

CR TRENDLINES

In April, Bull Market Loan Terms Prevailed Again

Amid strong market conditions, loan covenants of broadly syndicated, first-lien institutional loans eroded further in April, according to data compiled by Covenant Review. Headline themes include:

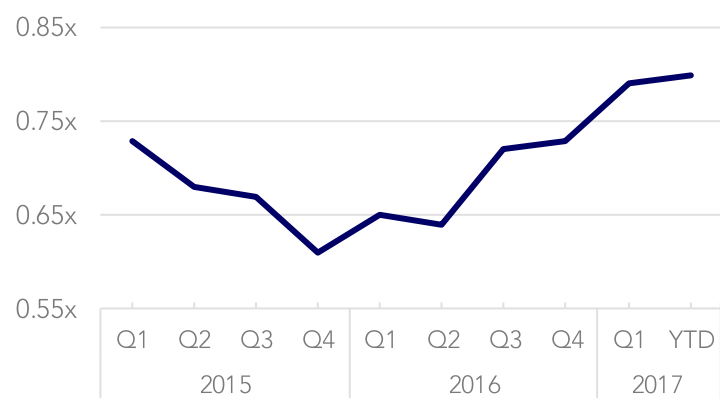
- **More generous incremental tranches:** In the year through April, the average free-and-clear hard cap among M&A-driven first-lien institutional loans increased to 0.80x of pro forma EBITDA at close from 0.73x in Q4.
- **Increased acceptance MFN sunsets / 75 bps yield protection:** Among loans whose final terms Covenant Review analyzed, 23% cleared with an MFN sunset in the year through April, up from just 9% in Q4. As well, a small number of sponsor-backed issuers pushed MFN yield protection to 75 bps, from the more traditional 50 bps.
- **Notable appearance of off-the-run terms:** We observed in early 2017 a small but meaningful increase in the use of asset sale sweep step downs and MFN carve-outs.
- **Large sponsors at the vanguard:** As usual, the most active sponsor groups were in the vanguard here, pushing for looser terms both on regular-way and idiosyncratic provisions.

We'll take each of these themes in turn before turning to the outlook for May and an overview of trends in Europe.

Free-and-Clear (F&C) Incremental Tranches: Pushing to 1x

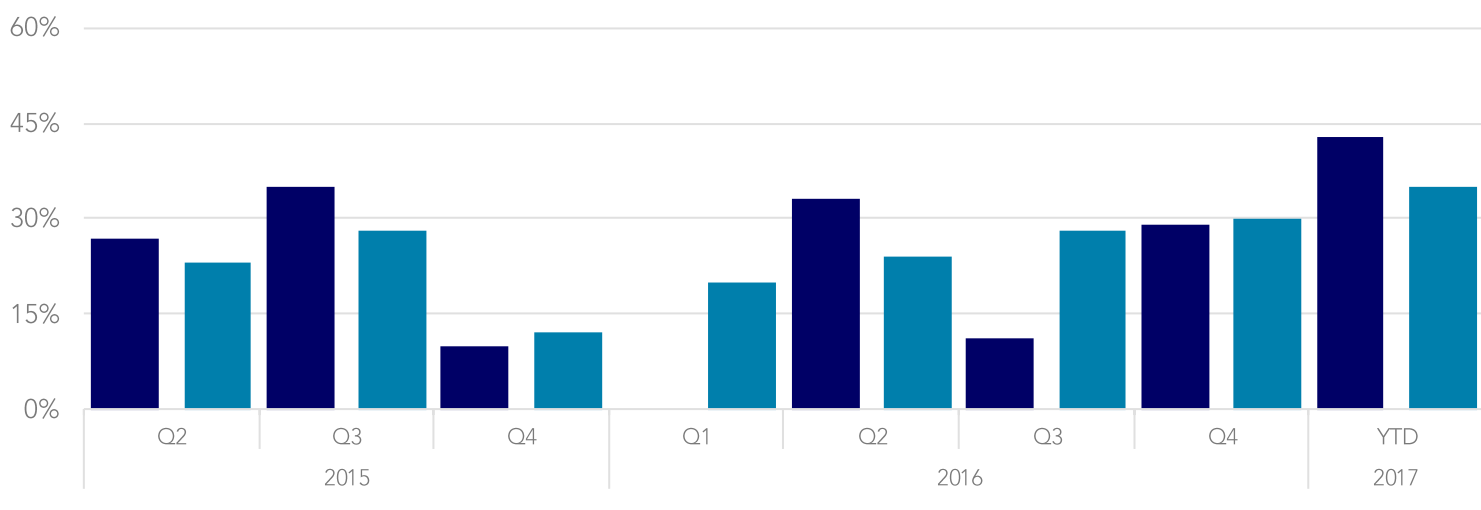
In the year to date, F&C incremental tranches edged to 0.8x of pro forma closing EBITDA on average. That's up from 0.73x in Q4 and the highest reading since Covenant Review began tracking these data in 2015.

