KEY POINTS

- The cov-lite model, the culmination of convergence between bank and bond terms, has set a new high-water mark for borrower-friendliness in the European leveraged buyout ('LBO') finance market.
- Cov-lite combines the greater operational freedom of bonds with the greater flexibility to change or refinance inherent in bank debt arrangements.
- The trade-off for borrowers is less control over transfers by lenders.

Spotlight

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Cov-lite – the new cutting edge in acquisition finance

Recently arrived in Europe from the US, 'cov-lite' represents the culmination of convergence between bank and bond terms and has set a new high-water mark for borrower-friendliness in the European LBO finance market. But what lies behind the headlines?

THE ROAD TO COV-LITE

Over the past four years the confluence of low default rates, good relative value and a positive economic environment has resulted in an unprecedented level of liquidity in the European leveraged acquisition finance market. With investors clamouring for opportunities to join lending syndicates, arranging banks have steadily conceded more and more traditional lender-protections in the loan documentation, safe in the knowledge that the debt will nonetheless syndicate successfully. All this has been to the delight (of course) of private equity houses, for whom the improved terms serve to some degree to offset against the greater exposure they were facing towards the lenders in their deals, as leverage-multiples rose and the lending community became more diverse.

Two types of lenders in particular entered the leveraged finance market in force in this period – institutional lenders and hedge funds. Institutional lenders, such as pension funds, and hedge funds were comfortable lending into bonds as well as bank debt, and as their presence grew, it became possible for bank debt to take on more of the features of bonds. As a consequence repayment profiles became more back-loaded, financial covenant definitions were relaxed and greater freedoms were granted to the borrower to operate without interference from the lenders.

Recently the inevitable has happened – several LBO deals have now closed in Europe where whole swathes of the senior bank loan agreement have been based on the equivalent terms of a traditional bond indenture. And so European cov-lite was born.

Bond terms are necessarily less restrictive than traditional bank loans, due largely to the difficulty of getting waivers and consents from the bondholders – of whom no central register is kept at any time. Banks, on the other hand, would traditionally impose greater restrictions but their instruments allowed waivers and consents to be obtained much more easily – their identity is known, they get a much greater involvement in the ongoing monitoring of the borrower, there may well be borrower controls over transfers to new lenders and there are typically mechanisms in place to allow the borrower to replace (or 'yank') non-compliant lenders.

FINANCIAL MAINTENANCE COVENANTS

As the title implies, cov-lite deals do not have the customary quiver of quarterly 'maintenance' tests that we are used to seeing in senior LBO financings in Europe, namely the debt-to-earnings (leverage) test, the cashflow-to-debt service (cash cover) test and the earnings to interest expense (interest cover) test. In addition, depending on the industry, there may or may not be restrictions on capital expenditure spending.

These tests (commonly referred to as 'financial covenants') act as an early warning trigger for lenders if the borrower strays outside certain financial performance parameters that were agreed at the outset of the deal. They give the lenders the rights to force the borrower to come to the negotiation table, to tighten their controls over the borrower and to demand a revision of the terms of the lending (under threat of declaring an event of default and enforcing the security, which would be cataclysmic for the sponsor). Undoubtedly, these are significant rights – they give the senior lenders control before trade creditors and other lenders have claims to enforce and the opportunity to maximise recoveries at a time when the value of the borrower group may well be fast draining away. That said, the devil is in the detail and there has been considerable relaxation of the definitions used in these tests over recent years, such that many would argue that they have for the most part lost their teeth already.

It is worth noting that cov-lite deals do not necessarily abandon the leverage test altogether. In US-based cov-lite deals the leverage test is often kept on its own for the protection of revolving credit facility lenders (who may additionally have 'super senior' status), or it may spring into the reckoning once a revolving credit facility is drawn over a threshold. This is to cater for the lenders of revolving facilities, who often still comprise the more conservative constituents of the lending community and who tend to require evidence of performance before they agree to lend more money. Interestingly, the European LBO cov-lite deals we've seen so far have had neither leverage maintenance covenants on the revolver, nor restrictions on capital expenditure.

