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CREDIT MARKET INSIGHTS // Q2 2019

Implications of the Growth in Covenant-Lite Loans

Introduction

The growth in covenant-lite (“cov-lite”) issuance in the loan market is a common subject of discussion in the financial world today. The most common concerns are around the level of cov-lite issuance and its impact on future defaults and recoveries. This is something that our team discusses on a consistent basis, so we felt it would be helpful to share some of our thoughts on the subject. Below we will discuss the evolution of covenants in the loan market, the emergence of cov-lite loans, our view on default and recovery impact, and how we are incorporating covenant analysis into our research process.

The Evolution of Covenants in the Loan Market

Entering the Global Financial Crisis (GFC), over 80% of the loan market was considered “covenant-heavy.”¹ Specifically, covenant-heavy loans featured maintenance covenants, or financial covenants that are required to be tested on a periodic basis. These include tests of leverage, interest coverage, and capital expenditures, among others. Prior to the

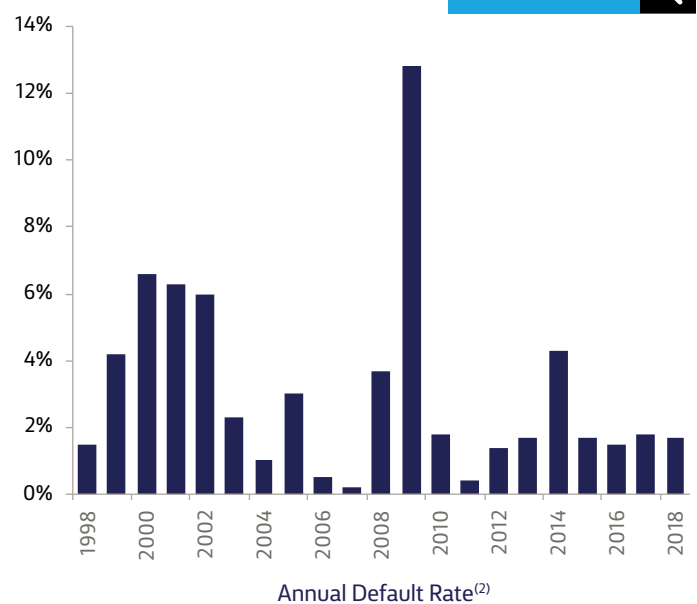
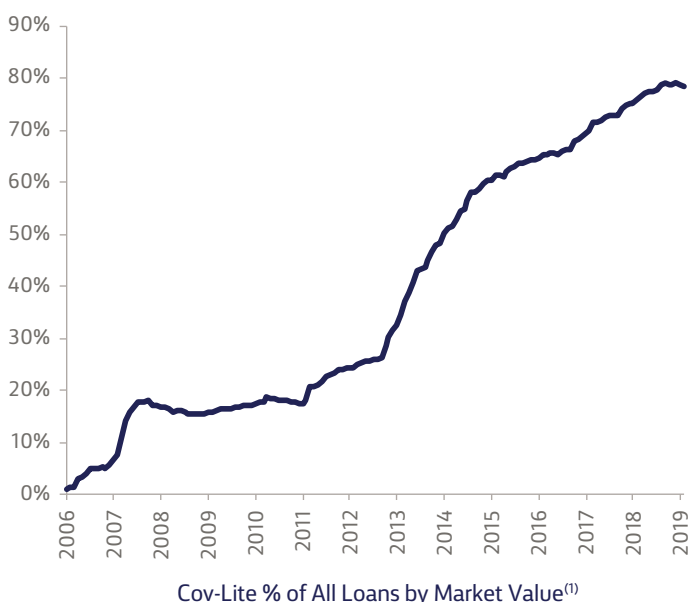
early 2000s, lending in the US was more of a bank-centric market, and banks have historically been more conservative in their lending practices. At the same time, most issuers then tended to be smaller, privately held companies with limited sources of capital. Therefore, lenders were likely to require these maintenance covenants to provide recourse in the event a borrower faced financial troubles.

