Loan Products
Special Report

Loan Preserver

The Value of Covenants

Analyst
Mariarosa Verde
212 908-0791
mverde@fitchibca.com

■ Summary

One of the more meaningful structural features of bank loan credit agreements is the covenant package. Fitch IBCA believes that loan covenants are valuable on two interdependent levels. Explicitly, loan covenants preserve seniority and collateral, two features which our research has demonstrated are critical in minimizing credit loss in the event of default *(see Fitch IBCA Research "Syndicated Bank Loan Recovery Study," dated Oct. 22, 1997, available on Fitch IBCA's web site at www.fitchibca.com)*. The dilution of either of these two features represents the primary structural risk to senior secured lenders. Implicitly, covenants help ensure that the actions of borrowers remain aligned with the interests of its lenders throughout the loan tenor. This is accomplished chiefly through financial tests which limit the likelihood that the company will embark on risky projects or will deplete cash or other valuable resources at the expense of the loan investors.

The content and scope of the covenant package is especially important for loans to non-investment-grade borrowers given their uncertain financial and business profiles. For these issuers covenants can contribute a great deal to value preservation and can impact the rating which Fitch IBCA will assign to their loans. Since leveraged loans derive the greatest benefit from well crafted covenants we focus our discussion in this report on such profiles. For the study that follows, Fitch IBCA reviewed the covenant packages of 200 loans using data provided by Loan Pricing Corp. (LPC) from 1994 to the present. Covenants relating to the most prominent deals in this sample were compared to covenants contained in the same issuers' bond indentures. Among our key observations are:

- Strong covenant packages preserve loan terms, mitigate credit risk and impact bank loan ratings.
- Financial covenants have held up well in the period 1994 to 1998 and continue to offer material protections for bank loan investors.
- As illustrated in the table below, leverage and coverage cushions (pro forma levels versus year one covenant levels) have, on average, remained fairly stable.
- There is a stark contrast between covenant protections found in leveraged loan credit agreements and high yield bond indentures.
- Standardization of terms and a shift in the investor mix toward institutional lenders could lead to covenant dilution in the future.

Table 1
Leverage and Coverage Flexibility
(%, Year 1 vs. Pro Forma)

	1994	1995	1996	1997	1998
Leverage Cushion					
Debt/EBITDA	14.3	20.2	19.8	20.7	21.0
Coverage Cushion					
EBITDA/Interest	22.5	24.7	20.5	19.7	22.0

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Introduction

Fitch IBCA's analytical process for rating secured bank loans begins with the assignment of a default rating which reflects the issuer's ability to meet its total debt service requirements in a timely manner. The foundation for this default rating is traditional credit analysis, namely a comprehensive review of the borrower's business profile, financial status, operating performance and industry position. This default rating is in turn adjusted or notched for special features of the loan structure which improve the lenders' recovery expectations vis-à-vis unsecured or subordinate obligations.

The three primary features which impact this notching process are capital structure, collateral and covenants. As discussed below, the value of the covenant package is not discrete but rather is intertwined with the preservation of seniority, collateral and cash flow. Fitch IBCA's position is that, although covenants do not change the credit profile of the issuer, they are critical in safeguarding loan terms and ensuring that potentially risky managerial actions are checked. Ultimately, the relative strength of the covenant package supports Fitch IBCA's loan ratings. Without certain covenant protections, loan rating enhancements relative to other debt securities could not be made. In fact, covenants that substantially reduce structural and credit risks are recognized through higher loan ratings.

Explicit Protections

Among the restrictions which preserve seniority, collateral and cash flow, credit agreements contain covenants which limit indebtedness, liens, asset sales, capital expenditures, acquisitions, dividends, intercompany distributions and other cash outflows. Table 2 at right itemizes covenants commonly found in loan agreements.

One of the key economic functions of covenants is to restrict leverage. Not only do standard credit agreements limit future debt in absolute dollar terms, they also limit debt in relationship to cash flow. The value of the latter cannot be underestimated since it offers the lenders some assurance that the company will not be able to take on more debt than it could reasonably support. In most cases the borrower must maintain leverage ratios pro forma for any material acquisitions. The latter provision is especially meaningful given the trend toward consolidation which has resulted in numerous deals focused exclusively on acquisitions as a means of achieving growth and rationalizing operating costs. Debt limitations also address structural subordination. For example, when the borrower under the loan facility is a holding company, covenants usually limit the amount of debt that may be incurred by the company's subsidiaries, thereby preserving the holding company lenders' position.

