Chapter 14
Structural Issues: Covenants

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EACH BOND INDENTURE or loan agreement has covenants. These are, effectively, rules that the company has to follow as long as these debt instruments are outstanding. The covenants in leveraged finance tend to be much more complex than investment-grade debt. Debt holders want more control over what a company can do because of the greater perceived risks in lending money to more leveraged companies. Covenant analysis is a vital part of credit analysis.

Methods to Approach Covenant Analysis

There are covenants that are common to most leveraged finance debt, but never assume that a covenant for one issue or one issuer is the same as another. Read them all the way through. Trends in covenant structure change over time. During some periods they shift toward favoring the issuer, and in other periods the buyer of the notes.

Analyzing covenants can be a complex task that has often been compared to peeling off layers of an onion, slowly uncovering each level of the covenant to see how it works; and each time one layer is peeled off, there is another one to peel. Just as peeling an onion causes tears, a few tears are likely to be shed during the process of analyzing covenants. Covenants are best read when in a cynical mood, with an eye toward how the company can harm the loan or bondholder. The covenants are the rules that help protect the loan and bondholders.

Covenants can sometimes show what a company wants to do in the future. For example, if certain types of transactions are specifically permitted under the covenants, such as a type of acquisition or distribution, it could be a sign that management hopes to shuffle its assets around.

Sometimes it is helpful to lay out the covenants in a flow chart or diagram to understand how they work. It is helpful to have a relatively consistent way to chart or diagram covenants when comparing the differences in debt instruments within the same company.

Usually, the most important covenants are negative covenants, which prevent a company from doing something such as issuing more debt or selling an asset. Affirmative covenants in bond agreements are usually less important. Affirmative covenants require a company to do something such as file financial statements or maintain a certain level of cash on the balance sheet. Affirmative covenants are much more common in bank agreements and are more commonly called maintenance covenants. They may require a company to maintain a certain amount of cash on the balance sheet or a minimum EBITDA. The trend in the institutional loan market has been to remove maintenance covenants, or significantly minimize them. Loans with little or no maintenance tests have begun to be called covi-lite loans.

The most important covenants found in bond indentures and bank agreements tend to deal with debt incurrence limits, restricted payments, restrictions on asset sales, and change of control. They are designed to protect the lenders and prevent the company from materially changing the credit quality of the company in a negative way compared to what the credit looked like when the money was originally loaned.

This chapter does not cover every type of covenant. Once ways to examine the details of these key covenants are understood, the thought process involved in analyzing these covenants can be applied to others.

Debt Incurrence

Debt incurrence covenants state under what terms a company is allowed to add to its debt. The basic test is often based on a leverage ratio or a fixed-charge coverage test. If the test cannot be met on a pro forma basis for the proposed new debt, the company cannot issue the debt.[10]

When a leverage ratio is used, the test sometimes uses a total debt/EBITDA ratio and states that, pro forma for the issuance of the new debt, this ratio has to be met. If it is assumed that the covenant uses a 5x leverage test, the basics of the test would work as follows: If the company were leveraged 4x and had $500 million of EBITDA outstanding, this covenant would allow it to issue approximately $500 million more in debt, which would bring the company pro forma ratio to 5x leverage. This addresses total leverage but does not directly address the ability to service the debt. If the new debt is particularly high cost (a high coupon), it could put a disproportionate strain on net FCF.

The other common test used for debt incurrence is the fixed-charge coverage ratio. This ratio is usually an adaptation of the EBITDA/interest expense ratio. In the case of a fixed-charge ratio test, the denominator (fixed charges) is defined. The ratio usually starts with interest expense and then may include items such as noncash interest, debt maturities due in one year, and capital expenditures.

10 *Pro forma* is a term for presenting information on a hypothetical basis, adjusted for an event. In this case, it applies to what the ratios would look like after issuing the new debt.

