Lead Left Interview – Jessica Reiss and Kerry Kantin

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This week we chat with Jessica Reiss, the head of leveraged loan research at Covenant Review. Also joining the conversation is Kerry Kantin, a managing director covering leveraged loans at sister company LevFin Insights. Begun in 2006, Covenant Review is the world's first boutique research firm focused on bond and loan covenants. LevFin Insights provides news and analysis covering the debt capital markets including leveraged loans, high yield, secondary trading, CLOs, middle market and BDCs.

The Lead Left: *Jessica and Kerry, thanks for joining us. It was almost exactly two years ago that we did our first Covenant Review spotlight. The focus on covenants – or lack thereof – has only intensified. Being two years further along in the business cycle probably is a factor. What kind of trends are you seeing?*

Jessica Reiss: Thank you for the time, Randy. Yes, we're seeing all sorts of indicators. For example, the typical 365-day period to allow sale proceeds to be reinvested into the business is sometimes being stretched to 24 months. It feels like the base reinvestment period in that case is eighteen months, with a six-month extension if there's a commitment to reinvest. That's prevalent for well-regarded firms.

Also, we're seeing a first-lien leverage calculation based on debt security by a first-lien on collateral assets, which is not new but has become more common. Now, though a few deals have included language that says that to count towards the calculation, the debt may not be subordinated in terms of security or in right of payment. This begs the question of whether debt that is first lien secured but last out in right of payment would be picked up by a first lien leverage calculation. It's become my soapbox issue.

TLL: *Are attorneys trying to thread the needle on this?*

JR: I believe it's drafted that way. They are being deliberately ambiguous at times. That way they can have room to maneuver down the road.

TLL: *What else are you seeing? Anything unique?*

JR: On the M&A front there was one transaction structured as a two-step process. First they planned to refinance, then enter into a merger. The baskets will be reset at the second stage (even if the company previously used capacity). With a straight amendment there's no resetting.

For example, you have existing financing plus, let's say, $50 million in incremental term loan debt for a dividend, but pro forma for incurrence, they're widening the all of the baskets. On top of that, any amounts utilized before the second stage are unaffected and essentially grandfathered in. The baskets are all refreshed and the company gets all that capacity back again.

TLL: *We have heard that portability is making a comeback. Could you explain what that is and what the nuances for lenders are?*

Kerry Kantin: Portability isn't common, but we've seen an uptick. There were actually two issuers this week, companies that were sold in which the incoming sponsor is using the portability.

The idea is straightforward. Lenders can offer a financing structure to a buying private equity sponsor that can be passed along to the next buyer without triggering a change of control provision in the credit agreement. Providing the borrower meets specified parameters, a new private equity owner can assume the position of the existing owner.

TLL: *Have these deals been more frequent of late?*

KK: At LevFin Insights, we saw nine portable deals last year. So far this year, there have been at least nine more.

TLL: *Are there provisions governing what the new sponsor looks like?*

KK: Each deal, not surprisingly, is different. You could, for example, require that the purchasing sponsor have a minimum fund size, say $1.0 billion. Additionally, there are provisions stating a change of control must occur within a certain period of time after closing the initial deal.

Finally, typical terms include no event of default existing at the time of the new deal, leverage must be no more than the existing structure, and a minimum equity contribution.

JR: There is a lot of variety in the parameters we've seen on portability. It's really difficult to say what is or isn't market. In some cases, it's almost as though anything goes. Assuming the deal sells.

KK: Lenders are often protected in two ways. First, to keep the creditworthiness of the borrower no worse than it is today, and second, to have some requirements around the new owner. Within those parameters, though, there's a spectrum of outcomes.

For example, the sunset period during which the change of control is permitted can be anywhere from one, two or three years, to forever.

TLL: *And I'm sure the envelope is getting pushed on all the portability terms.*

JR: Yes. One example of that is portability typically can only be used once. We're seeing the option of using it more than once.

To be Continued the Week of July 16

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