Chart 1: Average Free-and-Clear as a Multiple of Pro Forma Adjusted EBITDA (M&A-related)



As this suggests, a growing proportion of 2017's new issues have close to, or more than, one-turn of F&C capacity out of the blocks.

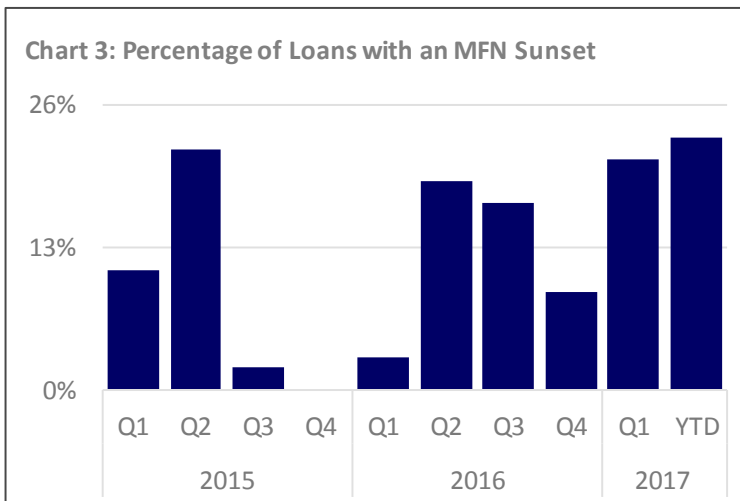
Chart 2: Percentage of Deals with F&C Tranche / PF EBITDA >0.9x (M&A-Related vs. All Deals)



Because, participants say, regulators are more and more focused on leverage capacity through the F&C, issuers that are pushing the edge of the envelope on leverage and adjustments are beginning to incorporate more creative F&C terms that separate discretionary incremental caps from caps tied to acquisitions that, presumably, result in adding EBITDA. Misys is a case in point. As Covenant Review sister publication LevFin Insights reported [here](#): “The loan’s unusually structured F&C provision provides for up to \$350 million, plus an additional \$300 million that could only be utilized for permitted acquisitions and investments, sources said. It’s no coincidence that regulators, in assessing deals, typically assume F&C capacity would be utilized to fund restricted payments, a potential credit negative. Thus, limiting the additional capacity to M&A allows for the assumption that the additional debt is offset by additional EBITDA. Even taken together, the two F&C components, at \$650 million, comprise a conservative 0.7x portion of projected credit agreement EBITDA, below the average 0.8x tracked by LFI sister company Covenant Review so far this year. And it’s well inside the one full turn of F&C capacity sought by numerous issuers in recent months.”

Misys is not unique in specifying that at least some portion of the F&C must be used for M&A. The recently completed LBO deal for USI Holdings did likewise, sources say, and as far back as 2015, AssuredPartners’ \$140 million F&C basket was barred from funding restricted payments, although it included a carve-out that could be used for non-M&A purposes. Still, Misys and USI may represent early adopters of this particular covenant technology that may get more play in light of regulatory pressure, on the one hand, and stretched leveraged multiples, on the other.

