An Examination of the Value of Covenant Lite Debt to Issuing Companies

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I. INTRODUCTION

The economic boom that peaked in the first half of 2007 was marked by seemingly limitless optimism. Academic reflections and criticisms frequently point to such representative examples as Tishman Speyer Properties' $5.4 billion purchase of Stuyvesant Town and Peter Cooper Village or the perplexing ratings of collateralized debt obligations. Another fascinating, albeit less frequently discussed, illustration of financial exuberance was the rapid escalation of first-lien covenant lite loan issuances and the corresponding valuation by secondary-market purchasers. For example, in May 2007 the average bid price for covenant lite leveraged loans was within 0.01 cents of the average bid price for all other first-lien leveraged loans, indicating that secondary-market investors attached essentially zero value to the existence of maintenance covenants.[1]

Of the literature that does exist with respect to covenant lite loan issuances, much of it contemplates the topic from the perspective of the lenders (banks). This paper will attempt to present the opposite point of view and identify four potential sources of future value that first-lien covenant lite debt provides to the borrower: (1) the value of eliminating interest ratcheting and forbearance fees to waive maintenance covenant violations; (2) the opportunity for the borrower to repurchase covenant lite debt at lower prices than if it had issued traditional first-lien debt; (3) the ability to delay bankruptcy and the associated restructuring costs; and (4) the opportunity to extend the above advantages by means of debt reinstatement. In order to mitigate the abstractness of the topic, this paper will examine two hypothetical companies that received debt financing in early 2007: one which procured covenant lite first-lien bank debt and the other whose bank debt featured traditional maintenance covenants. We will assume that each

[1] "Average Bid of Leveraged Loans." Chart. *Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index*. Standard & Poor's Financial Services LLC (S&P), 2009.

company's financial performance fell outside levels specified by the latter's covenants at the end of 2008.

II. BACKGROUND

II.1 What is First-Lien Covenant Lite Bank Debt?

Broadly speaking, a loan of this nature can be broken down into three points of characterization: (1) bank debt, (2) first-lien, and (3) covenant lite.

Bank Debt: As its name suggests, bank debt is a form of debt financing in which a banking institution is the lender. Bank debt facilities are comprised of a term loan, a revolving credit facility, or some combination of the two.[2] The entirety of a term loan is funded upfront, with payments of principal permanently reducing the balance.[3] Term loans typically amortize over the life of the loan, requiring the borrower to pay off principal (in addition to interest) at an agreed upon schedule. Frequently, term loans only partially amortize so that there remains a significant principal balance (a balloon payment) due at the end. At this point, the borrower can choose to pay off the remaining principal with its own funds or refinance the loan with new debt. A revolving credit facility, on the other hand, lacks a defined repayment schedule. Revolving credit facilities are "generally structured to finance the borrower's working capital needs."[4] Draw down, or the maximum borrowing potential, at any given point is typically defined by a borrowing base formula which takes into account the liquidation value of the collateral and is capped at the maximum borrowing capacity stipulated by the loan agreement.[5]

First-Lien: First-lien debt is the most senior security in a company's capital structure. While there are specific exceptions, the absolute priority rule generally dictates that in the event

[2] Moyer, Stephen G. *Distressed Debt Analysis: Strategies for Speculative Investors*. Boca Raton, Fla.: J. Ross, 2005. 306. Print.
[3] *Id.*
[4] *Id.*
[5] *Id.*

of a bankruptcy, creditors receive payment for their claims in accordance with the seniority of the securities they hold. That is, first-lien bank creditors receive payment in full prior to second-lien creditors, unsecured creditors, and equity shareholders receiving any payment. By definition, first-lien debt is secured by all or some of a borrower's assets. The credit agreement specifies which assets serve as collateral for the debt.

Covenant Lite: Covenants refer to the contractual obligations in the credit agreement that set forth specific standards of future conduct and performance for the borrower.[6] Affirmative covenants require that the borrower take certain actions or meet minimum performance levels while negative covenants prohibit the borrower from taking certain actions or exceeding maximum threshold levels.[7] Although covenants may cover everything from compliance with laws to maintaining insurance,[8] this paper focuses on financial covenants – those covenants which dictate minimum and maximum financial performance levels.

