THE Lead Left
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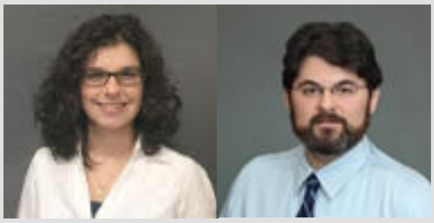
Lead Left Spotlight - Jessica Reiss and Justin Forlenza

This week we chat with Jessica Reiss and Justin Forlenza, attorneys with Covenant Review. Begun in 2006, Covenant Review is the world's first boutique research firm focused on bond and loan covenants.

Covenant Review



***The Lead Left:** It's been a while since we first featured Covenant Review. Give us an update.*

Justin Forlenza: We're an independent research firm, comprised of fifteen lawyers. Our focus is on credit agreements and bond documents as well as intercreditor agreements and term sheets. We provide analysis through our website in the form of research reports.

Jessica Reiss: We have a diverse customer base, primarily broadly syndicated loan investors, but also sell-side focused managers. We review terms from a covenant and legal perspective, and advise our customers on the risks. It's really about providing documentation ins and outs from a market perspective. It's also about weighing where terms are on the spectrum from aggressive to conservative. Our historical focus has been on large cap, but some are less than $100 million ebitda. We don't see as much in the traditional middle market, but we do see some in the $50-100 million range.

***TLL:** Do you have any plans to expand your research to the middle market?*

JF: Our mandate is mostly syndicated deals, but there's been some discussion about expanding to club type deals. That's in the initial stage of development.

JR: We have a bond group and a loan group. Justin and I focus on loans, along with about eight other lawyers. About the same number cover bonds. For bonds we cover every new high yield issue, except small or privately placed deals.

***TLL:** What's your typical issuance size?*

JF: Over $250 million. That's the overwhelming majority. We write up new issue and secondary deals that become interesting; for example, if something goes from investment grade to junk. We try to answer specific investor questions on credits. Also, we do event-driven reports, mostly on the bond side; say, if there's an acquisition that causes a change of control. Intelsat is one name with plenty of noise around it, with lots of loans and bonds and intercreditor issues. Valeant is another we've written a bunch of reports about.

***TLL:** What trends have you seen in covenants this year?*

JR: Market terms swung quickly from tightening at the end of 2015 and early part of this year, to the borrower-friendly terms we've seen recently. Deal volume is up, as is repricing volume. There were hung deals in October through December that ended up being funded by the arranger, and are now back out being marketed.

JF: Back then lenders could push back on incurrence tests, free and clear tranches were brought down, and ebitda-based grower baskets extended to 12-18 months. But the market has exploded since. We've seen fifteen to twenty term sheets in the last week or so, with pretty aggressive terms. That agents think they can go out with these is indicative of the market.

One good example is asset sales sweep language. In a mandatory prepayment from an asset sale, typically 100% goes to repay debt. Now we are seeing step downs to 50% subject to a leverage test, and even to zero assuming leverage falls below a certain level. The company used to have to reinvest in the business, but now can do anything with the cash.

***TLL:** Give us another hot covenant topic.*

JR: A real hot button is the sunset provision for MFN [most favored nation] treatment. That's the one that protects existing lenders from other debt getting favorable pricing. We're seeing that protection disappear in six months, which is pretty short; more typical is 12-18 months.

Most debt accordions [allowing lenders to increase the existing tranche] have either a free and clear basket based on a fixed dollar amount, or governed by leverage. Endurance International was a hung deal back in February. The accordion's MFN should have been triggered because the deal was funded at a discount, but that fee wasn't considered OID [original issue discount] – it was just a bad underwriting decision.

***TLL:** MFN is triggered if the company raises debt priced 50 bps from the existing debt.*

JF: That's correct. Lenders are always asking if prospective financings are subject to MFN.

JR: Another example of term erosion is something called "re-classification." For covenants and incremental debt facilities it's common on bond documents to have a ratio, for example, 2.0x interest coverage, above which the borrower can issue any debt. However, if the company has dollar-based baskets, they can go up those levels even if the interest coverage is less than 2.0x.