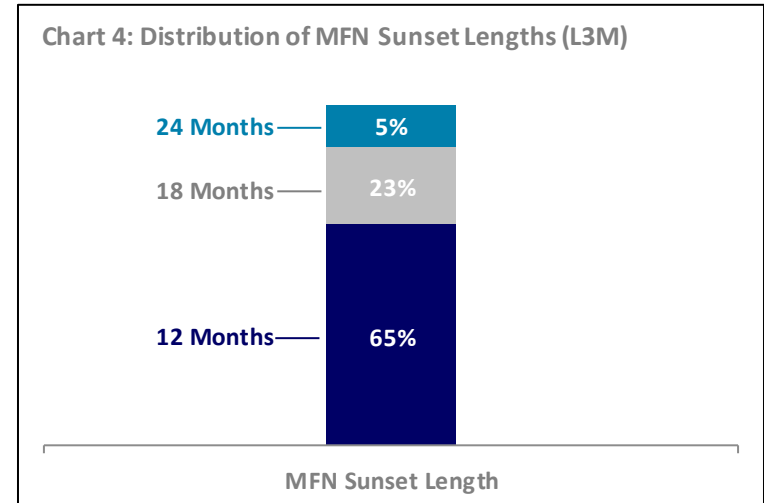
MFN Sunsets: Gaining Acceptance



With the buy-side on its heel in early 2017, the percentage of first-lien new issues in Covenant Review’s sample that cross the goal-line

with a sunset rose to 23% in the year to April, from 9% during the fourth quarter. Recall here that Covenant Review’s data set is comprised mostly of broadly syndicated first-lien loans and thus excludes club deals—and deals from smaller sponsors—that typically have tighter terms and rarely have sunsets.

Looking at the last three months of activity, sunsets have skewed to 12 months, as this chart illustrates.



Drilling down, no fewer than 22 of 2017’s new-issue institutional loans have cleared so far with an MFN sunset according to reporting by our colleagues at LevFin Insights. Understandably, the big sponsor groups dominate as Table 1 on page 3 demonstrates.

Another noteworthy point here: five of these 22 loans have 75 bps of MFN yield protection set, rather than the traditional 50 bps.

Off-the-Run-Provisions Get a Bit More Mainstream

Several issuer-friendly provisions are showing up more frequently, by all accounts, in early 2017. Here’s a lay of the land:

- **Asset sales sweep step down:** In the year to date, 26% of first-lien loans cleared with at least one ratio-based step down for mandatory prepayments from asset sales. In addition, 9% of the loans had a second ratchet down, typically waiving the sweep entirely.
- **Soft call primary provision exception:** Two third of year-to-April loans excluded refinancings that were not for the primary purpose of lowering spreads—such as those attached to IPOs, change of control, or transformative acquisitions—from the prepayment penalty.
- **MFN carve-out:** Though still an exception to the rule, 19% of year-to-April loans cleared with a dollar amount exception to the MFN. Participants say this is a fairly new feature that was far less frequent in years past. To give some context here, the average dollar MFN carve-out was 13% of the principal amount

of the loans in question, with a range of 6 – 30% across the data set.

- **RC springing tests:** 46% of year-to-April institutional loans are tied to a revolving credit with springing maintenance tests. The springing trigger was set largely at either 30%, where 40% of the loans cleared, or 35%, where half did.

Membership Has Its Privileges: Choice Terms for Big Sponsors

In light of a surplus of demand over supply, covenant erosion has been as clear of a theme in early 2017 as has tightening spreads. Understandably, the most influential private-equity firms have garnered the most favorable terms. To illustrate this point, Covenant Review culled a sample of 2017 loans to single B issuers—the few BB loans of recent vintage are excluded from the mix because these loans are naturally less restrictive. To provide a comparison, we divide the sample into two categories: (1) loans from the largest and most active sponsors such as Apollo, Bain, Blackstone, Carlyle, CVC, KKR, TPG, and Vista (PEI’s full list is [here](#)) and (2) loans from less active sponsor groups and corporate issuers.

