In a leveraged loan market where demand dwarfs supply, *Alt Credit* explores how lenders are getting to grips with ever more borrower-friendly loan docs

By James Harvey

Loan market participants can't agree on much these days. Is the recent boom in the US economy real, or largely illusory? Is an uptick in defaults on its way, or does the credit cycle have a few more years left to run? Fortunately (or unfortunately), there is one thing that everyone does agree on: it's a borrower's market.

The almost-universal nature of covenant-lite structures and a huge supply-demand imbalance caused by rising interest rates have contributed to a two-year-long bull market in leveraged loans, which shows no signs of slowing down. And naturally, sponsors have been doing everything they can to take advantage.

Over the past year, private equity sponsors have crafted ever more borrower-friendly loan documents, mostly safe in the knowledge that – given the huge demand for floating-rate products – there will be enough willing buyers, even if weak lender protections leave a sour taste.

Perhaps the most striking illustration of the balance of power being in borrowers' favour was last year's J Crew fiasco. The embattled retailer transferred roughly $250m of intellectual property to an unrestricted subsidiary under "permitted investments" rules and issued a new loan backed by this IP, making the firm's original loan investors less secure.

At a recent IMN industry conference, by far the most-used phrase was adjusted EBITDA, as loan investors lamented "egregious" additions to borrowers' official EBITDA, masking true leverage figures for many indebted companies.

But at what point should lenders fight back? And how should they do it? We spoke with loan investors and service providers about what to look out for in loan documents, and the chance of the pendulum swinging back in investors' favour any time soon.

EBITDA adjustments baffle US loan investors

As mentioned above, adjustments to contractual EBITDA in loan documents have become more and more common in the past year, often baffling and infuriating loan investors in equal measure. "Companies are being allowed to lever portions of EBITDA that are totally speculative," said Farboud Tavangar, a senior portfolio manager at LCM Asset Management, speaking at the IMN CLOs and Leveraged Loans conference in late May.

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"The adjustments that are being put in place are leading to true leverage levels that are significantly higher than what meets the eye."

Ross Hallock, an analyst at Covenant Review in New York, says that the concept of EBITDA has changed dramatically. "EBITDA started as a decent proxy for the ability to service debt, but has been completely steamrolled in recent years," he says. "It's often very difficult to make meaningful comparisons between companies, even within the same sector."

EBITDA adjustments started as a way for sponsors to factor in cost savings or "synergies" resulting from M&A activity and were originally accepted as a perfectly reasonable projection. For example, in the case of a merger, companies typically merge their headquarters, saving on rent and staffing costs, which could then be added back into the projected net income figure for the coming year.

The standard for these adjustments in loan documents was that they should be "reasonably identifiable and factually supportable," typically with sign-off from a third-party auditor, such as PricewaterhouseCoopers (PwC). However, increasingly, investors are facing unsupported, aggressive EBITDA adjustments applied to anything that can be classed as a "new initiative".

"EBITDA adjustments and forward projections are giving borrowers a tremendous amount of flexibility to do things that may benefit equity holders at the expense of creditors," says John Fraser, head of Investcorp Credit Management in New York.

Shared workspace provider WeWork has become the posterchild for ridiculous EBITDA adjustments, following a $700m bond offering earlier this year. The bond's prospectus lists no fewer than three adjusted EBITDA figures: adjusted EBITDA, adjusted EBITDA before growth investments, and community adjusted EBITDA, a bespoke figure that adds back general and administrative expenses.

The additions meant that WeWork's adjusted EBITDA of -$193m became +$49m before growth investments, with community adjusted EBITDA of +$233m. While the latter figure is not being used in the bond's covenants, sources say it was used extensively in marketing.

Europe: it's all about transferability

While EBITDA adjustments are a considerably bigger talking point in the US market, they have begun creeping into European loans as well. "As a general rule, trends within the US loan market tend to show up pretty quickly over here," says Tyler Wallace, portfolio manager at Fair Oaks Capital in London. This is a sentiment shared by Jane Gray, co-head of European research at Covenant Review.

"More and more, we're seeing loans come to market in Europe with uncapped cost savings and synergies," she says. "Pro forma adjustments for cost savings and synergies used to be limited to acquisition or disposal loans, but that is no longer the case and can be applied to any type of transaction."