For a simple example, assume that a company has a fixed-charge ratio test in which the denominator is based only on total interest expense and the numerator uses EBITDA. If we were to employ the example from the prior paragraph, it would work as follows: If the debt incurrence test were a 2.0x fixed-charge coverage test (as defined above), prior to the transaction, the ratio would be 2.5x. If the new debt were issued at an interest rate of 10% (see Exhibit 14.1), the company could issue $500 million more debt and pro forma for the new debt would still meet the test of 2.0x. If the rate on the new debt were only 7%, the company could issue $800 million in debt (this would be more debt than the 5x leverage ratio test would allow). If the rate were higher (e.g., 13%), the company would be permitted to issue only $400 million of new debt.

The fixed-charge test ratio is much more sensitive to the overall interest rate environment and the company's borrowing costs than a leverage test would be. Therefore, an improving credit that uses a fixed-charge coverage test under its debt incurrence test should see the combination of its increasing EBITDA and its decreasing borrowing costs combine to give it more capacity to increase the leverage on the company if it chose to do so.

Exhibit 14.1: New Issuance under Incurrence Tests in $000,000s (Except for Ratios)

EBITDA	500
Debt (@ 10% coupon)	2,000
Interest expense	200
EBITDA/interest expense	2.5×
Debt/EBITDA	4.0×
With New Debt at 10% Coupon	
EBITDA	500
Debt (@ 10% coupon)	2,000
New debt (@10% coupon)	500
Total debt	2,500
Interest expense	250
EBITDA/interest expense	2.0×
Debt/EBITDA	5.0×
With New Debt at 13% Coupon	
EBITDA	500
Debt (@ 10% coupon)	2,000
New debt (@ 13% coupon)	400
Total debt	2,400
Interest expense	252
EBITDA/interest expense	2.0×
Debt/EBITDA	4.8×
With New Debt at 7% Coupon	
EBITDA	500
Debt (@ 10% coupon)	2,000
New debt (@ 7% coupon)	800
Total debt	2,800
Interest expense	256
EBITDA/interest expense	2.0×
Debt/EBITDA	5.6×

Defined Terms and Carve-Outs

There are many words and phrases within a covenant that are known as defined terms. When a word is a defined term, its meaning in plain language does not matter in the legal reading of the document. What matters is how that term is defined in the bond or loan document. Defined terms usually are capitalized in the description of the notes or loans and have a specific definition for the purposes of the document. The terms are usually defined elsewhere in the document, often in a section dedicated to definitions. This is where bookmarks and highlighting come in handy. It is common to switch back and forth between the pages with the covenant language and the pages with the definitions. After the covenant ratio is calculated, there is still work to be done. Often the covenant will also include a whole section on exceptions to the covenant, often referred to as carve-outs. As an example, in a leverage test, certain types of debt may specifically be excluded from the debt incurrence restrictions. These carve-outs might include loans to employees or debt related to a specific project.

These concepts of defined terms and carve-outs apply throughout the analysis of covenants and structures in bond and loan agreements. The following sections describe some of the items that are typically defined, starting with the debt incurrence test.

Defined Term Examples

A total debt/EBITDA ratio in a covenant can be made significantly more complex than it seems when the two terms in this ratio are defined in the document.

1. *Total debt*: This may seem a straightforward term, but do not assume so. It may, or may not, include debt at a parent company, or it could exclude analysis of debt junior to the instrument, or it could exclude non-cash-paying debt. It also may be defined if it includes short-term debt or borrowing-based facilities such as accounts receivable facilities. All these exceptions and more have been seen in various debt documents as the loan agreement redefines a simple definition of total debt.

2. *EBITDA*: These definitions can be even more complex and may or may not apply to noncash charges, fees paid to owners, and other items. More interestingly, they can apply to pro forma add-backs, including EBITDA, from a company being acquired and may also include cost savings that the company has budgeted from the acquisition or simply cost savings from its own plans that have not been achieved yet. Furthermore, they may add back the actual cash costs that are related to these cost savings (because there are usually cash costs related to achieving cost savings).

Making all these adjustments for total debt and EBITDA can end up creating a very different set of metrics than what might be produced if simple definitions of the terms were used. Often on a summary spreadsheet, analysts choose to show both debt and EBITDA, as they would typically be calculated for financial purposes and also for comparisons with other companies. An analysis can then also have lines showing covenant defined debt and EBTIDA and the related covenant ratios. Some companies will report covenant EBITDA or covenant ratios. Other companies will not report those figures and may not even report all of the data needed to calculate the covenant data. In these latter cases, an analyst has to estimate these figures. The absence of this type of information made available by the company should be a warning of how the company approaches transparency for investors.

