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Investors Are Finally Pushing Back on Corporate Debt Issuers

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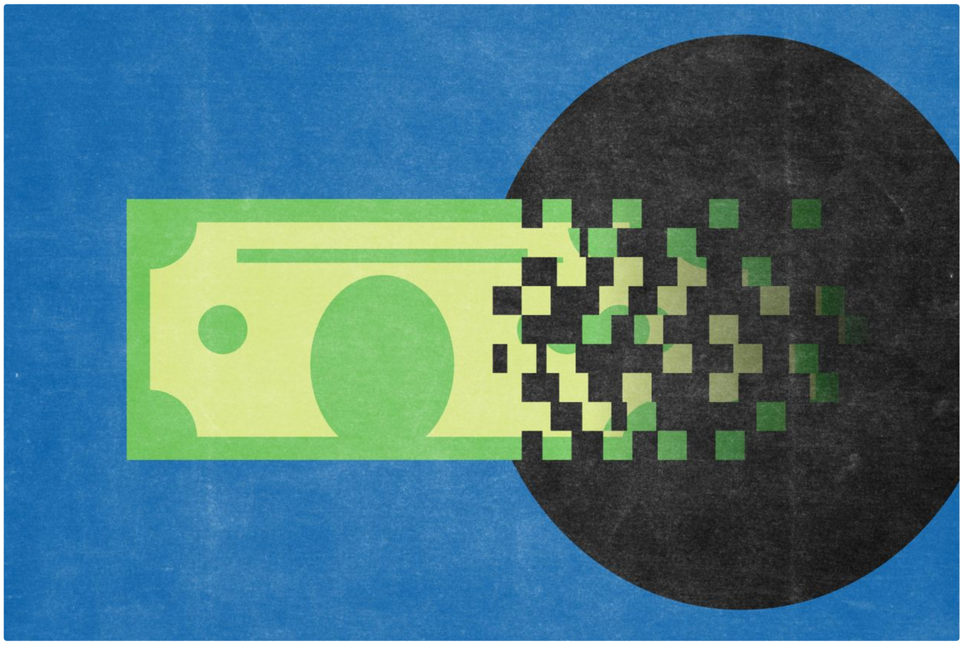

Robert A. Di Ieso Jr.

Trap doors. Black holes. Restricted payment baskets.

These things sound scary, and they are—to buyers of corporate debt.

Issuers have increasingly been able to sell new debt with lower yields and looser "covenants," or promises to lenders meant to restrict corporate borrowers from doing anything to erode the debt's value.

In recent years, lawyers have been writing in provisions that let issuers move collateral, tangible assets backing the debt, should fortunes turn south and interest payments dry up.

Without covenants flagging a deteriorating situation, a company can stay out of bankruptcy longer, burning cash and selling assets that creditors may have otherwise been able to recoup. By the time it files for bankruptcy, there is far less to recover. That reduces the odds that it can emerge as a healthy company, and making liquidation more likely.

"There's no safe place," says Mike Damaso, co-founder of CBAM Partners, which buys loans.

Now, some investors are finally pushing back.

Justin Smith, managing director of Xtract Research, says that after hearing complaints from a number of clients, his firm developed and introduced this spring a covenant scoring system to help investors evaluate a deal's terms. Flagging egregious terms means investors have a shot at pushing back in time.

Xtract's finance attorneys review credit agreements and assign a "covenant score"—zero to 10, weak to strong—based on risks to collateral and other aggressive terms. They also give a "market score" benchmarked against the average over the preceding six months. And they are naming names, ranking the private-equity firms whose deals are the most dangerous for lenders.

Leveraged-loan investors are also seeking to schedule regular discussions with corporate borrowers, according to credit-rating agency Moody's . And the conditions have boosted demand for Covenant Review, which issues deal reports and highlights risky terms.

> **"Even when you complain to [the ratings agencies], 'how can you give that rating if the documents allow it to be gutted?' they say, 'well, they allow it to be gutted, but they haven't gutted it yet.' "That's a very scary position to be taking. "**
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> —Mike Damaso Co-founder of CBAM Partners

Mutual fund and debt buyers alike should fret about such terms because they likely portend lower recoveries and bankruptcies that end in liquidation. As one investor puts it, second-lien loans are now basically equity risk with the upside potential of fixed income.