The second major category of explicit protection found in credit agreements is limitations on liens and asset sales. Limitation on liens address uncertainty regarding the company's ability to pledge security to other creditors. This provision is valuable since the issuance of secured debt in the future can substantially dilute the existing lenders' claims. A strong collateral position guarantees negotiating power for the senior secured lenders in a bankruptcy reorganization and is key in achieving maximum recovery in a bankruptcy liquidation.

The terms of approved asset sales and use of proceeds are also important. Asset sales could result in a material reduction in the collateral base and can represent a significant loss of a cash producing resource. Bank loan credit agreements typically restrict asset sales outside of the company's regular course of business. Further, Fitch IBCA's study found that 95% of leveraged loan credit agreements include asset sale cash flow sweeps which ensure that the proceeds from such sales are applied toward the reduction of senior secured debt.

Table 2

Covenants Found in Senior Secured Credit Facilities

Financial Covenants
Maximum Total Debt/EBITDA
Maximum Total Senior Debt/EBITDA
Minimum Interest Coverage
Minimum Fixed-Charge Coverage
Minimum EBITDA
Minimum Net Worth
Minimum Current Ratio

Negative Covenants
Limitation on Indebtedness
Limitation on Liens
Limitation on Contingent Obligations
Limitation on Sale of Assets
Limitation on Leases
Limitation on Dividends
Limitation on Capital Expenditures
Limitation on Transactions with Affiliates
Limitation on Sale/Leaseback

Mandatory Prepayments
Excess Cash Flow Sweep
Asset Sale Sweep
Debt Issuance Sweep
Equity Issuance Sweep

Table 3
Covenant Frequency in Leveraged Loan Credit Agreements
(1994–1998)

Leverage	**%**
Maximum Total Debt/EBITDA	78
Maximum Senior Debt/EBITDA	11
Maximum Debt/Capitalization	7
Maximum Debt/Net Worth	5
Maximum Senior Debt/ Capitalization	1
Coverage	
Minimum Interest Coverage	70
Minimum Fixed-Charge Coverage	54
Minimum Senior Interest Coverage	4
Mandatory Prepayments	
Asset Sales Sweep	95
Debt Issuance Sweep	76
Excess Cash Flow Sweep	69
Equity Issuance Sweep	64

Bank loan covenants also explicitly protect the interests of the loan investors by restricting cash outflows. These covenants include limitations on dividends, loans and intercompany distributions as well as restrictions on cash expenditures outside of the company's business plan. The covenants also typically define acceptable fund distributions to unrestricted subsidiaries which are not covered by the loan agreement. Further, if the borrower generates excess cash above operating costs, investments, and mandatory debt obligations, leveraged loan credit agreements commonly require that such balances be used to prepay outstanding bank debt. Fitch IBCA noted in its study that approximately 69% of leveraged loan credit facilities included excess cash flow sweeps. Table 3 above sets forth frequency statistics for covenants contained in typical leveraged loan credit facilities.

■ Implicit Protections

In addition to the explicit protections discussed above, well-structured loan covenant packages help prevent the objectives of management from straying too far from the interests of the secured bank group by establishing performance benchmarks and triggering remedies in the event of significant credit deterioration. This protection is afforded specifically through the ongoing financial tests.

Lender Options Upon Covenant Default

- Loan Recall
- Conditional Waiver
- Unconditional Waiver

Uncured covenant breaches can entitle senior creditors to recall loans immediately. This is an extreme measure, which would most likely force the borrower into bankruptcy. Lenders opt for acceleration and its consequences if they firmly believe doing so will preserve their loan. In less dire circumstances, the lenders have the option to waive covenant defaults. Waiver does not detract from the usefulness of the covenants because it is at the lenders' option and can be conditional on numerous actions that help mitigate risk. These actions can include discontinuing advances under revolving credit facilities, disallowing discretionary capital expenditures, requiring more frequent performance reports, requiring additional capital contributions from deal sponsors, and, in some cases, enhancing the security package. The value here is the ability to compel the borrower to renegotiate.

