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Search and Recovery (Third of a series)

THE LEAD | November 13, 2018

Continuing with our special series on leveraged loan recoveries, let's turn to one of the most pondered questions on the subject; namely, how will covenant-lite loans fare in the next downturn?

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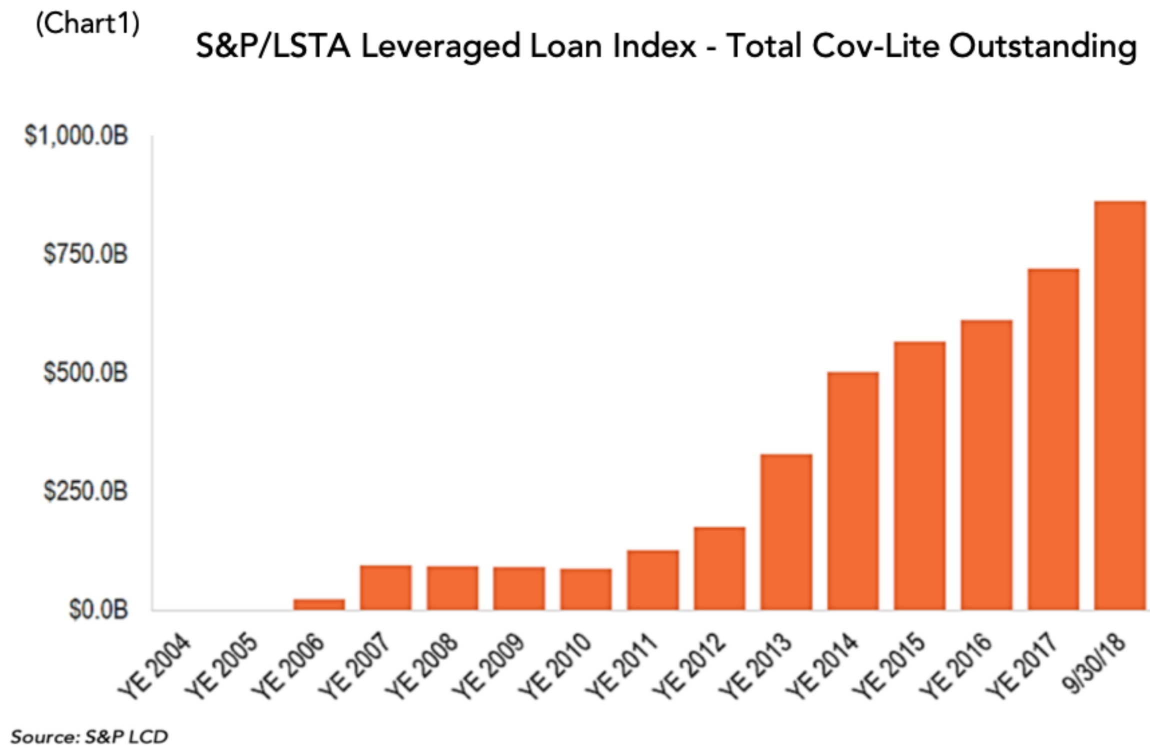
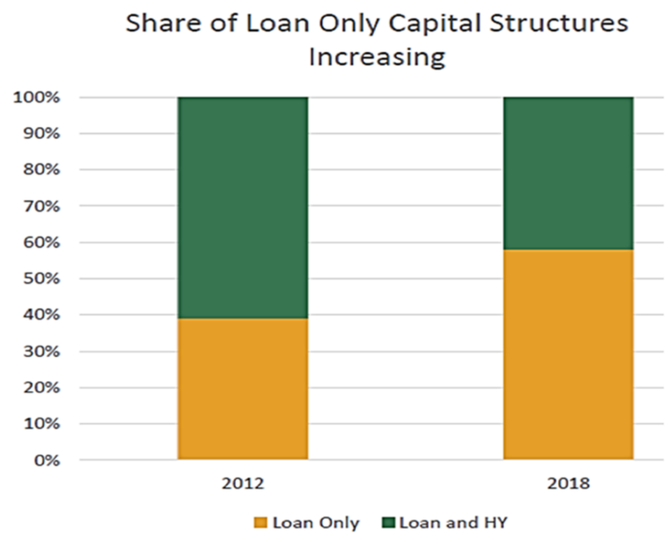


credit crisis.

Today the vast majority of liquid loans are cov-lite. Defaults overall have been relatively scarce during this nine-year economic recovery. Cov-lite defaults even scarcer (see *Chart of the Week*). While cov-lite was applied to only the best credits in the early stage of the post-crisis period, it appears that qualification has slipped.

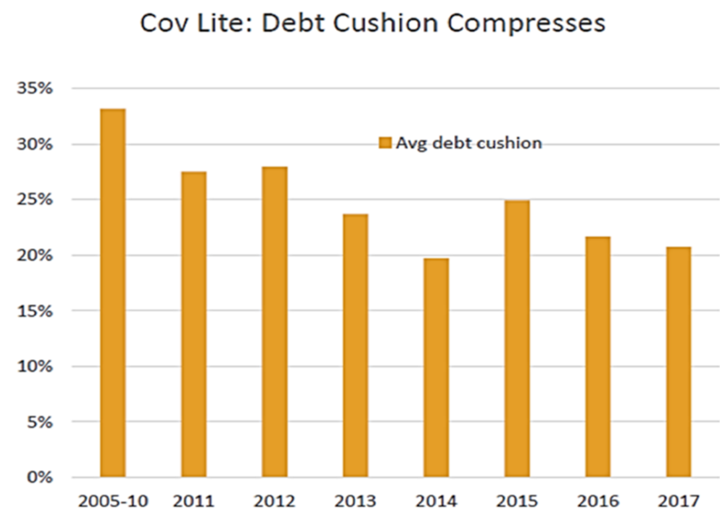
In the broadly syndicated market, the share of loan-only deals has grown since 2012 (Chart 2). Without bonds underneath them, loan holders are at risk for lower recoveries. Not surprisingly, then, that the debt cushion below cov-lite loans is also shrinking (Chart 3).

(Chart2)



Source: LSTA

(Chart3)



Source: LSTA

It's challenging to extrapolate from such limited historic data points on cov-lite defaults to predict what the future will hold in a downturn. Sponsors argue that allowing borrowers maximum freedom from lender interference preserves recovery value. But as all-senior leverage increases, cushions shrink, and terms weaken, will managers regret not having more control when borrower performance slides?