

Auto Parts Giant First Brands Implodes: A Case Study in the Perils of Covenant-Lite Lending

October 2025

- The First Brands bankruptcy highlights systemic flaws in broadly syndicated loan (BSL) markets, where aggressive financial engineering and opaque liabilities can escape scrutiny until it's too late.
- Core middle market lending, as practiced by PennantPark, emphasizes maintenance covenants, proactive oversight, and disciplined underwriting
- PennantPark's relationship-driven approach and focus on senior secured, first lien loans offer a transparent, lower-leverage alternative that prioritizes capital preservation for investors.
- The core middle market remains structurally differentiated and less competitive, providing better risk-adjusted returns and stronger protections

The recent Chapter 11 bankruptcy filing by First Brands Group, the global supplier behind popular aftermarket brands like FRAM filters and Raybestos brakes, is a stark warning about the vulnerabilities hidden within the modern leveraged loan market. The company's collapse, fueled by massive debt and complex, opaque financing, highlights the consequences of the aggressive lending standards prevalent in the upper middle market.

The Collapse: Debt, Deals, and Disguised Liabilities

First Brands Group was a product of an aggressive, debt-financed "roll-up" strategy. Over the last decade, it quickly amassed a portfolio of over two dozen brands through a flurry of acquisitions. While this created an automotive parts juggernaut, it saddled the company with an estimated \$10 billion to \$50 billion in total liabilities.

The rapid unravelling was a direct result of critical financial distress:

1. *Crippling Liquidity Crisis:* The company struggled to pay its suppliers, with payment delays reaching four to five times the industry average, a clear sign of deep cash flow issues.

2. *Opaque Off Balance Sheet Financing*: First Brands heavily relied on financing methods like factoring (selling invoices for immediate cash) through affiliated entities. When lenders began scrutinizing these complex structures and demanded greater transparency, a crucial \$6 billion debt refinancing effort failed, triggering a sudden, catastrophic liquidity shortfall.
3. *Rushed Bankruptcy*: The company's fortunes unraveled so quickly that it was forced to file for Chapter 11 with no pre-arranged restructuring plan, an unusual and alarming sign of how rapidly its liquidity evaporated.

The Systemic Root: Upper Middle Market and Covenant-Lite Loans

PennantPark views First Brands' swift implosion as a textbook example of the risks inherent in the lending practices of the upper middle market. UMM is a segment where large, high-leverage companies often obtain financing through the broadly syndicated loan (BSL) market.

Erosion of Creditor Protection

The key enabler in this scenario was the reliance on [Covenant Lite Loans](#).

- *Absence of Early Warnings*: Cov-lite structures typically lack maintenance covenants (financial metrics tested every quarter). Instead, they rely on incurrence covenants (if any), which only restrict the borrower if they choose to take a *new* action (like making an acquisition). This meant that First Brands' core financial health could degrade for months without triggering a covenant breach, preventing lenders from intervening until it was too late.
- *A Black Box of Debt*: The lack of strict documentation provided the latitude to layer billions of dollars of complex, opaque off-balance-sheet financing. Without the ongoing financial oversight required by maintenance covenants, the true scale of the company's leverage and risk remained largely hidden until its liquidity was exhausted.

PennantPark's point of view is that the borrower-friendly nature of upper middle market debt essentially delayed the crisis, allowing a solvable problem to fester into a sudden, complex bankruptcy.

Why the Core Middle Market is Different

In our opinion, financial implosion of this magnitude would be far less likely in the core middle market (\$10-\$50M in EBITDA), which is generally financed by direct lending from private credit funds like PennantPark.

Feature	Core Middle Market	Upper Middle Market (First Brands)
Loan Structure	Maintenance Covenants are common.	Primarily Covenant Lite (Incurrence-only).
Lender Control	High. Lenders get early warning and can force a management change or debt restructuring <i>before</i> a crisis.	Low. Lenders are passive until a liquidity crisis or payment default occurs.
Capital Structure	More conservative and transparent.	Aggressive leverage and complex, often opaque financial engineering.

In the core middle market, a quarterly breach of a maintenance covenant would have forced First Brands and its lenders to the negotiating table long before the situation became unmanageable. This early intervention mechanism, largely removed from the upper middle market, is the fundamental difference that makes the First Brands bankruptcy a crucial warning sign for the entire leveraged finance ecosystem.

For investors evaluating private credit or diversifying beyond the mega funds, we encourage you to reach out to our team to discuss these trends in more detail.

About PennantPark:

PennantPark was founded in 2007 as an independent middle market credit platform. The firm was founded by Art Penn, a private credit industry veteran that previously co-founded Apollo Investment Management. We have invested over \$26 billion across multiple economic and credit cycles since inception, and we manage \$10 billion in AUM today.ⁱ PennantPark serves a broad range of sophisticated investors with product offerings that include business development companies, private capital funds, joint ventures, and other specialized funds.

Our highly experienced team primarily invests in the core middle market, targeting companies with earnings of \$10 million to \$50 million. These mid-sized companies are often overlooked by banks and large investment managers, resulting in senior secured loans that feature higher

yields, lower leverage, and stronger lender protections when compared to the upper middle market and broadly syndicated loans. We focus on five key industry verticals where our track record is excellent and where we have the most expertise and experience. These industries include healthcare, government services, business services, consumer, and software & technology.

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