Financial covenants can be further broken down into maintenance covenants and incurrence covenants.[9] Maintenance covenants are financial covenants that must be met on an ongoing basis throughout the term of a loan (e.g., quarterly) while incurrence covenants are only effective if and when the borrower performs a specified action (such as increases debt or acquires another company).[10] Standard & Poor's defines covenant lite loans as those which feature incurrence covenants but have no maintenance covenants ("pure" covenant lite) and extends consideration to loans which have maintenance covenants that are "effectively meaningless" because the "headroom exceeds the normal market standard," thus making a

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[6] Paglia, John K. "An Overview of Covenants in Large Bank Loans." *RMA Journal* (Mar. 2002). *BNET*. Web. 7 Mar. 2010.
[7] Wise, J. Eric. "Banking and Finance Market Snapshot: A Beginner's Guide to Thinking about Covenants." Kramer Levin Naftalis & Frankel LLP, Dec. 2006. Web. 8 Mar. 2010.
[8] *Id.*
[9] Wise, "Banking and Finance Market Snapshot: A Beginner's Guide to Thinking about Covenants."
[10] Lai, Ana, and Steven M. Bavaria. *The Leveraging Of America: Covenant-Lite Loan Structures Diminish Recovery Prospects*. Rep. Standard & Poor's, 18 July 2007. Web. 8 Mar. 2010.

technical default highly unlikely even if the borrower's operating performance deteriorates.[11] This is the definition that shall be used for this paper, though it should be noted that others may prefer to adopt a broader definition of covenant lite so as to allow a maximum of one or two financial maintenance covenants.[12]

II.2 The Rise of First-Lien Covenant Lite Bank Debt

As investors' appetites for loans grew in 2006 and early 2007, the market became flooded with available cash. Aptly stated in a December 2006 Bloomberg news article, "[s]o much money is available that investors are lowering their standards."[13] This idea of lowered standards ultimately manifested itself in the form of increased covenant lite debt issuances. With the default rate of *speculative-grade* debt at a mere 2% at the end of 2006,[14] creditors remained optimistic that they would continue to collect on their covenant lite debt.

Although covenant lite debt had been available to borrowers for many years, the number of issuances in 2007 dwarfed that of the preceding decade. From 1997 through 2006, a total of $32 billion in covenant lite loans were issued,[15] with approximately three-quarters of that coming from 2006.[16] In the first 6 months of 2007, covenant lite volume exploded to $97 billion.[17] This represented 32% of all loan issuances for the period (as compared to 8% for the comparable period in the year prior).[18] An even more staggering statistic is that covenant lite

[11] *Id.*
[12] Deutsche Bank AG, London Branch. "Memorandum Submitted by Deutsche Bank." *www.parliament.uk*. United Kingdom Parliament, 22 Aug. 2007. Web. 08 Mar. 2010. <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/567/567we40.htm>.
[13] Rubinroit, Harris. "Bank Loans Lure KKR, Carlyle with Junk-Bond Returns (Update2)."*Bloomberg.com*. Bloomberg L.P., 27 Dec. 2006. Web. 25 Mar. 2010.
[14] *Id.*
[15] Rubinroit, Harris, and Darrell Hassler. "Goldman, Lee Stymied as Investors Jettison Covenants (Update1)." *Bloomberg.com*. Bloomberg L.P., 9 May 2007. Web. 8 Mar. 2010.
[16] Lai, Ana, and Steven M. Bavaria. *The Leveraging Of America: Covenant-Lite Loan Structures Diminish Recovery Prospects*.
[17] *Id.*
[18] *Id.*

loans represented almost one-fifth of all bank debt outstanding at their peak, up from a mere 1% at the beginning of 2006.[19] Unfortunately for borrowers, the abundant availability of covenant lite loans abruptly came to an end as market conditions weakened in the latter half of 2007.

III. ANALYSIS

As previously noted, this paper will explore the value of covenant lite first-lien debt to borrowers in the context of two hypothetical companies: CovCo and CovLite. Each featured an enterprise value of $1 billion[20] and borrowed $500 million in first-lien bank debt[21] on January 1, 2007 (so as to approximate a typical LBO deal in 2006 or early 2007). CovCo's credit agreement included standard affirmative maintenance covenants defining the minimum current ratio, minimum net working capital, minimum interest coverage ratio, and minimum net worth, as well as negative maintenance covenants denoting a maximum debt/worth ratio, maximum total debt, maximum capital expenditures, and maximum dividends.[22] Antithetically, maintenance covenants were completely absent from CovLite's credit agreement.

