Credit FAQ:

A Closer Look At How Covenant-Lite Structures Affect Recoveries For Institutional Loans

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On April 12, S&P Global Ratings published "Lenders Blinded By Cov-Lite? Highlighting Data On Loan Covenants And Ultimate Recovery Rates," which discussed the impact of covenant-lite loan structures on recovery outcomes for institutional loans. The report focused on recovery levels observed for pre-petition covenant-lite and noncovenant-lite institutional loans issued by companies that recently emerged from bankruptcy. Specifically, we used a sample consisting of the first-lien, institutional term loans of 28 companies that exited bankruptcy between January 2014 and December 2017, either through a reorganization or asset sales (see table 1, which is from the original report).

Table 1

Actual Recoveries By Emergence Year: Covenant-Lite Vs. Noncovenant-Lite

	--Covenant-lite--				--Noncovenant-lite--			
Emergence year	Observations	Prepetition debt at default (bil. $)	Avg. recovery	Median	Observations	Prepetition debt at default (bil. $)	Avg. recovery	Median
2014	0				4	5.8	72.5%	79.0%
2015	3	4.0	74.1%	62.9%	2	1.4	72.0%	72.0%
2016	7	6.2	72.3%	63.5%	2	0.6	99.3%	99.3%
2017	7	7.0	69.9%	81.0%	3	15.8	90.6%	100.0%
Total/avg.	17	17.2	71.6%	63.5%	11	23.5	82.2%	84.1%

Additionally, the report highlighted how our recovery methodology analyzes covenant-lite and noncovenant-lite loans. Below, we answer some frequently asked questions we received on our analysis and approach.

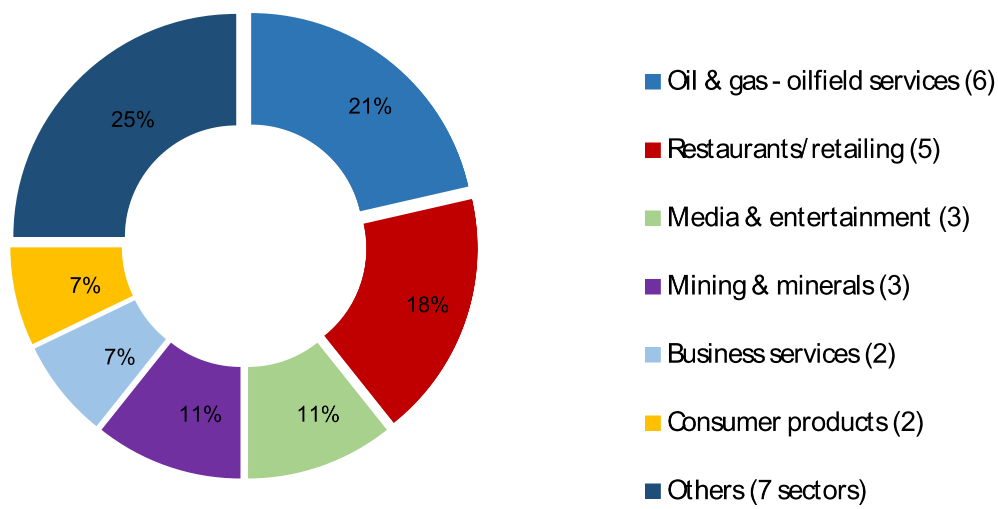
Frequently Asked Questions

Is there any sector concentration in your sample and does this affect the outcomes? For example, the sample could be overexposed to oil and gas or retail companies given the recent bankruptcies in the industry.

While there is some sector concentration, no sector overwhelmingly drives the recoveries in our sample. Our sample covers a wide range of industries (see chart 1), with the largest sector (oil and gas: oilfield services) making up 21% of all companies, followed by restaurants/retailing (18%). In our view, the muted concentration in oil and gas reflects differences in the debt-financing structures for oil and gas exploration and production (E&P) companies, which represent a large share of the oil and gas industry and defaults in recent years. E&P companies predominantly rely on reserve-based lending (RBL) revolving credit facilities as their main source of senior secured financing versus borrowing through the more common first-lien institutional term loans. As a result, only one E&P company was captured in our study sample, which focused exclusively on broadly syndicated first-lien loans.

Chart 1

Sample By Sector (28 Companies)



That said, there was a material, though not dominating share, of defaults among oilfield services companies in the sample, particularly in the covenant-lite universe. Of the 17 covenant-lite institutional term loans we tracked, six were issued by oilfield services companies. Excluding these and the one E&P loan (also covenant-lite) would have resulted in an average recovery rate of 64.1% for covenant-lite loans--7.6% lower than the overall average of 71.6%. So, if anything, removing oil and gas companies from the sample set would have further widened the average recovery gap between covenant-lite and noncovenant-lite to 18.2% from 10.6%.

Similarly, the sample was not over-concentrated in retail defaults, although average sector recoveries were lower than the overall average at 61% versus 76% (echoing our article "U.S. Retail Debt Recoveries Likely To Be Below Average Amid Sector Challenges And Rising Defaults," published July 13, 2017.