Carve-Outs

Within a high yield bond prospectus or a loan document, the debt incurrence covenant is usually only a small part of the covenant. The bulk of the rest of the covenant typically describes exceptions to the ratio test. These exceptions outline other ways in which debt can be issued even if the debt test ratio is not met and are often called carve-outs. Some carve-outs are fairly straightforward and standard in bond and loan agreements—these might include a lien that is already in place on an acquired property, or a court imposed tax lien.

A typical carve-out may include the existing bank line. The key is how this carve-out is written. Sometimes it allows borrowing on the bank line above and beyond the ratio test. Sometimes the carve-out for the bank line is reduced by permanent repayments of the bank borrowing. This means that prepayments of the bank debt will permanently reduce a company's borrowing capacity, and the company may look to avoid making these prepayments. If the covenant does not reduce the bank borrowings by prepayments, the company could deleverage and then releverage, even if it did not meet the leverage ratio test. The prepayments of a revolver are not normally permanent, and the company may look to repay a revolver ahead of term loans for this reason. How the agreement defines bank borrowing can be a factor too. If it is defined as senior secured debt, the facility could be funded with a bond financing if it is senior secured. If a bank or credit agreement is specified, any financing using this carve-out would need to be in the form of an actual bank loan.

You must read all the other carve-outs because there may be specific carve-outs for acquisitions or refinancing. An investor usually does not mind a refinancing of junior existing debt as long as the new financing is longer-dated and no more senior than the existing financing that is in place.

Another type of carve-out involves early-development-stage companies that might need multiple rounds of funding from various sources and is based on equity value, frequently perceived or real asset value. This carve-out would allow additional debt financing based on new equity funding raised. As an example, for every $1 of new equity raised, the carve-out would allow the company to add $0.50 of new debt regardless of other debt tests.

In this section, we discussed carve-outs using the debt incurrence test as an example. Carve-outs commonly appear in all major covenants throughout the debt documents.

Restricted Payments

Restricted payments covenants try to restrict what the company can do with its cash flow and other assets. The concept behind the covenant is that holders of a bond or loan would want the company to meet certain goals before it can use money to either pay dividends on the equity, do stock buybacks, or be able to retire securities that are more junior to the loan that they hold.

Within the document, what constitutes a restricted payment is defined. As a rule, this definition is not short and includes many carve-outs. From a debt holder's perspective, the definition of restricted payments should specify that money or other assets going to the equity holders through dividends or stock repurchases and early retirement of more junior debt are all included as restricted payments.

There has been some controversy over private-equity-owned firms using carve-outs in this test to transfer assets from a company to the equity holders (entities controlled by the PE firm). There can be debate over how the asset is valued in the transaction and if the transfer is being done under the restricted payments test or through other covenants such as permitted investments.

The core of a restricted payments covenant normally has two parts. The first is a test that has to be met to be able to make such a payment. The second is a basket that limits how big a payment can be made.

Typically, the test that would have to be met feeds off the debt test. It is common to have language in the restricted payments test stating that, pro forma for a restricted payment, the company would have to meet the ratio portion of its debt test and be able to issue at least $1 of debt under that test. When analyzing this covenant, an analyst will have to circle back to the debt incurrence test and apply either the leverage ratio or a fixed charge test that is used in that covenant to meet the restricted payment test.

The basket measures how much is available for a restricted payment, and it can build up over time. It starts from a specific date and builds by cumulatively adding 50% of net income from that start date to the time of the payment. Whatever that accumulates to is what the company can use for restricted payments, and any restricted payment made gets deducted from that basket. However, if the test mentioned in the preceding paragraph is not being met, the basket cannot be used via typical traditional language. More aggressive covenants include a starter basket as well, which may state that in addition to the basket, the company has a certain dollar amount available to pay out through a restricted payment test.

Instead of the 50% of net income test, another common test for a basket builder is any EBITDA over 1.4x interest coverage, or some other ratio.

Here are some items to examine in the definitions and terms of restricted payment basket language:

- How are periods of negative net income counted? Are they deducted from the basket or just excluded?
- How are net income and interest coverage defined?