III.1 The Value of Eliminating Maintenance Covenant Violations

By the end of 2008, CovCo and CovLite experienced a significant decline in revenue as market conditions worsened. The two companies' EBITDA to interest expense ratio slipped below levels deemed acceptable by CovCo's affirmative maintenance covenant. The result was

[19] Lattman, Peter. "'Covenant-Lite' Loans Face Heavy Hits." *WSJ.com*. The Wall Street Journal, 18 Mar. 2009. Web. 8 Mar. 2010.
[20] Grocer, Stephen. "August: Month of the Shrinking Deal." *WSJ.com*. The Wall Street Journal, 11 Sept. 2007. Web. 8 Mar. 2010.
[21] Blaydon, Colin, and Fred Wainwright. "The Balance Between Debt and Added Value." *FT.com*. The Financial Times Ltd., 28 Sept. 2006. Web. 8 Mar. 2010.
[22] Strischek, Dev. "Coming to Terms with Financial Covenants." *RMA Journal* (June 2007). *BNET*. Web. 7 Mar. 2010.

that CovCo was in technical default of its credit agreement while CovLite could continue to conduct business as usual without interference from its lenders.

Credit agreements typically state that the borrower's violation of any covenant allows the bank to accelerate the maturity of the loan.[23] In practice, however, the bank and the borrower frequently reach a compromise in the form of an amended agreement. Given the powerful negotiating leverage that covenants afford the lender, the absence of maintenance covenant violation penalties encompasses the most direct and tangible value to covenant lite borrowers. In order to produce a *baseline* quantification of this value, data was collected on 31 instances of interest ratcheting on senior credit facilities in 2008 and 2009. For the purposes of selecting the data, only instances in which there was an explicitly stated change of interest (such as from prime + 300 bps to prime + 500 bps) were used. Credit agreement amendments which made less transparent modifications to the interest rate (such as changing the definition of "Base Rate" or swapping LIBOR for prime) were not used. Revolvers and term loans of the same borrower were considered separately. Public filings (predominantly 10-Qs and 10-Ks), news articles, and company press releases were utilized to obtain all information relating to this analysis.

The results indicate that interest ratcheting arises from one of three circumstances: (1) a borrower is in technical default for violating one or more covenants and a default rate of interest becomes effective in accordance with the credit agreement, (2) a borrower is in technical default for violating one or more covenants and receives a waiver from the lender in exchange for an increased interest rate and perhaps other forms of consideration, or (3) a borrower anticipates that it will be in technical default for violating one or more covenants and negotiates with the lender to prospectively avoid the violation. On average, the above events result in an increase in the interest rate of 194.44 bps, with increases ranging from 50 bps to 450 bps (see Exhibit 1).

[23] *Id.*

However, as noted, this represents only a *baseline* cost to violating borrowers. In addition, they are frequently required to consent to additional covenants (though, some requirements and restrictions are reduced so as to preclude the borrower's immediate violation upon signing the amendment or forbearance agreement), pay forbearance fees, or pay down a portion of the loan's principal. In some cases, these additional costs are quite substantial. For instance, forbearance fees generally range from 0.25% to 2.00% of the loan balance.[24]

III.2 The Opportunity for the Borrower to Repurchase Covenant Lite Debt at Lower Prices than if it had Issued Traditional First-Lien Debt

At the time the hypothetical loans were signed, the average bid price for covenant lite loans on the secondary market was actually about 0.2 cents on the dollar *higher* than the average bid price for all other first-lien leveraged loans.[25] This was an entirely counterintuitive and irrational (but also short-lived) phenomenon. It meant that investors were willing to pay more for covenant lite first-lien debt (100.29 cents on the dollar as of 12/29/2006) than otherwise comparable first-lien debt featuring traditional maintenance covenants (100.10 cents on the dollar).[26] From the beginning of 2006 through June 2007, the average bids for covenant lite debt and all other first-lien debt stayed within 0.4 cents of each other.[27] However, in the months and years that followed, as realization set in that covenant lite could mean drastically reduced recoveries for the ultimate holder of the debt, the spread between average bids continued to fluctuate in accordance with market conditions but consistently in favor of the traditional first-lien variety (see Exhibit 2).