LIVING WITH COV-LITE

So how can senior lenders get comfortable with this reduced 'protection'? Well, needless to say they will have to have a high degree of comfort with the credit risk. One would expect them to be more focused than otherwise on making sure that the security package is tight and that the important protections that remain (for example the restricted payments regime)

are well drafted, because there will be little opportunity to tighten these at a later stage if the group's performance falters. But probably the first thing that they will check is whether they will get the necessary information to monitor the borrower's performance and whether they will be free to quickly trade out of their cov-lite investments if performance goes south.

Lenders can track for themselves the financial performance of the borrower using the information they receive from the borrower. Although they may not get the same level of information regarding cashflow and debt service, they would still expect to get monthly management reports and quarterly financial statements. Indeed, they will need to receive the information necessary to track the borrower's leverage for the purpose of calculating the margin ratchet and the 'incurrence-type' restrictions mentioned below.

And clearly lenders are going to be very focused on their freedom to transfer out of cov-lite deals. Expect to see, as we have seen on the European deals to date, cov-lite deals allowing transfers of bank commitments without the borrower consent rights (albeit not to be unreasonably withheld and falling away on an event of default) that are being quite frequently seen in strong sponsor deals nowadays. This equates more closely to the position in bond deals.

In practice, we expect to see alert lenders rapidly trade out of cov-lite credits as soon as there are signs of underperformance. Given that in these circumstances mostly only distressed players will be interested, the value of these credits is likely to be more volatile than in deals with financial covenant protection. Again, probably much like bond values do.

INCURRENCE-BASED COVENANTS

It is not just the financial covenants that are changed in cov-lite deals.

While the representations and warranties, the mandatory prepayment terms, the information covenants and the positive covenants will likely be more or less the same in a cov-lite deal as in a traditional senior deal, many of the restrictive undertakings will be quite different. The restrictions on further indebtedness, the negative pledge, restrictions on acquisitions and restrictions on payments to shareholders tend to read more like the incurrence-based covenants in a bond indenture than a traditional senior bank deal.

So, for example the borrower under an incurrence based restriction on indebtedness will only be permitted to borrow more debt if and to the extent that its leverage ratio will not exceed a certain multiple. And the borrower group can make an acquisition if and to the extent that following the acquisition the borrower would be allowed to incur at least an additional €1 under the limitation on indebtedness (sometimes set at a different leverage multiple). In addition, in relation to the restriction on payments to shareholders, expect to see bond-like provisions permitting the distribution of a proportion of its consolidated net income and new equity proceeds if the borrower would be allowed to incur at least an additional €1 under the limitation on indebtedness at a certain leverage multiple.

Interestingly, perhaps because of their provenance, European cov-lite deals have not had Material Adverse Change ('MAC') default triggers and the definition of Majority Lenders is 50.1 per cent rather than the normal European standard of 66 2/3 per cent. This follows the norms in the US for senior deals generally (not just US cov-lite). Again, it may be that revolving lenders will demand the retention of a MAC trigger for their borrowings in some deals.

SOME FURTHER THOUGHTS

It will be interesting to see if the trend towards cov-lite takes off as it has done in the US, where according to some statistics, cov-lite deals account for a third of new issuance in acquisition financings. However, in the US cov-lite deals tend to have slightly lower leverage and a larger equity contribution than in cov-heavy deals.

So how does cov-lite impact on the various players in an LBO?

Cov-lite is terrific for borrowers – for whom these deals incorporate the best aspects of bank deals (relatively cheap and easy to put in place, margin ratchets and other flexibility to adjust the terms to the improving performance of the company and the ability to get waivers and to refinance without prohibitive prepayment premia if threats or opportunities arise) and the some of the best aspects of bond deals (no financial performance testing, greater operational flexibility, postponement of default triggers).

Not only that, but judging from the first couple of deals in Europe, pricing has not proven to be noticeably higher in cov-lite than pricing of equivalent cov-heavy deals, though the pricing on these initial deals was done on a book-building basis (as bonds are) rather than on a fully underwritten basis. In the US pricing of cov-lite deals is typically fully underwritten, as in bank deals.

