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Leveraged Finance:

Covenant-Lite Loans And Cure Provisions Weigh On Lenders' Recovery Prospects And Bargaining Power

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Table Of Contents

Loan Covenants Loosened During The LBO Boom

Financial Maintenance Covenants

Debt Incurrence Covenants

Asset Sale Covenants

Restricted Payments Covenants

The Potential Effects On Recovery

Leveraged Finance:

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Standard & Poor's Ratings Services believes that "covenant-lite" loans and loans with "equity cure" provisions may hamper the early-warning system that financial covenants typically provide. In our view, lenders with exposure to these loans may face the potential for lower post-default recovery prospects and diminished bargaining power. Recoveries may also face potential stress from heightened exposure to event risk in bank deals where debt, asset sale, and other incurrence covenants have moved from the traditional credit agreement model toward packages that include features once largely confined to high-yield indentures.

"Covenant-lite" typically refers to loans that lack financial maintenance covenants and describes many loans extended to speculative-grade borrowers during the recent leveraged buyout (LBO) boom that ended in 2007. Standard & Poor's analysis of selected credit agreements executed between 2005 and 2007 reveals that the weakening of traditional protections in leveraged loan agreements of this vintage can encompass a good deal more than just the absence of financial covenants (in fact, only four of the 14 agreements we looked at were true "covenant-lite" deals). The advent of equity cure rights and the extent to which high-yield indenture concepts and language have appeared in traditional loan covenants suggest to us a more complex picture.

Loan Covenants Loosened During The LBO Boom

By requiring a company's financial performance to be measured against pre-established benchmarks, bank lenders have historically relied on financial covenants to address potential adverse developments with a borrower before the situation deteriorates to the point of no return. In this sense, financial covenants have traditionally operated as "maintenance" tests as opposed to the more porous "incurrence" tests commonly found in high-yield indentures. Incurrence-based covenants--including those related to restricted payments, debt, or asset sales--only come into play when a borrower wants to take a particular action, such as pay a dividend, borrow additional money, or sell an asset. In other words, the borrower generally must trigger the application of an incurrence-based covenant. A maintenance covenant, on the other hand, isn't event driven and is, in fact, intended to capture the effects of changes or events that may be beyond the borrower's control. Before the proliferation of covenant-lite structures, the credit agreement for a typical speculative-grade borrower would most likely have included both financial maintenance covenants and an array of incurrence-based and other negative covenants.

Covenants in loan agreements became looser during the recent LBO boom, with once robust speculative-grade protections such as financial maintenance tests either being diluted or disappearing altogether as lenders lowered their standards in response to demanding private-equity sponsors. In this light, Standard & Poor's Ratings Services considered the rise of covenant-lite transactions and the potential consequences for post-default recoveries in July 2007 (see "Covenant-Lite Loan Structures Diminish Recovery Prospects," published July 18, 2007). Here, we examine the ways in which loan covenant packages lost much of their potency through a closer look at the loan agreements arranged for 14 borrowers across a variety of different sectors during the recent LBO era (see table).