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[24] Solomon, Jordan S. "Negotiating Forbearance Agreements." *www.gibbonslaw.com*. Gibbons P.C., 7 Apr. 2009. Web. 09 Mar. 2010.

[25] "Average Bid of Leveraged Loans." Chart. *Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index*. Standard & Poor's Financial Services LLC (S&P), 2009.

[26] *Id.*

[27] *Id.*

Let's imagine that CovCo and CovLite desired to buy back $250 million of their bank debt (face value) on the secondary market at the beginning of 2009 in order to reduce ongoing interest payments and avoid bankruptcy. CovLite would spend about $21 million less than CovCo on account of the difference in trading values. This would have represented a cost savings equivalent to 2.11% of CovLite's original enterprise value.

Table 1: Hypothetical January 2009 Debt Repurchase ($250 Million Face Value)

	CovCo	**CovLite**
Average Bid (1/2/2009)[28]	**65.7902¢**	**57.3310¢**
Cost to Company	**$164,475,500.00**	**$143,327,500.00**

While this would appear to be a simple choice for a wide range of companies with bank debt trading at cheap prices, there are actually a host of legal and tax considerations involved that may preclude the company, or even the private equity sponsor,[29] from repurchasing loans on a secondary market. In general, the ability for a borrower to repurchase its own debt in this fashion should not be considered an automatic right.[30] The borrower may be required to amend the credit agreement (which may entail amendment fees), as was the case with Citadel Broadcasting and Harrah's Entertainment, or seek lender consent.[31]

III.3 The Present Value of Delaying Restructuring Costs

A primary argument for the inclusion of maintenance covenants is their ability to safeguard the interests of the lender. The requirements and restrictions set forth an expectation of performance that a borrower must meet. A covenant violation, which leaves the borrower in technical default, allows the lender to accelerate the loan and potentially force the borrower into

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[28] *Id.*
[29] "Private Equity Investments in Portfolio Company Debt: An Overview of Legal Issues." *Simpson Thacher's Client Memorandum* (13 Feb. 2009). *www.simpsonthacher.com*. Simpson Thacher & Bartlett LLP. Web. 9 Mar. 2010.
[30] Razin, Ely. "Credit Terms: Loan Buyback? Bring Out The Vote." Web. *WestlawBusiness.com*. Thomson Reuters, 27 May 2009. Web. 9 Mar. 2010.
[31] *Id.*

bankruptcy. This is an immensely powerful bargaining chip for the lender. Recall earlier that CovCo violated its interest coverage ratio covenant at the end of 2008. Instead of amending the credit agreement, let's now imagine that CovCo's lender decided to accelerate the loan. Given its poor financial condition and the illiquidity of the credit market at the time, CovCo was unable to come up with the capital to pay off the loan in its entirety and was forced into bankruptcy.

A comprehensive study on chapter 11 bankruptcy fees found that large debtors (averaging about $1.2 billion in assets plus debts) pay fees equivalent to 4.53% of their assets and debts for a corporate reorganization.[32] Assuming that this number for CovCo was $1 billion at the time of bankruptcy, it would have paid out $45.3 million in total fees and expenses. CovLite, though in a similarly precarious financial position, was able to continue in the ordinary course of business as long as it could make the required debt service payments. Even if it could only manage this for one additional year and assuming a discount rate of 7%, the present value of that delay in restructuring costs would have been worth more than $3 million. This savings would have been further augmented by the present value of delaying or mitigating intangible costs (damage to reputation, damage to relationships with suppliers and customers, etc.).

III.4 The Opportunity to Extend the Aforementioned Advantages Via Debt Reinstatement

The ability to avoid technical default and delay bankruptcy confers additional benefits to CovLite beyond what the previous present value calculation suggests. In cases where the act of filing for bankruptcy constitutes the sole reason for default (that is, the debtor is up to date on all interest and principal payments and is not in breach of a loan's covenants), a debtor may seek to

[32] *Lubben, Stephen J.* "Corporate Reorganization & Professional Fees." 82 Am. Bankr. L.J. 77 (2008).

