Leveragin' Loans

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So much that was disturbing about the news last week. Social media was abuzz with opinions flying on both sides. Twitter was filled with long-submerged memories of crazy times hanging out at…everyone's favorite orange-and-red java shops.

We're referring, of course, to the decision by Dunkin' Donuts to drop "Donuts" from the brand name. In today's world of streamlined consumer marketing, the move was not wholly unexpected. In the same way that "Starbucks" jettisoned "Coffee" back in 2011, the donut king looks to enhance its image as selling more than…well, donuts.

Somewhat more curious was Weight Watchers announcing its shrinkage to a skinnier "WW." Board member Oprah Winfrey (who knows a thing or two about last name dropping) said: "The role WW can play…goes far beyond a number on the scale."

Coincidentally, WW was also featured in this month's issue of Creditflux. Our fellow columnist, Tom Majewski at Eagle Point Credit, noted that Weight Watchers, as a leveraged borrower and public company (WTW), may have avoided a payment default because of its absence of a maintenance covenant. How did that work?

Turns out it has to do with CLO mechanics. Roughly two-thirds of leveraged loan buyers in the broadly syndicated market are CLOs. Because those loans are liquid, managers can readily buy or sell depending on their appetite for a given name. Loan values depend on their prices, which vary based on the market's view of performance.

Three years ago Weight Watchers went through a turbulent financial period. Its loan prices plummeted to distressed levels. Had there been a leverage test, it likely would have been breached. Secured lenders would then have sought remedies to improve their position. Under some restructuring scenarios, CLOs in the lender group might have been forced to "crystalize" losses at the lower prices.

Since there was no test, that was avoided. The company recovered, its loans traded back up to par, and (as long as you held on) losses were avoided.

Because of the active secondary market for large liquid names, current lenders in the credit may be very different from the borrower's original list. A mixed bag of loan buyers brings disparate objectives in a workout. Some may have come into the deal at 99, while others at distressed prices. The latter group is incented to sell at any price above their entrance cost, while the former will hang on for the long haul to get out at par.

Middle market issuers have far fewer lenders in the group. Those lenders are often sponsor relationships whose incentives are aligned with the owner and each other. Everyone has the same goal: work together to sustain credit and equity value.

Covenant-lite loans may work when keeping opportunity funds from interfering with the company in a stressed scenario is a good idea. But with smaller companies, that plan doesn't work. Their lack of both scale and access to capital markets requires more hands-on support. In that case, dropping the “lite” from “cov-lite” is a better idea.