Naturally, in any given period not all sponsors will have M&A-related executions to include in the data set.

As Table 2 on page 4 illustrates, some terms are fairly universal, such as the primary purpose limitation to soft call provisions. Others—for example, MFN sunsets and asset sale sweep step-downs—are largely reserved for big sponsor groups.

Outlook: Issuers on Offense

Despite a welcomed increase in net new issue volume largely from two multibillion-dollar M&A loans—Misys at \$3.6 billion and Tempo at \$2.6 billion—the market’s technical situation favored issuers again in April. In the end, supply exceeded visible demand from CLO issuance and loan mutual fund flows by \$13.4 billion, according to data from LFI and Lipper FMI. In the first quarter, by comparison, demand edged net supply by \$0.3 billion. Still, April’s supply bump was clearly not sufficient to mop up liquidity chasing the asset class. Thus, price flex activity favored issuers again in April 29 to 8, according to LFI. That compares to an even more lopsided score of 152 down to just 27 up during the first quarter.

Table 1: 2017 Deals w/ MFN Sunsets

Issuer	Sunset	MFN	Sponsor
Alix Partners	12 months	50 bps	Caisse de depot et al
Atotech	12 months	50 bps	Carlyle
CCC Info Services	12 months	75 bps	Advent
Change Healthcare	12 months	75 bps	Blackstone*
Cole-Parmer	6 months	50 bps	Golden Gate
Cologix	12 months	50 bps	Stonepeak
Cytera	12 months	50 bps	BC Partners
Epic Health/Aveanna	12 months	50 bps	Bain, JH Whitney
Gavilan	12 months	50 bps	Blackstone
Go Daddy	12 months	50 bps	Public
Misys	12 months	50 bps	Vista
NeuStar	18 months	50 bps	Golden Gate
Optiv	12 months	50 bps	KKR
SESAC	12 months	75 bps	Blackstone
Synchronoss	18 months	50 bps	Public
Team Health	12 months	75 bps	Blackstone
Tempo Acquisition	12 months	75 bps	Blackstone
USI Inc.	6 months	50 bps	KKR, Caisse de dépôt
VC GB Holdings	18 months	50 bps	AEA
Visteon	12 months	50 bps	Public
World Kitchen	12 months	50 bps	Cornell Capital
Zayo Group**	18 months	100 bps	Public

Source: LFI

*Minority shareholder in combined entity

**Only applicable to shorter-dated tranche

Table 2: M&A-Driven First Lien Loans for Single B Rated Issuers (YTD)

	Large Sponsors	Other Sponsors / Corporate Issuers
Accordion		
Average Free & Clear Incremental Dollar Cap / PF EBITDA	0.98x	0.70x
% w/ Sunset	91%	16%
% w/ MFN Dollar Carveout	73%	18%
Soft Call		
% @ Six Months	73%	63%
% @ 12 Months	27%	38%
% w/ Primary Purpose Limitation	100%	88%
EBITDA Adjustment		
Percentage w/ Uncapped EBITDA Adjustments	75%	24%
Average EBITDA Adj. Cap (for Loans with Caps)	20%	20%
Asset Sale Sweep		
Percentage w/ Asset Sale Sweep Step-Down(s)	64%	16%
Springing RC Covenants		
Percentage w/ Springing Trigger	73%	56%
Average Revolver Utilization Springing Trigger	34%	28%
Average Initial First Lien Leverage Cap	7.11x	6.18x
Average First Lien Headroom at Close	2.99x	1.98x

Looking ahead to May, the technical meter starts in an issuer-friendly setting. Start with net prospective supply, which after April's bump has receded to a mere \$0.9 billion after visible repayments, according to LFI (latest data [here](#)).