- What other items can be added to the basket, such as proceeds from equity offerings?

Some higher-quality issuers use restricted payments tests that are much simpler; they have a debt test that must be met. As long as pro forma for any transaction the company undertakes stays within that test (perhaps a 4x leverage ratio), the company has no limits on its ability to make restricted payments.

Restricted payments descriptions tend to have many more carve-outs than debt incurrence tests. In the normal course of running a company, some selected stock buybacks or other payments may have to be made. These are typically allowed to a limited amount. There might be a carve-out for the repurchase of stock from a departing employee up to a total of $10 million in any one year and a total of $100 million over the life of the debt. (These sizes will vary depending on the company's size.) There are often general carve-outs for one-time payments and some carve-outs for refinancing as well. There are also carve-outs that allow proceeds from equity financing to be used to make restricted payments. These carve-outs can be very aggressive, particularly in transactions by PE firms.

PE firms use the leveraged debt markets to help finance companies they purchase. Their primary goal is to get the best returns for their investors, and the more quickly they can get payments back on their equity investment, the better the net present value of their returns can be. Therefore, they look to have very loose restricted payments tests or many carve-outs so they can rapidly begin distributing money to the equity and boost their returns.

Permitted Investment Covenants

If time permits, you should try to look at the permitted investment covenant. Some structures have multiple subsidiaries, and permitted investments can sometimes include moving money or another asset into a legal structure within the corporate organization but out of the lender group. So, effectively, that money used under the permitted investment clause no longer directly supports the loan or bond, which can give a debt investor an unpleasant surprise. Permitted investments can often be in completely unrelated entities too.

Change of Control

Change-of-control covenants generally relate to a takeover of the company or a change in the control of the board. Typically, if a change of control, as defined in the document, takes place, the company that issued the debt must make an offer to repurchase the bonds at 101 of the face amount, usually within ninety days of the event's closing (not the announcement date). There is usually a clause that allows an acquiring company to make the offer as well. Bank covenants for change of control are fairly similar, although often the offer to purchase is at par.

The definition of *change of control* is important and varies significantly from document to document. A common example would be when anyone obtains 35% or 50% of the voting control of the equity or control of the board of directors. Numerous variations exist.

Usually the description of change of control carves out *permitted holders*. This is a defined term that must be examined. Sometimes it applies to the family of the controlling shareholder; sometimes it applies to another company that already has a significant stake in the issuer; or it can be defined in any number of other ways.

Other features sometimes appear in the change-of-control section. Exceptions might prevent the change-of-control offer from going into effect. The covenant may specify that as long as the leverage ratio pro forma for a change of control is no higher than it was prior to the event, the change of control is not triggered. Another common exception might specify that as long as the ratings agencies do not lower the ratings due to the change of control, the covenant is not triggered. They could include a specific ratio target that must be met, or perhaps require a ratings upgrade or an investment-grade rating.

Change-of-control covenants often come into effect in event analysis. This is especially true when two companies are merged. The structure of the transaction and the language of the change of control can be key to whether this put option for debt holders comes into play.

Asset Sale

Asset sale covenants typically define the form that major asset sales can take and how the proceeds from an asset sale can be utilized.

This type of covenant usually first prescribes the size of an asset sale covered by the covenant. It may have a dollar amount, such as any asset sale valued at over $50 million. It may define a percentage of assets, such as any asset sale that would be valued at more than 15% of net tangible assets. Or it may be prescribed in some other manner.

The next section of the covenant may dictate how the asset sale can take place. For example, it may dictate that 85% of the proceeds must be in cash. Or it may allow that a swap for similar assets may be undertaken.

Finally, there is usually a description of what can be done with the proceeds from such an asset sale. Typically, an offer has to be made to repurchase bank debt and any more senior debt. If proceeds remain after this offer, the usual language of a senior subordinated note gives the company 180 days in which to either reinvest the money into permitted assets or make an offer to repurchase the bonds at par. Permitted assets would be a defined term in the document. If no bondholders choose to sell bonds into this offer, the company is typically free to do as it wishes with the balance of the proceeds, within the boundaries of the other covenants.