Gray says that the US-style method of calculating leverage based solely on first lien debt – rather than all senior debt – has crept into the European loan market, perhaps as an unintended consequence of the new leveraged lending guidelines introduced in 2017, but more likely due to demand outweighing supply.

"The overall effect is to narrow the numerator and widen the denominator in the debt/EBITDA ratio," she says.

A much bigger problem for European loan investors, however, has been a general trend towards restricting transferability – i.e. the ability to trade out of a loan easily. There has been a sharp increase in transfer restrictions in European loan documents since 2017. For example, according to Covenant Review data, 62% of loans now have restrictions on 'loan-to-own' buyers – up from 50% in 2017.

Meanwhile, 63% of loans only allow lenders to trade out of a loan with the borrower's consent – except in an event of default. (In 2017, the figure was 50%). And while transfer restrictions – particularly those relating to loan-to-own buyers – are not exactly new, they are also becoming more stringent, says Fair Oaks' Wallace. "We continue to see transfer language that potentially limits the ability of a lender to trade out of a credit, especially in a stressed scenario," he says. "Drafting language can be aggressive in defining a loan-to-own buyer – potentially capturing par/performing credit investors."

Compounding the problem is the lengthening – or even removal – of 'deemed consent' periods, where a lender can sell a loan after a certain number of days unless there is an explicit objection from the borrower.

Covenant Review's data shows that the average deemed consent period has increased from 6.9 days in 2017 to 8.1 days this year, and 26% of loans make no provisions for deemed consent at all, meaning that affirmative consent is required from the borrower in all cases (in 2017, that figure was 9%).

"While there's usually a way around transfer restrictions, it certainly isn't a helpful trend," says Wallace. This is particularly true for CLOs – which make up around 60% of the loan market – since it is not uncommon for them to have some mark-to-market-based restrictions on sales and asset purchases.

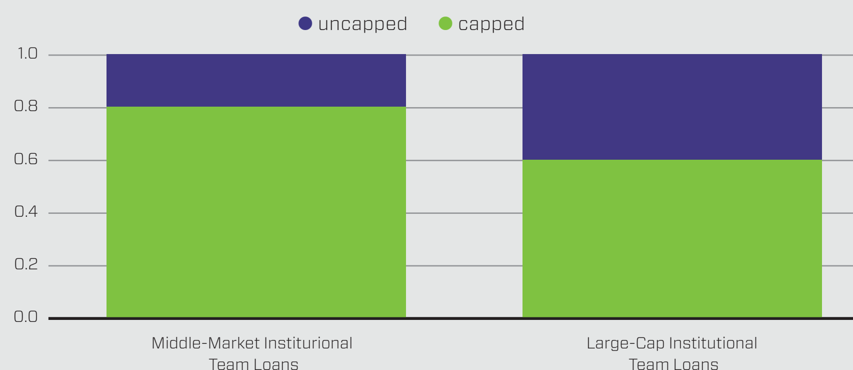
The fightback begins

Given the extent to which the supply/demand balance has shifted in borrowers' favour, it is perhaps not surprising that investors have so far had little luck in pushing back against aggressive documentation.

Lisa Byrns, a leveraged loan analyst for Covenant Review in New York, notes that not only are addbacks accounting for a larger portion of EBITDA – on average about 34% in M&A-driven large cap institutional loans – but that the timeframe for forward projections is increasing as well. "There used to be a 12-month limit on the 'look-ahead period' for EBITDA synergistic adjustments, which is still the average in middle market, but, for more than 50% of large cap loans, the new standard is 24 months," she explains.

Indeed, data from a recent survey carried out by Covenant Review and the LMA show that the average look-ahead period in US loans has increased to 22.3 months in 2018, up from 20.1 last year. In Europe, the average

Avg. pro forma synergies / "run rate" costs savings adjustment (LTM) capped vs. uncapped



Source: Covenant Review, LLC

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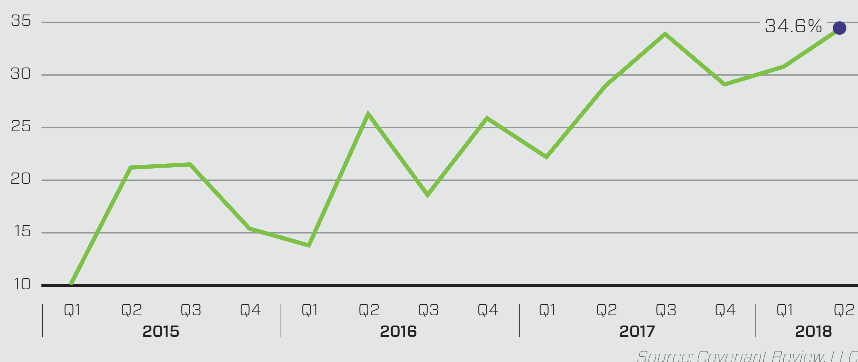
Avg. adjustments to EBITDA as % of reported EBITDA, M&A-driven large-cap loans



