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Private equity sponsors are struggling to buy low and sell high, so they are trying to take advantage of weak debt covenants

Economists might be debating whether recent volatility in public equity and bond markets portend a downturn, but there's little sign of the private equity valuations bubble bursting. Even so, credit providers are asking how asset valuation plays into covenant packages, and how terms are being negotiated.

Sponsors today are challenged more than ever to establish platforms maximising future shareholder value. In part, that's because purchase price multiples are at record highs, making 'buy-low, sell-high' increasingly fraught. Also, competition for good properties is fierce. Schedules are greatly compressed for auctions and for the timeframes to execute add-ons that can lower effective in-bound multiples.

Credit agreements ideally mirror the sponsor's blueprint for growth, so it's no surprise that buyers look for wriggle room. Lenders, of course, don't want to relinquish control over the terms that protect their investment.

Where's the line between too much control and not enough? The analysis flows not just around the credit agreement, but the development of the commitment papers, evaluation of financial covenants, as well as unrestricted subsidiaries, negative covenants, incremental facilities and baskets.

Ironing out most of the major negotiation of terms up front is key. That gives a competitive advantage to lenders already comfortable with the 'precedent' document used in prior transactions. This is why there's so much fuss on both sides about new lender-unfriendly terms: precedents are tough to remove.

> Negotiating terms up front and getting comfortable with the precedent document is key

It gets complex for larger deals

Lenders try first to establish the scope of which entities are covered by covenants. In the traditional middle market, that's generally the borrowers and their subsidiaries. For larger deals, it gets complicated. Typically, they are 'restricted' and 'material', and further limited to 'material restricted subsidiaries' in the broadly syndicated market. Recent well-publicised cases of borrowers moving assets to unrestricted subsidiaries have made these distinctions critical.

The battleground includes areas of the credit agreement that might otherwise appear innocuous. Quarterly financials are typically due within 45 days after fiscal quarter-end, and annuals within 120 days after fiscal year-end. Borrowers often ask to stretch out these deadlines for at least the first few periods after the deal closes. Yet even with these extensions, it's surprising how often deliveries are missed.

Other affirmative covenant erosions include limits in security and guaranty provisions. As with moving assets, weakening collateral and credit support packages can diminish lenders' value more than anticipated. This is also true of provisions allowing additional debt within the existing credit agreement.

Deciding when to test conditions

Another contested arena is the 'limited condition transaction'. Borrowers can decide, at their option, when to test conditions. They may include debt incurred and ebitda acquired at the time of signing, even though the deal hasn't actually closed yet. If another M&A deal occurs after signing, but before closing, the borrower still gets to count the transaction in process as if it closed.

Defining ebitda is obviously one of the most hotly negotiated of credit document elements. It runs through financial tests, both for maintenance covenants and ratio-based baskets. Even in smaller deals, ebitda definitions contain add-backs, often without caps. Add-backs for M&A synergies present challenges to lenders. Sponsors can include run rate numbers based on actions that may not have been taken yet.

When accounting for the cushion in the sponsor's model for setting covenants — anywhere up to 40% — the scope or looseness of ebitda add-backs can drive much wider accommodation in the final numbers.

It's evident a common theme amid today's easing of covenants is that transactional flexibility is key for borrowers. With current technicals in the private markets favouring sponsors, it's clear they will often be successful in negotiating for this elbow room. What's not clear is how long these conditions will last.