ZAIS Insights

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ZAIS Group

Yes, Financial Covenants are Important – But HOW Important?

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"The more things change, the more they stay the same." - Jean-Baptiste Alphonse Karr

Credit agreement terms will continue to evolve.

We at ZAIS, like many leveraged loan managers, are monitoring the erosion of financial covenants. However, we also want to caution that investors should not overweight their covenant-lite ("Cov-lite") concerns and lose sight of the merits of sound fundamental analysis, diversification and active portfolio management. At the end of the day, credit agreement terms will continue to evolve, and CLO managers will have to adapt to that environment. The leveraged loan market is cyclical, and we believe terms will likely continue to swing back and forth, over time.

Financial covenants did not completely alleviate excessive leverage, industry cyclicality, poor management or any of the other reasons why companies fail.

While, in the past, there were fewer lenders participating in this market, and credit agreements were more tightly written, loans still defaulted. Financial covenants did not completely alleviate excessive leverage, industry cyclicality, poor management or any of the other reasons why companies fail. Recovery in the event of a default was (and still is) based on a senior secured lender's uppermost position in the capital structure, with a claim on assets ahead of all other lenders.

The existence of financial covenants does not, in itself, correct a lending mistake.

Does a lack of financial covenants really matter to a senior secured lender? On balance, yes; we would rather have them than not, but their value can be overstated. First, as noted above, the existence of financial covenants does not, in itself, correct a lending mistake. A covenant breach gives lenders the opportunity to gather additional information and improve their economics by, for example, negotiating economic or non-economic improvements to the credit agreement, among other such actions. But, lenders do not step into the shoes of management and generally do not make business decisions.

A Cov-lite loan may allow a company to operate with less market "noise", giving management more breathing room.

A covenant breach can be a warning signal, not just to lenders, but also to suppliers and customers (since a company will then be in default). Concern can lead to tightened vendor terms or loss of customers, and can be enough to tip a company over the edge, potentially resulting in an actual insolvency or bankruptcy situation. This is particularly true these days, when any information, real or rumored, is rapidly and broadly disseminated into the market. A Cov-lite loan may allow a company to operate with less market "noise", giving management more breathing room.

Second, with the wide dispersion of loans amongst many types of investors these days, getting a non-technical amendment approved is no easy task. Lenders may have disparate agendas and consensus is harder to achieve. It must also be said that, in some cases, a troubled situation may improve over time. In these situations, allowing business conditions to evolve, or management actions to take effect, may lead to recovery in a credit without the need for significant bank group intervention.

The eradication of financial maintenance covenants is just one element in a trend of generally weaker protections for secured lenders.

The eradication of financial maintenance covenants is just one element in a trend of generally weaker protections for secured lenders. Senior secured lenders are still (or should be) the uppermost class in a company's capital structure. Therefore, we would be more concerned about any weakening of terms that are designed to maintain value to the senior secured lenders. This would include weak additional indebtedness clauses and restricted payments baskets. As we have seen in a number of recent situations, the implications of loosely written credit agreements can be hard to predict ahead of time, as they will be dependent on the whims of the borrower or sponsor, both of which would have a say on credit terms and other conditions, should there be a default.

ZAIS continues to view credit selection as the key factor in investment decisions. We look for companies with stable, defensible business positions, ideally in non-cyclical industries. Relatively moderate leverage; sustainable, positive, free cash flow; and a meaningful level of equity or junior debt below us are other important factors.

Our Leveraged Finance team is wary of situations that include excessive leverage, first lien-heavy capital structures, earnings that appear temporarily inflated or are subject to significant cyclicality, and credits where the borrower's ability to service its debt requires substantial cost savings, synergies or new earnings streams. We focus on the difference between stated EBITDA and the actual cash available after interest and capital expenditures. We also believe that acting on early signs of trouble, where possible, is advisable; in our experience a quarter of "temporary underperformance" is often followed by another disappointing quarter.

> Continuously monitoring credits, knowing each credit in a portfolio, and actively managing the portfolio are key.

Our approach comes down to credit process and execution, and, just as important, continuously monitoring credits. Knowing each credit in a portfolio, being deliberate in buy decisions and actively managing the portfolio may mitigate the risks of Cov-lite loans in the next downturn. Diversification will also play a large role, as we see much overlap among CLO portfolios. Managers who can be strategic about purchases and closely monitor each credit will have a better sense of risk/return attributes, and whether they have adequate protections in place.

Summary

In summary, while the nature of loan terms may change, not always in the lender's favor, the principles involved in making a good loan investment decision will remain the same.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com.

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