Counterintuitively, it is our view that covenant-heavy lending agreements actually triggered a higher total default rate during the GFC. The existence of covenants created multiple near-term triggers that could push a company into a restructuring. Of course, there were myriad factors driving defaults in this time period, but in many instances a maintenance covenant test was tripped, meaning there were likely some borrowers that could have survived with more runway. As shown in the exhibit below, US loan market default rates peaked in 2009 at 12.8%.²

Since the GFC, the loan market has changed in several ways. For one, there has been substantial growth in two segments of the market: 1) unlevered institutional and retail capital and 2) collateralized loan obligations (CLOs), which make up approximately 50% of the ownership

TITLE OF EXHIBIT

EXHIBIT 1



1 Chart data as of February 28, 2019. Source: LCD, an offering of S&P Global Market Intelligence.

2 Source: Courtesy of J.P. Morgan Chase & Co., Copyright 2019. Chart data as of December 31, 2018.

base of leveraged loans today.³ These two buyer segments took market share away from banks, which now hold only a fraction of outstanding loans. Second, on the supply side, LBO sponsors began to prefer the use of loan-only capital structures to finance buyouts, which fueled growth and pulled market share from high yield. The growth in private lending and business development companies (BDCs) also added to this trend by providing dedicated capital for other junior capital solutions, such as second lien loans. Lastly, as loan issuance expanded and the size of issuers increased, a deep secondary market developed. In other words, lenders are able to control risk exposure through a secondary sale, which would have been difficult several years ago. All of these factors contributed to the growth in cov-lite issuance. Today, cov-lite structures comprise nearly 80% of outstanding loans and have become standard within the US institutional loan market.⁴

We believe this has a few direct implications for how the next cycle will manifest itself:

- **Importance of viewing the credit agreement holistically:**
In our view, reviewing documentation to ensure collateral remains pledged to term loan holders is one of the most important diligence items. We believe restricted payment provisions, incremental debt baskets, subsidiary terms and a few other clauses matter the most in preserving value to lenders.
- **Going forward, recoveries in first-lien loans will likely be lower than long-term averages and more similar to secured bonds:**

We expect recoveries will be lower through the next credit cycle. We believe historical secured bond recovery rates are a decent proxy and similar to the values we have seen for first lien loans from 2015-2018..

- **We expect overall defaults will be lower given fewer companies will have covenant-based triggers to enter bankruptcy:** The result will likely be a binary default and recovery pattern – some companies will survive that otherwise would not, while others will delay an inevitable outcome, possibly leading to lower recoveries.

We will review each of these views in further detail.

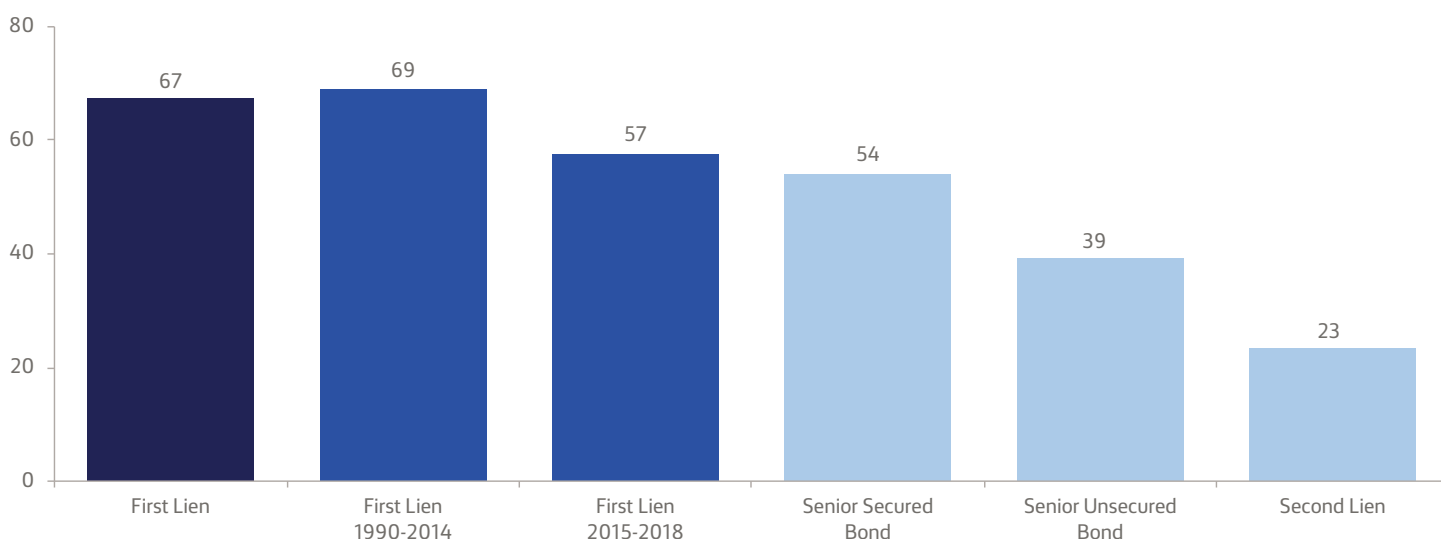
Preserving Value to Lenders: The Importance of Limiting Collateral Leakage

While our first focus remains on our fundamental view of credit at an issuer and industry level, an almost equally important aspect of diligence is our review of loan documentation and lender protections. We begin our analysis with an evaluation of expected company behavior. While it is situation dependent, below is a sample of the questions and issues we consider when evaluating documentation.