Lately, lenders have clawed back some ground. Over the last three quarters, covenants in big sponsor deals improved marginally on Xtract's scoring system, to 5.85 at the end of the second quarter, from 5.17 at year-end.

How did we get here? Go back to the financial crisis: Steep stock drops terrified investors, sending them up the capital structure in search of safety. First they bought bonds and then—whenever the threat of rising rates crested—floating-rate loans, sending money pouring into mutual funds and collateralized loan obligations, even exchange-traded funds, and now into funds that make relatively small middle-market loans.

Such competition to buy corporate debt meant borrowers had more power. Issuers, particularly those backed by aggressive private-equity firms, have helped erode the fundamental understandings that underpinned markets, lenders say. Basic "maintenance covenants"—taking a company's temperature every quarter or so—largely disappeared years ago.

Investors complained, but bought anyway.

So the deterioration continued. Issuers and sponsors exploited loopholes and created new ones, in particular those that allowed them to redistribute collateral.

The most notorious case occurred when private-equity firm TPG Capital and creditors led by Blackstone Group 's GSO Capital Partners ripped intellectual property out of a debt box in retailer J.Crew in 2017—an instance now affectionately known as "J.SCrew." (TPG and Blackstone declined to comment for this article.)

Once someone pushes a term—this one is now known as a "trap door"—others follow. Now there are "black holes," which allow unlimited amounts of collateral to move, and restricted payment baskets, which let borrowers make payments without incurring debt.

"When J.Crew happened, we spent all our time on the trap door," Damaso says. "But more recently, more and more language has worked its way into the documents. You add up all these things and you have to calculate how much in totality could leave the box, how much value could be degraded."

And all in 24 hours.

When a company is seeking to sell a big loan, bank syndicate desks canvass investors to find the balance of deal size and price. Investors often get 24 hours to give comments on lending documents that can run 500 pages—while knowing that hundreds of competitors are eyeing the same documents.

All of which makes it hard to find the dangerous legal language and push back effectively.

The rising risks—increasingly loose covenants used as weapons in stakeholder wars—aren't being adequately captured in credit ratings, as the firms that grade issuers and new bonds persist in using old frameworks, Damaso says.

"Even when you complain to them, 'how can you give that rating if the documents allow it to be gutted?' They say, 'well, they allow it to be gutted, but they haven't gutted it yet,'" he says. "That's a very scary position to be taking."

With fewer limits on what an issuer can do once it has the money, creditors have less clarity on what they're getting into. But they're sure it will show up in recovery rates.

The Toys "R" Us bankruptcy was a preview. The toy retailer, overburdened with debt but still generating substantial revenues, managed to stay afloat with willing lenders offering cheap debt. Until it couldn't. When it filed, the market was unprepared, with some bonds trading over 70 cents on the dollar just before. But too little value remained, and the big-box toy giant abruptly liquidated.

"Investors hadn't gotten those early-warning triggers, those signs that something was wrong, because they had borrowed without these lender protections," says Anne Walsh, chief investment officer of fixed income for Guggenheim Partners.

That will be true for other "zombie companies," she adds, which should have already filed for bankruptcy but for the grace of market leniency.

And that means lenders will recover substantially less of their outstanding loans in bankruptcy than they had in the past, Walsh says.

That will also mean more lawsuits. Drawn-out bankruptcies rack up high fees for restructuring advisers and lawyers, which sap a company's cash.

Xtract's ratings "won't mean much now, because there's not enough history," Damaso says. But investors "will start using them" once there are ratings for thousands of agreements, so they might demand more compensation for aggressive terms that currently are free.

Once loose terms increase the cost of capital, issuers and sponsors may reconsider, and restrictions will tighten.

Or so lenders hope.

"We're still a long way," Damaso says, "but this creates the first inning of the baseball game."

Write to Mary Childs at mary.childs@barrons.com