The food fight over covenant-lite leveraged loans

There are two food fights going on. First, there has been a mad scramble by investors racing to buy them, as they now represent 80% of the $1.2 trillion US leveraged loan market. Leveraged loan performance has been welcome at a time of low Fed policy rates: 5% leveraged loan annualized returns since 2010, which is 2/3 the return of high yield bonds, and with commensurately lower volatility.

The second and equally important food fight is over whether cov-lite loans are a harbinger of doom for investors. Moody’s broad-based assessment of loan covenants shows that they’re at their weakest level on record, with a Moody’s covenant specialist writing earlier this year that “our scores reflect weaker protections on a year-over-year basis in nearly every risk category we assess. Given the breadth and depth of covenant weakness, existing loans are in uncharted territory.” All things considered, a decade of easy Fed policy and aggressive loan underwriting argue for materially lower loan recovery rates in the next recession. In this special Eye on the Market section, we explain why.

Loan investors waving the white flag: Moody’s loan covenant quality score is the weakest on record

Moody’s: “When borrowers can make restricted payments, investments, junior debt prepayments or incur new debt even after default, all lenders can do is hope for a satisfactory outcome”. June 27, 2019

1 Loan investors wave the white flag. Covenant assessment scores by Moody’s and Fitch analyze leverage and interest coverage maintenance tests, most-favored-nation provisions, mandatory prepayments from asset sales, exceptions to negative covenant restrictions, restricted payments clauses, definition and scope of allowable EBITDA adjustments, leakage of assets from the collateral pool, caps on investments in or transfers to unrestricted subsidiaries and affiliates, the ability to add senior pari-passu or priority debt, lien dilution by non-guarantor subsidiaries, etc. In other words, the means by which lenders try to prevent issuers and their legal counsel from diminishing lender rights and protections. These are the protections that loan investors are now surrendering at a record pace.

2 Moody’s, “North American loan covenant quality hits new record-worst in Q3 2018”, January 24, 2019. Moody’s reported back in 2016 that loan covenants were already weaker than they were in 2007, before the crisis.
A. Leveraged loan interest coverage looks good, but there are some caveats. First, average leverage is rising as well. Second, coverage and leverage measures are artificially boosted by increasing use of “EBITDA add-backs\(^3\)”. This refers to the practice of companies adding back non-recurring expenses and assumed merger synergies/cost savings to earnings, thereby artificially enhancing any measure derived from EBITDA:

- According to S&P, the use of EBITDA add-backs has increased from 10% of all deals to around 30%. In terms of magnitude, S&P reports that such add-backs range from 10%-15% of unadjusted EBITDA. However, according to Moody’s, some deals allow add-backs up to 20%-30% of unadjusted EBITDA, and some deals have no caps at all
- Fitch’s Covenant Review reports that 35% of middle-market loan issuers used EBITDA add-backs. While assumed synergies were usually capped at 10%-15% of unadjusted EBITDA, in some cases there were also no caps, just as Moody’s reported
- According to S&P, around half of all M&A loan issuance in 2017 and 2018 had leverage above 6.0x once the benefits of assumed synergies are excluded (second chart below)
- Moody’s analyzed how successful European companies have been in achieving assumed cost savings. They found that only 45% of EBITDA add-backs were achieved on average, and that nearly 20% of issuers didn’t achieve any of their projected add-back targets

B. Some see the increase in cov-lite as a reflection of a loan market now dominated by larger, more well-known issuers (loans less than $300 mm were 50% of the loan market in the year 2000, but now represent just 10% of the market). Since 2017, these larger cov-lite loans have been issued with tighter spreads than fully covenanted loans. Whatever; I don’t believe investors need less covenant protection simply because the companies issuing them are larger and better known. After all, they are still mostly non-investment grade (junk) credits. If anything, the loan market has become a little more “junky”: since 2016, the % of the loan market rated below split BB has risen from 50% to 60%.

C. There’s not a lot of history on recovery rates of defaulted cov-lite loans vs fully covenanted loans, since cov-lite loans were only a small fraction of the total market during the prior credit cycle. Since 2010, a period of very low overall corporate default rates, only 13 cov-lite loans defaulted. Their recovery rates were 56%, compared to 80%-85% for all bank loans and senior secured bonds.

---

\(^3\) EBITDA is a proxy for cash flow and refers to earnings before interest, taxes, depreciation and amortization.
Some argue that financial sponsor (private equity) firms will support their loans during a period of economic stress using resources of their funds. I don't buy it, unless there are clear financial advantages to the private equity firm for doing so. While sponsor-backed loan default rates were lower than for non-sponsor loans during the credit cycle 10 years ago, once debt exchanges are included (corporate actions which frequently entail large losses for lenders), sponsor-backed loan default rates look the same, if not slightly worse. Examples of large debt exchanges from the 2009/2010 period: TXU, Harrah’s, Freescale, Realogy, Intelsat and Hexion.