“reinstate” its senior loans[33] under §1124 of the Bankruptcy Code[34] against the wishes of those lenders. This means that a borrower with covenant lite debt is more likely to have this option than one subject to traditional maintenance covenants. Debt reinstatement allows a debtor to preserve the entirety of the secured debt (its interest rate, term, covenants, etc.) rather than seek then-current market terms, but only if “the lenders' legal and equitable rights would be unaffected after the bankruptcy case and that all defaults would be cured by the plan's effective date, i.e., the lenders would have the full benefit of their prepetition bargain notwithstanding the intervening bankruptcy.”[35]

Given the time cushion that the absence of maintenance covenants provided for CovLite, it had much greater flexibility in choosing to file for bankruptcy prior to being in technical default. This option can yield substantial cost savings for the debtor. For example, in late 2009 Charter Communications Inc. was allowed to reinstate its secured debt against the wishes of those lenders, thus preserving the below-market interest rate and saving the company approximately $500m annually in interest expenses.[36]

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[33] Analysis Group. “Reinstatement and Bankruptcy Litigation: A Q&A with Affiliate Robert Grien and Managing Principal Maureen Chakraborty.” *www.ag-inc.com*. Analysis Group. Web. 10 Mar. 2010.
[34] *Hedberg, Steven M.* “Reinstatement: How Valuable is Below-Market Secured Debt? A Closer Look at ‘In Re: Charter Communications.’” *Law.com*. ALM Media Properties, LLC, 5 Nov. 2009. Web. 10 Mar. 2010.
[35] *Id.*
[36] *Id.*

IV. CONCLUSION

As this paper has shown, the value of covenant lite debt extends well beyond the avoidance of increased interest rates and one time fees resulting from covenant violations.

Table 2: Traditional Debt versus Covenant Lite Debt - Summary

	Traditional First-Lien Debt	**Covenant Lite First-Lien Debt**
Interest Ratcheting	Companies face an average interest rate increase of 194.44 bps for financial maintenance covenant violations (or in anticipation of such violations). This is often accompanied by one-time forbearance fees, mandatory principal repayments, and/or other amendments to the loan agreement.	Maintenance covenants are absent from the loan agreement. Therefore, these costs are not applicable to covenant lite borrowers.
Debt Repurchase	As of 01/15/2010, the average bid price for traditional first-lien leveraged loans on the secondary market was 93.24 cents on the dollar. [37]	As of 01/15/2010, the average bid price for covenant lite first-lien leveraged loans on the secondary market was 91.19 cents on the dollar. Average bids for covenant lite debt have remained lower than traditional debt bids since mid-2007. [38]
Bankruptcy Timing	Maintenance covenants increase the likelihood that a borrower will find itself in technical default, allowing the lender to accelerate the maturity of the loan and potentially force the borrower into bankruptcy. On average, corporate reorganizations will cost large debtors 4.53% of assets plus debts in total fees and expenses.[39]	The absence of maintenance covenants increases a borrower's ability to delay (or potentially avoid) bankruptcy. The present value of delaying reorganization costs can be quite substantial.
Debt Reinstatement	Debt reinstatement is not an option where the debtor is in breach of the loan's covenants.	The absence of maintenance covenants provides a borrower additional flexibility in entering bankruptcy prior to being in technical default. This leaves open the possibility of debt reinstatement to preserve a loan's favorable interest rate and covenant lite status.

CovLite, much like many of the companies that were fortunate enough to borrow covenant lite first-lien bank debt in 2006 and 2007, was additionally presented with a variety of very powerful

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[37] "Average Bid of Leveraged Loans." Chart. *Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index*. Standard & Poor's Financial Services LLC (S&P), 2009.
[38] *Id.*
[39] *Lubben, Stephen J.* "Corporate Reorganization & Professional Fees." 82 Am. Bankr. L.J. 77 (2008).

options. Depending on the state of the market (and subject to the various other considerations previously discussed), it could have chosen to repurchase its own debt at a price significantly lower than if it had traditional bank debt. In the event that bankruptcy was imminent, CovLite had improved flexibility in delaying the costs associated with the reorganization and pursuing debt reinstatement as an option. Overall, these benefits not only provide real, quantifiable cost savings to a covenant lite borrower, but also allow management to focus on an effective long-term corporate strategy without disruption from short-term covenant requirements and restrictions.