- What is the company ownership base? If public, has the issuer stated leverage goals to the market? Has the company proven deleveraging historically?

LONG-TERM RECOVERY RATES ⁽⁵⁾

EXHIBIT 2



³ Data as of December 31, 2018. Source: Wells Fargo Securities.

⁴ Source: LCD, an offering of S&P Global Market Intelligence.

→ We favor management teams which have demonstrated history of managing leverage profile through a cycle

- What is the company's management or growth strategy? Do they plan to be acquisitive? → If so, this has direct implications for incremental leverage provisions.
- Are divestitures imminent? Are portions of the business logically severable? Who are the buyers, what is the timing and what are expected proceeds?
→ Restricted payment provisions are even more important in this scenario.
- What percentage of revenue, EBITDA and assets are in the guarantor package? Is international growth an important part of the company strategy? How may the static picture change over time?
→ We strive for the highest percentage of assets and profitability to reside within the collateral package.
- International subsidiaries pledge lower levels of collateral due to tax restrictions so can reduce recoveries if there are large unsecured claims.

We believe it is important to prioritize documentation asks in negotiations based upon company specific factors. During the approval process, we discuss what terms are required for our participation and convey those to the banks. If we do not receive them, we do not participate.

An Evaluation of Recoveries: What Have we Learned From Recent Years?

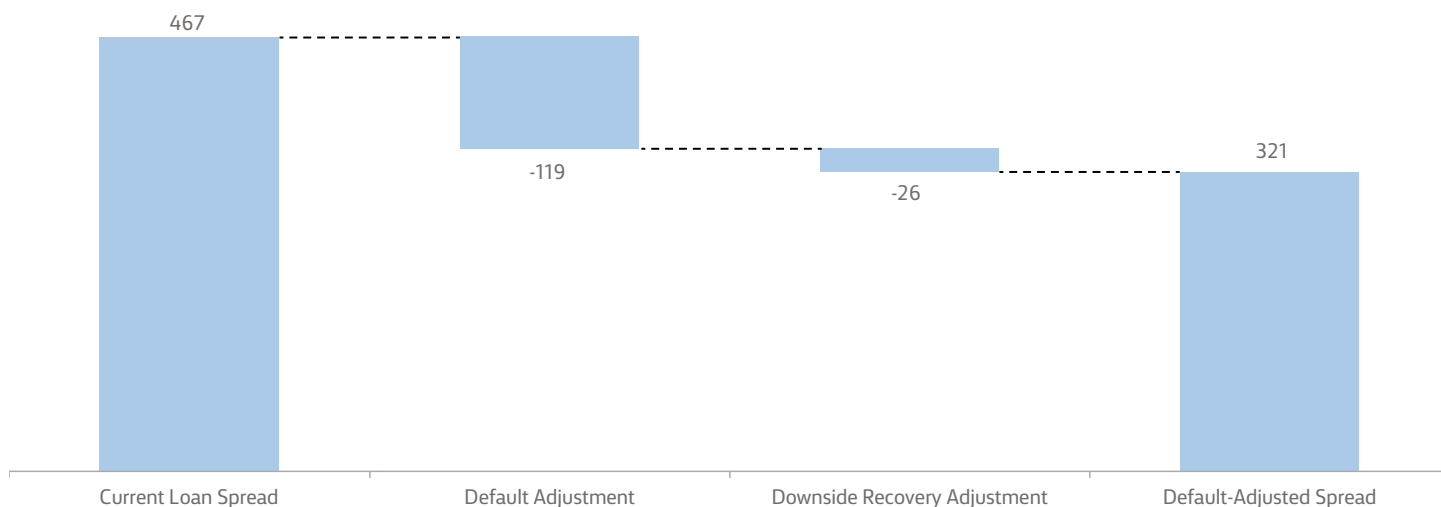
It is difficult to quantify the exact impact of weaker documentation on loan recoveries. Moody's and Barclays both have attempted to quantify the impact and estimate a range of 4-15 point lower recoveries, which we believe are reasonable estimates. That said, we believe that part of this impact may have already been priced into recent defaults. As depicted in the graph below, long-term recovery rates for senior secured loans averaged 69 cents between 1990 and 2014, though in recent years (2015-2018) it has dropped to 57. This is similar to the historical long-term average recovery for secured bonds of 54 cents. This makes sense since a secured bond, while a different type of instrument, is a debt obligation secured by collateral but lacking covenants, which is akin to a cov-lite senior secured loan. In a sense, we can use secured bond recovery rates as a reasonable proxy for future recovery expectations for cov-lite first-lien loans. In addition, we believe that secured debt will continue to recover higher levels than unsecured bonds given the lien on assets; therefore, we can infer a quasifloor for secured loan recoveries above the long-term recovery rate for unsecured bonds, which has averaged 39 cents.⁵

