Announcement: Moody's: Weak structures of cov-lite loans, now the majority of US leveraged loan market, suggest lower-than-average recoveries in the next downturn

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New York, May 23, 2017 -- Poorly structured covenant-lite loans today make up a much larger proportion of the US leveraged loan market than they did before the credit crisis, and this does not bode well for investor recoveries during the next downturn, Moody's Investors Service says in a new report. But deterioration in structuring of first-lien loans, alongside erosion of debt cushions overall, will adversely affect recoveries whether or not a loan has a full array of covenants.

Thomson Reuters LPC data shows that cov-lite loans now comprise three-quarters of the US leveraged loan market, against just one quarter before the last default cycle.

"After three years of record issuance, cov-lite loans now account for the largest share ever of the US leveraged loan market, while at the same time debt cushions below first-lien cov-lite loans have fallen dramatically," said Moody's analyst Julia Chursin. "This deterioration portends lower investor recoveries in the next default cycle."

But whether or not a loan includes maintenance covenants, the loss absorption capacity for both cov-lite and cov-heavy first-lien loans is now lower, Chursin says in "Cov-Lite Loans Dominate the Market, Will See Worse Than Average Default Recoveries." Among loans Moody's recently examined, the layer of debt subordinated to both senior secured cov-lite and non-cov-lite first-lien loans was almost identical, which would translate to similar recovery rates in the event of default. The important difference for investors is that the maintenance covenants in non-cov-lite deals can signal impending default.

Today's loan structures, important for determining recovery rates, has deteriorated substantially since prior the Great Recession default cycle, Moody's says. The agency forecasts recoveries on recently rated first-lien loans, both with and without maintenance covenants, at just over 60% -- significantly lower than the 85% long-term average recovery for first-lien secured bank debt.

The much larger number of companies now issuing cov-lite loans, as well as the generally declining default rate among US speculative-grade corporates, means that cov-lite borrowers now default at the same rate as the broader US speculative-grade corporate universe. But while the three-year average cumulative default rate of all cov-lite loans has dropped to 12% from 18% over the past three years, average recoveries on defaulted cov-lite loans are gradually getting worse.

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