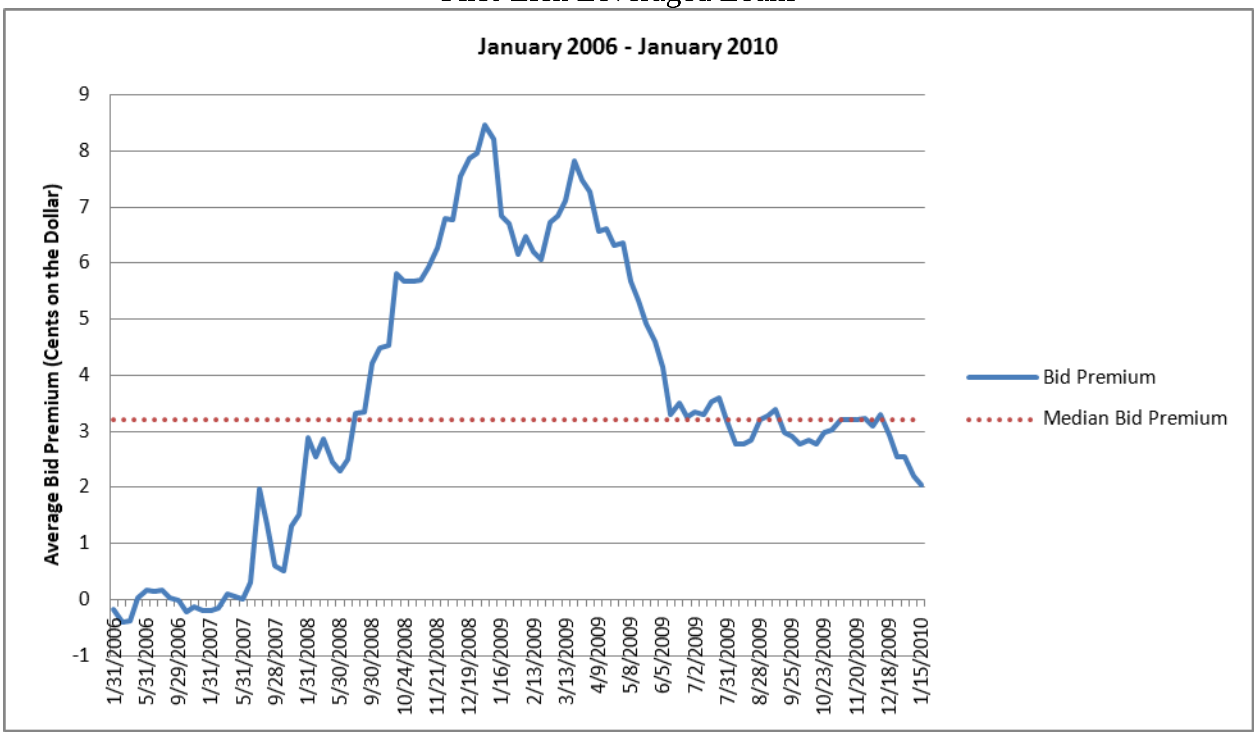
Despite the adverse implications of covenant lite lending, banks in 2010 appear to be warming up to the idea once again. In January 2010, Hexion Specialty Chemicals was allowed to refinance its existing covenant-lite debt without adding restrictions.[40] As of March 2010, Lyondell Chemical Co.'s chapter 11 exit financing package includes a $500 million covenant lite term loan.[41] Prospective borrowers should remain cognizant of the potential sources of value attributable to covenant lite bank debt and negotiate against maintenance covenants accordingly.

[40] Greene, Katherine. "Cov-Lite Loans Make a Return: High Demand as Lyondell Pares Yield; Skittish No More?" *WSJ.com*. The Wall Street Journal, 26 Mar. 2010. Web. 26 Mar. 2010.
[41] *Id.*

Exhibit 1: Interest Rate Increases in Response to (or in Anticipation of) Covenant Violations

Sample Size	**31**
Average Increase	**194.44 bps**
Median	**200 bps**
High	**450 bps**
Low	**50 bps**
Standard Deviation	**106.36 bps**
Standard Error	**19.10 bps**

Exhibit 2: Average Bid Premium of Traditional First-Lien Leveraged Loans over Covenant Lite First-Lien Leveraged Loans*



*Derived from data provided by Miyer A. Levy of Standard & Poor's LCD (Source: Standard & Poor's LCD and S&P/LSTA Leveraged Loan Index). Data excludes all facilities in default.

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