Waiver is subject to a majority vote from the lender group. We noted in our study that voting rights ranged from 51% to 67% consent, with 51% appearing in approximately two thirds of our sample. While not a rating consideration, investors should note that a 51% vote potentially allows a few lenders with large stakes to make waiver decisions for the entire group. Although all the lenders share the desire to protect their loan, they may differ in their assessment of material and immaterial covenant defaults and in their opinion regarding appropriate remedies.

Covenant protections are particularly useful when the issuer's business profile is expected to change considerably. This point is illustrated in the following discussion of two common financing profiles in the leveraged loan market.

A popular investment theme in the leveraged loan market is the platform growth strategy, often referred to as the leveraged "buildup" or "roll-up." This strategy anticipates growth to be achieved through significant acquisition activity or development expenditures or a combination of both. If not carefully managed and monitored, these profiles can become far more levered than they were at the original closing date, which necessitates thoughtful consideration of the external financing ramifications of adverse operating performance. To reduce such risks, senior credit facilities can be structured with covenants that require lender consents for material acquisitions. Additional protections may include limitations on the amount of leverage that may be incurred to effect each acquisition and provisions that tie advances to operating performance.

Such covenants are especially meaningful in the case of start-up operations, which initially have no core cash flow to help offset the impact of unfruitful

acquisition or development projects. This theme has become more prevalent in the leveraged loan market in recent years, as numerous wireless communication companies have issued large-scale credit facilities to support their build-out strategies. To account for the inherent development risks associated with these transactions, the syndicated loan market has adopted a two-stage financial covenant structure, similar in concept to project finance deals. Covenants track debt-to-total capitalization, revenue and subscriber growth during the early stages of the loan term when cash flow is either negative or negligible. After the build-out is completed and positive cash flows are generated, traditional leverage and coverage tests are applied.

A second popular transaction premise in the leveraged loan market is the assumption of considerable post-closing cost savings or revenue improvements. In many cases, these transactions are syndicated under the premise that the budgeted improvements have a large probability of being realized in short order, an assumption that helps explain why many of these transactions carry higher levels of leverage than the loan pricing might indicate. In these profiles, it is critical that company's performance during the early years of the loan term does not deviate materially from management's base line projections. Well-crafted covenants for senior credit facilities within these profiles will include minimum interest coverage and fixed charge coverage tests and maximum leverage thresholds based on the assumption that a significant percentage of the operational improvements are effected over a reasonable time frame.

■ Covenant Objectives

In general, Fitch IBCA looks for covenants that support critical loan terms, limit leverage, restrict cash outflows and monitor the issuer's key business drivers. Higher risk profiles necessitate tighter covenants. This is especially true late in a business cycle. Tighter covenants can take many forms depending on the profile of the borrower and can include financial tests set closely to management projections, more frequent reporting of key financial ratios such as same store sales for retailers, and less spending flexibility for capital expenditures and acquisitions. Covenants should parallel the company's core business strategy without being unduly burdensome. Management must be allowed moderate flexibility to act on strategic opportunities and react to industry cycles.

■ Loan Covenants vs. Bond Covenants

In exploring the role of covenants in bank loan agreements, it is worthwhile to discuss the ways in which bank loan covenants, specifically leveraged loan covenants, differ from covenants contained in high yield bond indentures. Our focus here is on negative and financial covenants. Credit agreements and bond indentures also contain affirmative covenants. These include provisions such as requiring that the borrower provide lenders with timely financial information, maintain certain types of insurance and pay taxes.

Fitch IBCA's study indicated that bank loan agreements for non-investment grade issuers currently contain 20 covenants on average, versus six covenants underlying standard high-yield indentures. Debt limitations in these indentures are generally subject to "incurrence tests" that restrict the issuer from increasing leverage unless certain predefined ratios, such as fixed-charge coverage, are satisfied. Other restrictions parallel those contained in loan agreements, such as restricted payments and limitations on asset sales; however, the scope of the restrictions and the level of compliance required of the borrower are generally loose and add little value in protecting bondholders. Set forth in Table 4 on page 5 is a sample covenant package for subordinated high-yield notes.

