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Alternative Investments Group Client Alert: CLO 1.0 vs. 2.0 – Part II of a Series: Cov-Lite Loans

This is the second in a series of Milbank client alerts focused on distinguishing characteristics of post-credit crisis CLOs ("**CLO 2.0**") compared with their pre-2008 predecessors ("**CLO 1.0**"). In this edition, we will focus on recent trends around "cov-lite loans."

COV-LITE LOANS

The debate surrounding the potential risks—or lack thereof, depending on one's viewpoint—associated with investing in loans that do not contain financial maintenance covenants,[1] or "cov-lite loans," continues to intensify in the CLO space, driven in part by the limited supply of leveraged loans that are available for purchase by CLO issuers and the steadily decreasing supply of such loans that contain maintenance covenants. So far this year, the proportion of cov-lite loans in the U.S. leveraged loan market has risen to more than 50% of total issuance, which is double the level seen in 2007.[2]

To briefly summarize both sides of the issue, some industry participants place little significance on lack of maintenance covenants and instead focus above all on a borrower's creditworthiness, which is in part a function of a borrower's size and sophistication. They reason that it is better to hold a good cov-lite loan than a bad credit with financial maintenance covenants. This group derives comfort from the fact that cov-lite loans provide borrowers with greater flexibility to manage the loan in times of distress, which for well-managed borrowers may well be a better scenario than having lenders dictate how a borrower should run its business. Moreover, this group argues, the existence of a maintenance covenant does not guarantee the covenant will ever be tested. Indeed, with

[1] Maintenance covenants require a borrower to comply on a periodic basis with certain financial tests, such as minimum levels of cash flow coverage and maximum levels of leverage. They are distinguishable from incurrence covenants, which require a borrower to comply with certain such financial tests only if it takes an action, such as issuing debt, making an acquisition or paying a dividend. It is important to note that the term "cov-lite" is something of a misnomer. Cov-lite loans do not contain any financial maintenance covenants but do often contain incurrence covenants and significant affirmative and negative covenants.

[2] Stephen Foley, *'Cov-lite' Loans Soar in Dash for Yield*, Financial Times (May 27, 2013).

large, sophisticated borrowers, this has often been the case. These arguments are compelling given that cov-lite loans have historically experienced fewer defaults than, and performed no worse from a recovery standpoint than, loans with maintenance covenants.[3] In the CLO context, this historical performance data is critical, given the primary objective of the collateral manager at the inception of a CLO to source loans of sufficient credit quality to perform well throughout the life of the CLO. From this standpoint, an exclusive focus on the existence or absence of maintenance covenants can be short-sighted.

On the other side is the "covenant bubble theory" view—that the recent dramatic increase in cov-lite loan origination could extend to companies with poor credit quality, leaving lenders without any meaningful influence when a credit deteriorates. Moreover, this group argues, the historic performance of cov-lite loans may not be relevant if cov-lite loans are now extended to borrowers with weaker credit profiles than in the days of CLO 1.0 originations.

CLO 1.0 documentation dealt with cov-lite loans in a non-uniform manner, with some deals containing no restrictions on issuers owning cov-lite loans (or only containing restrictions with respect to the recovery rate treatment of such loans and providing that cov-lite loans be identified in monthly collateral reports) while other deals imposed caps on the amount of cov-lite loans in an issuer's portfolio, typically in the range of 10-15%. Throughout the beginning of the CLO 2.0 era in 2010 and 2011, cov-lite loan concentration limits were generally 25-30%. In 2012, this figure rose to approximately 30-40%. In 2013, the number has climbed even higher, to around 50-60%, and in some deals as high as 70%.

Lately, as cov-lite loan origination has become the "new normal," the CLO market has adapted not only by increasing the size of cov-lite baskets, but also in some transactions by modifying relevant indenture definitions to allow for even greater flexibility in the purchase of cov-lite loans. For example, some indentures provide for a carve-out that excludes from the definition of "cov-lite loan" any loan that does not contain a maintenance covenant but that is pari passu with, or contains a cross-default to, another loan of the same obligor[4] that is subject to a maintenance covenant.[5] Another common feature involves permitting the cov-lite concentration limit to be increased with the consent of only a majority of the controlling class of notes.

As for the rating agency response, earlier this year S&P expressed concern with the increase in concentrations of cov-lite loans, specifically noting that cov-lite loans were

[3] John Bell, Kevin Perry, *'Covenant-Lite' Loans: Credit Quality is Still the Dominant Factor*, http://www.loomissayles.com/internet/internetdata.nsf/0/0BF67A378755F21085257B5000566A43/$FILE/CovenantLitePaper.pdf (April 2013).

[4] A slightly more restrictive variation on this provision limits the carve-out to loans of the same obligor in the same loan facility. This formulation is meant to address transactions in which there are maintenance covenants for the direct benefit of the revolving lenders but not the term lenders.

[5] Note that this provision explicitly does not apply for purposes of calculation of the S&P recovery rate.

being issued in the market to borrowers with weaker credit profiles than had been the case in the past.[6] Due to the fact that S&P haircuts its recovery ratings of cov-lite loans, S&P recovery ratings have declined over the past year.[7] In response, issuers in certain recent transactions have engaged other rating agencies to rate their notes, although S&P still maintains significant market share of the CLO note rating business.

While the performance of a new generation of cov-lite loans remains to be seen, one thing seems certain. For so long as cov-lite loan origination continues to dominate the commercial lending market, we can expect CLOs to continue evolving and adapting to the changing environment. Those who have been active in the CLO market for decades have seen many variations on this theme, from the establishment of concentration limits for synthetic letters of credit to address potential adverse tax consequences to incorporation of delayed draw note features to deal with scarcity of warehouse financing and diminished loan origination. The cov-lite phenomenon surely will not be the last to which the ever-evolving CLO market will need to adjust.

[6] Robert Chiriani, Anne-Charlotte Pedersen, *For U.S. Collateralized Loan Obligations "2.0," Views On Recoveries Make A Big Difference*, www.StandardandPoors.com/RatingsDirect (April 5, 2013).
[7] Tom Davidson, *CLO Managers Hit Out at S&P on Loan Recovery Ratings*, CreditFlux Newsletter (May 2, 2013).

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