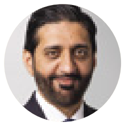
On thin ice?

Guest comment by **Alex Griffith** and **Faisal Ramzan**, partners at Proskauer

Increasingly borrower-friendly terms are a result of high liquidity and competition among private debt funds. But are players taking on risker propositions?

Even as fundraising totals have trended downwards since the record-breaking year of 2017, competition to lend in many parts of the market remains intense. With global dry powder only marginally down from a peak of $292 billion in 2018 to $261 billion in 2019, there's still ample liquidity.

Consequently, investor protection terms have loosened, to which the increased prevalence of covenant-lite, covenant-loose and EBITDA addbacks attests. So are funds taking on riskier investments in a bid to deploy capital? In some cases, yes. In highly competitive situations, funds are under pressure to provide the most borrower-friendly terms at the lowest possible cost.

This does not mean LPs are up the proverbial creek without a paddle. There's much that funds can do, and in many instances are doing, to mitigate risk in the absence of more traditional protections such as covenants.

There's a clear need for lenders to be creative and ensure diversification across industries and geographies, taking a holistic view of the terms in individual deals and of the broader market. It's clear that the number of covenants in the mid-market and above has been on the decline. Of 75 recent deals our firm has worked on in Europe, including the UK, 64 percent in the mid-market and upper mid-market only had one covenant.

For large-caps, covenant-lite deals are the norm. Yet while covenants provide early warning, a deal's overall documentation can offer stronger protection than absolute numbers might suggest.

Tighter documentation

Where a covenant is in place, lenders can set documentation at tighter levels than if there were multiple covenants. There may, for example, be fewer exceptions in a credit agreement that relies on a covenant test, and borrowers may be more restricted on debt incurrence and dividend payments.

The quantum of debt offered may also be lower if borrowers are seeking loose terms and reduced pricing. Even where this is not the case, lenders can place a heavy emphasis on borrower liquidity and ability to repay during due diligence and selecting deals to finance.

$261bn

Dry powder in the market in 2019, according to Preqin

On a broader basis, funds can still find opportunity without reducing LP protections because in less competitive situations or certain sectors the picture is quite different. For example, lenders still require covenants and the terms they agree to are far more robust while also offering borrowers sufficient flexibility to turn things around and improve profitability.

Furthermore, terms in the lower mid-market and below bear little resemblance to those farther up. This part of the market is less subject to competitive pressures, so that in off-the-beaten track situations, lender protections remain strong.

Today, managers are faced with what can appear to be competing aims. They must manage the difficult balancing act of adequately protecting their investments while deploying capital in a highly liquid market. Yet covenants, or the lack thereof, are only part of the story. Lenders can concentrate on other creditor protections in their agreements. They can also manage concentration risk by diversifying investments in their portfolio to include not just competitive mid-market, and above, situations, but harder-to-source opportunities where creditor protections remain robust. ■