As discussed earlier, loan covenants provide both explicit and implicit protections. Explicit protections are afforded through the numerous provisions that preserve the terms of the loan agreement and restrict cash outflows. Implicit protections are derived from the on-going financial tests that frame an acceptable risk profile for the borrower and facilitate credit monitoring. Financial covenants are formulated to track management projections, with levels normally discounted to account for a reasonable measure of underperformance. They serve as benchmarks for lenders to compare operating performance against and represent a meaningful lever in protecting against credit loss since they can provide creditors with recourse in the event of non-performance. High yield investors generally do not have the benefit of financial projections or financial covenants.

In addition to the lack of financial covenants, explicit protections afforded high-yield bondholders are weak in comparison to those provided to leveraged loan creditors. Debt restrictions, for example, although typically subject to fixed charge coverage tests, allow for numerous carve-outs. In its study, Fitch IBCA found the efficacy of the fixed charge test itself to be inadequate due to loose definitions of coverage. In some instances fixed charge was calculated based on the annualized cash flow run rate implied by the issuer's performance during its most recent fiscal quarter. In other instances, the calculation was made based on cash costs rather than all fixed costs, allowing the company to increase debt by issuing paid-in-kind securities.

High-yield indentures have not always contained questionable covenant packages. An inflection point was crossed in the late 1980's early 1990's during which

Table 4

Sample Covenant Package For Senior Subordinated Notes

Limitations on Indebtedness
Debt limitation is typically subject to an incurrence test based upon either debt to capital, debt to assets, or interest coverage ratios.

Additional debt and preferred stock at the subsidiary level is also restricted, although debt of acquired entities is not always included.

Covenants include prohibitions against inserting additional debt between the senior subordinated notes and any senior debt (Anti-Layering).

Limitations on Restricted Payments
Includes restrictions on the payment of dividends on the capital stock of the company and its subsidiaries and limitations on the purchase, redemption and retirement of capital stock and certain debt.

Payments may be tied to a financial measure such as net worth.

Contrary to its counterpart in credit agreements, this convenant does not always limit broader forms of distributions, such as loans, advances, and investments.

Limitations on Sale of Assets
This covenant requires that the company receive "fair consideration" for assets sold. Essentially there is no limitation on the borrower's ability to sell assets. The covenant addresses application of proceeds that may be used to pay down senior debt or for new capital investments.

Any excess above a certain level can be used to tender for some part of outstanding notes.

Limitations on Certain Transactions with Affiliates
An example of restricted activities includes the purchase, sale or leasing of property or other contractual arrangements. These activities are prohibited to the extent that they are deemed not "favorable" to the company in which case the company must get an external opinion regarding the fairness of the transaction.

Limitation on Mergers
The company may consolidate or merge with another entity if the surviving company is a U.S. corporation, no event of default has occurred, and the new entity will absorb obligations under the indenture.

protections that had previously been written into these agreements began to vanish. During the mid to late 1980's, a significant number of high-yield bond indentures contained provisions such as minimum tangible net worth, escalating interest coverage tests and minimal debt carve-outs. High-yield investors interviewed by Fitch IBCA believe this deterioration has been partly driven by an evolving investor preference for yield vs. safety. In fact, historical bond pricing studies do suggest that bonds with more restrictive covenants trade at lower yields than similar bonds with less restrictive covenants.

It is interesting to note that the presence of credit facilities with stringent covenants indirectly benefits the bondholders in the same capital structure. The implicit value of the financial covenant package discussed earlier protects the bondholders as well by keeping management in check. For the bondholders, though, this protection can be fleeting since most loans are refinanced or repaid substantially earlier than bonds. If the borrower negotiates a new credit facility there is no guarantee for the bondholders that the new covenant package will offer the same level of protection.

■ Loan Covenant Trends

Most senior secured loans in the current leveraged loan market have financial covenant packages that include at least one coverage covenant, either an interest or fixed charge coverage test, and at least one leverage measure, typically total debt-to-EBITDA or senior debt-to-EBITDA. Table 3 on page 3 sets forth data resulting from Fitch IBCA's study of LPC's database for the transactions that comprised its 1994 to 1998 Zone Charts, LPC's representative sample of the leveraged loan market.