When thinking about default rates, remember that there’s an important difference between market pricing and realized losses. The chart on the left shows peak loan default rates of 20%-22% in 2010. If recovery rates averaged 65%-70%, peak realized losses would have been around 6%-8%. However, as shown on the right, peak declines in the loan total return index (e.g., market pricing) were closer to 25%-30%. In other words, in the fog of recession, investors didn’t know exactly which credits would default and which wouldn’t, driving pricing lower across the entire loan market at a time of falling dealer liquidity. In a milder recession than 2008 but with lower loan recovery rates, I can imagine the loan total return index declining by roughly 7%-10%. **Bottom line: loan investors sometimes have to ride out periods of market declines that are well in excess of ultimate realized losses.** Over the last few years, this hasn’t been a problem, since loan default rates have averaged 1%-2%.

---

**Sponsored vs non-sponsored default rates %, 2000-2012**

- Sponsor-backed, including debt exchanges
- Non-sponsored
- Sponsor-backed, excluding debt exchanges


**Leveraged loan default rates %, 2012-2019**

Wave of energy defaults


**Leveraged loans: market pricing versus realized losses Index, 9/15/2008 = 100**

Our estimates of actual peak realized losses

S&P/LSTA Leveraged Loan Index

E. Following on point D on financial sponsors, I would go further and say that in some cases, they can substantially increase risk on leveraged loans. There are recent reported cases of **collateral stripping** in which sponsors transfer collateral beyond the reach of senior creditors⁴. They have been infrequent so far, but when/if the economy turns, this kind of activity could increase due to the laxity of “restrictive payment” and other covenants outlined in footnote 1 on page 3, which should be required reading for loan investors.

- In 2016, as J.Crew was on the verge of bankruptcy, sponsors TPG and Leonard Green extracted intellectual property behind the brand name from collateral pledged to existing creditors. In 2017, they offered this IP as collateral to new creditors, and borrowed $300 mm of new money. Sponsors used proceeds to reinvest in the business, and so far, consequences for loan investors have been positive; but if J Crew were to fail, original creditors would lose out due to dilution of collateral

- In 2017 PetSmart transferred stakes in Chewy.com (which PetSmart had bought for $3.4 billion) to a special subsidiary and a holding company that would be hard for bondholders to reach in case of bankruptcy. Sponsors BC Partners convinced lenders to limit future litigation over these actions; Chewy has since gone public, with none of the proceeds used to pay down Pet Smart’s $8 bn debt

- In Sept 2018, Neiman Marcus (struggling with $5 bn in debt, some of which traded at 45 cents on the dollar) disclosed that it was transferring its online luxury fashion e-commerce site MyTheresa to a holding company owned by sponsors Ares and the Canadian Pension Board. This would move MyTheresa out of reach of Neiman Marcus creditors in case of a bankruptcy filing

This kind of activity was notable enough to be mentioned in an October 2018 speech on leveraged loan risks by a Senior Director at the Federal Reserve⁵. There are competing signals coming from the official sector: while the Fed has been raising red flags regarding risks in the loan markets, the OCC has been lowering them by softening the EBITDA leverage guidance that it put in place in 2013⁶.

One last comment on financial sponsors: many of them instruct banks arranging their syndicated loans as to which law firm the bank should use as it own counsel, a practice known as “sponsor-designated counsel”. Given all the lender-issuer tradeoffs required to negotiate a set of covenants, I would not be surprised if people ask questions about this when/if the cycle turns.

All things considered, these trends don’t argue for higher default rates, those will be determined by the depth of whatever recession occurs, and I believe it will be a much milder one rather than in 2008; the Fed is also now pushing out the timing of a recession by easing. But in my view these trends argue for lower loan recoveries on defaults that eventually occur. Historically, loan recoveries averaged 70% compared to 40% for high yield. The midpoint of 55% is where loan recoveries may end up next time around. In the covenant food fight between issuers and lenders, issuers are winning, hands down.

---

⁴ Sources: Bloomberg July 19, 2019; DigitalCommerce360.com; WolfStreet.com
⁵ “Perspectives on Leveraged Lending”, Todd Vermilyea, Federal Reserve, October 2018.
⁶ While loan examiners are in practice still tracking highly leveraged loans, particularly those that amortize less than 50% over 7 years, they do not explicitly prohibit them, and highly leveraged loans with unadjusted debt/EBITDA over 6.0x-7.0x are still commonplace, as described on the prior page.
IMPORTANT INFORMATION

This material is for information purposes only. The views, opinions, estimates and strategies expressed herein constitutes Michael Cembalest’s judgment based on current market conditions and are subject to change without notice, and may differ from those expressed by other areas of JPMorgan Chase & Co. (“JPM”). This information in no way constitutes J.P. Morgan Research and should not be treated as such.

