Lead Left Interview – Derek Gluckman (Part 2)

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This week we continue our conversation 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. ***Second of two parts –*** ***View part one*****.**

The Lead Left: What else has been catching your attention on documentation concerns?

Derek Gluckman: We look at things like incremental facilities, which almost uniformly now have both fixed dollar and ratio-based capacities. Increasingly, it's common to have a sub-limit of the incremental that permits earlier maturity dates than the loans. That's fairly unusual, or had been until recently.

Also, we see more backdating of builder baskets. In the refinancing-heavy universe we've been in, we have seen lots of builder baskets that don't bring down the builder basket start date. Builder baskets allow the accumulation of excess cash flow or consolidated net income which is set aside to make restricted payments, investments or prepayments of junior debt and the amounts remain available for the life of the loan. In the documents we see, the average builder basket start date precedes the (amended) document date by over two years, but that average masks a wide range. The problem with not resetting the start date is that if the loan is refinanced multiple times and the date isn't reset, there could be many years of accumulation which adds up to a lot of capacity over time. Lenders may wake up and be shocked. I don't see any commentary on this issue.

TLL: Do you also see excess cash flow recapture – subject to leverage – being impacted?

DG: Yes. Increasingly we see the ECF sweep stepping all the way down to zero % upon achieving certain leverage. More generally, in the world of loan/bond convergence that we're living in we see the ability to make any restricted payments, investment or prepayment of junior debt subject to compliance with a leverage ratio.

But the sweep step downs and all these broad covenant carve-outs are a function of debt to EBITDA, which is increasingly prone to management by the borrower both on the debt and EBITDA sides of the equation. A lot has been said about the increasing aggressiveness of EBITDA add-backs, but you don't hear people talking about cash netting as much. So far this year we have seen uncapped cash netting in nearly 80% of deals, and capped cash netting in another 10%. So none of these leverage calculations are using pristine EBITDA and debt numbers to determine leverage. And when leverage is the key to all of these capacities that unlocks everything in the credit agreement.

TLL: In the broadly syndicated market, my experience on the sell-side was that nobody read the docs.

DG: When I represented the agent bank as a lawyer, we didn't get many comments from other lenders. When I represented syndicate members the response was often "We're three times oversubscribed, but thanks for your feedback!"

TLL: What other surprises have you come across?

DG: We just published a report looking at restricted payments. We found that in 2015 the percent of loans that permitted any restricted payment, subject to compliance with a leverage ratio, was about 50%. That rose to around 60% in 2016. Year-to-date it's 95%. Even more shocking: of loans we have seen this year, 45% were for borrowers which had that feature and were already in compliance on the closing date. That means they can dividend all their cash (beyond what is required to maintain that leverage level via cash-netting) starting immediately. This doesn't seem ideal from a lender's perspective.

We have also looked at additional debt allowed immediately after closing and found that, on average, credit agreements permitted borrowers to incur an additional 3x of leverage immediately after closing. Bonds, as a comparison, permit as much as 6x additional debt on average at closing. While we don't think it is necessarily likely that borrowers would utilize all of this flexibility, or could always find additional investors who would lend into such a deal, these are significant concessions built into the documents making it harder for lenders to exert meaningful control over their investments. You have to ask, what is the all-in worst scenario? For example, with J. Crew no one expected to be stripped of the crown-jewel assets, but every new bit of flexibility is destined to be pushed to the limit by a company facing the right pressures.

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

DG: I understand sponsors' points in wanting operational flexibility. But that argument is true of every limitation in the document and has no logical end. Cov-lite is just the most visible marker of the erosion of many other terms. We just published a report showing that structural protections are correlated with absence or presence of maintenance covenants and highlighting that documents without maintenance covenants have materially increased weakness elsewhere, notably the debt and lien covenants. But is there any return for absorbing cov-lite risk? We're hard pressed to quantify it. Spreads are so compressed now, we don't see where you're getting compensated for weaker structures.

People say in the last downturn cov-lite fared better. The last downturn was abbreviated with Fed easing. But the next downturn could be longer. The elimination of the maintenance covenant eliminated a default trigger which is activated in the short term, allowing some borrowers to stave off default. If distress continues for longer in the next cycle, the borrowers who are under pressure will eventually default for some other reason. The cov-lite structure buys time and allows borrowers to spiral downward for longer while taking actions that may be detrimental to the lenders. Companies might be tempted to move assets to unrestricted subsidiaries and strip assets from secured lenders in order to raise new debt secured by those assets. Or borrowers could boost leverage temporarily through asset dispositions. If the cash proceeds constitute unrestricted cash borrowers can reduce net leverage and may be able to satisfy various leverage tests described above. With ever-lengthening reinvestment periods on such proceeds, and no other short-term pressures, borrowers have more time to organize and implement actions that may ultimately inflict pain on lenders.

TLL: Are we headed into a period of worse defaults and recoveries?

DG: Our view is that capital structures matter and will heavily influence outcomes. The absence of junior debt is going to hurt recoveries. One investor asked us, "Who cares if there's no junior debt as long as I'm fully secured by collateral?" which makes sense in theory, but not in practice. Having that loss absorbing cushion is critical. You don't meaningfully sit on top of the capital structure if there's nothing beneath you. And for the secured lenders this problem has been exacerbated by looser documentation which gives them less protection just when they need it most.

Institutionally we have a wealth of data analyzing default and recovery statistics, but we haven't tested our covenant strength measures through a downturn yet. Who knows when we're going to see it? I expect it will be ugly with lots of unpleasant surprises. But the Moody's liquidity stress indicator – the percent of credits having the weakest liquidity rating – is at an all-time low of 2.6%. The 12 month US spec-grade default rate forecast is at 2.1% for October 2018, compared to 3.2% today and well below the long-term average of 4.7%. We are concerned that when the cycle hits it’s going to be worse than people may realize, but we don’t know when that will be and don’t see evidence of that happening in the short term.

TLL: What’s the role of your team as far as investors are concerned?

DG: Our research is intended to be complimentary with all the other research Moody’s provides. Our covenant scoring is independent of debt rating, leaving the decisions up to investors as to which pieces of research are the most useful. Everyone’s positioned a bit differently. Everyone has to decide for themselves how to use the information we provide.

TLL: Last question, Derek. What’s been the biggest surprise of the year for you?

DG: I am surprised by the steadiness of the trend in declining covenant quality. I shouldn’t be, at this point, but I feel like the story has been the same for years now as investors compete to get into deals and terms keep getting weaker. And based on our near-term forecasts there is no obvious catalyst for a change.

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