Private Credit Deep Dives – Leverage Covenants and Auto-Resets (Europe)

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As the private credit industry has relentlessly expanded and the capital available for deployment by private credit asset managers has rapidly grown, those investing at the top end of the market have increasingly had to compete on terms with the financing packages offered by underwriting banks for broadly syndicated deals. Until the last two or three years, one of the key points of differentiation between a liquid loan and a private credit loan was that the former would likely be "cov-lite" (meaning there would be no financial maintenance covenant for the benefit of the term loan lenders) while the latter would generally require that at least a leverage-based maintenance covenant be included. That distinction has become less clear-cut and, whilst some private credit institutions continue to insist upon the inclusion of a maintenance covenant (including the significant majority of such institutions within the true mid-market), others have become increasingly comfortable in telling sponsors that they can live without one, where they like the credit story. The motivation for this is that their stance may enable them to seize increased share in the upper-mid to large-cap market segments. In light of current macroeconomic circumstances, where it is likely that any diversified credit portfolio will see at least some signs of strain for specific borrowers, the potential value of a maintenance covenant is likely to come into sharp focus once more.

This deep dive with Daniel Hendon (Partner) and Phil Anscombe (Associate), lawyers in Proskauer's Private Credit Group in London, will explain how "cov-loose" loans differ from "cov-lite" loans, how leverage covenants offer protection to lenders and how the covenant levels and profiles are typically set (where they are included), as well as describing the parameters around "auto cov re-set" features, that are increasingly being pushed by sponsors and their financing advisers.

Cov-Lite Vs. Cov-Loose

It was once the case, historically, that leveraged loans would benefit from a suite of financial covenants, which would be tested quarterly. These might have included covenants pertaining to maximum leverage, minimum cashflow cover, minimum interest cover and maximum capital expenditure. More recently there has been an increase in maximum recurring revenue-based leverage covenants (particularly in high-growth tech businesses) and (in the US) rent-adjusted leverage covenants, but those covenants are negotiated and deal-specific. And while on deals in the lower mid-market (or where it is a more storied credit or difficult structure) it is still not uncommon to see some kind of liquidity maintenance covenant (whether it be minimum cashflow cover or minimum interest or a more crude measure like minimum available liquidity (e.g., free cash on balance sheet plus available revolving commitments)), on the majority of leveraged transactions you would now only typically expect to see a maximum leverage covenant based on EBITDA.

Around a decade ago, the first “cov-lite” transactions started to be seen in Europe in the syndicated loan market, with the concept having migrated across from the US. What is meant by “cov-lite” is that there will be no maintenance covenant at all for the benefit of the term loan lenders. Instead, where there is a revolving credit facility sitting alongside, the revolving facility lenders will benefit from a “springing” leverage covenant (meaning that it only applies to the extent the revolving facility is actually drawn to a certain extent, commonly 40%) – it would only be upon those revolving facility lenders accelerating their loans that the term loan lenders would have any cause of action, via the cross-acceleration provisions. Other than that, no maintenance covenant would be included and leverage would only be tested on an incurrence basis (whereby compliance with a maximum leverage ratio may be required in order to take certain positive actions; for example, incurring incremental debt or paying distributions to equity-holders). As described above, this concept has started to permeate into the world of private credit.

In order to retain a leverage covenant within their documentation but while offering sponsors some additional flexibility, lending institutions began to provide “cov-loose” loans instead. What is meant by “cov-loose” is that a maximum leverage covenant will be included, tested quarterly on a maintenance basis, but will be set at such a level that a very material level of financial underperformance would have to occur before the covenant will be breached. We will revisit how exactly covenant levels are set, later in this piece.

Benefits of Maintenance Covenant

The key benefit of a leverage covenant, tested on a maintenance basis, is that it should (if set properly) ensure that lenders have an actionable default and therefore, a seat at the negotiating table with the company and its sponsors, earlier than they would do otherwise in the event of material financial underperformance. The evolution of credit documentation during the bull market of the last few years has caused various traditional default events either to be diluted or removed altogether. As such (and assuming the group does not actively take steps that breach its negative undertakings) lenders would, absent a financial maintenance covenant, very likely be left waiting either for a non-payment default or some type of formal insolvency event to occur, before being able to take enforcement action. This delay could result in significant value destruction.

The worst-case scenario for a lender is one in which performance has declined to an extent that the implied equity value is a fraction of the sponsor's original equity investment value, and the sponsor has therefore disengaged from active involvement in running the business and declined to inject further capital to support it, but there is still just enough liquidity for management to avoid a payment default or insolvency process. In this situation, lenders can end up being forced to sit on their hands while the situation deteriorates further, which can materially reduce their recoveries once a default does indeed finally occur. In the same vein, the inclusion of a meaningful leverage covenant should (in theory) mean that the risk of default will materialise while there is still material equity value in the business – it therefore acts as an incentive for the sponsor to inject more equity capital into the business to reduce net leverage and avoid the prospect of the lenders "taking the keys" by enforcing their share security.