On the other side of the technical equation, there has been a clear downshift in retail flows in recent weeks as interest rates eased. Indeed, funds that report to Lipper FMI took in \$542 million during the final two weeks of April, the lowest two-week period in six months and down from an average of \$1.7 billion earlier in the year. CLO issuance, meanwhile, remained robust in April at \$6.9 billion as AAA discount margins tightened into a 120 context for large platforms. [CSAM](#), [CVC](#), and [GSO](#), in fact, printed vehicles with a 118 discounted margin in April and managers expect levels to track tighter as a result of demand from yield-starved banks and institutional investors in Japan and across Asia.

In light of these conditions, issuers will undoubtedly press their technical advantage as long as that advantage persists. Covenant Review's loan analysis team notes a number of further proposed covenant weakening in recently launched deals that have yet to print. These include:

- Cases of excess cash flow sweeps that require payments to only exceed specified threshold. Traditionally, by contrast, the sweep might kick over at a threshold but apply to all cash flow, including below-threshold amounts.
- Amendments to MFN provisions only requiring majority lender consent; this less rigorous requirement ebbs and flows with market tone, but Covenant Review has seen it crop up in more term sheets lately.
- 200% contribution debt baskets, rather than the more typical 100% level.
- Smaller sponsors, or larger sponsors that deal in the sub \$100 million EBITDA range, asking for aggressive items that are typically seen for broadly syndicated loans for major PE firms. These include MFN limitations, inside maturity exclusions, uncapped EBITDA add-backs, substantial investments capacity, non-standard builder basket components, asset sale sweep step-downs, and the like—but all were tightened or removed.

Though the jury is out on whether these aggressive asks from issuers will clear, they illustrate how issuers are attempting to use their leverage to push for further optionality in the documents.

– Steve Miller

United States vs. Europe

Table 3: Average United States vs. European Deals Stats (LTM)

	Average	
	United States	Europe*
Free-and-Clear Tranche as a Multiple of EBITDA	0.72x	0.63x
Pro Forma Leverage	4.76x	4.39x
Pro Forma Leverage through Free-and-Clear**	5.41x	4.83x

* Includes preliminary terms data

** Includes deals without a free-and-clear tranche

Incurrence Test Headroom, Free-and-Clear Incremental Tranche, and EBITDA Adjustments

Table 4: Distribution of Free-and-Clear / Pro Forma EBITDA

Period	<0.3x	0.3x-0.5x	0.5x-0.7x	0.7x-0.9x	0.9x-1.1x	>1.1x
2Q15	18.2%	0.0%	36.4%	18.2%	27.3%	0.0%
3Q15	5.9%	5.9%	17.6%	35.3%	35.3%	0.0%
4Q15	14.3%	33.3%	19.0%	23.8%	9.5%	0.0%
1Q16	0.0%	14.3%	28.6%	57.1%	0.0%	0.0%
2Q16	20.0%	26.7%	20.0%	0.0%	33.3%	0.0%
3Q16	11.1%	11.1%	22.2%	44.4%	11.1%	0.0%
4Q16	5.9%	11.8%	11.8%	41.2%	29.4%	0.0%
YTD	3.6%	10.7%	21.4%	21.4%	39.3%	3.6%

Table 5: Accordion First Lien Ratio Incurrence Metrics

Period	First Lien Leverage Ratio Incurrence Test	First Lien Leverage Headroom
1H15	4.14x	0.01x
2H15	3.93x	0.07x
1H16	4.12x	0.05x
2H16	3.95x	0.04x
L6M	3.95x	0.08x

Chart 5: Average EBITDA Adjustment Cap for Synergies & Cost Savings (Sponsored | Not Sponsored)

