Concentration of Control Rights in Leveraged Loan Syndicates

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Leveraged Lending and Covenant-Lite Loans

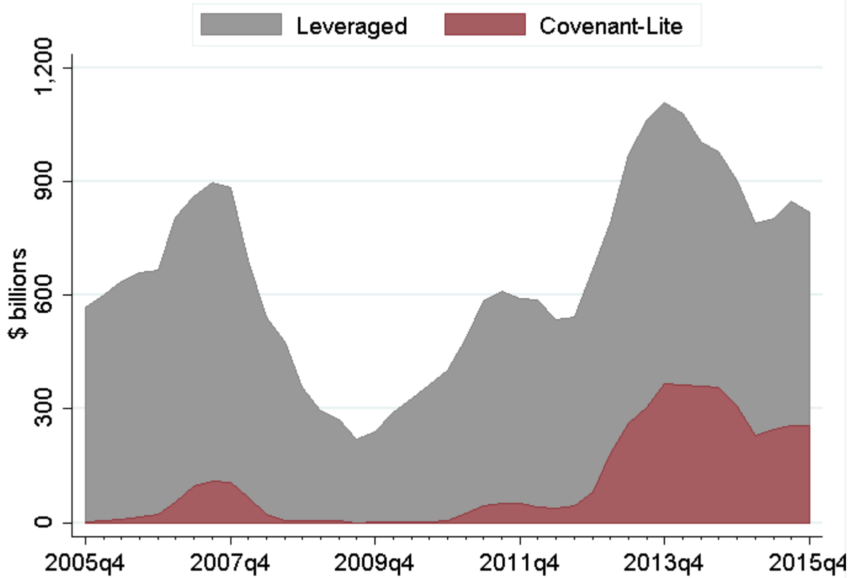
Fed Governor Jerome Powell, February 2015:

"Over much of the low interest rate period, demand for higher-yielding assets has been very strong... Price and nonprice terms in the syndicated leveraged loan market have been highly favorable to borrowers... The share of loan agreements that lack traditional maintenance covenants increased to historic highs."

2013 Leveraged Lending Guidance

- Goal to reduce origination of risky leveraged loans.
- Discourage covenant-lite loans.

Issuance of Leveraged Loans



Challenge to Received Wisdom

Banks "screen" and "monitor" their borrowers.

- Covenants are standard.
- Relationships are common.
- Loans are private and have concentrated ownership.

Bank loans seem unique among financing options.

- Positive announcement returns.
- Firms improve even after a covenant violation.

Research Questions

1. What does covenant-lite mean?

2. Have banks stopped monitoring borrowers?

3. What is the value of a covenant-lite loan?

A Recent Deal

Time Inc. issued a $1.2 billion syndicated loan in April 2014.

- Deal arranged by Citibank, JP Morgan, Morgan Stanley, and Wells Fargo.
- $500M Revolver: 5-year maturity, Libor + 225 bps, shared among 10 banks
- $700M **Term Loan B**: 7-year maturity, Libor + 325 bps
    - More than 100 CLOs owned $260M by December 2014.

Financial Covenants for Time Inc.

The credit agreement includes the following financial covenant:

Maximum Secured Leverage Ratio

"The Borrower shall not permit the Consolidated Secured Net Leverage Ratio as of the last day of any Test Period to be higher than 2.75 to 1.00."

"Test Period means, for any date of determination under this Agreement, the four consecutive fiscal quarters of the Borrower then last ended."

Time Inc. TL Lenders "Carved Out" from Covenant

Violating the financial covenant is an event of default, but not for the term loan lenders:

Financial Covenant Default

a "Financial Covenant Event of Default" shall not constitute an Event of Default with respect to any Term Loans until the Revolving Credit Lenders have declared all amounts outstanding under the Revolving Credit Facility to be immediately due and payable ...

Additionally, only the revolving lenders can waive or modify the financial covenant.

"Split Control Rights"

Split Control Rights: Maintenance financial covenants that apply to the revolving lenders but not the term loan lenders.

- Can also be implemented through separate loan contracts.

The TL is covenant lite.

Economic Benefit: maintain monitoring while reducing the costs of renegotiation

Our Sample

We collect all leveraged loans from 2005 through 2014.

Loan Deal: set of facilities current on the same day.