In the interests of balance, it is worth noting that sponsors would argue that "cov-loose" loans, whilst containing a leverage covenant, typically set that covenant level so high that it is unlikely that it would ever breach without the company running into liquidity issues first. That assessment is certainly not always correct, but it may be so in some instances, depending on the specific features of the business in question. Whether or not it is true will also be affected by the extent of the adjustments that are permitted to be made in calculating EBITDA and/or financial indebtedness, when calculating leverage for the purposes of testing covenant compliance – this topic is lengthy and complex and (in the interests of reasonable brevity) outside of the ambit of this particular piece.

Setting of Covenant Levels

Traditionally, leverage covenants have been set with an agreed level of headroom and by reference to a “base case model.” The “base case model” is a financial model agreed between the sponsor and the lenders as a condition precedent to the initial transaction. As the name might suggest, it reflects relatively conservative “base case” projections for growth and profitability (and will therefore differ from the more bullish model the sponsor will likely prepare for its own internal approvals). What is meant by “headroom” is the level of underperformance in EBITDA (in comparison to the projections set out in the base case model for the relevant period) that would need to occur in order for the covenant to be breached. While historically the appropriate level of headroom was often 25%, almost all deals today have headroom of 30%+, with 35%+ headroom representing what is generally described as “cov-loose” and 40%+ being common in aggressive large cap documentation.

The effect of setting the financial covenant levels by reference to the base case (which itself assumed EBITDA growth) was that the covenant levels would inevitably show a deleveraging profile (as the model itself would assume that the group would de-lever over time due to EBITDA growth and headroom would be set off those projections). It was usual for the covenant levels to reduce down to, and ultimately below, closing leverage. From a lender's perspective, this acted as an incentive to the group to reduce its leverage over time and looks to ensure that, as maturity approaches, the group is relatively lowly levered and easily able to obtain refinancing options (assuring the lender of a straightforward exit from its debt investment). However, outside of the lower mid-market it has become relatively uncommon for financial covenant levels to reduce to below closing leverage. Most transactions now include a "flatline" level, below which the covenant level will not reduce. This might be set at or around closing leverage but is often set with some headroom to closing leverage. On more aggressive transactions, there is sometimes a covenant that is set at a flat level for the life of the loan, based on the agreed headroom level over structuring EBITDA and closing debt (and others may have just one or two small step-downs from such closing level) – in either case the projected EBITDA growth through the base case model is largely unrelated to the covenant levels. It is worth noting that, in calculating these levels, only the drawn day one term facility is deemed to have been drawn. Care should be taken when reviewing term sheets and grids that the sponsor is not deeming all or some of any delayed draw facility to have been drawn as well. This would effectively build in further headroom on the covenant levels by factoring in additional debt, whilst not adding the corresponding EBITDA you would expect to be generated by the pro forma usage of such additional debt. In any case, the exact nature of the profile of any leverage covenant is subject to extensive negotiation on a deal-by-deal basis.

Auto Cov Re-set Mechanics

In recent years, it has become commonplace for European credit agreements to permit a borrower group to incur incremental indebtedness, provided that (on a pro forma basis) leverage does not exceed the leverage level as at closing of the original transaction. This permits the group to re-lever back up to closing leverage at any time, even if the group has previously delevered as a result of EBITDA growth or paying down its debt burden. An ancillary concept in the US market (and in aggressive top-tier European deals in the large cap space) allows the borrower to incur incremental indebtedness, provided that (on a pro forma basis) leverage does not increase, regardless of what the requisite incurrence test is. This is the so-called "no worse than" test, which (even in the US) lenders have largely successfully pushed back on in the middle market. Both of these flexibilities stand in contrast to the more traditional formulation seen in credit agreements in years gone by, whereby incremental debt capacity would be capped at a fixed monetary amount, rather than by reference to a maximum pro forma leverage level. Clearly, a permission to incur debt up to closing leverage at any time during the life of the loan conflicts in a philosophical sense with a leverage-based maintenance covenant which declines to near, or even below, that same closing leverage level. As a result, European sponsors and their advisors have increasingly pushed various iterations of an "auto covenant re-set" concept, whereby (subject to certain conditions and parameters), the financial covenant levels may be automatically re-set to a higher level than originally set out for the corresponding period in the credit agreement. Clearly, this concept is not of use when the covenant was only ever set with a flat profile in the first place. The typical conditions and potential pitfalls to consider, with respect to any automatic covenant reset, are as follows:

1. **Trigger Event** – Aggressive sponsors will request that any form of permitted drawing of the term facilities under the credit agreement may, at the election of the borrower, be accompanied by an automatic covenant re-set. However, lenders will generally look to limit the usage of this feature to a permitted acquisition made using the term facilities under the credit agreement (or perhaps even limited to a "transformative permitted acquisition" (being, for example, one which would cause a >20% increase in consolidated pro forma group EBITDA)). This is primarily to ensure that the transaction in question will be accretive to EBITDA (given that delayed draw facilities are increasingly available for a reasonably large variety of permitted purposes, including maintenance capex and restructuring expenditure and very occasionally even working capital). However, it should also be noted that permitted acquisitions are typically required to be accompanied by

various due diligence deliverables – this is of particular importance to ensure there is sufficient available information to verify the re-set covenant levels (see bullet below).

2. **Relevant Information** – It is important to be clear, on the face of the document, what information is to be used to determine the appropriate re-set covenant levels. Generally, you would expect to see the LTM EBITDA of the business to be acquired added to the consolidated EBITDA of the existing business before the application of any permitted synergies and other pro forma adjustments. The metrics attributable to the acquired business may then be verified by the lenders pursuant to the financial due diligence materials that are typically required to be delivered in connection with any such acquisition of significant materiality. This is helpful as it ensures that the lenders have at least some visibility as to a professional third party’s assessment of the acquired entity’s profitability and financial condition, before any re-setting of covenants can be operational.

3. **Timing** – While sponsors might look to negotiate a re-set option that can be exercised on multiple occasions, lenders typically require that such an option may only be exercised on a one-time basis. Furthermore, lenders often put a timing limitation on the usage of the option, such that it may only be exercised for a certain period after closing (for example, three years, which may match the availability period of any initial delayed draw facility). The reason for this is to ensure that, even after any such re-set, there is still time to implement material deleveraging via the covenant profile before the loans become due for repayment at maturity.

4. **Re-Set Level** – It is generally accepted that the way the re-set option works is that the agreed level of headroom that was used when setting the original covenant levels will be used again in order to re-establish the new covenant level (i.e., based on new leverage, pro forma for the acquisition in question and the incurrence of the related indebtedness). Assuming that the debt incurrence provisions do not permit re-levering to above closing leverage, then logically this means the re-set covenant level cannot be any higher than the initial opening covenant level, given the same headroom is to be used. Indeed, it may be lower if the relevant transaction does not quite re-lever the group to closing leverage levels. However, on aggressive deals where the debt permissions do allow incurrence to above the closing leverage level, lenders should be mindful that (absent any express provision to the contrary) this may facilitate a re-set covenant level that is looser than the day one deal.

5. **Re-Set Profile** – A number of documents containing auto covenant re-set features are (surprisingly) lacking in detail as to how the covenant profile will be modelled after the initial re-set level has been fixed. The optimal position for

lenders is to require that the sponsor and the lenders must liaise in order to agree (each acting reasonably) a substitute base case model containing reasonable projections on EBITDA growth using the same methodology as was applied for the base case model on the original deal (and then apply the agreed headroom levels to such revised projections). This is the method used on a number of deals. However, some sponsors may take the view that requiring lender consent on a revised model taints the "automatic" aspect of the re-set option, preferring to hard-wire the deleveraging profile up-front. In such circumstances, the key decision for lenders is whether to require the same deleveraging profile (so that leverage steps down in the same increments as the covenants stepped down in the initial deal) or an accelerated deleveraging profile (so that leverage steps down faster in order to ultimately arrive at the same flatline level and at the same time as was contemplated on the initial deal). The position ultimately reached will depend on the dynamics of the deal and the strength of the negotiating position of the relevant parties.

While market conditions remain somewhat challenging, the debate will continue as to the future of maintenance covenants within private credit financings. Such covenants remain an absolutely central point of concern for sponsors (given they constitute the most likely route to their losing control of the asset in question) but nonetheless are of proven value to lenders in maximising their downside recoveries. Given the continuing attraction of roll-up and consolidation strategies for private equity investors, where regularly re-levering in order to debt finance an aggressive M&A strategy may be a core part of their investment thesis, it will continue to be very attractive for such sponsors to be able to re-set covenant levels and in doing so, afford themselves a little extra breathing room for a particularly transformative transaction. For any related questions on this topic, please reach out to your contact within Proskauer's Private Credit Group.

About Proskauer

Proskauer's Private Credit Group consists of over 90 dedicated professionals, located in London, New York, Boston, Chicago and Los Angeles, and the team consistently executes some of the largest number of private credit financings in the market (closing 250 direct lending deals globally in 2022, representing nearly $85 billion of new capital).

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