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North American Leverage Loan Covenants

Credit Agreements Allow Borrowers to Lever Up to Worrisome Levels

Leveraged loans allow borrowers to add an additional 3.1x EBITDA of debt on their closing date. Borrowers had pro forma debt levels of 4.8x debt/EBITDA in 2016, squarely below the 6x level cited by regulators as cause for concern. But according to our analysis, credit agreements typically permit borrowers to increase debt/EBITDA to 7.9x.

The largest component of this additional debt capacity is based on borrowers' ability to incur debt subject to the satisfaction of certain financial ratios. Virtually every loan we analyzed permit some form of ratio-based debt incurrence. On average, these structures permit borrowers to incur 1.9x EBITDA of debt.

Fixed-dollar debt baskets represent nearly 1.2x EBITDA on average. These baskets generally permit the borrower to incur debt without reference to a maintenance covenant or other financial ratio.

Nearly one in five credit agreements have no discernible cap on unsecured, junior or subordinated debt. Borrowers with these structures are able to incur unlimited debt with little to no conditionality.

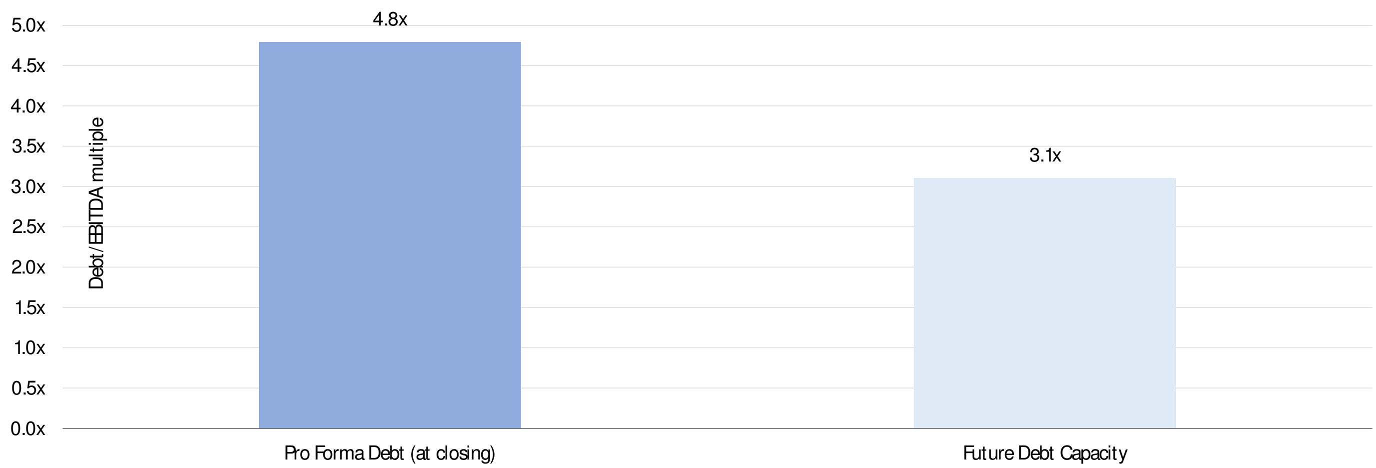
Leveraged loans allow borrowers to add an additional 3.1x EBITDA of debt on their closing date

For 2016 leveraged loans[1], we analyzed debt covenants in credit agreements to measure the average debt capacity available to borrowers as of the initial closing date of the loans (see shaded box, page 4, for our methodology).

Debt covenants restrict the ability of a borrower and its subsidiaries to incur debt, with the competing objectives of both (1) ensuring that a borrower does not take on more debt that it can service, and (2) giving the borrower enough operational flexibility to incur future debt to meet its business needs.

