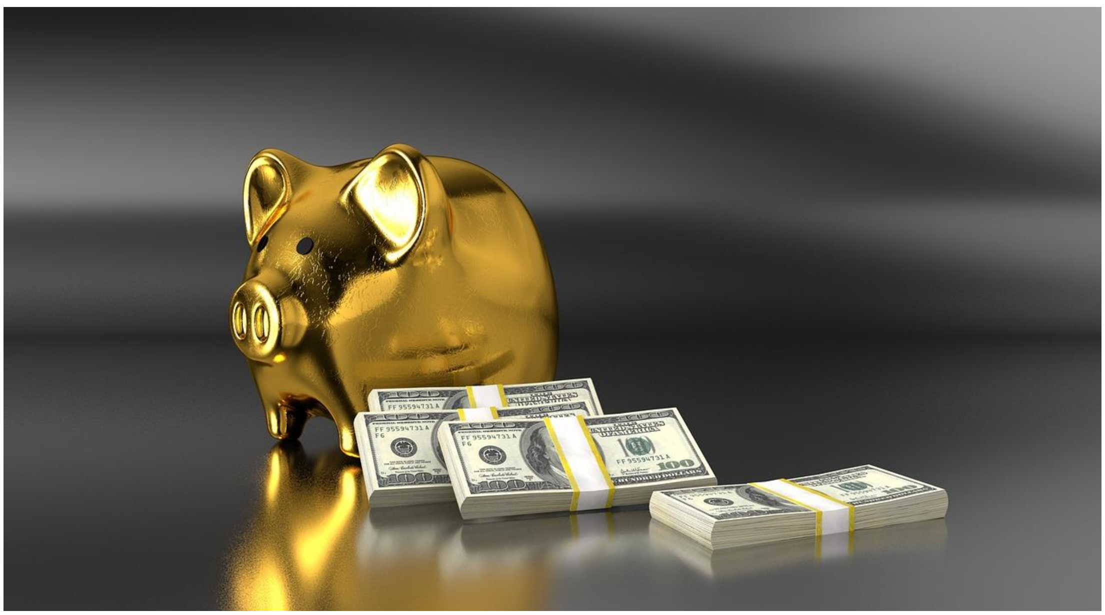
Amid Bad Debt Deals, Loan Covenant Analyst Says This Deal Is The Worst Ever

Jenny Warshafsky, a covenant analyst at Xtract Research, sees terms for lenders getting worse and worse. But Warshafsky says a recent $250,000 deal put together in the software industry by Vista Equity Partners might be the worst yet. And she didn't soft-pedal her legal issues in a June report titled "The Worst Debt Covenant Ever."



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The report comes amid a trend of weakening loan covenants. Loan covenants are designed to protect lenders by limiting actions a corporation can take to increase risk in an investment. For example, they can limit how much additional debt a company can layer on, how much they can pay in dividends to equity holders, or limit a corporation from selling assets that have been used as collateral to securitize a loan.

The worst debt terms yet comes amid a panoply of increasingly questionable deals.

The $10 billion financing supporting the buyout of Johnson Controls, was initially categorized as close to the worst ever, drawing sharp criticism for weakening of the lender's position. After tense negotiations, the covenant was eventually changed to provide more security to lenders, including adding restrictions on payments and the amount of indebtedness a company can accept.

Nearly a year ago, a private-equity buyout of a roofing company, SRS Distribution, was among the worst covenants, according to Covenant Review, and independent credit research firm. The initial terms provided weak collateral commitments and were "written with near-arbitrary levels of complexity," according to CR analyst Ross Hallock.

In both examples, covenants were altered after negotiations, making the final deal more palatable. "We have definitely seen term sheets and first drafts where sponsors throw everything at the lenders and see what sticks," Warshafsky told ValueWalk. "However, given the extent of bad covenants we have seen in the last couple years, it seems like if it's only a negotiating strategy, it is certainly one that is working."

With investors searching for yield in a near zero interest rate environment, stricter covenant provisions that can disadvantage lenders are often an outcome of the process where demand outstrips supply.

And then along came the loan covenant prepared by Vista Partners for an unnamed corporation. Warshafsky categorizes as the worst to date based primarily on five factors, many of which move the deal terms away from being pari passu, or putting lenders on equal footing, to disadvantaging existing lenders after they made an investment.

Silent First and Senior Lien: From one perspective, this issue is endemic of many that make this the worst debt covenant ever. The credit agreement implies that the lender's collateral interest can be subordinated by new senior liens or diluted with new pari passu liens, so long as they are not specifically prohibited in the agreement. "The significance is one of risk in terms of whether a court would consider a subordination/dilution to in fact be permitted by the agreement," Warshafsky explained, pointing to a special report on the topic, *Apollo Burns Its Investors with 'Silent' First Lein*. "The 'not prohibited' language is one of a few key portions of the agreement which differ from the typical language in this context."

Worst RP Debt Provisions: "Restricted Payment" (RP) debt provisions allow a borrower to switch payments from dividends and distributions, which is positive for borrowers, and instead use those payments to carry additional debt. In a previous paper titled "Why We Hate RP Debt Baskets," Warshafsky had reasoned that a borrower can take on additional debt that could be "structurally senior to the existing loans," she explained. "This would actually put these new lenders of the 'RP Debt' ahead of the existing Lenders on any assets the non-guarantor holds."

Aggressive Ratio Debt Tests: Another area where existing lenders could suddenly find their claims junior to new investors comes through aggressive ratio debt tests. This agreement is structured so that it is easy for the borrower to incur new debt and that debt may be senior to existing lenders.

Incremental Payment Amount: This section in the loan covenant is problematic for several reasons. “It can increase the amount of debt the borrower can incur in a way that is not apparent,” Warshafsky said. “First, general basket debt can be incurred by non-guarantors (making it structurally senior and ahead of the Lenders). Second, the result is to double the impact of a payback (it clears up general basket debt while also increasing incremental basket amount).”

Worst MFN: Most Favored Nations clause is typically an omnipresent protection for lenders which requires that new debt cannot be priced higher than the lenders’ debt, unless the lenders’ pricing is also increased. Warshafsky explains:

If Lenders’ debt is priced at L+200 and they have 50 bps MFN, that means that new debt cannot be priced at more than L+250 or, in the alternative, if the new debt is priced at L+450, then the Lenders’ debt pricing must increase to L + 400.

While the trend has been for looser covenants, Warshafsky has seen some terms have been better in 2019 compared to the end of 2018, particularly for middle market deals.

How can lenders get better terms? “It is a game of leverage, she says. “From what we’ve seen, lenders do comment and push back, but at the end of the day, if they want to get in the deal based on the business terms, they may go ahead despite poor legal terms. The fact that this deal (Vista Equity Partners) never closed (as far as we know) may be a sign that the market is shifting toward lenders, but it is hard to say, as I have not heard any specific insight from lenders on this deal.”

Vista Equity Partners did not respond to a request for comment.