This type of covenant tends to not have that many carve-outs but does have many defined terms. A common carve-out includes specific types of asset that may be excluded from this definition. If the company owns a large piece of real estate or a nonstrategic subsidiary, this may be excluded from the asset sale restrictions.

Reporting Requirements

Another very important covenant for companies that do not have public stock outstanding is the affirmative covenant to make financial statements available. If a company has public stock outstanding, most countries and exchanges require financial statements to be regularly and widely available, either quarterly or semi-annually. It is not always the same with debt securities.

Leveraged finance debt is usually not listed on exchanges. Some formats of the notes are considered private placements. This maintenance covenant is important to debt holders if the company is private, and even if it is public, in case the company goes private at some point. Additionally, the public financials filed to fulfill the requirements for a company's stock will usually be the holding company financials. Often, the bonds or loans are issued at a subsidiary. In some cases the subsidiary that is issuing the debt may have very different financials from those of the parent or holding company. Debt holders will want to see the financials for the actual credit they are lending to, not necessarily the parent company, so that they can analyze the credit risk at the correct entity. From the issuer's perspective, having to file separate subsidiary financials carries an extra cost and may also make more information available than the issuer cares to have in the public domain. But that should be factored into the management's decision to issue debt at a subsidiary.

How the financials are made available can be important. Some companies may prefer not to have their financials publicly available, for competitive reasons. However, the more inaccessible these financials are, the less liquid the trading in the related debt issues will be. From a debt holder's perspective, if the expectation is that there will be any trading in the debt, it is important that the company make financial results available. The most open forum for financial statements is filing them with a regulatory body such as the US Securities and Exchange Commission (SEC) or making them available on the company's website. A more restrictive practice might be to have them made available to existing debt holders. The company may legally limit these holders from forwarding the financials to others. There are also closed sites that require company approval to obtain the financials and limit their distribution. From a trading and information-flow perspective, this covenant can be important. Some bonds and loans may covenant in a requirement to hold quarterly or semiannual investor conference calls, effectively requiring the management to make themselves available to investors.

Other Covenants

Other covenants may include the following:

- *Business lines*: A covenant might restrict a company's lines of business. For example, an oil and gas exploration company may be limited by this type of covenant to staying in the energy business.
- *Related parties transactions*: Restrictions are often placed on transactions with related parties and include a description of how they need to be handled. For example, if the chairman of the company also owns a consulting business that the issuer of the bonds wants to hire, this may have to be approved by all outside board members. Or the covenant might limit the fees that can be paid.
- *Drop away*: This covenant appears in some bonds and typically states that if one, or a combination, of the major ratings agencies upgrade the bonds to investment grade, a number of the covenants may no longer become operative. These drop-away covenants are carefully defined and usually include the most restrictive ones. One item to look for when reading this type of covenant concerns the reinstatement of covenants if the company is later downgraded.

Typically, bank agreements have negative covenants that are slightly tighter than those found in bonds.

Words to Watch For

There are a few words to always be careful of when reading covenants:

- *And/or:* When a covenant lists criteria that have to be met, it can be very important if the word *and* or the word *or* appears between the last two items on the list. In a change-of-control covenant, it can make a big difference if the change-of-control offer to repurchase does not go into effect because 1) there is a ratings upgrade ___, 2) the leverage ratio is no higher than pro forma for the event. The meaning is quite different depending on whether *and* or *or* is inserted in the blank.
- *Notwithstanding:* For example, after its fourth or fifth paragraph, a covenant might state: "Notwithstanding the prior paragraphs in this section ..." This means that readers should ignore everything they just read when they go on to the next section of the document.

Affirmative (Maintenance) Covenants

Most of the covenants described so far are known as negative covenants. The reporting requirement described earlier is an affirmative covenant because it requires the company to do something. Typically, bonds do not have many affirmative, or maintenance, covenants. Leveraged bank agreements sometimes have a lengthy section of affirmative covenants. Failing to meet these covenants is a covenant default, sometimes called a technical default as opposed to a financial default. Not all loan agreements have maintenance covenants, but they are more common in loans than bonds.

Some common maintenance covenants can include a required minimum amount of cash or liquidity, maintenance of annual appraisals on the security underlying the loans, or other annual information.

