MEKETA
INVESTMENT GROUP

Private Markets Viewpoints

The impact of covenant-lite from an allocator's perspective—public vs. private credit

Investors are well aware of the proliferation of covenant-lite (or "cov-lite") issuance over the past few years in the broadly syndicated bank loan and high yield markets and appreciate that the diminished investor protections were beneficial for the issuer, not the debtholder.[1] In the recent pre-Covid benign credit market, the magnitude of the impact had largely remained obfuscated. However, as corporate defaults rise, the impact is becoming more evident and is likely to further highlight the divergence between public and private credit investments.[2] In this brief note we outline that divergence by focusing on the impact of cov-lite for debtholders and offering some observations on the potential opportunities for private credit investors.

©2020 MEKETA INVESTMENT GROUP

Our observations on the key impacts of the proliferation of cov-lite issuance are as follows:

- **More creditor-on-credit litigation**. Over the past few years, the market has seen a meaningful uptick in inter-creditor litigation – i.e., stakeholders of a company who typically represent different parts of the capital structure suing each other or the company over the stripping of collateral or other re-assignment of assets or liabilities – as well as holders of the same part of the capital structure engaging in litigation, with the latter representing the most meaningful change.[3] High profile examples of this type of litigation includes Claire's, J. Crew, JC Penney, PetSmart and Serta Simmons. While the premises of the cases have varied – some involved the re-assignment of intellectual property, while others involved the alleged transfer of assets, for example – all were likely a by-product of the covenant-lite issuance market and all, regardless of the outcome, likely were expensive with the legal costs largely being borne by underlying creditors who are in most cases LPs.

- **More "priming."** Getting "primed" or "layered" refers to the practice of issuing new debt that supersedes existing debtholders in the repayment pecking order and is detrimental to existing debtholders. Historically, debtholders have been protected against priming through document protections that require unanimous (or near unanimous) consent by lenders to change the aforementioned pecking order in the event of a recovery. Documents have been weakened to the point where, according to *Covenant Review*, nearly 95% of outstanding first lien syndicated bank loans allow for priming. Since the market dislocation stemming from Covid, issuers including AMC Entertainment, Six Flags Entertainment and Carnival Corporation have used this provision.

- **Lower recovery rates.** In a period with diminished investor protections, debtholders should expect lower recovery rates, and that is indeed what they are experiencing. Historically, high yield bonds have averaged approximately a 40% recovery rate, with first lien broadly syndicated loans averaging approximately 65%. As shown in Figure 1, both high yield bond and loan recoveries are at historically low levels. The recent Bloomberg article, "Bond Defaults Deliver 99% Losses in New Era of Bankruptcies," highlighted how credit default swap levels likely portends further bad news for debtholders with the median level for the worst performing debt trading at 3.5 cents on the dollar compared to over 23 cents from 2005 to 2018.