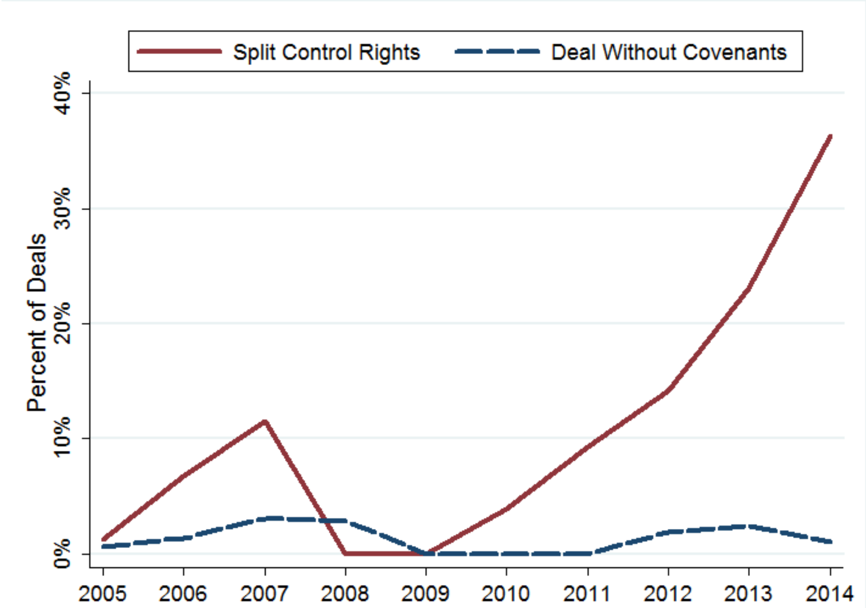
We account for covenants in all facilities in a deal.

- We assume that lenders have mutual awareness.
- 95% of term loan issuers have a line of credit.

We read 1,072 contracts for 946 deals.

- Appendix provides guidance on using Dealscan.

(1) Covenant-Lite is Really Split Control Rights



(2) Does Split Control Rights Reduce Monitoring?

We examine several measures of the monitoring intensity of deals with split control rights.

Two Goals:

1. Test the hypothesis that covenants exist but are irrelevant.
2. Provide some evidence about relative strictness.

Results: Firms with split control rights are still monitored.

1. Covenant strictness similar to other loans.
2. Reported violations similar to other firms.
3. Revolving lenders and agent bank's share similar to other loans.

(3) Why Have Split Control Rights?

Reduce renegotiation frictions with **institutional investors**.

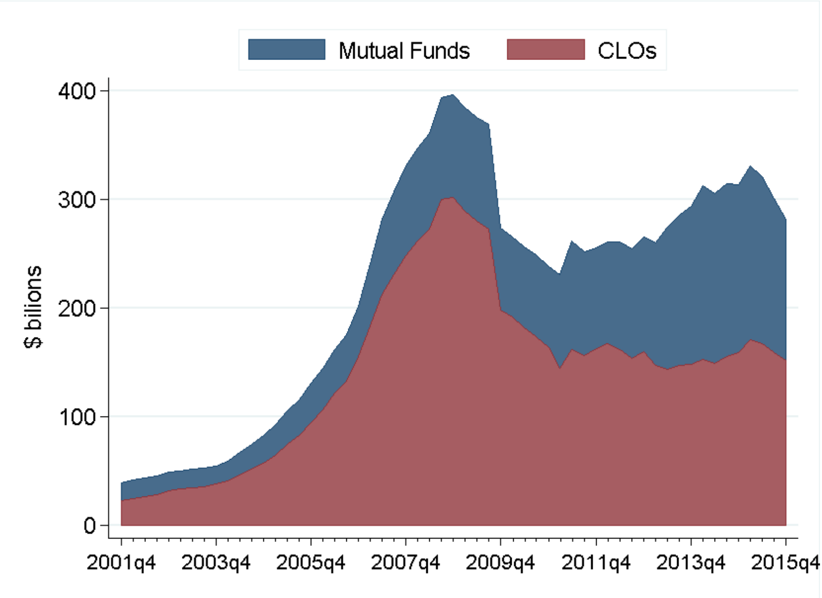
Institutional term loan tranches likely raise the costs of renegotiation.

- Tranches are widely held.
- Tranches trade in a secondary market.
- No relationships.