Loan Agreements Made During LBO Era					
Company	Rating/Outlook	Sector	Credit Agreement Date	Facilities And Amounts	Issue/Recovery Ratings
ARAMARK Corp.	B+/Positive	Consumer Products	Jan. 26, 2007, as amended	Revolver: \$600 mil	BB/1
				TL: \$4.15 bil	BB/1
				Synthetic LOC: \$250 mil	BB/1
Charter Communications Inc.	B-/Negative	Telecommunications	Amended and restated March 6, 2007	Revolver: \$1.5 bil	B+/1
				Initial TL: \$1.5 bil	B+/1
				Refi TL: \$5 bil	B+/1
				Incremental TL: \$500 mil	B+/1
Dole Food Co. Inc.*	B-/Negative	Consumer Products	Amended and restated April 12, 2006	Prefunded LOC: \$100 mil	B+/1
				TLB: \$225 mil	B+/1
				TLC: \$750 mil	B+/1
Dollar General Corp.*	B/Stable	Retail	July 6, 2007	First Out TL: \$1.7 bil	First Out Tranche: B+/2
				First Loss TL: \$600 mil	First Loss Tranche: CCC+/6
First Data Corp.	B+/Negative	High Tech	Amended and restated Sept. 28, 2007	Revolver: \$2 bil	BB-/2
				TL: \$13 bil	BB-/2
Freescale Semiconductor Inc.	B+/Watch Neg	High Tech	Dec. 1, 2006, as amended	Revolver: \$750 mil	BB/Watch Neg/1
				TL: \$3.5 bil	BB/Watch Neg/1
Hawaiian Telcom Communications Inc.	D/--	Telecommunications	June 1, 2007	Revolver: \$90 mil	CC/3
				TLC: \$484.7 mil	CC/3
HCA Inc.*	B+/Negative	Health Care	Nov. 17, 2006, as amended	Revolver: \$2 bil	BB/1
				TLA: \$2.75 bil	BB/1
				TLB: \$8.8 bil	BB/1
				Euro Tranche TL: €1 bil	BB/1
Michaels Stores Inc.*	B-/Stable	Retail	Oct. 31, 2006, as amended	TL: \$2.4 bil	B/2
Realogy Corp.	CC/Watch Neg	Real Estate	April 10, 2007	Revolver: \$750 mil	CCC+/Watch Neg/2
				TL: \$3.17 bil	CCC+/Watch Neg/2
				Synthetic LOC: \$525 mil	CCC+/Watch Neg/2
SunGard Data Systems Inc.	B+/Stable	High Tech	Aug. 11, 2005, as amended	Revolver: \$1 bil	BB/1
				TL: \$4.4 bil	BB/1
				Incremental TL: \$500 mil	BB/1

Loan Agreements Made During LBO Era(cont.)					
Swift Corp.¶	B-/Negative	Transportation	May 10, 2007	Revolver: \$450 mil	B+/1
				TL: \$1.72 bil	B+/1
Tribune Co.	CCC/Negative	Media & Entertainment	May 17, 2007	Revolver: \$750 mil	CCC/4
				TL: \$2.105 bil	CCC/4
				TLB: \$5.515 bil	CCC/4
				TLX: \$1.5 bil	CCC/4
				Delayed-Draw TL: \$263 mil	CCC/4
Univision Communications Inc.	B-/Negative	Media & Entertainment	March 29, 2007	Revolver: \$750 mil	B-/3
				TLB: \$7 bil	B-/3
				Delayed-Draw TL: \$450 mil	B-/3

Note: Standard & Poor's Ratings Services' analysis of the above-referenced credit agreements is based on, and limited to, publicly available SEC filings. *Companies also have asset-based revolving credit facilities (Dollar General (\$1.125 billion); Dole Food (\$350 million); HCA (\$2 billion); and Michaels Stores (\$1 billion)), which were not reviewed for this article. ¶Swift terminated its SEC registration in May 2007. TL -- Term loan. LOC -- Letter of credit.

Financial Maintenance Covenants

On the whole, the deals we examined, in our view, lacked strong financial covenant protection. Four transactions--Dole, Freescale, Michaels Stores (the secured leverage ratio test of which was eliminated by amendment in May 2007), and Dollar General--had no financial maintenance covenants. Of the 10 credit agreements in our review that did include financial covenants, six contained just one such covenant. Five of those--Univision, Realogy, First Data (the covenant for which doesn't appear to take effect until the quarter ending Dec. 31, 2008), Hawaiian Telcom, and ARAMARK--provide for a secured leverage test, and one (HCA) specifies a total leverage test. (We note that HCA's separate ABL facility provides for a minimum interest coverage test, and Dole's separate ABL facility provides for a minimum fixed-charge coverage test.)

In at least a couple of instances (Univision, Hawaiian Telcom) the covenant isn't applicable unless borrowings or letters of credit are outstanding under the revolving credit facility. (ARAMARK's covenant applies so long as a revolving commitment remains in place.) Only three credit agreements (Sungard, Swift, and Tribune) provided for an interest coverage test. From a lender's perspective, tests based on interest or fixed charges have the advantage of capturing increases in borrowing costs, whether as a result of changes in LIBOR (or some other benchmark rate) or the issuer's interest rate margin. Other types of financial covenants, such as leverage tests, may not reflect the effect of a credit rating downgrade on borrowing costs in instances where the interest rate margin is tied to the rating on a borrower or a specific issue.