©2020 MEKETA INVESTMENT GROUP

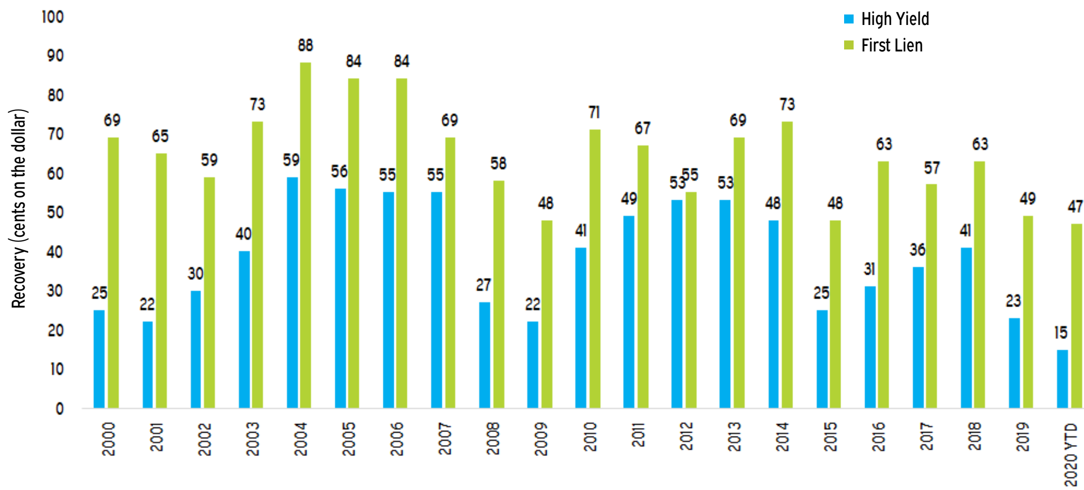

FIGURE 1

Bond and Loan Recovery Rates at Historical Low Levels

Source: JP Morgan Default Monitor, October 2020

Concluding thoughts

All of the aforementioned impacts are negative, if taken from the perspective of a public markets corporate credit investor. The tumult, however, can create opportunity for skillful private credit managers who can take advantage of weak existing credit documents and offer alternative solutions to troubled companies through new privately-negotiated capital solutions and/or rescue financing. Experienced distressed and special situations managers understand the key factors that impact restructurings – namely, the nuances of different jurisdictions in legal proceedings, a thorough understanding of creditor agreements and being an active participant in creditor committees or other processes – and position themselves accordingly. In summary, while a treacherous environment for many public credit managers, the opportunities stemming from cov-lite issuance can create fertile opportunities for skillful private and opportunistic credit managers.

[1] For reference, covenant-lite loans typically lack a maintenance covenant that requires the borrower to meet certain minimum thresholds related to EBITDA, leverage or interest coverage. Please see Meketa's "Bank Loan Credit Quality" Research Note (July 2019).

[2] Fitch Ratings projects that defaults in leveraged loans will increase to 7% to 8% in 2021, up from 1.8% in 2019.

[3] This has typically involved CLOs, which are restricted by the vehicle's structure from participating in certain forms of restructuring.

©2020 MEKETA INVESTMENT GROUP

Contact the author

Mary Bates, Private Markets Consultant
Phone: (503) 226-1050
Email: mbates@meketa.com

Meketa Investment Group began providing private markets services in 1999 and currently serves over 100 institutional clients, representing over $125 billion in private markets investments. Averaging 22 years' industry experience, more than 40 members of the private markets team cover a broad array of opportunities including pirvate equity, private debt, real estate, infrastructure, and natural resources.

Disclaimers

This document is for general information and educational purposes only, and must not be considered investment advice or a recommendation that the reader is to engage in, or refrain from taking, a particular investment-related course of action. Any such advice or recommendation must be tailored to your situation and objectives. You should consult all available information, investment, legal, tax and accounting professionals, before making or executing any investment strategy. You must exercise your own independent judgment when making any investment decision.

All information contained in this document is provided "as is," without any representations or warranties of any kind. We disclaim all express and implied warranties including those with respect to accuracy, completeness, timeliness, or fitness for a particular purpose. We assume no responsibility for any losses, whether direct, indirect, special or consequential, which arise out of the use of this presentation.

All investments involve risk. There can be no guarantee that the strategies, tactics, and methods discussed in this document will be successful.

Data contained in this document may be obtained from a variety of sources and may be subject to change. We disclaim any and all liability for such data, including without limitation, any express or implied representations or warranties for information or errors contained in, or omissions from, the information. We shall not be liable for any loss or liability suffered by you resulting from the provision to you of such data or your use or reliance in any way thereon.

Nothing in this document should be interpreted to state or imply that past results are an indication of future performance. Investing involves substantial risk. It is highly unlikely that the past will repeat itself. Selecting an advisor, fund, or strategy based solely on past returns is a poor investment strategy. Past performance does not guarantee future results.

©2020 MEKETA INVESTMENT GROUP