The maintenance covenants that analysts most closely monitor tend to be financial maintenance tests. These can include revenue levels, EBITDA levels, and/or some combination of ratio tests. Defined leverage tests are common, such as debt to EBITDA, or interest coverage tests. As with the other covenants, the terms must be read carefully, because definitions can make a major difference. The definitions of these maintenance tests in the bank agreements have an even greater tendency than the bond definitions to include add-backs for cost savings or temporary losses from a single subsidiary.

Financial tests are often not static; they are sometimes constructed to get tougher over time, as lenders want to see credit improvement. When the bank agreement is publicly available, the grids that indicate changes to maintenance covenants can show an analyst what the company's own internal model may look like. Traditionally, bankers who build these covenants work with the company's model to create a grid that makes sense. The covenants usually build in some cushion over the company's projections. It is not atypical to assume that there is about a 20% to 25% cushion versus the company's actual internal models.

Another feature that is commonly found in bank covenants is a springing maturity. If a tranche of bonds or any more junior debt is outstanding and matures on a date ahead of the bank debt, a springing maturity often exists. In this case, the clause typically states that if the more junior debt is not refinanced or retired, say, six months prior to its actual maturity, it will trigger a default in the bank debt.

Modeling Maintenance Covenants

When building a model, if the bank agreement has maintenance covenants, an analyst will often want to show how much headroom there is between a bank agreement's maintenance covenant and the actual figure generated by the company's operating results. The analyst has to be sure to define the actual ratio in the same way it is defined in the covenants, even if it seems to be an illogical way to calculate the data.

Restricted and Unrestricted Subsidiaries

Bank agreements and bond indentures employ the concept of restricted and unrestricted subsidiaries. Restricted subsidiaries are entities that are party to the bond or loan agreements. They must abide by all the covenants and must support the payment of these debt instruments. Unrestricted subsidiaries do not have any obligation to support the bond or loan or follow its restrictions. So effectively, from the debt holder's perspective, management can do what it wants with these unrestricted assets.

For example, assume that a company owns five casinos: Two in Atlantic City, two in Las Vegas, and a new early-stage riverboat casino in Indiana. The four established casinos in Atlantic City and Las Vegas are the restricted subsidiaries, and the property in Indiana is unrestricted. The EBITDA from the restricted subsidiaries must meet any required ratios in the covenants. Any EBITDA gains or losses at the new Indiana casino do not affect these ratios. Additionally, the company could add debt, or sell the unrestricted Indiana assets, and not have to worry about whether this is allowed under any of the covenants in the restricted group debt agreements.

In this example, the casino company will likely report consolidated results for all five properties. When a bond or loan agreement includes the concept of restricted and unrestricted subsidiaries, the company often is required to separately report the results for the restricted group, even if it is public and reported results include all the consolidated operations. If the company is private, the reporting requirements typically require only the results of the restricted group, not the unrestricted subsidiaries, to be reported. Investments or transactions with the unrestricted subsidiaries usually should have to meet the requirements under the restricted payments basket and the restricted investment basket because this effectively results in money leaving the group that is supporting the debt.

When debt agreements contain the concept of restricted and unrestricted subsidiaries, there are also definitions of how a subsidiary's classification can change from a restricted subsidiary to an unrestricted one. Typically, the restrictions are pretty loose, but this type of transaction would not be allowed if it would violate the various restricted payment and debt tests. It is recommended that when these structures are present, the permitted investment covenant is carefully analyzed.

Not all companies and their debt instruments are structured with restricted and unrestricted groups. However, when they are, this is an important concept to understand. In some cases, the restricted group that supports the bonds will own the equity of the unrestricted group so that it may, theoretically, reap some asset value benefits from the entity.

Closing Comment

Understanding covenants can be time-consuming. It can also be frustrating because, in some cases, even after much time is invested in analyzing the covenants, there may not be a clear answer, due to ambiguity in the language. Increasingly, battles over what is actually allowed or not allowed within the covenants end up in courtrooms. The quote that always comes to mind when analyzing covenants is part of Sir Winston Churchill's description of Soviet foreign policy: A covenant is "a puzzle, inside a riddle, wrapped in an enigma."