While a 10-15 point lower recovery may sound like a significant impact on the market, it is important to keep it in context. First, if it is true that first-lien loan recoveries are lower in the next cycle, it is also likely that junior capital (unsecured high-yield bonds and second-lien loans) will also be lower. Second, in order to compensate for potential lower recoveries investors would require higher spreads. Assuming recoveries move in line with the long-term secured bond average, it would result

⁵ Source: Courtesy of J.P. Morgan Chase & Co., Copyright 2019. Chart data as of December 31, 2018. Shows annual average recovery rate from December 31, 1990 to December 31, 2018 for First Lien, Senior Secured, and Senior Unsecured and December 31, 2008 to December 31, 2018 for Second Lien. Recovery rates are issuer-weighted and based on price 30 days after default.

DEFAULT-ADJUSTED LOAN SPREADS (bps) ⁽⁶⁾

EXHIBIT 3



in a 26 basis point incremental decline in default-adjusted spreads as shown on the following page. This is not an immaterial adjustment, but we believe the market can digest it with ease.

Finally, in any given period, only a small percentage of the market is in default or approaching default. In the 10-year period of 2008-2017 the average annual default rate according to JPM was 3.1%, including 2009, a year with a 12.8% default rate. In other words, there is a deep pool of issuers in which to invest with lower (but not zero) probabilities of default. Beyond maintenance covenants, there are other covenants and protections (e.g. limitations on restricted payments) found within credit agreements. At the time of our underwriting, understanding these other covenants is a key element that goes into our overall decision on whether or not to lend money to a particular issuer.⁶

What Factors May Offset Lower Recovery Rates for the Market?

There are other factors which could help offset lower recovery rates in the next cycle:

1. Lower overall defaults – we believe the lack of covenants will reduce the number of issuers who enter bankruptcy. While the duration and severity of the cycle will matter, liquidity events, unsustainable cost structures and other more tangible factors will be the primary drivers of the decision to enter bankruptcy.
2. Issuers may trade at a discount for longer while distressed. This will present trading opportunities if investors are able to identify the right companies in the right industries. Understanding distressed dynamics in the secondary market will be key in building par and capitalizing on total return opportunities in the asset class.
3. The actual recovery may differ over longer periods of time. Also, it is important to point out that there are various methodologies in calculating recovery rates. The analysis above is sourced from J.P. Morgan, which calculates recovery as the market value 30 days after default. We believe this is relevant for historical analysis purposes, but in practice the true recovery may not occur until several months after the default. The ultimate recovery will depend on longer-term company performance trends and industry fundamentals.

Conclusion

As a manager of loan portfolios and CLOs, we are well aware of the growth in cov-lite issuance and its potential impact on defaults and recoveries. Cov-lite has become standard practice in the market, which we believe will reduce recoveries in the future, but may also lead to fewer companies defaulting. Importantly, we have long considered document analysis a key component of our investment process alongside fundamental research. We believe combining these two elements is the best strategy to minimize defaults and maximize recoveries. This is especially imperative today given we believe we are late in the credit cycle. As such, we are paying close attention to documentation during the negotiation process and managing more diverse portfolios with smaller positions in riskier credits. We believe this is a sound approach to risk mitigation and also enables us to be opportunistic in times of volatility.

⁶ Data as of March 31, 2019. Market spread data shows the Credit Suisse Leveraged Loan index. Default adjustment and downside recovery adjustment courtesy of J.P. Morgan Chase & Co. Default adjustment for loans assumes 3.1% default rate and 63.6 recovery rate since 1998. Downside recovery adjustment assumes loan's recovery rate is equal to the long-term senior secured bond recovery rate.

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