The financial covenants in the loan agreements we reviewed were generally EBITDA based. What constitutes "EBITDA" depends entirely on how that term is defined in a particular credit agreement. The greater the departure from a traditional, generic definition of EBITDA, the more discretion the borrower has in determining the ultimate result. (In our view, a good illustration of the considerable latitude that a borrower may have in formulating EBITDA is the ability provided by some of the agreements we reviewed for the borrower to factor in "business optimization expenses.") From a lender's perspective, it seems to us that the benefit of an EBITDA-based financial covenant hinges as much on the particulars of the definition as it does on the specified levels or ratios.

Equity cure provisions

Seven of the 10 credit agreements we reviewed that did include financial maintenance covenants also contained equity cure provisions. The details vary somewhat from deal to deal, but in substance, these provisions achieve the same objective: to allow borrowers to forestall a financial covenant violation through an injection of fresh capital. The size of such a cash infusion is usually equal to the amount by which EBITDA for the relevant measurement period would have to be increased in order to satisfy the applicable financial ratio (since most financial covenants involve EBITDA-related ratios).

In the agreements we reviewed, there were no requirements that the borrowers use cash contributed as common equity for bank debt reduction--or in any particular way, for that matter. In essence, an equity cure provision provides sponsors with an option to contribute capital to cure a default. However, the resulting cash infusion may be modest and may not materially improve the borrower's financial condition or reduce the lenders' exposure.

Moreover, when borrowers exercise an equity cure, the lenders relinquish their contractual right to accelerate loans as a consequence of a borrower's noncompliance with a financial covenant. This deprives lenders of the opportunity to seize the upper hand in working out potential problems or recalibrating the terms of a deal to reflect any deterioration in credit quality. At the very least, lenders lose the chance to generate fees through the execution of an amendment or waiver. But more worrisome, in our view, is the loss of any ability to impose substantive change through an amendment or waiver, such as repricing the credit, requiring reductions in capital spending, or taking additional collateral. And even if lenders believe that pulling the plug on a deal would be in their best interest, they've lost that right, too.

Equity cure rights can create tension when it comes to credit ratings. On the one hand, such a provision can serve as a means to head off a potential liquidity crisis when a covenant violation might otherwise impair a cash-strapped borrower's access to its revolving credit facility. In this sense, a borrower's risk of default may be mitigated, at least for the time being. But from a recovery perspective, exercising a cure right--to the extent that it merely delays the inevitable--could hurt lenders if an earlier bankruptcy filing or the ability to negotiate changes to the loan's terms would have preserved greater value for creditors.

While one might argue that a sponsor has little incentive to pour equity into a business that is sliding inexorably into Chapter 11, lenders and sponsors/borrowers may not see eye to eye on the company's prospects. Just how much an equity cure provision might weaken the benefits that financial covenants afford depends on the frequency with which the borrower can exercise the right and the appropriateness of the financial ratios in the covenants. In the agreements we reviewed, four of the seven that contained equity cure provisions (Univision, Realogy, First Data, and HCA) permit the cure right to be exercised up to three times in any four-quarter fiscal period. The others (Hawaiian Telcom, ARAMARK, and SunGard) limit this exercise to twice.

Although none of the companies we reviewed had exercised their cure rights, this may soon change for those borrowers that lack sufficient covenant headroom. Realogy, for instance, referred to its equity cure provision in an SEC filing earlier this year, and Standard & Poor's is of the view that the company's equity sponsor may well have economic incentives over the near term to avail itself of the option to cure a financial covenant violation through an equity contribution. (See Standard & Poor's research report on Realogy Corp. published Nov. 7, 2008.)

Debt Incurrence Covenants

In many of the cases we looked at, covenants governing the incurrence of debt were, in our opinion, fairly permissive. A number of the credit agreements (Realogy, First Data, Dollar General), for example, allow for the incurrence of additional debt in accordance with a senior secured leverage test, which would appear to give the borrower significant leeway to load the capital structure with unsecured debt. In our view, this may heighten a borrower's susceptibility to untimely default and, in turn, hurt lenders' recovery prospects.