According to the Fitch IBCA study, more than two-thirds of the bank loan agreements contained interest coverage covenants, while 54% included fixed charge coverage tests. In the majority of cases, these tests were required to be performed quarterly on a rolling four-quarter basis (i.e. calculations were based on cash flow and interest expense data for the prior four fiscal quarters). Substantially all of the credit agreements reviewed also contained total debt-to-EBITDA as the primary measure of leverage migration. These ratios were calculated using total indebtedness divided by rolling four-quarter EBITDA. As is evident in Table 3, the balance sheet leverage tests of the past have been overwhelmingly replaced by cash flow based leverage covenants.

Of note, most leveraged loans contain pricing grids that tie the borrower's interest cost to movements in its debt-to-EBITDA ratio. If a borrower's condition deteriorates such that its debt-to-EBITDA ratio exceeds the upper limit of the grid, it is likely that the borrower will also have violated its maximum

leverage covenant. In this case waiver negotiation can include increasing the credit spread on the borrower's loan, thus compensating the lenders for the borrower's riskier profile.

With the exception of hybrid loans, which accounted for less than 1% of leveraged syndicated loan commitments over the past year, the nature and degree of covenant protection does not appear to have changed measurably during the past four years. Hybrid loans are bank loans that have bond-like features such as fewer covenants. Our study of 200 prominent deals for the period 1994 to the present, including the LPC zone credits mentioned above, indicated that lenders continue to draft their coverage and leverage covenants on the premise that the borrower's EBITDA can fall moderately before tripping either covenant. As reflected in Table 1 on page 1, the degree of cushion between pro forma leverage and coverage and initial covenant levels has on average remained fairly stable.

The data also revealed that the degree of latitude given to borrowers with regard to year one covenant levels declined with an increase in pro forma leverage at closing. For example, for 1997 transactions, leverage and coverage cushions for borrowers with pro forma debt/EBITDA in the range of 3x to 4x averaged 35% and 27%, respectively, compared to average leverage and coverage cushions of 11% and 20%, respectively, for borrowers whose debt/EBITDA ranged from 5x to 6x. This relationship held in each of the observed years, confirming Fitch IBCA's expectation that highly levered transactions are accompanied by more stringent covenants.

Fitch IBCA's study also indicated that non-financial covenants did not weaken measurably. The content and scope of these remained steady throughout the four year period. Approximately 95% of the sample loans required asset sale cash flow sweeps. Of these, most required 100% of the proceeds to be utilized to reduce senior debt. Although the frequency of debt issuance sweeps was a bit lower at 76%, these for the most part also required 100% application of the proceeds toward senior debt reduction. Approximately 70% of the credit agreements required sweeps of at least 50% of excess cash flow. Mandatory prepayments relating to initial public offering proceeds were less uniformly addressed in the credit agreements reviewed. One-third of the loans did not require such proceeds to be used to prepay senior debt, another third required 50% to 75% of the proceeds to be used in this fashion and the remaining third required all of the proceeds swept toward senior loans.

In recent years, an increasing number of senior credit facilities have been distributed through the broadly syndicated bank loan market for smaller enterprises. These transactions are considered by many capital markets participants to represent higher risk profiles than their larger counterparts due to their comparative lack of customer, geographic and product diversity and limited ability to tap the capital markets for external financing. While Fitch IBCA also takes a cautious view of these profiles, it recognizes the structural benefits that often accompany senior credit facilities tailored for these issuers. Loans to smaller issuers tend to have tighter financial covenants, tougher restricted payment provisions, higher average excess cash flow sweep requirements and stricter limitations on permitted incremental indebtedness.

■ Conclusion

Loan covenants are a very meaningful structural feature of credit agreements. This is especially true for risky credit profiles. One of Fitch IBCA's concerns is that as the loan market becomes more liquid and more highly standardized, some of the safety features embedded in credit agreements such as strong covenants might begin to disappear as they have in the high yield bond market. Outside of the sparse hybrid transactions syndicated in the past few years, we have yet to witness this on a broad scale. We are aware that any material dilution of structural features would erode the credit risk differential between bonds and loans and as such, would impact the degree of rating enhancement assigned to loans relative to bonds. It remains to be seen whether the numerous institutional investors now engaged in the loan market will continue to value these safety provisions relative to yield. Our belief is that given economic uncertainty going forward, there will be heightened attention paid to safety and at least in the near term covenant structures should remain intact.

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