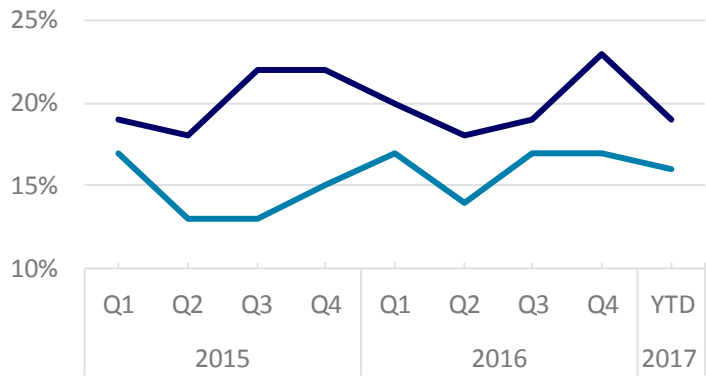


Chart 6: Average EBITDA Adjustment Horizon (Months) for Synergies / Cost Savings (Sponsored | Not Sponsored)

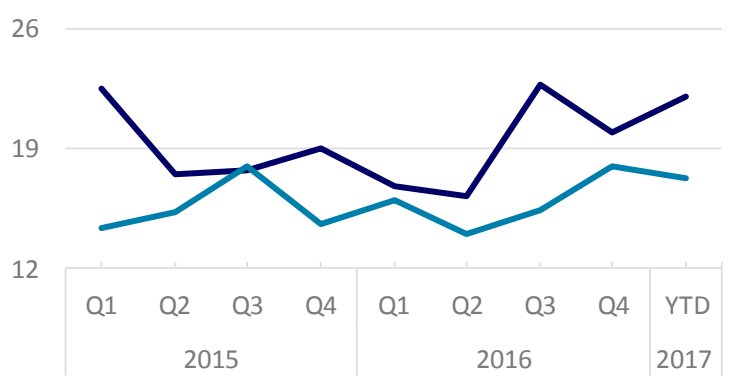


Chart 7: Synergies & Cost Savings EBITDA Addback Capped | Uncapped | None Allowed

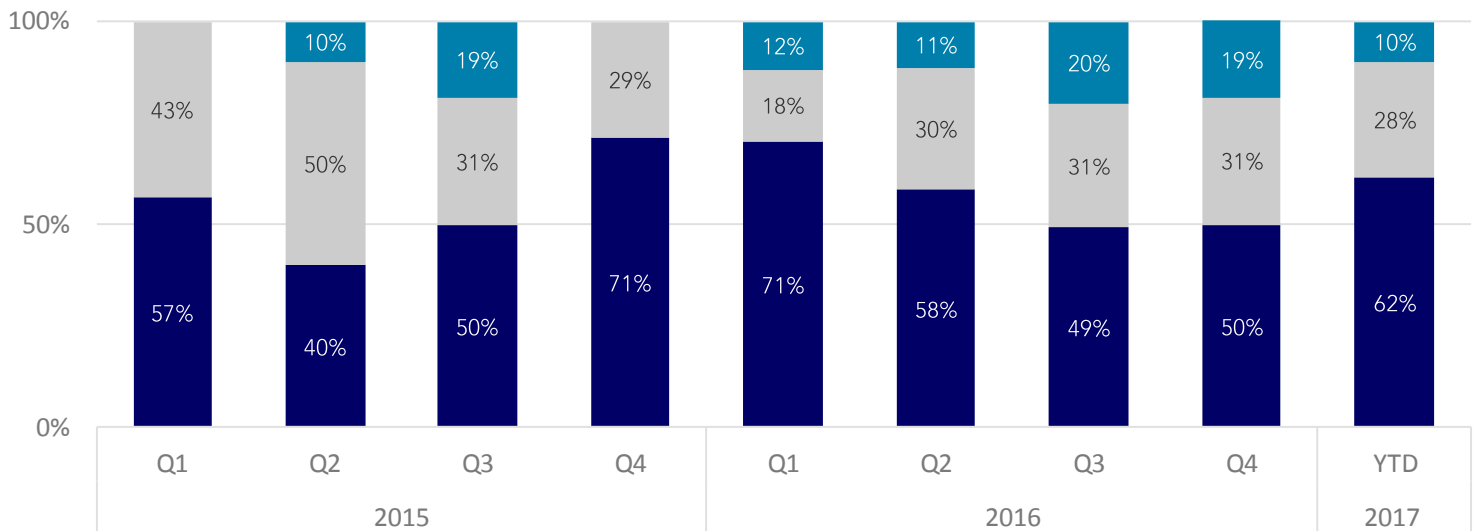


Chart 8: Average Headroom under Accordion First Lien Ratio Debt Incurrence Test Based on Initial PF Leverage (LTM)

