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A New Way to Look at Covenant Lite Collateral in CLOs

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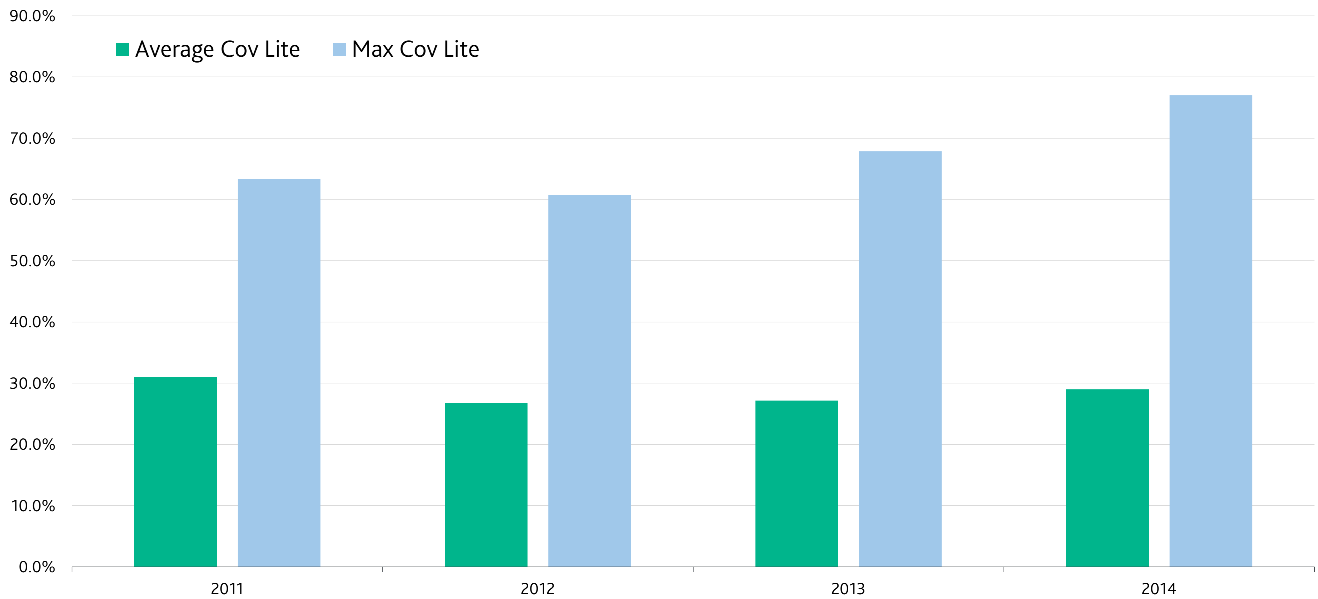
While Covenant Lite ("Cov Lite") may have been replaced by risk retention as the topic de jour, it is still important to a significant number of participants in the CLO market. The purpose of this piece is not to comment on the merits of loan covenants, but to help the market better understand their extent in broadly syndicated loan ("BSL") CLO portfolios.

Before beginning the analysis, I would like to define Cov Lite in a general sense. Cov Lite loans are loans with fewer financial covenants designed to alert or protect a borrower from credit deterioration. Typically the maintenance covenants are reduced or eliminated while occurrence covenants may still exist (see the appendix). It should be noted that there is no universal specific definition for Cov Lite and it may vary by CLO. Some investors worry about this reduction while others find the eliminated covenants have limited value and are more focused on the credit directly. It should be noted that the highly active High Yield Bond market typically includes equal or fewer covenants than the Cov Lite leveraged loan market.

The vast majority of 2.0 CLOs and some 1.0 CLOs report their Cov Lite percentage. Chart 1 shows the average and maximum reported Cov Lite percentage by vintage for the 2.0 CLOs. While the average has been fairly stable, the maximum has generally grown with each vintage to a high of 77% for the 2014 vintage based upon recent data. This is partly a function of the growth of the Cov Lite market. We see from Chart 2 that Cov Lite loans now represent over 60% of new issuance of BSL compared to roughly 20% four years ago.