Exhibit 1

Pro Forma Debt vs Future Debt Capacity for Leverage Loans



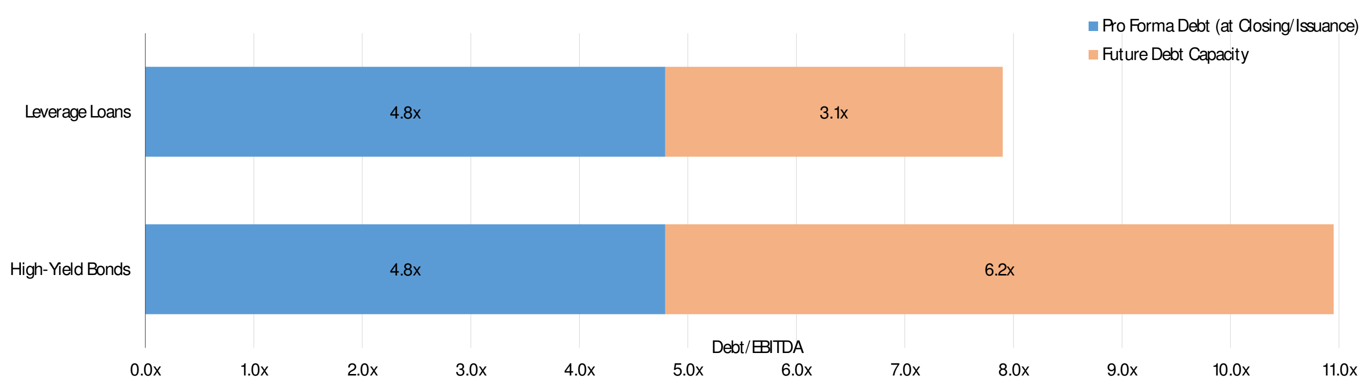
Source: Moody's Loan Covenant Quality Database

As shown in Exhibit 1 above, the average amount of pro forma debt was 4.8x EBITDA as of the initial closing date. This is squarely below the 6x debt/EBITDA level cited by regulators as cause for concern in leveraged lending guidance published in 2013. (For more on the guidance, please see Stubbornly Weak Loan Covenant Protection Will Only Modestly Improve in 2016).

However, future debt incurrence capacity represented an additional 3.1x EBITDA, permitting borrowers to lever up to 7.9x EBITDA as of the initial closing date.

Exhibit 2

Maximum Potential Debt for Leveraged Loans vs. High-Yield Bonds



Source: Moody's Loan Covenant Quality Database; Moody's Bond Covenant Quality Database

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High-yield bonds issued in 2016 permit issuers to lever up to 11x EBITDA on their issuance date, according to our analysis. That's 3.1x EBITDA more than leveraged loans permit, which is not surprising. High-yield bonds are typically more flexible than leveraged loans because debt incurrence is generally governed by an easier-to-meet interest coverage ratio. (See Exhibit 2 above for a direct comparison of leveraged loans and high-yield bond maximum debt capacity.)

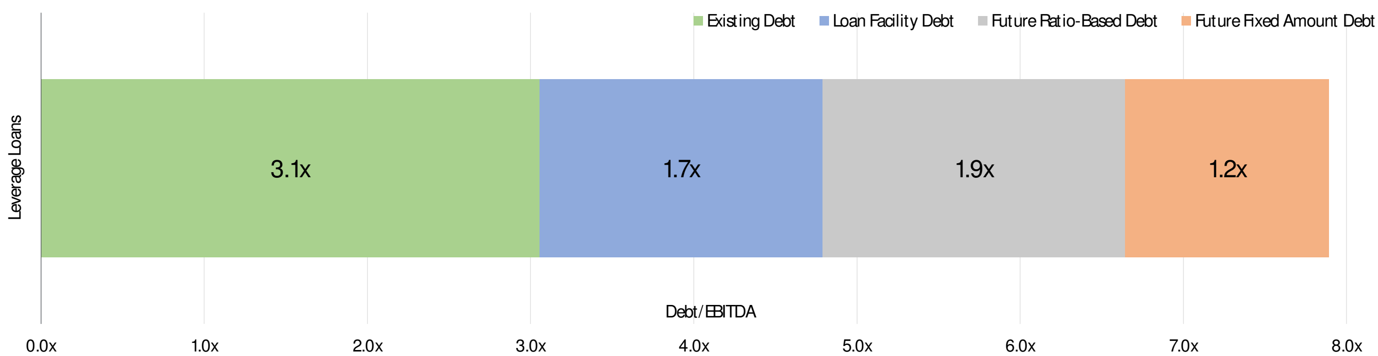
The largest component of additional debt capacity is based on borrowers' ability to incur debt subject to the satisfaction of certain financial ratios

Customary exceptions to the debt covenant include carve-outs for existing debt (i.e. debt “grandfathered” by the debt carve-outs), loan facility debt, and two distinct varieties of other debt baskets. These two distinct varieties are fixed amount debt baskets and ratio-based debt baskets.

