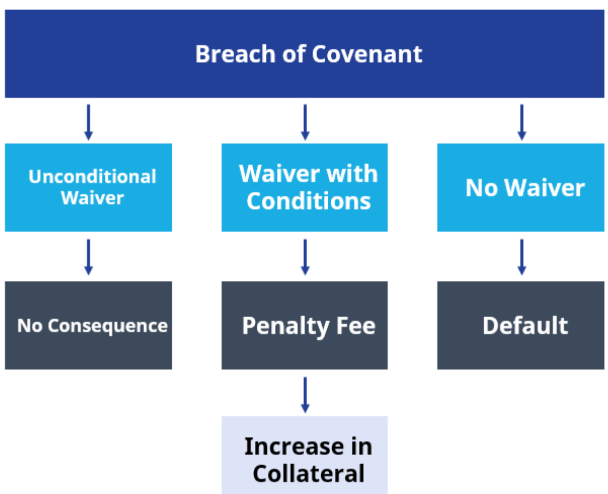
Covenants: What Are They and Why Do They Matter?

February 2024

Approximately 90% of loans underwritten today are considered "covenant-lite"[1]. Covenant-lite deals expose the lender to increased risks as the lender has limited protections in place to ensure that their loan repayment is fulfilled and prioritized. This is particularly problematic in a rising or high-rate environment.

A loan covenant is a protective agreement made between a borrower and a lender outlined in a credit agreement contract. A covenant outlines behaviors or actions that a borrower must follow to comply with the terms of a loan. Covenants are used to protect the lender, align incentives between both parties and reduce risks. If the borrower violates a covenant, the lender has certain rights, such as imposing penalty fees, increasing the loan's interest rate, increasing the collateral behind the loan, or even terminating the loan agreement.



The upper-middle market and broadly syndicated loan space has grown rapidly over the last several years, resulting in increased competition amongst lenders. With increased competition, managers have less power to negotiate favorable terms. As a result, approximately 90% of loans underwritten today are considered "covenant-lite"[1]. Covenant-lite deals expose the lender to increased risks as the lender has limited protections in place to ensure that their loan repayment is fulfilled and prioritized. This is particularly problematic in a rising or high-rate credit environment like today.

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[1] *Source: Goldman Sachs Asset Management, Credit Terms: The Rising Importance of the Fine Print*

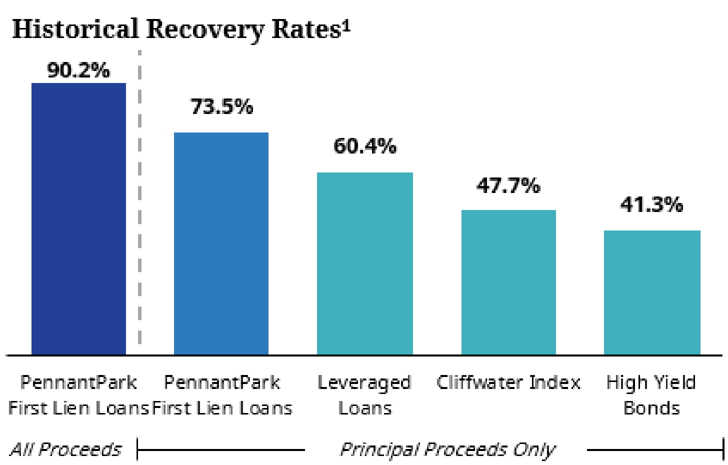
Private credit managers are typically able to secure tighter financial covenants in the core-middle market segment as there is less competition from banks and mega-fund lenders. PennantPark focuses on securing prudent terms and structural protections on every loan, including a target of at least two financial covenants for each loan.

Examples of financial covenants include:

- Maintaining a specified interest coverage ratio (earnings relative to interest cost)
- Maintaining a certain level of debt relative to earnings

We view covenants as imperative structural elements of credit negotiation in the core-middle market. They act as guardrails for lenders to intervene early on before serious issues arise, jeopardizing principal.

When allocating to private credit, investors need to evaluate a credit manager's commitment to protective covenants, paying special attention to a manager's historical loss and recovery rates. At PennantPark, we believe our focus on structural protections has contributed to our ability to withstand turbulent economic cycles, and our impressively low loss rate and high historical recovery rates, since our founding in 2007.



1. *Source: Cliffwater 2023 Q3 Report on U.S. Direct Lending. Benchmark recovery rates are estimated based on the market price of defaulted loans at the time of default over par value. Benchmark recovery rates are calculated as an average of monthly LTM recovery rates since the inception of PennantPark managed vehicles in 2007. PennantPark's recovery rate on first-lien loans is calculated by dividing the sum of principal proceeds and market value of defaulted first-lien investments by the total capital invested in such defaulted first-lien investments. "Leveraged Loans" and "High Yield Bonds" are represented by JPMorgan Markets, Bloomberg US High Yield Index, Morningstar LSTA Leveraged Loan Index.*

We welcome a conversation; please contact invest@pennantpark.com or the professionals listed on the next page.

Contact Us

About PennantPark:

PennantPark is an independent middle market credit platform with $6.8 billion of assets under management. The firm is headquartered in Miami with additional offices in New York, Chicago, Houston, Los Angeles, and Amsterdam. PennantPark primarily invests in the core middle market, defined as companies with earnings of $10 million to $50 million. Our industries of focus include business services, government services, healthcare, consumer, and software/technology. In addition to middle market CLOs, the firm offers its investment strategies through a range of public and private fund structures.

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