CHART 1

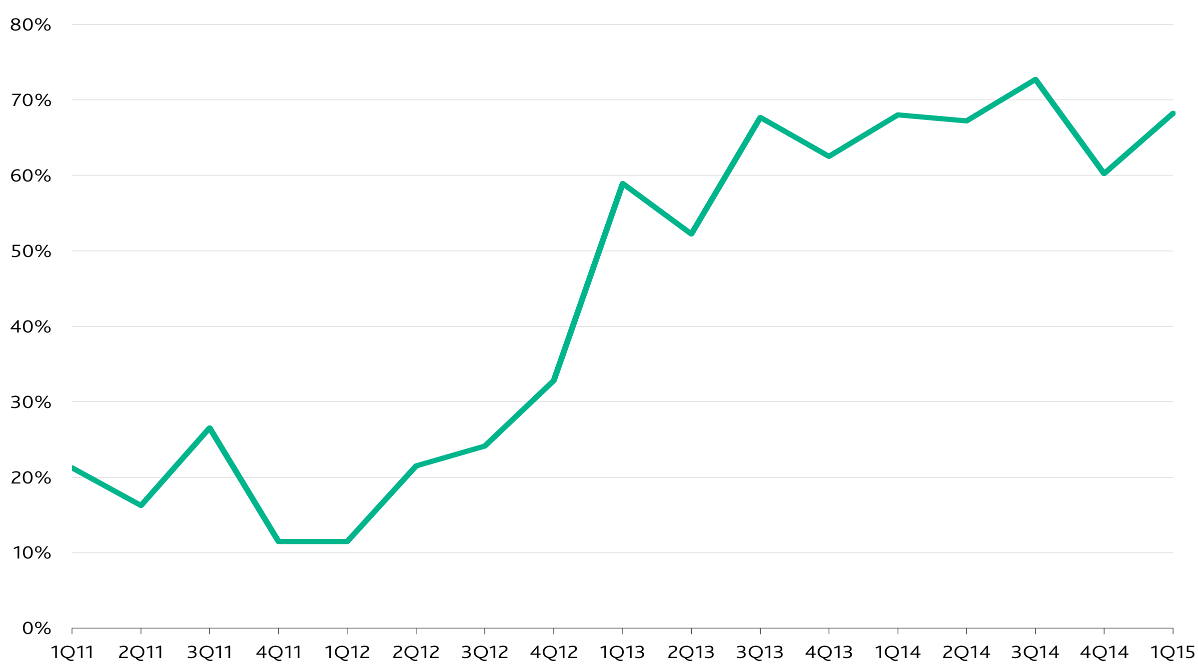
Average vs Maximum Indicated Cov Lite by Vintage