Chart 2a

Covenant-Lite Loans By Sector (17 Companies)

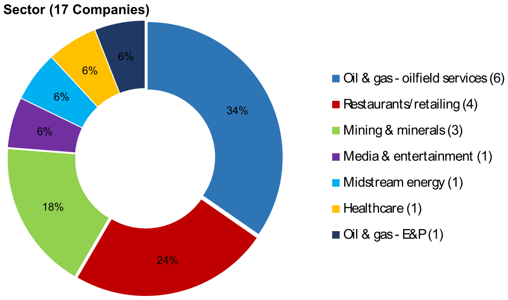
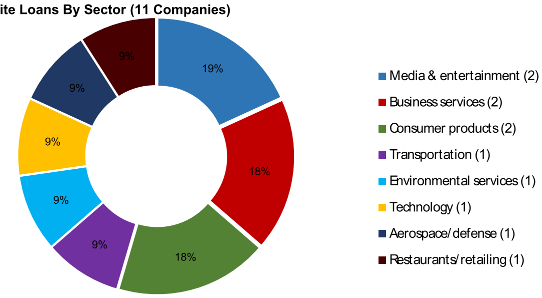


Chart 2b

Noncovenant-Lite Loans By Sector (11 Companies)



Does the time spent in bankruptcy proceedings affect ultimate recoveries?

Although we believe that a prolonged restructuring process could saddle the company with large legal and financial advisory fees, and leave less value on the table for term loan lenders (as these expenses are paid before all other liabilities), in our sample we did not observe a close tie between actual recoveries and the time companies spent in court.

Other than credit quality and the presence or absence of financial maintenance covenants, do you see other characteristics driving the recoveries in the sample?

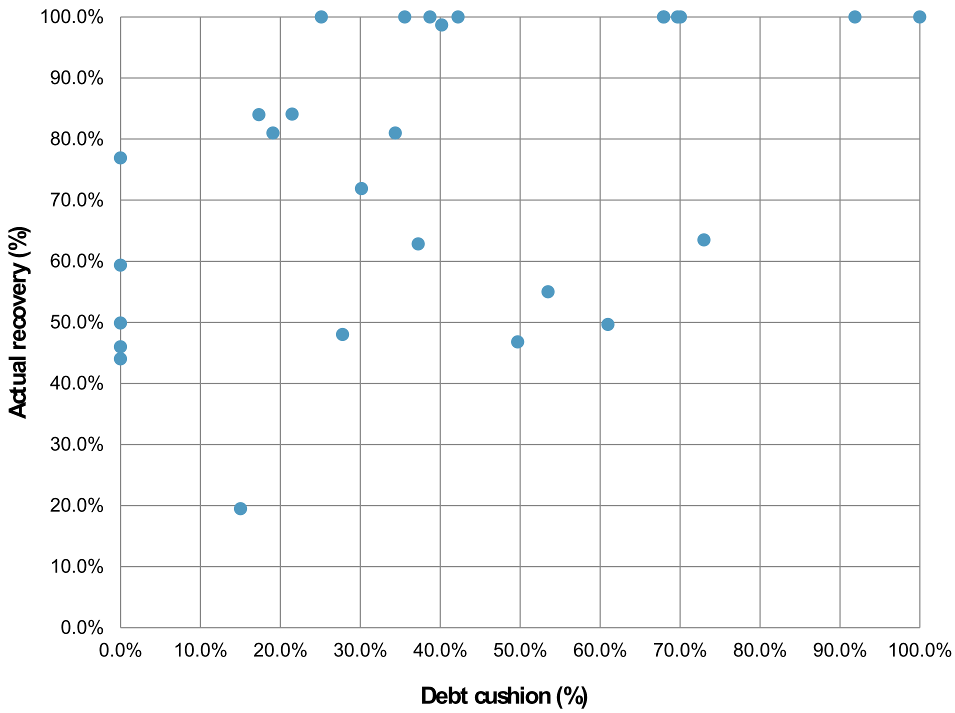
As noted in our report, a variety of factors played critical roles in influencing recovery outcomes, and many are more considerable determinants than the maintenance covenant. One such factor is subordination (defined as the percentage of a company's total debt claims outstanding at default that is junior to the first-lien).

Among the nine term loans with debt subordination below 25%, the average recovery rate was 61% (median 59%). This was notably below the average of 76% across the entire sample. At the other end of the cushion spectrum, the two term loans that had the most debt subordination (greater than 75%) received full recovery, followed by those comfortably cushioned (50%-75%), with seven loans averaging recovery rates of 81% with a median of 100%.

Chart 3 shows the distribution of actual recoveries by cushion level. To quantify this relationship, the correlation coefficient between actual recovery and subordination was 0.49, indicating a positive and moderate correlation. For more information on how deal structure or subordination influence recovery outlooks, see "Lean Senior Debt Cushion Threatens Recovery Prospects For U.S. Leveraged Loans," published Nov. 30, 2017.

Chart 3

First-Lien Debt Cushion And Actual Recovery



Do you see company size making a difference in recovery rates?

To determine the size influence, we used debt size as a proxy for the firm size as debt levels are typically more stable than performance-based measures such as EBITDA or revenue during a business downturn. In fact, about a third of the companies in the sample reported negative EBITDA leading up to default. Based on our analysis, debt size played a less significant role and was not a direct driver of recoveries in the sample, partly because the most indebted companies are not necessarily the most leveraged ones (see chart 4). Still, we want to emphasize that we did not weight individual recovery by debt size to calculate the average, meaning our recovery averages were not skewed by borrowers with the largest amount of debt.

Chart 4

Total Debt And Actual Recovery

Related Research

- Lenders Blinded By Cov-Lite? Highlighting Data On Loan Covenants And Ultimate Recovery Rates, April 12, 2018
- Lean Senior Debt Cushion Threatens Recovery Prospects For U.S. Leveraged Loans, Nov. 30, 2017
- U.S. Retail Debt Recoveries Likely To Be Below Average Amid Sector Challenges And Rising Defaults, July 13, 2017