The trade-off for the borrower will probably be the reduced control over transfers and assignments of commitments by lenders in and out of the syndicate. However, this aspect of the borrower's 'control' is usually weak at best in even the most borrower-friendly bank deals. Consent was invariably 'not to be unreasonably withheld' and fell away on an Event of Default – exactly the point at which the borrower tends to be most concerned about 'vulture funds' joining the syndicate. Cov-lite deals retain the useful measures of the borrower's 'control' over the syndicate – notably the ability to make structural amendments with less than unanimous consent and the ability to 'yank' non-compliant lenders out of the syndicate. And so on the whole this concession on the borrowers' part looks like a price well worth paying.

Payment-in-kind lenders ('PIK', lenders of loans where the interest gets 'paid in kind' ie rolled up as part of the loan) and bondholders will benefit from the fact that the senior lenders' default triggers will equate more closely with their own and consequently these classes of lenders will be relatively less subordinated. However, these lenders often look to the senior lenders' covenants as the first line of defence against the equity (bonds trade up when the senior lenders call a default) and so they are likely to be more nervous overall with a cov-lite senior than in a traditional cov-heavy deal. And an increase in volatility of the senior debt is

Biog box
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likely to be amplified at the level of the PIK and bond securities.

Senior and mezzanine lenders will feel more exposed in cov-lite structures. Their big concern will be that the business deteriorates to a point where senior lenders are impaired and the lack of covenant trigger results in lower recoveries. Their relationship with the sponsors may make it awkward to quickly trade-out of investments if performance deteriorates. They may well take the view that cov-lite is principally suitable for very stable businesses, or at least ones where the volatility in the value of the borrower group should only affect the equity and junior capital but not the senior debt. It remains to be seen whether there will be an appetite for cov-lite deals on a grander scale in Europe and, if so, whether lenders will look for better margin compensation on these deals or bond-style call-protection.

Where the sponsors are wanting to achieve cov-lite because of volatility in performance, other solutions may be more appropriate. In these cases one might expect to see senior lenders preferring to offer less frequent testing of covenants or the 'mulligan' approach, where an event of default is only triggered by missing the covenants in two successive quarters. Both these solutions have been seen in the market in the last couple of years and, though generally considered very aggressive by lenders six months ago, these are now looking relatively reasonable in the new world where some LBO financings are being done on terms which are entirely covenant free. ■

Table – The watering-away of covenant protection

TEST	**Dilution in recent years (some common examples) …**	**The position in a cov-lite deal**
DEBT-TO-EARNINGS (LEVERAGE)	Relaxation of definitions generally, for example including reasonably projected cost savings and synergies on acquisitions. Increasing headroom over base-case model projections from around 15-20% to around 25-40%. Ability to deem new equity injections to be added to earnings, rather than just being deemed to reduce debt (so called 'Equity Cure').	The covenant to maintain a certain leverage is often dropped altogether or retained merely for the benefit of the revolving facility lenders. The leverage ratio will however still be measured as it will continue to be relevant, for example for the margin ratchet and other ratchets and for the incurrence-based tests in the restrictive undertakings.
CASHFLOW-TO-DEBT SERVICE (CASH COVER)	Relaxation of definitions generally, for example including retained excess cashflow from prior years. Reducing required cover ratio (usually now simply 1:1). Reduced amortising debt has the effect of reducing Debt Service. Equity Cure being used to boost cashflow and sometimes to deem Debt Service to be reduced as if contributed at the start of the calculation period.	This covenant is often dropped in a cov-lite deal.
EARNINGS-TO-INTEREST EXPENSE (INTEREST COVER)	Relaxation of definition of Earnings (see above). Increasing headroom over base case model from around 15-20% to around 25-40%. Equity Cure (see above).	This covenant is often dropped in a cov-lite deal.
CAPITAL EXPENDITURE LIMITS	Permitting disposal proceeds and retained excess cashflow to boost limits. Allowing carry-forward of unused limits to the following year and allowing carry-back of following year's limit. Increasing headroom over business plan projections from around 110% to 120-130%.	These limits are often dropped in a cov-lite deal.