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Covenants in the Coal Mine (Last of Two Parts)

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The onset of renewed market volatility last week reminded credit participants that exogenous events do impact prices and new issuance, though to differing degrees.

Broadly syndicated loan and high-yield bond markets both saw price declines in secondary trading. But new junk issuance slowed to a crawl after the Brexit vote, while loan activity continued uninterrupted.

This divergent behavior is unsurprising. High yield investors, knowing their assets are unsecured and set at a fixed interest rate, are more sensitive to both rate and recessionary expectations. This was certainly borne out by cash exiting from retail funds last week – around $1.6 billion, according to Lipper.

The loan market, featuring senior secured, floating rate instruments, tends to soldier on despite market hiccups, albeit at costs to spreads and structures. Because the impact of Brexit looks to be fairly limited in the US, at least in the short-run, loans have recovered more rapidly.

Where observers expect more of a pushback is with edgier credits and aggressive dividends. In part this is due to the still uncertain market capacity as seen by sell-side arrangers. As we quoted one top syndicator last week, "Volatility clouds visibility."

There is also concern about the risk of a slowing economy Brexit may have hastened. Although the drag on the US is expected to be minimal, economists worry that global growth, hardly robust at the moment, could melt away over the next year.

All the more reason that the buy-side has been cautious about broadly syndicated loan structures, particularly covenants. As our experts from *Covenant Review* pointed out in their two-part interview with us [link], the focus has been on deterioration of such features as MFN sunset provisions and debt incurrence baskets.

For the middle market, covenants are a given. During periods of froth, large cap bank debt arrangers will try to sneak in a covenant-lite transaction here and there, particularly for issuers around $50 million ebitda. In general, though, smaller borrowers have at least one maintenance financial covenant. Indeed, as our *Chart of the Week* shows, almost two-thirds of middle market loans have two or more such covenants.

Experienced managers of middle market loans tell us that quality, more than quantity, determines the strength of a covenant package. "Sponsors are still pushing the envelope,'' one says. "I worry most about ebitda adjustments. The debt-to-ebitda test may look like tight, but if the ebitda definition is fluffy, the cushion is actually wide."

Another lender agrees. "I'm less worried about a recession scenario than I am about integration risk. If the borrower isn't executing on cost reductions, a good leverage covenant can catch it. Same with expected synergies. Neither is growth-driven."

Like the proverbial canary in the coal mine, covenants are good early warning systems for lenders. It looks like Brexit will keep them front and center for a while.