Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

John Heitkemper: Thanks for joining this week's Tortoise QuickTake credit podcast. I'm John Heitkemper, portfolio manager for high yield bonds and leveraged loans at Tortoise. In U.S. credit markets, the weeks following Labor Day are typically busy with new issuance, as bankers try to push out as many deals as possible before the holidays start and the year comes to an end. This September has been no exception in the high yield and loan markets, as we've seen the launch of three well-telegraphed financings for leveraged buyout transactions. These types of deals don't normally grab many headlines, but this month's high profile deals have been notable for their aggressive terms. To do this subject justice, I thought I'd have John Wlodek join us this week; he's the group lead of our taxable corporate credit research team. Welcome, John!

John Wlodek: Thanks for the introduction. I'm glad to be here.

John Heitkemper: John, can you just give us a brief overview of the transactions?

John Wlodek: Well, first let's get oriented. The market environment we're dealing with is one where transaction sponsors, namely private equity firms completing LBOs, continue to push the boundaries of what buyside investors consider to be market acceptable credit standards. In that effort, they seek favorable pricing. In other words, low interest rates and the flexibility to act without interference from lenders. And that's where the loose covenants enter the picture.

As you know, the financial press has identified Refinitiv and AkzoNobel Specialty Chemicals as examples of recent large transactions that contain weakened covenants. In addition, the LBO financing transaction for Envision Healthcare launches this week, and some analysts worry that it too will feature weaker covenants as sponsors could cite the Refinitiv and AkzoNobel transactions as precedents.

Now covenants are provisions built into loan agreements that protect lenders and investors. So long as a covenant isn't violated, the borrower may generally go about its business without any lender interference. However, if a borrower violates a covenant, for example, if its leverage one day exceeds the maximum allowable in a credit agreement, the borrower will often find itself in violation of its contractual obligations. This is known as a technical default. In such cases, the lender banks can often force repayment of the loan or compel the company to undertake a restructuring or even file for bankruptcy.

The point being, these covenants, if properly structured, can provide lenders with exercisable rights prior to any actual payment default. If a company's business prospects are in decline, it's commonly accepted wisdom that lenders benefit from the ability to act sooner rather than later to protect their interests. Today's loose covenants set the stage for a possible future where lenders to some companies may have to sit on the sidelines and await an outright payment default before they gain the right to intervene in a failing business. That is not an optimal situation.

John Heitkemper: Thanks for that background. Now let's talk about what makes these LBO financings notable. I typically think of covenants, which are the terms that protect debt investors, as somewhat secular, meaning that they start out as relatively restrictive for borrowers early in a credit cycle and then get looser as the cycle advances. The covenants in these deals definitely feel late-cycle to me, but some would argue they go even beyond that. Can you talk about some of the ways that these deals take covenant erosion to a new level?

John Wlodek: Well look, there are a lot of ways that covenants can be weakened, these include:

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- Increasing maximum allowable leverage limits;
- Providing for greater allowances with regard to the utilization of expense add-backs and other adjustments in the calculation of cash flow or EBITDA;
- The increased ability to prime existing lenders by issuing super-priority debt;
- You can also relax limitations on dividends, share buybacks and other forms of what we call “restricted payments;”
- Some of these transactions also come with weakened collateral packages and guarantees;
- Other ways to reduce covenants would be to reduce restrictions regarding the application of proceeds from asset sales for investments.

And you’re right, while loosened transaction terms aren’t unusual in the late stages of a credit cycle, there seems to be some concern that there’s more going on here.

John Heitkemper: Thanks John. Now, if you’re the company or private equity sponsor, it’s pretty clear why you’d want to have all of that flexibility, but the final covenants in a loan or bond deal are always a negotiation between prospective lenders and the company, the private equity sponsor and the bankers. Why are investors agreeing to lend to terms so friendly to the issuer?

John Wlodek: Well, for now, it seems an important lesson is that market supply can trump fundamentals and deal structure, at least temporarily. And what I mean by that is, as these deals were brought to market in recent weeks, the overall leveraged loan and high yield bond new issue supply fell short of expectations, so investors found a way to avoid the bad taste of weak covenants in order to fill their portfolios. Poor covenants won’t immediately affect a loan or bond issuer’s business and they won’t immediately affect the financial fundamentals supporting an issuer’s credit profile. So, hungry investors eat what’s served now, and set aside any worries about future indigestion. It’s not a problem until it’s a problem. I believe that’s a fitting description of the situation.

It might be helpful to explain that leveraged loan capital markets are balanced by issuers on one side and investors on the other. In the middle sit the investment banks who manage the sides’ competing interests. Theoretically, investors voice any concerns regarding deal structure to the investment bank placement agent. Practically speaking however, it’s usually a small group of larger investors who drive that part of the process, because they usually commit to taking down large proportions of any transaction, and their absence from a deal could create a shortfall between the amount of financing requested and that ultimately provided. So, you’re right, the process does include an avenue for investor feedback and negotiation with the placement agent and the loan issuer itself. It just seems that the buyside’s effort to push back in recent weeks hasn’t overcome its appetite for new high-yielding corporate loans and bonds.

John Heitkemper: Okay, so investors now own all this debt with arguably weak protections. As the economic cycle plays out, what should bond holders or lenders expect? What could go wrong? Does it necessarily end badly for holders?

John Wlodek: Well, while a bit of bad sushi will quickly make you miserable, but loose covenants can linger for months or even years before upsetting a fixed income portfolio. The rubber hits the road only if financial fundamentals weaken, and that might take a year or more, or it might not happen at all.

John Heitkemper: Thanks, one last question, John. Where do we go from here? Do you think these deals represent the new normal?

John Wlodek: We’ve had a few weeks where leveraged loan and high yield bond investors haven’t been able to source sufficient product to fulfill their portfolio demands. The result is a highly favorable environment for leveraged corporate issuers to bring deals to market. For me, that is currently the only explanation. Issuance characteristics in the next few weeks and months will be telling. If especially weak covenants continue to find their way into credit agreements, analysts will have to reconsider the thesis that a short-term supply shortfall has temporarily allowed a few weak-covenant transactions to slip through.

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John Heitkemper: Thanks, John, I really appreciate you coming on. Thanks for listening, and please join us for future Tortoise credit podcasts.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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