Lead Left Interview – Derek Gluckman

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This week we chat with Derek Gluckman, a vice president and senior covenant officer at Moody's. Derek is responsible for research on the Covenants team. He's been at Moody's since 2015. Prior to that he was a corporate attorney at Orrick, Herrington & Sutcliffe.

The Lead Left: *Derek, thanks for making time for us today. You've written extensively about covenants in the leveraged loan market. Give us some perspective on what that means at Moody's.*

Derek Gluckman: I sit on our covenants team. We have nine people globally, most of them in New York. Seven of our professionals focus on high-yield bonds, and two on leveraged loans. Our senior staff is made up of attorneys. We were outside counsels who in many cases helped negotiate these credit agreements and bond documents. I have to say this is a very unique role at Moody's.

TLL: *How are you different from Covenant Review or Xtract?*

DG: We provide something different. Our team sits in the corporate finance ratings division at Moody's which means we get to integrate our research with other teams including those focusing on general leveraged finance research, default and recovery research and liquidity analysis. We work together closely and talk a lot, and work with our corporate ratings teams as well. These resources allow us to offer a really unique research product that integrates many different views of the market. We also operate under a different time-frame. While our bond product reviews basically every rated bond at the time of issuance, we can't tackle every loan in the market and require financials for our review so we typically wait until the financials are filed, unless there is a concurrent bond offering available.

All of this gives us a unique perspective that other shops or banks can't put together. It's a better gig than being a lawyer.

TLL: *What kind of innovative things are you doing?*

DG: We've recently launched a Loan Covenant Quality Indicator. People are clamoring for this. We had a Bond Covenant Quality Indicator, so this brand extension makes sense. By this new measure everything we see is getting worse over time. We break loan covenant packages into seven separate risk categories. Each one is getting weaker, even relative to the pre-crisis peak in 2007.

Reading through those older credit agreements, there is no comparison to the current market. The difference is like night and day in terms of technology weakening credit protections. We will see two or three dozen carve-outs to a covenant now whereas we saw one dozen before. Some of these are boilerplate, but others are new areas for real borrower flexibility. It raises the question whether the asset you think you have is the asset you've really got.

What sets apart a first lien loan – the fact that it's the only debt in that class; that you're sitting on top of the capital structure with meaningful junior debt cushions; that you have financial maintenance covenants and other robust covenant protections – is all changing. Borrowers are incurring more *pari-passu* debt. They're allowing more asset stripping, moving collateral beyond the reach of secured lenders. Obviously covenant-lite structures are more prevalent. These are the features that had defined first lien loans, but if it doesn't walk like a duck or quack like a duck, you have to ask what it really is at the end of the day.

We meet with investors and they cite our recovery rates back at us, noting that first lien bank debt has recovered above 80% historically. But we say past performance won't be predictive of future performance where credit terms and capital structures are materially weaker than they were in the past. The more current loans differ from last-generation loans, the more investors will suffer in a downturn scenario.

TLL: *Is this all because of too much cash chasing too few deals?*

DG: Yes, too much cash looking for a place to go. It's a borrower's market. Spreads are compressed pretty profoundly. We get calls from investors allocating between loans and bonds, but these pressures are pervasive because there's so much money everywhere. It's impressive to see so many areas where this crops up. There seems to be no end in sight. The rise of dividend recaps, as one example. I think we'll continue to see structural erosions as a result of this dynamic.

TLL: *Do you examine all debt tranches?*

DG: Mostly first lien term loans; we don't see a lot of second lien loans that meet our criteria.

TLL: *What are the criteria for the loans you examine?*

DG: We look at North American leveraged loans, with term B tranches $500 million or more in size rated speculative grade by Moody's which are publicly available with public financials and reported EBITDA. So this includes some private equity deals but skews towards large public deals and we don't have a perfect sense of the private equity market. We don't generally look at the middle market.

To be continued the week of Jan 1

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