Source: Moody's Analytics, Structured Finance Portal, CLO Module

CHART 2

Cov Lite percent of Lev Loan Market



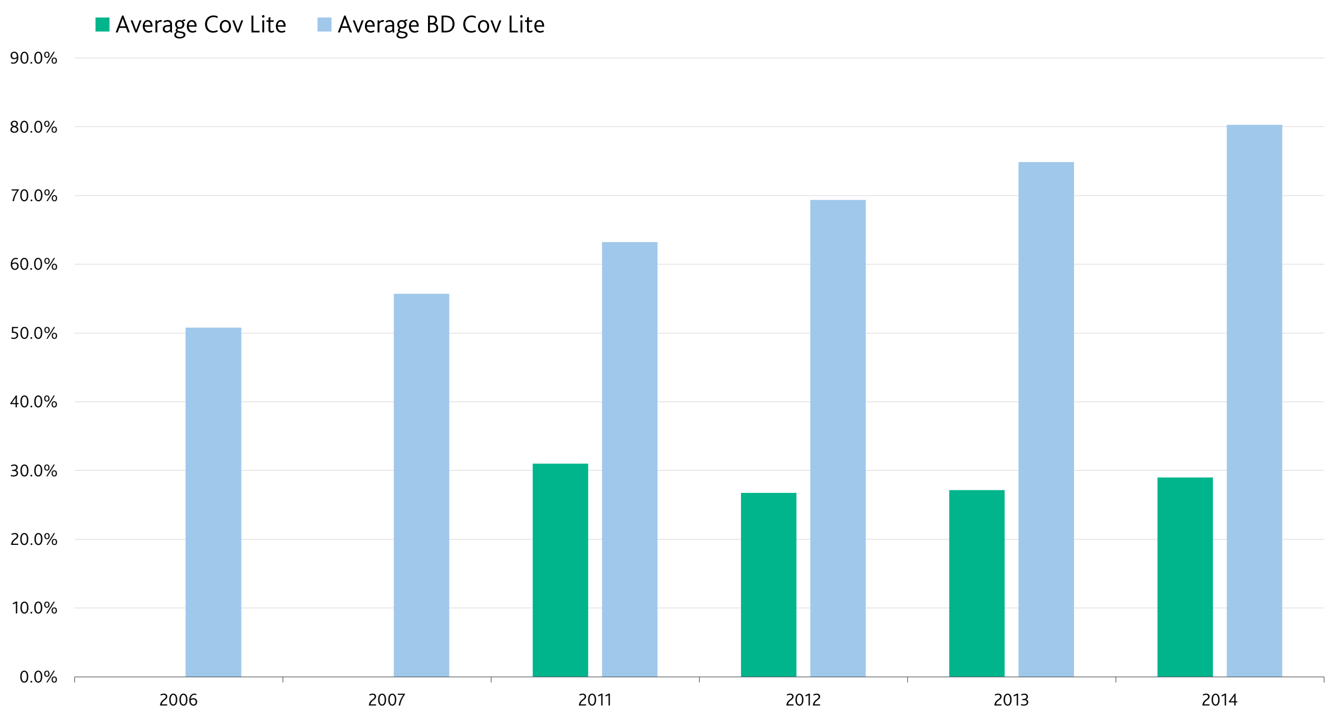
Source: Thomson Reuters

The Cov Lite percentage displayed in surveillance reports often exempts certain loans with Cov Lite characteristics from being classified as such. One typical example of an exception is if the loan ranks pari passu with a loan with covenants (see the appendix). Since the two loans are pari passu, the loans will be treated similarly. If the pari passu covenanted loan matures, the other loan will now be reported as Cov Lite. The Moody's Structured Finance Portal ("SF Portal") shows both the reported Cov Lite loan percentage as well as the percentage of collateral that is reported Cov Lite in any CLO in any surveillance report. Let's call this enhanced CLO collateral transparency Broadly Defined Cov Lite or "BD Cov Lite". BD Cov Lite loans are loans that are classified as Cov Lite in any CLO.

Chart 3 shows a comparison of the average reported Cov Lite vs BD Cov Lite by vintage. The 2006-07 vintages BD Cov Lite percentages are also displayed. While these older vintage CLOs generally are not required to report their Cov Lite loans, the level of BD Cov Lites in the deals could be useful to better understand a particular transaction. BD Cov Lite data as reported in the SF Portal is used for this analysis. Chart 3 shows that the BD Cov Lite percentage is at least double the reported Cov Lite and it has been growing with each vintage while the reported Cov Lite percentage has been relatively stable. This is likely both a consequence of the increased market issuance of Cov Lite leveraged loans and asset managers' greater comfort with these loans.

