Covenant-lite loans are a type of financing that is structured with limited restrictions on the borrowers. Traditional loans generally have protective covenants built into the contract to protect the lenders from borrowers taking certain actions which may negatively impact their ability to make their payments. Despite their reduced protection for borrowers and investors, the market has become increasingly borrower-friendly. In fact: covenant-lite loans now make up more than 75% of the ~$1 Trillion U.S. traded loan market.*

WHAT IS A COVENANT?

A loan covenant is a condition that requires the borrower to meet certain conditions, restricts the borrower from certain activities unless other conditions are met, or even forbids the borrower from taking certain actions. If a covenant is violated the loan may be declared in default or penalties may be applied to the borrower including the immediate repayment of the loan in full.

The purpose of covenants is to help lenders mitigate risks by placing limitations and restrictions on the borrower's ability to increase business risks and provide clear remedies for the correction of curing of these situations.

Visit cioninvestments.com
for more information.

* Cross, Tim. Covenant-Lite Credits Continue to Dominate U.S. Leveraged Loan Market. Forbes, 8 Feb. 2018.

TYPES OF COVENANTS

Maintenance covenants require borrowers to meet certain financial tests every reporting period, usually quarterly, regardless of any new debt issuance or similar activities. If a borrower's loan agreement contains a covenant that limits debt to cash flow but with a maintenance test instead of an incurrence test, the borrower could violate the covenant without increasing their debt if cash flows diminish sufficiently to break the specified threshold. When maintenance covenants are breached the borrower is brought to the table to have their finances re-evaluated by the lender and actions are taken to get the loan back on track.

Lenders and investors much prefer maintenance covenants because they provide an opportunity to create a "time-out" or take action in a situation requiring attention more quickly than incurrence covenants.

Incurrence covenants require that if a borrower takes a voluntary action such as taking on more debt, paying or increasing a dividend, or making an acquisition, they would need to do so within the bounds agreed to within the loan agreement. This would be measured by an incurrence test that, for example, may require the borrower to maintain a certain financial metric such as debt to cash flow ratio. The borrower would only be able to incur more debt if the debt to cash flow ratio on a pro forma basis for such incurrence was still within the limits set by the lender. If the borrower were to incur more debt to the point where they no longer fall within the acceptable limit of the ratio, they would be in default.

Incurrence covenants are typical of bonds but are also the type of covenants found in covenant-lite loans. For borrowers, incurrence covenants are preferred because of the increased flexibility that comes with less stringent restrictions on financial activities.

TYPICAL CATEGORIES OF COVENANTS

- Cash Flow: These covenants are used to measure excess cash generated by the business to service debt. The metric by which cash flow is measured is typically EBITDA.
- Leverage: Measured by the ratio of debt outstanding compared to cash flow. The amount of leverage a lender will agree to depends on the predictability of cash flow, projected growth of the business, or presence of secondary collateral.
- Liquidity: The liquidity of the borrower is represented by the sum of cash on hand, marketable securities, receivables, and inventory. These covenants are typically measured by balance sheet ratios like the current ratio or inventory turnover ratio.
- Net Worth: The measure of total assets versus total liabilities. Common covenants include minimum net worth, and debt to assets.

SUMMARY

Loan covenants are designed to offer lenders and loan investors a means of making sure the risk associated with a loan does not deteriorate over time, prior to maturity. The extent to which a covenant can accomplish this effectively depends on the way the covenants are structured into the terms of a loan. As investors evaluate potential investments in loans they should be aware if a loan features maintenance covenants, typically found in directly-originated and arranged loans, or incurrence covenants more commonly associated with bonds or covenant-lite loans.

To learn more please contact your financial professional.