A few deals (Univision, ARAMARK, First Data, Michaels Stores, and Dollar General) have debt covenants that incorporate the high-yield indenture concept of debt "reclassification" in one form or another. The typical debt covenant in a high-yield indenture contains two broad categories of exceptions: ratio debt and basket debt. The ratio debt exception allows a company to incur additional debt subject to pro forma compliance with a specified financial ratio (that is, after giving effect to the proposed incurrence), such as leverage. A basket, on the other hand, is an exception that allows a company to incur a specified amount or type of debt without regard to any financial ratio or test.

At the time additional debt is issued, the company is supposed to classify the debt according to the exception(s) under which the incurrence is permitted. In other words, the borrower must determine whether the new debt can be incurred as ratio debt or must fit within one or more of the baskets. Some indentures, however, provide an additional measure of flexibility by permitting the company to subsequently reclassify basket debt as ratio debt if the company's financial performance improves to a point where the requisite ratio test is satisfied. Simply put, reclassification at its extreme allows the borrower to replenish its baskets, which we believe could increase the risk of default--or the potential loss given default--by enabling a borrower to maximize its ability to add debt.

Univision's and ARAMARK's debt covenants appear to us to be the most permissive in this respect, allowing for most types of basket debt to be reclassified as ratio debt. The debt covenants for First Data, Michaels Stores (which doesn't appear to provide for a general ratio debt incurrence exception in any case), and Dollar General employ a more diluted version, enabling reclassification only among various baskets. At any rate, what was originally a high-yield indenture phenomenon appears to have entered into some credit agreements during the LBO boom years.

Asset Sale Covenants

In our assessment, most asset sale covenants in the credit agreements we looked at give borrowers considerable flexibility to sell assets, with limitations generally tied to a percentage of consolidated total assets or fixed dollar amounts.

Bank loan agreements have traditionally required borrowers to pay down credit facilities with all or part of the proceeds from specified types of asset sales, unless they use the proceeds within a specified time to acquire new assets. While the credit agreements we reviewed provide for this basic "repay or reinvest" mechanism, the rules applicable to the reinvestment alternative are, in our view, softer than those in documentation put in place before the recent LBO era. Most of the credit agreements we looked at contained what we view as only a very general mandate that the company acquire assets that are "useful in its business." This type of expansive language may actually allow a company to sell a fixed asset and then apply the proceeds to the purchase of a current asset. Such exchanges may reduce a company's cash-generating potential to the detriment of all lenders, particularly secured

lenders, which may suffer a reduction in their collateral coverage or, conversely, an increased loan-to-value ratio.

In only a couple of instances are companies required to purchase capital assets or precluded from acquiring inventory. Moreover, the time frames in which a reinvestment must be made appear to have become more generous. In most cases, companies have at least 15 months--and, in some cases, 18 months or two years--to purchase new assets before being obligated to use asset sale proceeds for loan repayment. (Reinvestment periods of six to 12 months were more the norm in bank deals before the latest spate of LBOs; high-yield indentures, on the other hand, have historically offered longer time frames.)

Reinvestment periods are further stretched by frameworks that give companies a six-month grace period to consummate an asset purchase transaction so long as the company has entered into a binding commitment within the requisite time frame. The length of the reinvestment period raises questions about whether even subsequent capital asset purchases actually restore the company's capital base or merely represent regular capital spending that also reduces a company's debt repayment requirements. Ultimately, we believe that the repayment mechanisms we've seen generally don't offer lenders much clarity as to whether or when a company will use asset sale proceeds to reinvest in its asset base or reduce debt.