CHART 3

Average Cov Lite vs BD Cov Lite by Vintage

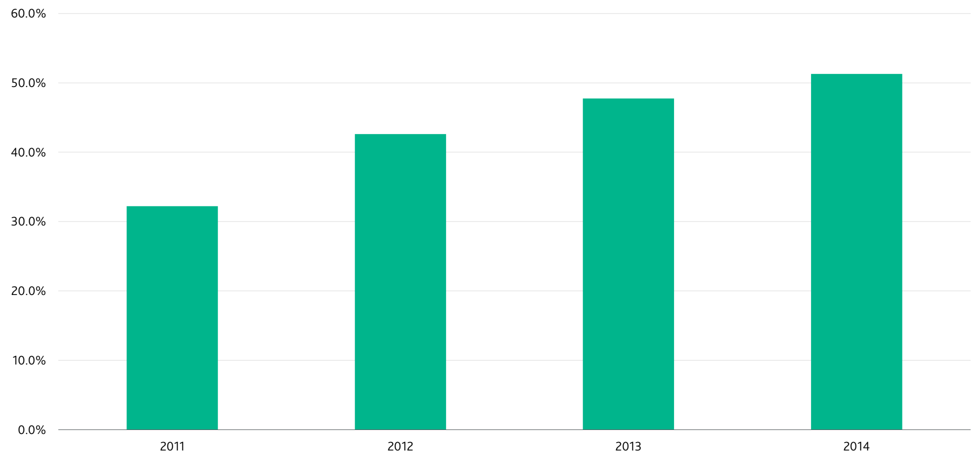


Source: Moody's Analytics, Structured Finance Portal, CLO Module

It is apparent that there is a significant difference between the reported Cov Lite percentage and the amount of BD Cov Lite loans. For the 2014 vintage, the difference is over 50%. The relevance of this difference depends on one's reliance on covenants in the investment. Chart 4 isolates the difference and shows its growth with each more recent vintage.

CHART 4

Difference between Average BD Cov Lite & reported Cov Lite

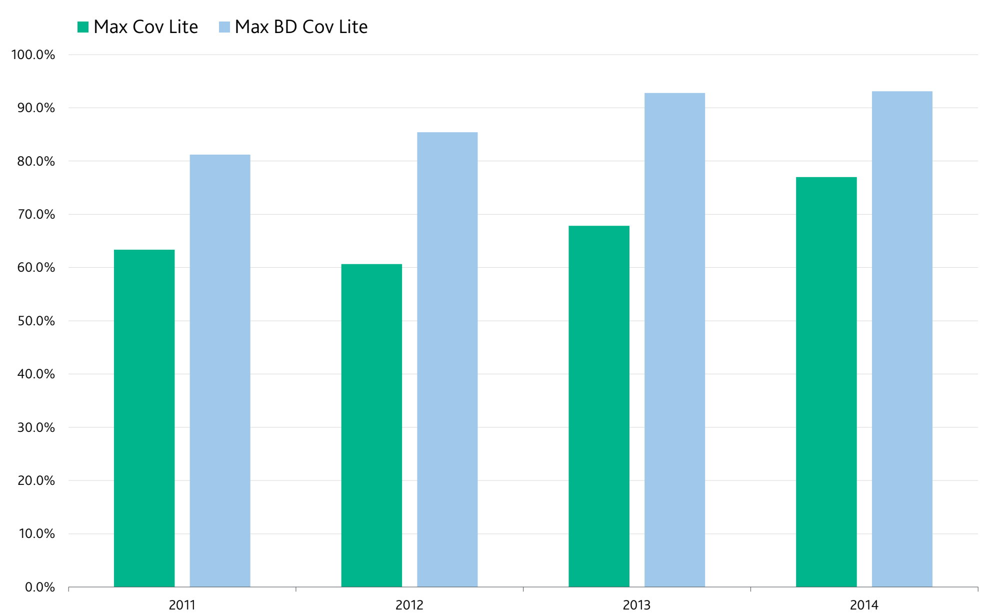


Source: Moody's Analytics, Structured Finance Portal, CLO Module

Chart 5 is a comparison of the maximum BD Cov Lite with the maximum indicated Cov Lite for each vintage. The maximum BD Cov Lite has been rising though at a slow pace recently.