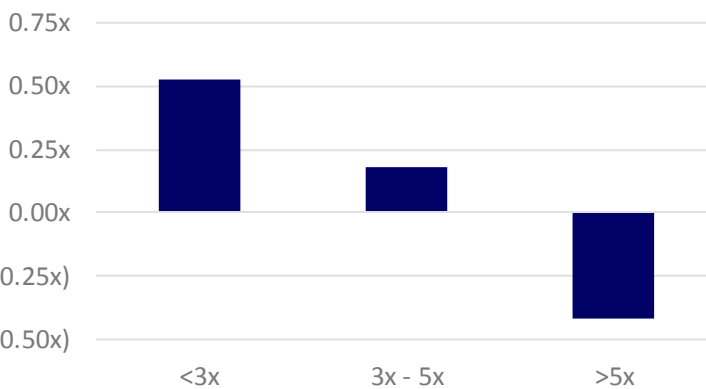
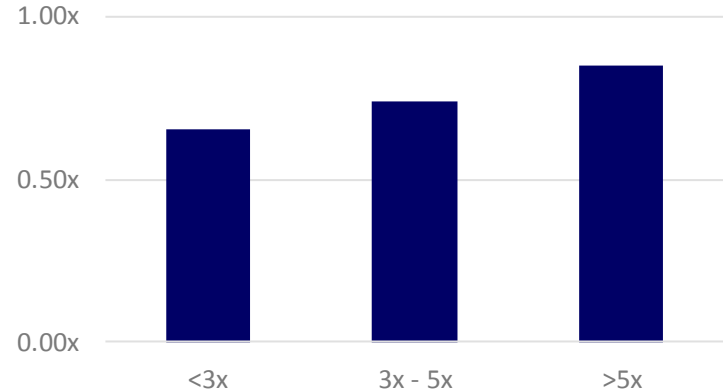


Chart 9: Average F&C Tranche / Pro Forma EBITDA Based on Initial PF Leverage (LTM)



Excess Cash Flow Sweep

Table 6: Initial Excess Cash Flow Sweep Distribution

Initial ECF Sweep	1H15	2H15	1H16	2H16	L6M
0%	8.0%	6.0%	0.0%	0.0%	0.0%
25%	0.0%	0.0%	0.0%	0.0%	1.0%
50%	73.0%	67.0%	88.0%	82.3%	82.8%
75%	17.0%	26.0%	11.0%	16.1%	14.1%
100%	2.0%	1.0%	1.0%	1.6%	2.0%

Covenant Statistics: Large Corp vs. Middle Market

Table 7: Covenant Statistics by Pro Forma EBITDA of Issuer (M&A-Related), LTM

	EBITDA Amount			
	<\$100M	\$100M - \$250M	\$250M - \$500M	>\$500M
Average Free-and-Clear Tranche / EBITDA	0.72x	0.85x	0.66x	0.76x
Average Pro Forma Leverage	5.70x	4.99x	4.63x	4.91x
Average 1st Lien Leverage	4.31x	4.05x	3.69x	3.68x
Average F&C/EBITDA + Pro Forma Total Leverage*	6.30x	5.82x	5.23x	5.63x
Average F&C/EBITDA + Pro Forma 1st Lien Leverage*	4.91x	4.88x	4.30x	4.40x
Average EBITDA Adjustment Cap for Synergies / Cost Savings	21.8%	20.0%	17.2%	15.6%
Average Time Horizon to Realize Synergies / Cost Savings (Mos.)	16.8	20.7	17.0	19.5

* Includes deals without a free-and-clear tranche

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