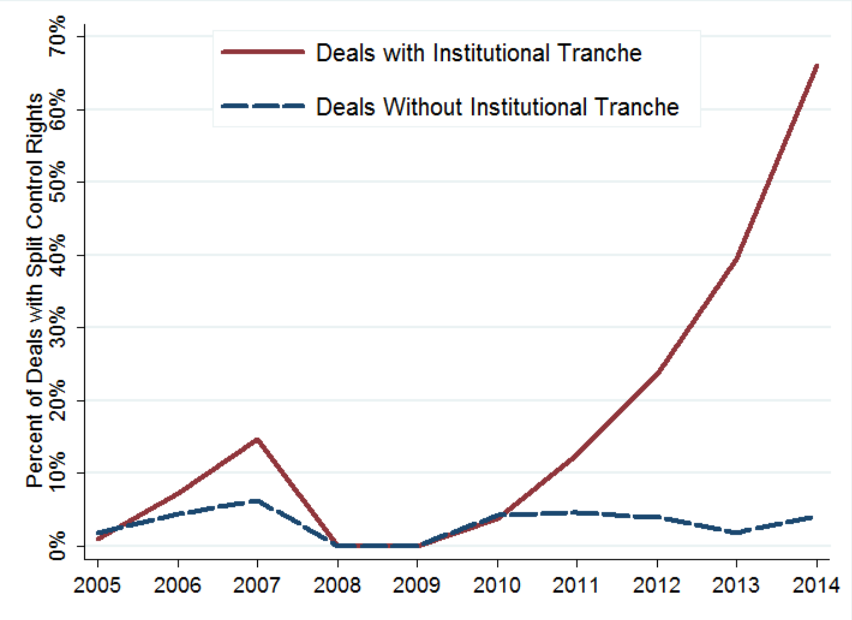
Hypothesis: split control rights are more common for deals with an institutional tranche.

- Becker and Ivashina (2016) show that issuance of covenant-lite term loans positively covaries with institutional fund flows.

The Rise of Institutional Investors



Split Control Rights and Institutional Investors



What Explains the Rise in Split Control Rights?

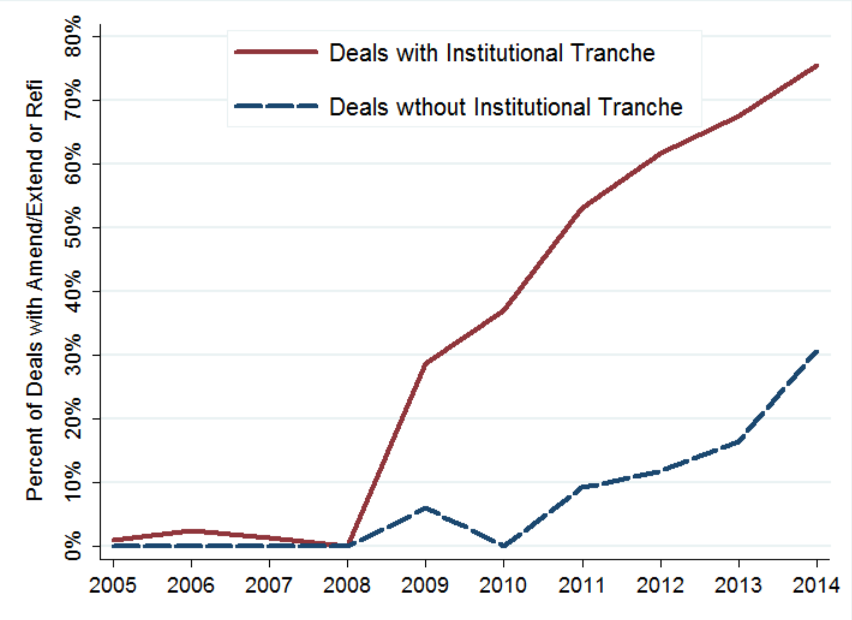
Hypothesis: contracts have been redesigned due to the experience of the financial crisis.

Test: examine changes in other contract provisions that facilitate renegotiation.

Amend/Extend and Refinancing Facility: contract provisions that permits the borrower to extend the maturity or reduce the interest rate on just a portion of the loan.

- Relaxes unanimity requirement.

Amend/Extend and Refi and Institutional Investors



Monitoring Remains an Essential Part of Loans

Firms are still monitored by financial covenants.

- There are virtually no covenant-lite deals.

Revolving lenders remain larely commercial banks.

- Revolving loans still have covenants.

This Isn't New

Corporate Bonds:

- Widely-held by institutional investors
- Secondary market
- No maintenance covenants

Subtle change: bank debt is no longer senior to all other debt

Renegotiation is Essential Part of Monitoring

Contracts structured to minimize the costs of renegotiation.

- Limiting strategic default is not a primary goal.

Institutional investors are a net positive, despite undesirable costs of renegotiation.

- Changing the contracts is preferable to removing the institutional investors.

The Optimal Contract Evolved

Renegotiation-related contract terms changed despite no changes in other fundamentals.

- Borrower characteristics are largely unchanged over time.
- Other loan terms (prices, quantities, maturity) do not show a similar pattern.

This suggests some caution to researchers examining historical data.