CHART 5

Maximum Indicated Cov Lite vs BD Cov Lite

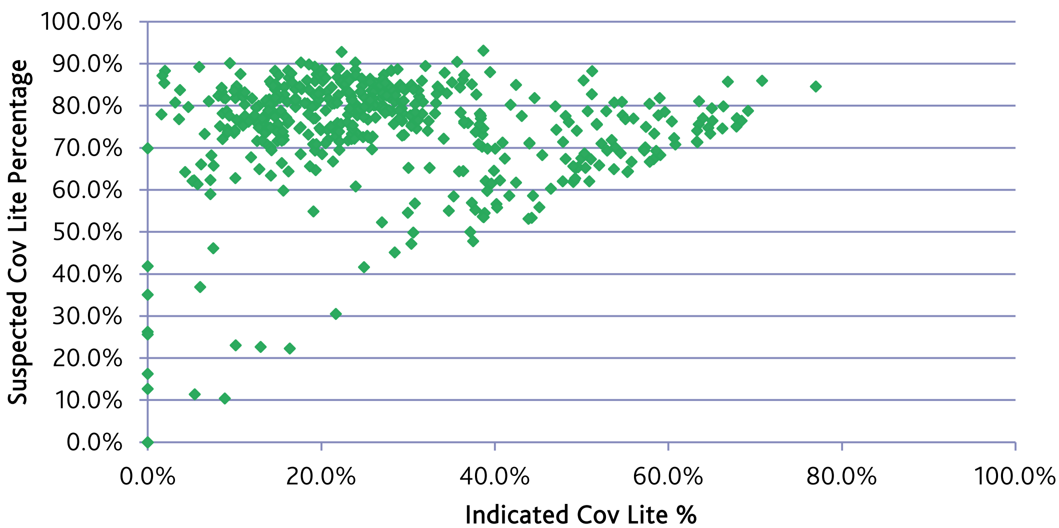


Source: Moody's Analytics, Structured Finance Portal, CLO Module

Chart 6 displays the results from the 2011-14 vintages by deal. The Y-axis displays BD Cov Lite while the X-axis shows indicated Cov Lite on a deal by deal basis. The CLOs are concentrated in the upper left quadrant. The average Cov Lite percentage is 28% while it is 74% for BD Cov Lites. Each vintage from 2011 to 2014 has a larger maximum BD Cov Lite percentage with it topping out at 93%.

CHART 6

Broadly Defined vs Indicated Cov Lite (2011-14 Vintages)



Source: Moody's Analytics, Structured Finance Portal, CLO Module

Now that I have highlighted the extent of the difference between Cov Lite and BD Cov Lite both within and across vintages, it is interesting to see how concentrated among managers the results are. For example, one manager has five CLOs within the top ten for Cov Lites and a different manager has five CLOs in the top ten for BD Cov Lites. The managers with more than 3 places in the top ten for Cov Lite are different than those for BD Cov Lite. This could be due to varying definitions of Cov Lite or it could be different strategies by the managers. The next few tables show the concentration in more detail.

In table 1, I looked at the ten highest Cov Lite percentages for each of the 2011-2014 vintages which includes 40 CLOs. 6 managers had at least three CLOs in the top ten and one manager had five. The average Cov Lite percentage of these five CLOs is over 57%. This manager was in the top ten 3 times in the 2013 vintage. This group of six mangers represent over half of all the CLOs with a high Cov Lite percentage.

Table 1: Indicated Cov Lite Top Ten (2011-14)

Manager	Total Count	Total Average
Manager 1	5	57%
Manager 2	4	59%
Manager 3	4	52%
Manager 4	3	59%
Manager 5	3	63%
Manager 6	3	64%
Manager 7	2	53%
Manager 8	1	65%
Manager 9	1	71%
Manager 10	1	67%
Manager 11	1	42%
Manager 12	1	52%
Manager 13	1	51%
Manager 14	1	56%
Manager 15	1	32%
Manager 16	1	63%
Manager 17	1	50%
Manager 18	1	63%
Manager 19	1	65%
Manager 20	1	37%
Manager 21	1	44%
Manager 22	1	44%
Manager 23	1	30%
Grand Total	**40**	**56%**

Source: Moody's Analytics, Structured Finance Portal, CLO Module

Table 2 is similar analysis for the top BD Cov Lite deals with the inclusion of the 2006-07 vintages. Seven managers show up in at least 3 of the top ten lists with one appearing five times. This manager averages 89% BD Cov Lites in their portfolio for these five CLOs. Another manager ranked in the top ten three times in the 2014 vintage and averaged 91% BD Cov Lite. The managers with more than 3 places in the top ten for Indicated Cov Lite are different than those for BD Cov Lite.