Source: Covenant Review, LLC

Uncapped EBITDA addbacks for pro forma synergies & 'run rate' cost savings, % of large-cap loans

Source: Covenant Review, LLC

has seen a more modest increase, from 17.0 to 17.8 months.However, in the past few months, lenders appear to have decided that enough is enough, and slowly but surely, have begun restoring some protections to loan deals – particularly related to EBITDA adjustment caps.

According to Covenant Review data, the number of US loans coming to market with no caps on addbacks for pro forma synergies and cost savings peaked at over 60% of the primary market in Q1 of this year – considerably higher than at any point in the past three years. However, by Q2, this figure had declined to 39% of the market, indicating significant pushback from loan investors.

Meanwhile, across the Atlantic in Europe, only 36% of new loans in 2018 have had uncapped EBITDA adjustments – down from 51% in 2017, and a 63% rolling 12-month average. Illustrating this, one loan manager in London tells an anecdote about a European sponsor bringing a very borrower-friendly loan to market in late 2017, which cleared with almost no fuss from investors.

However, when the same sponsor tried to place another loan in the second quarter using the earlier transaction's terms as a template, investors insisted on a raft of changes, including wider pricing, a "most-favoured nation" clause guaranteeing favourable terms in the event of a new loan issue, a cap on EBITDA adjustments, and limiting prepayments on the company's second lien loans.

Even with all these changes, however, the loan's terms were still very much borrower-friendly, meaning the sponsor was happy to give way to ensure the deal got done. "There's a sense that sponsors are just trying to see exactly how much they can get away with," said the manager.

Haunted by the ghost of J Crew

One area where lenders appear to be having some success, however, is in their attempts to avoid getting "J Crew'd" by insisting on tighter language around "permitted investments" by borrowers.

As alluded to in the introduction, J Crew made headlines last year when it transferred roughly $250m of intellectual property from its holding company to a newly created, Cayman-domiciled unrestricted subsidiary under the guise of a permitted investment as part of a distressed debt exchange.

The retailer then issued new bonds guaranteed by the subsidiary, turning lenders to the holdco from first lien creditors into second or third lien creditors, and pushing junior bondholders to the front of the line in any fight over J Crew's IP. Eaton Vance and Highland Capital Management sued to reverse the debt exchange but have so far been unsuccessful in their efforts.

Similar collateral leakage has cropped up again in recent deals, such as PetSmart's 2017 acquisition of Chewy for $3.4bn.

Last month, *Bloomberg* reported that PetSmart had transferred 20% of Chewy's equity to an entity controlled by private equity sponsor BC Partners, while transferring an additional 16.5% to an unrestricted subsidiary of Petsmart.

Investcorp's Fraser says that senior lenders need to be very careful when investing in loans that contain similar trapdoor provisions. "What we think of as a fully secured loan may end up becoming dramatically undercollateralised as a result of the ease with which borrowers can transfer value between subsidiaries," he says.

Stephen Hazelton, founder and CEO of Street Diligence, says the J Crew and Petsmart transactions have led lenders to look again at "permitted investments" language in loan documents. "Historically, permitted investments were mainly made in the form of cash, rather than transferring assets between subsidiaries," he says. "Increasingly, lenders are exploring ways of protecting themselves, either by tightening the definitions of permitted investments, or implementing caps on asset transfers."

Engineering firm McDermott and cosmetics company Coty are classic examples of this recent push by lenders. According to a recent report from Fitch Ratings, McDermott's latest credit agreement, dated May 2018, explicitly bans the transfer of intellectual property to unrestricted subsidiaries, while containing covenants requiring that intellectual property can only be held by loan parties. Meanwhile, the loan limits "permitted investments" to a total of roughly $600m of assets.

Meanwhile, a cross-border refinancing by Coty, which came to market earlier this year, entirely removes the permitted investments basket for non-loan parties, as an alternative approach to protecting asset leakage. ◻

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