Non-Reliance: Certain information contained in this material is believed to be reliable; however, JPM does not represent or warrant its accuracy, reliability or completeness, or accept any liability for any loss or damage (whether direct or indirect) arising out of the use of all or any part of this material. No representation or warranty should be made with regard to any computations, graphs, tables, diagrams or commentary in this material, which are provided for illustration/reference purposes only. JPM assumes no duty to update any information in this material in the event that such information changes. Any projected results and risks are based solely on hypothetical examples cited, and actual results and risks will vary depending on specific circumstances. Forward-looking statements should not be considered as guarantees or predictions of future events.

Nothing in this document shall be construed as giving rise to any duty of care owed to, or advisory relationship with, you or any third party. Nothing in this document shall be regarded as an offer, solicitation, recommendation or advice (whether financial, accounting, legal, tax or other) given by JPM and/or its officers or employees, irrespective of whether or not such communication was given at your request. JPM and its affiliates and employees do not provide tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any financial transactions.

General Risks & Considerations: Any views, strategies or products discussed in this material may not be appropriate for all individuals and are subject to risks. Investors may get back less than they invested, and past performance is not a reliable indicator of future results. Asset allocation does not guarantee a profit or protect against loss. Nothing in this material should be relied upon in isolation for the purpose of making an investment decision. You are urged to consider carefully whether the services, products, asset classes (e.g. equities, fixed income, alternative investments, commodities, etc.) or strategies discussed are suitable to your needs. You must also consider the objectives, risks, charges, and expenses associated with an investment service, product or strategy prior to making an investment decision. For this and more complete information, including discussion of your goals/situation, contact your JPM representative.

JPM may hold a position for itself or our other clients which may not be consistent with the information, opinions, estimates, investment strategies or goals/situation, contact your JPM representative. JPM or its affiliates may hold a position or act as market maker in the financial instruments of any issuer discussed herein or act as an underwriter, placement agent, advisor or lender to such issuer.

Legal Entities and Regulatory Information: In the United States, bank deposit accounts and related services, such as checking, savings and bank lending, are offered by JPMorgan Chase Bank, N.A. Member FDIC.

JPMorgan Chase Bank, N.A. and its affiliates (collectively “JPMCB”) offer investment products, which may include bank managed accounts and custody, as part of its trust and fiduciary services. Other investment products and services, such as brokerage and advisory accounts, are offered through J.P. Morgan Securities LLC (“JPM”), a member of FINRA and SIPC. Annuities are made available through Chase Insurance Agency, Inc. (CIA), a licensed insurance agency, doing business as Chase Insurance Agency Services, Inc. in Florida. JPMCB, JPM and CIA are affiliated companies under the common control of JPMorgan Chase & Co. Products not available in all states.

In Luxembourg this material is issued by J.P. Morgan Bank Luxembourg S.A (JPMBL), with registered office at European Bank and Business Centre, 6 route de Treves, L-2633, Senningerberg, Luxembourg. R.C.S Luxembourg B10.958. Authorised and regulated by Commission de Surveillance du Secteur Financier (CSSF) and jointly supervised by the European Central Bank (ECB) and the CSSF. J.P. Morgan Bank Luxembourg S.A. is authorized as a credit institution in accordance with the Law of 5th April 1993. In the United Kingdom, this material is issued by J.P. Morgan Bank Luxembourg S.A—London Branch. Prior to Brexit, (Brexit meaning that the UK leaves the European Union under Article 50 of the Treaty on European Union, or, if later, loses its ability to pass passport financial services between the UK and the remainder of the EEA), J.P. Morgan Bank Luxembourg S.A—London Branch is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from us on request. In the event of Brexit, in the UK, J.P. Morgan Bank Luxembourg S.A—London Branch is authorised by the Prudential Regulation Authority, subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. In Spain, this material is distributed by J.P. Morgan Bank Luxembourg S.A., Sucursal en España, with registered office at Paseo de la Castellana, 31, 28046 Madrid, Spain. J.P. Morgan Bank Luxembourg S.A., Sucursal en España is registered under number 1516 within the administrative registry of the Bank of Spain and supervised by the Spanish Securities Market Commission (CNMV). In Germany, this material is distributed by J.P. Morgan Bank Luxembourg S.A—Frankfurt Branch, registered office at Taunustor 1 (TaunusTurm), 60310 Frankfurt, Germany, jointly supervised by the Commission de Surveillance du Secteur Financier (CSSF) and the European Central Bank (ECB), and in certain areas also supervised by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). In Italy, this material is distributed by J.P. Morgan Bank Luxembourg S.A—Milan Branch, registered office at Via Cantena Adalberto 4, Milan 20121, Italy and regulated by Bank of Italy and the Commissione Nazionale per le Società e la Borsa (CONSOB). In addition, this material may be distributed by J.P.Morgan Chase Bank, N.A. (“JPMB”), Paris branch, which is regulated by the French banking authorities Autorité de Contrôle Prudentiel et de Résolution and Autorité des Marchés Financiers or by J.P. Morgan (Suisse) SA, which is regulated in Switzerland by the Swiss Financial Market Supervisory Authority (FINMA).