Table 2: Broadly Defined Cov Lite Top Ten (2006-07, 2011-14)

Manager	2006-7	2011-14	Total Count	Total Average
Manager 1		5	5	89%
Manager 2	1	3	4	80%
Manager 3	2	1	3	77%
Manager 4		3	3	85%
Manager 5		3	3	79%
Manager 6	2	1	3	80%
Manager 7		3	3	91%
Manager 8		2	2	83%
Manager 9	1	1	2	83%
Manager 10		2	2	81%
Manager 11	2		2	72%
Manager 12		2	2	83%
Manager 13	1	1	2	71%
Manager 14		2	2	79%
Manager 15	2		2	68%
Manager 16		2	2	85%
Manager 17	1		1	100%
Manager 18		1	1	71%
Manager 19		1	1	89%
Manager 20	1		1	68%
Manager 21		1	1	81%
Manager 22	1		1	69%
Manager 23	1		1	71%
Manager 24		1	1	72%
Manager 25	1		1	70%
Manager 26	1		1	71%
Manager 27	1		1	68%
Manager 28		1	1	73%
Manager 29	1		1	68%
Manager 30		1	1	86%
Manager 31		1	1	89%
Manager 32		1	1	90%
Manager 33	1		1	75%
Manager 34		1	1	86%
Grand Total	**20**	**40**	**60**	**80%**

Source: Moody's Analytics, Structured Finance Portal, CLO Module

Finally, I wanted to see the how concentrated the difference between the Broadly Defined and reported Cov Lite percentages. Table 3 shows that one asset manager has CLOs within the top ten 15% of the time for the 4 vintages. The manager has two deals in each of the 2012 to 2014 vintages' top ten. Only two other managers have more than three CLOs in the top ten. As before, I excluded the earlier vintages since Cov Lite is not consistently reported.

Table 3: Broadly Defined Cov Lite less Indicated Cov Lite Top Ten (2011-14)

Manager	Total Count	Total Average
Manager 1	6	80%
Manager 2	4	73%
Manager 3	3	73%
Manager 4	2	69%
Manager 5	2	64%
Manager 6	2	61%
Manager 7	2	69%
Manager 8	2	42%
Manager 9	2	75%
Manager 10	2	82%
Manager 11	1	74%
Manager 12	1	70%
Manager 13	1	67%
Manager 14	1	47%
Manager 15	1	52%
Manager 16	1	75%
Manager 17	1	44%
Manager 18	1	70%
Manager 19	1	64%
Manager 20	1	63%
Manager 21	1	72%
Manager 22	1	44%
Manager 23	1	67%
Grand Total	**40**	**68%**

Source: Moody's Analytics, Structured Finance Portal, CLO Module

Conclusion

While Cov Lite investment is not important to some investors, it is to others. For those that care about it, I wanted to show both the reported Cov Lite percentage as well as the amount of the collateral that is Cov Lite in any CLO regardless of the particular CLO's reporting criteria. The BD Cov Lite average 30-50% greater than the reported Cov Lites. Again, some of this difference could be due to alternative indenture definitions and carve outs for Cov Lite loans. Separate from the definitional variation, the variation may represent greater risk in these portfolios or it could show asset managers finding buying opportunities in a particular type of asset which will benefit CLO investors. The relevance of that difference will vary across investors and asset managers. Only time will tell who is correct. But either way, a thorough analysis of Cov Lite loans, including BD Cov Lite loans, in a CLO portfolio could be an important factor in assessing the overall risk and return profile of a CLO.

Appendix I

SAMPLE LANGUAGE FROM A CLO INDENTURE DEFINING COV-LITE LOANS

"Cov-Lite Loan": A Loan the Underlying Instruments for which do not (i) contain any financial covenants or (ii) require the borrower thereunder to comply with any Maintenance Covenants (regardless of whether compliance with one or more Incurrence Covenants is otherwise required by such Underlying Instruments); provided that… a loan which contains a cross-default provision to another loan of the underlying Obligor forming part of the same loan facility that requires the underlying Obligor to comply with both an Incurrence Covenant and a Maintenance Covenant will be deemed not to be a Cov-Lite Loan.