Restricted Payments Covenants

Restricted payments covenants generally establish boundaries around a borrower's ability to distribute value to shareholders and junior creditors, such as through dividends, share buybacks, and the prepayment of subordinated debt. What especially struck us about the restricted payments provisions in the agreements we reviewed was the resemblance that many of them bear to high-yield indenture covenants. In most of the agreements we looked at, the building blocks for the general restricted payments basket (i.e., the borrower's capacity to use cash to make payments as it sees fit, rather than in accordance with a more narrowly tailored exception) included both a fixed dollar allowance and an amount derived primarily from some percentage of excess cash flow, consolidated net income, or similar measure. Availability of this secondary source of restricted payments capacity (referred to in the documentation as the "applicable amount," "available amount," or something similar) is generally subject to a leverage test. The degree to which this indenture-like concept has made inroads into bank loan covenants appears to us to be yet another development associated with the recent LBO boom.

Similar to the formulations in high-yield indentures, the applicable amounts in the agreements we examined include various add-ins (i.e., amounts associated with certain transactions or events that the applicable EBITDA, cash flow or net income definition wouldn't otherwise capture). Some of these are seemingly uncontroversial, in our opinion, such as those for equity issuances or cash capital contributions (other than in connection with the exercise of an equity cure right); others are perhaps less so, such as add-ins for cash proceeds of those asset sales that are not captured by the repayment/reinvestment requirements outlined in the preceding asset sale discussion. The rationale behind the indenture approach to restricted payments is to align a borrower's ability to distribute value to shareholders and junior creditors with sustained positive net earnings or EBITDA. The ascendance of the applicable amount concept in credit agreements suggests a murkier exercise for lenders in assessing potential exposure to restricted payments than in previous years, when general baskets were more commonly pegged to a fixed dollar amount.

From what we saw, the applicable amount often does double duty, in that it also serves as a basket for the borrower to make investments in unrestricted subsidiaries--a construct that is yet another hallmark of high-yield bond

indentures. Generally speaking, an unrestricted subsidiary is one that essentially operates below the radar: It is neither a so-called "credit party" (and thus wouldn't serve as a subsidiary guarantor or pledge its assets) nor is it subject to the covenant package. Instruments that incorporate this concept generally give borrowers the flexibility to designate subsidiaries as restricted or unrestricted (and to move subsidiaries in and out of the restricted category), although the company's interests in any unrestricted subsidiaries generally must pass muster under an investment covenant or other applicable requirements. Most of the credit agreements we examined provide for the potential for unrestricted subsidiaries. We believe that an excessive concentration of value in unrestricted subsidiaries could hurt recovery prospects because those entities don't directly provide any credit support for the debt obligation in question.

The Potential Effects On Recovery

One of the challenges from a credit ratings perspective is assessing how, if at all, the particulars of a covenant package ought to affect the ratings of a borrower or a debt issue. As a general matter, the looseness or flexibility attributable to an incurrence covenant--such as those governing debt, asset sales, and restricted payments--isn't susceptible to the kind of quantification that would be directly meaningful to a rating. While a "permissive" covenant heightens so-called event risk (i.e., the risk that a borrower may take actions that increase the likelihood of default and/or diminish the prospects for recovery), it is difficult to measure this in the abstract. Rather, it generally takes an actual event, or an analytical judgment that a particular event is sufficiently likely to occur, for Standard & Poor's to incorporate these factors into an issuer rating, issue rating, or recovery rating. In that sense, the potential effects on ratings posed by most of the incurrence covenants in the agreements we reviewed--as is the case for issuers in general--is by and large dealt with in our normal surveillance process.

Financial maintenance covenants are a bit different from a recovery perspective. Our recovery ratings take into account the absence of financial covenants in that we don't assume any increases in interest rate margin that would arise as a consequence of amendments or waivers to resolve covenant violations. As a result, additional cash flow deterioration would be required to trigger a payment default, which generally produces a lower enterprise valuation estimate following default, and lower issue and recovery ratings for covenant-lite loans.

How the current turmoil in the capital markets will specifically affect the 14 companies that we reviewed remains to be seen. The loosening of constraints that the apparent convergence of leveraged loan and high-yield bond covenant structures suggests, not to mention the extra breathing room that deals without financial covenants or with equity cure rights afford, may provide the flexibility that allows borrowers and their owners to weather the storm. Then again, where borrowers cannot recover, this flexibility may hamper the ability of lenders to call defaults or negotiate changes to loan terms that might protect or enhance their recovery prospects.

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