In Hong Kong, this material is distributed by JPMCB, Hong Kong branch. JPMCB, Hong Kong branch is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission of Hong Kong. In Hong Kong, we will cease to use your personal data for our marketing purposes without charge if you so request. In Singapore, this material is distributed by JPMCB, Singapore branch. JPMCB, Singapore branch is regulated by the Monetary Authority of Singapore. Dealing and advisory services and discretionary investment management services are provided to you by JPMCB, Hong Kong/Singapore branch (as notified to you). Banking and custody services are provided to you by JPMCB Singapore Branch. The contents of this document have not been reviewed by any regulatory authority in Hong Kong, Singapore or any other jurisdictions. For materials which constitute product advertisement under the Securities and Futures Act and the Financial Advisers Act, this advertisement has not been reviewed by the Monetary Authority of Singapore. JPMorgan Chase Bank, N.A., a national banking association chartered under the laws of the United States, and as a body corporate, its shareholder’s liability is limited.

With respect to countries in Latin America, the distribution of this material may be restricted in certain jurisdictions. We may offer and/or sell to you securities or other financial instruments which may not be registered under, and are not the subject of a public offering under, the securities or other financial regulatory laws of your home country. Such securities or instruments are offered and/or sold to you on a private basis only. Any communication by us to you regarding such securities or instruments, including without limitation the delivery of a prospectus, term sheet or other offering document, is not intended by us as an offer to sell or a solicitation of an offer to buy any securities or instruments in any jurisdiction in which such an offer or a solicitation is unlawful. Furthermore, such securities or instruments may be subject to certain regulatory and/or contractual restrictions on subsequent transfer by you, and you are solely responsible for ascertaining and complying with such restrictions. To the extent this content makes reference to a fund, the Fund may not be publicly offered in any Latin American country, without previous registration of such fund’s securities in compliance with the laws of the corresponding jurisdiction. Public offering of any security, including the shares of the Fund, without previous registration at Brazilian
Securities and Exchange Commission – CVM is completely prohibited. Some products or services contained in the materials might not be currently provided by the Brazilian and Mexican platforms.

J.P. Morgan Chase Bank, N.A. (JPMCBNA) (ABN 43 074 112 011/AFS Licence No: 238367) is regulated by the Australian Securities and Investment Commission and the Australian Prudential Regulation Authority. Material provided by JPMCBNA in Australia is to “wholesale clients” only. For the purposes of this paragraph the term “wholesale client” has the meaning given in section 761G of the Corporations Act 2001 (Cth). Please inform us if you are not a Wholesale Client now or if you cease to be a Wholesale Client at any time in the future. JPMS is a registered foreign company (overseas) (ARBN 109293610) incorporated in Delaware, U.S.A. Under Australian financial services licensing requirements, carrying on a financial services business in Australia requires a financial service provider, such as J.P. Morgan Securities LLC (JPMS), to hold an Australian Financial Services Licence (AFSL), unless an exemption applies. **JPMS is exempt from the requirement to hold an AFSL under the Corporations Act 2001 (Cth) (Act) in respect of financial services it provides to you, and is regulated by the SEC, FINRA and CFTC under US laws, which differ from Australian laws.** Material provided by JPMS in Australia is to “wholesale clients” only. The information provided in this material is not intended to be, and must not be, distributed or passed on, directly or indirectly, to any other class of persons in Australia. For the purposes of this paragraph the term “wholesale client” has the meaning given in section 761G of the Act. Please inform us immediately if you are not a Wholesale Client now or if you cease to be a Wholesale Client at any time in the future. This material has not been prepared specifically for Australian investors. It:

- may contain references to dollar amounts which are not Australian dollars;
- may contain financial information which is not prepared in accordance with Australian law or practices;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address Australian tax issues.

References in this report to “J.P. Morgan” are to JPMorgan Chase & Co., its subsidiaries and affiliates worldwide.

This material is intended for your personal use and should not be circulated to or used by any other person, or duplicated for non-personal use, without our permission. If you have any questions or no longer wish to receive these communications, please contact your J.P. Morgan representative.

© 2019 JPMorgan Chase & Co. All rights reserved.