Ratio-based debt baskets provide the borrower with the ability to incur an unlimited amount of debt, subject to the satisfaction of specified financial ratios, such as pro forma compliance with a financial maintenance covenant or other ratio (e.g., total leverage, total net leverage, first lien leverage, interest coverage, etc.). Virtually all of the loans we reviewed in 2016 had some form of ratio-based debt incurrence, a large increase from a decade ago when only 75% of loans included this concept.

Exhibit 3

Detailed Breakdown of Existing and Future Debt Capacity for Leveraged Loans



Source: Moody's Loan Covenant Quality Database

As shown in Exhibit 3 above, existing debt equaled 3.1x EBITDA, with the average loan facility sized at 1.7x EBITDA. Ratio-based debt capacity made up the largest component of a future debt, equaling 1.9x EBITDA.

Fixed-dollar debt baskets represented nearly 1.2x EBITDA, on average

Fixed-dollar debt baskets generally permit the borrower to incur debt without reference to a maintenance covenant or other financial ratio. Fixed debt-amounts (typically purchase money debt, general baskets and other subsidiary debt) are set to a certain dollar amount or a “grower” amount (e.g. the greater of $100 million or 10% of assets). Sixty-nine percent of loans used “growers”, and a majority were pegged to total asset “growers” (which we identify as weaker than tangible asset “growers” because goodwill and other intangible are included in total assets). Furthermore, these baskets generally have no requirement for their use other than a simple no default or event of default condition.

Nearly one in five credit agreements had no discernible cap on unsecured, junior or subordinated debt

17% of loans we reviewed in 2016 had the ability to incur unlimited amounts of unsecured, junior or subordinated debt without the requirement to meet any financial ratios. While these types of debts are generally subordinated to the loans, they raise concerns for investors because of the unlimited capacity borrowers have under their credit agreements to increase debt levels. This type of aggressive debt incurrence capacity is likely tolerated by loan investors because of a loan's placement at the top of the capital structure, since senior secured obligations have priority over unsecured, junior and subordinated debt.

How We Calculate Future Debt Capacity

We calculated all basket sizes based on turns of EBITDA to facilitate comparisons and averages across all borrowers and industries.

In addition, for purposes of calculating ratio-based amounts in circumstances in which multiple ratio-based baskets were used, we used the ratio that provided the greatest amount of debt incurrence, including whether a basket contemplated only pro forma maintenance covenant compliance.

We also assumed that all fixed amount baskets were available, in addition to the use of any ratio-based baskets, with incurrence of fixed debt baskets excluded from the ratio calculations. (This mechanism is found in many incremental facility provisions in the current market that use a combination of both fixed and ratio-based baskets).

For deals with covenants, we assumed that debt was incurred before the first quarterly testing period.

For both leveraged loans and high-yield bonds, we did not calculate uncapped subordinated, junior or unsecured debt or unused revolving capacity. For tests using an interest coverage ratio, we assumed that blended interest rates at close would remain constant.

Note that all EBITDA numbers are based on issuer-reported adjusted EBITDA.

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» Stubbornly Weak Loan Covenant Protection Will Only Modestly Improve in 2016

» Aggressive Incremental Facility Structures Put Investors at Risk

» Protection Much Weaker Today than Before Recession, Increasing Risk in a Downturn

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Endnotes

1 All covenant score data reflects loans meeting our criteria from Q1 2016 through Q3 2016 and for which data was available at the time this report was prepared (29 separate tranches of debt representing over $33 billion of Term B Loans) Moody's covenant team analyzes syndicated speculative-grade leveraged loan issuance over $500 million originated in the US and Canada with publicly and timely available credit and financial documentation. The covenants team identifies whether a loan is leveraged by whether the loan is rated non-investment grade by Moody's, followed by other characteristics such as spread, use of proceeds, presence of equity sponsor, etc.

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