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PROTECTION LITE AND INVESTOR RISK IN LEVERAGED LOANS

Limited loss experience for protection-lite loans makes them difficult to analyze, but risks are higher for investors.

By Mark Carey, Co-President, GARP Risk Institute

For decades, lender protections in loan contracts were strong and stable. In the last few years, however, protections have weakened.

Loans with weakened protective covenants are referred to as "protection-lite" in this article. These loans are riskier for investors because default and, particularly, recovery rates may be worse than historical norms, as borrowers may take advantage of a protection-lite-enabled ability to move firm value out of lenders' reach.

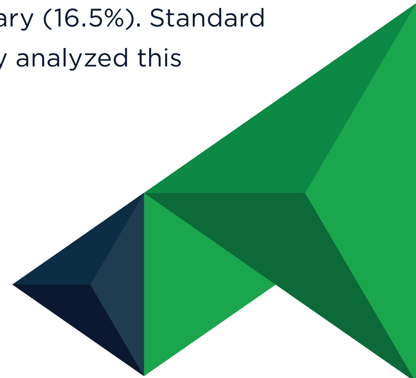
Understanding the role of incurrence covenants in loan contracts is important for comprehending the risks of leveraged loans. Traditionally, loan contracts have contained text that limits the borrower's ability to do many things that would increase the risk borne by lenders. Examples include transferring or selling collateral, so that lenders are no longer senior to other claimants in bankruptcy; paying large dividends, which lessens firm value remaining to repay lenders; and issuing new debt that is equal or superior to loans in bankruptcy priority.

Protection-lite loans differ from covenant-lite loans, which have received much attention in recent years. Covenant-lite loans are those that lack the maintenance covenants that give power to lenders when measures of borrower risk, such as financial ratios, fall outside specified ranges.

To be in technical default on maintenance covenants, borrowers do not need take any action. In contrast, a violation of most incurrence covenants occurs only if the borrower takes a forbidden action.

While protection-lite loans have received less attention, they may be associated with materially increased risk borne by lenders. For instance, if a borrower's actions under protection-lite loans are followed by bankruptcy, the recovery received by lenders may be far less than historical norms. A recent example is instructive.

In June 2018, PetSmart Inc. transferred 36.5% of its equity interest in Chewy Inc., a key subsidiary, to a consortium of investors led by BC Partners (20%) and to an unrestricted subsidiary (16.5%). Standard and Poor's (S&P) subsequently analyzed this transaction in a report.



WHILE PROTECTION-LITE LOANS HAVE RECEIVED LESS ATTENTION, THEY MAY BE ASSOCIATED WITH **MATERIALLY INCREASED RISK** BORNE BY LENDERS. FOR INSTANCE, IF A BORROWER'S ACTIONS UNDER PROTECTION-LITE LOANS ARE INSTEAD FOLLOWED BY BANKRUPTCY, THE RECOVERY RECEIVED BY LENDERS MAY BE FAR LESS THAN HISTORICAL NORMS.

"According to PetSmart, the Chewy share transfers were permitted under its loan agreement and bond indentures, and resulted in the termination of Chewy Inc.'s guarantees and the removal of Chewy's assets from the collateral package for PetSmart's first-lien term loan and secured notes -effectively reducing the lenders' security interest in Chewy to a pledge of 63.5% of Chewy's stock," S&P wrote in its analysis.

Ultimately, the unrestricted subsidiary engaged in an IPO and, as part of settlement of lawsuits brought by the lenders, the loans were paid off. But if the remainder of PetSmart had entered bankruptcy,

its lenders' priority in bankruptcy would have been protected by less collateral and their recovery would have been smaller.

DATA AND COMPLEXITY CHALLENGES

Little historical experience is available as a basis for estimating the effect of protection-lite status on risk. Historically, even bonds contained many protection covenants, so there is a lack of historical bankruptcies with protection-lite debt structures.

Moreover, protection-lite contracts are complex. For example, the borrower's ability to take forbidden actions is often conditional on financial ratios being within specified ranges; the borrower may adjust the definition of the ratios, so historical ratios calculated according GAAP are not indicative; and different clauses in the contract are written to be interdependent.

Consequently, unlike covenant-lite loans – which are similar in their omission of maintenance covenants – the details of loss of protection for each protection-lite loan may differ.

Protection-lite first appeared in loans to firms with private equity sponsors. One can imagine the motivations of the sponsor: They may see a variety of strategic alternatives for a firm and want the ability to implement their choices rapidly and without renegotiation with lenders, potentially reducing the probability of default. Alternatively, sponsors may want the ability to maximize the value they can extract from a troubled firm before it goes bankrupt, which very likely would substantially worsen the loss suffered by loan investors in the event of bankruptcy.

LITTLE HISTORICAL EXPERIENCE IS AVAILABLE AS A BASIS FOR ESTIMATING THE EFFECT OF PROTECTION-LITE STATUS ON RISK. HISTORICALLY, EVEN BONDS CONTAINED MANY PROTECTION COVENANTS, SO THERE IS **A LACK OF HISTORICAL BANKRUPTCIES** WITH PROTECTION-LITE DEBT STRUCTURES.

Although rating agencies analyze loan contracts and have called attention to protection-lite developments, they do not currently reflect differences in protection-lite status in either their default or their recovery ratings, perhaps because of the lack of historical experience.

However, in an economic downturn, which is when many defaults occur, it seems likely that recovery rates on protection-lite loans will be far worse than historical averages. Investors would be wise to plan for that and to price loans only after taking into account their protection-lite features.

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