JF: The catch is even if the company has no access to the ratio basket, they can retroactively apply it later after they use it, and still have the dollar-based baskets free and clear.

JR: In the past two weeks, we've seen three deals where this has made its way into accordion baskets. Incremental debt under the credit agreement is ok, but if the company incurs side-car debt, you'll often have a different set of lenders. You don't know if they'll be on the same page with you. Incentives may not be aligned.

***TLL:** What's your perspective on covenant-lite loans?*

JR: It's a continuum. At one end is when both the RC and TL have maintenance covenants. Then the TL can have a springing covenant, in which the RC has a maintenance test, but it's subject to the RC being 35% drawn. If there's an ABL in the capital structure, the TL may not have a maintenance covenant.

If you're in the institutional tranche with a maintenance covenant, you get a quarterly test, but only for the RC. The TL gets some derivative protection, but TLs can waive a breach or call a breach on their own. You can't charge a fee, etc.

JF: If you have a maintenance covenant, there may be an indirect benefit to the company meeting their ratio, but you get dragged along with no rights. Of course, the borrower still has to deliver its financial statements and other obligations.

JR: Lack of maintenance covenants is not the worst thing. There are other flexibilities that go along with covenant-lite. For example, debt incurrence tests where they get more room. There are things under the company's control, such as incurring debt vs. having a covenant triggered because your cash flow falls below a certain level.

JF: It's a fact of aggressive markets that for broadly syndicated loans, those with covenants are suspect. It would be interesting to run recovery rates on covenant vs. cov-lite deals.

***TLL:** What are the hidden traps lenders should look for?*

JF: MFN protection has gotten a lot of attention. Not just for the accordion, but also other incremental debt. For example, permitted debt for acquisitions allows for additional pari passu first lien debt. The existing lenders did not get the benefit even though pricing was over the 50 bps test. If it's under the ratio basket, the MFN usually applies. Debt incurred under a sidecar applies. But under the permitted acquisition basket, the MFN isn't always there.

***TLL:** Why not?*

JR: No one noticed. We've seen it in a number of deals. Even with a sidecar, if it's a bond, you can do first lien secured bonds and the MFN won't apply.

JF: Or the company can call the incremental debt a "note purchase agreement" and since it's not technically a TLB, MFN won't apply.

***TLL:** How about the middle market?*

JF: We don't look at the middle market, but it depends on the sponsor. The large cap sponsors will push through large cap terms to smaller companies. Sometimes in the $50-75 million ebitda range you can't tell the difference between terms for a middle market borrower and one with $500 million ebitda.

TLL: What about the unitranche trend?

JR: We don't see a ton of unitranche. There was a big unitranche in the news recently; that one was the biggest we've seen. It's more a supply/demand dynamic.

JF: It's a very appealing product for the borrower; a blended rate and one lender. It's very convenient. Where it will go remains to be seen.

TLL: What's been the biggest surprise for both of you in terms of covenant trends?

JF: Things were decently steady in terms of a pipeline earlier in the year, but the last couple of weeks have exploded, especially going into the summer. That was very surprising to see.

JR: Is this the look of things to come? Or are we headed for a new cycle? We are certainly seeing more defaults. We've had a ton of questions on oil and gas bonds. Will they file?

JF: There's lots of money out there. It makes sense there's an uptick in refinancings and new buyout business. It does seem it could continue, but for how long? One month, six months?

About The Lead Left

Churchill Asset Management's exclusive capital market's publication, *The Lead Left* reviews deals and trends with a unique focus on the mid-market space and is read by thousands of influential industry participants.

- Original commentary backed by thirty years of capital markets experience
- Weekly interviews with top decision makers in banking, private equity, and credit investing
- Data and commentary from four of the leading global capital market research firms
- Detailed information on deals in the market
- Plus our popular Charts and Quotes of the Week

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Contact

Randy Schwimmer

Senior Managing Director, Head of Origination & Capital Markets

Churchill Asset Management LLC

T 212-478-9203

randy.schwimmer@churchillam.com