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Looking under the hood at the rise of liability management exercises

From the Field
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Key Insights

- The era of ultralow rates led to investors accepting weaker bond covenants in exchange for higher yields.
- Distressed companies started testing these weak covenants, and the trend accelerated when rates rose sharply between 2022 and 2023 and it became more difficult to refinance debt.
- This has led to a rise in liability management exercises in recent years, and the consequences can be dramatic, so it's critical to incorporate this growing risk into the analysis of companies, in our view.

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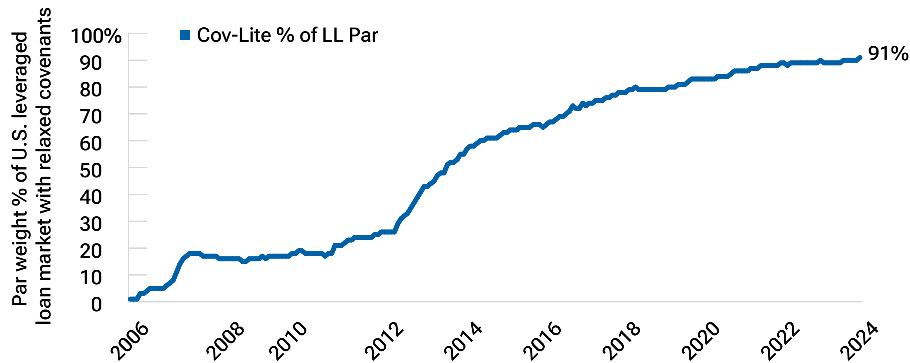
Companies experiencing financial stress from bond coupon payments or impending debt maturities may seek to increase liquidity, extend debt maturities, or reduce debt levels by capturing discount via liability management exercises (LMEs). These transactions can involve exchanging existing debt for new bonds or loans, raising additional capital, or shifting assets—all with a goal of gaining time to improve the company's finances and avoiding expensive bankruptcy proceedings. LMEs can have dramatic consequences for holders of the existing debt, potentially leading to litigation between creditors. This "creditor-on-creditor violence" regularly involves shifting alliances and complex legal maneuvering.

LMEs often utilize common loopholes in covenants to shuffle assets and layer in new, structurally senior or higher-priority lien debt. For example, a company facing a significant debt burden or near-term maturity could seek to manage its liabilities through exchange offers for new debt. The new debt could be more senior or secured by assets that had originally secured existing debt if allowed by terms in debt offering documents, which have become commonplace due to lax covenants.

The issuer typically only needs a majority of the holders of a particular bond or loan to agree to the new terms to effect the LME transaction. For unlucky creditors not invited to participate in the liability management transaction, an

"Covenant lite" composition of the leveraged loan market

(Fig. 1) Less restrictive covenants have become commonplace in leveraged loans



As of July 2024.
Sources: PitchBook LCD, Barclays Research.

out-of-court LME can result in significant mark-to-market losses. LME deals can be very valuable to equity holders while simultaneously devastating to some creditors that are not invited to participate in the transaction, as existing debt holdings that are subordinated in the corporate capital structure no longer benefit from collateral securing their investment.

Why is this happening? How did we get here?

The aggressiveness and frequency of LMEs have increased significantly since 2019, as investors have grown eager to deploy cash to earn increased yields and agreed to relaxed covenants in return. At the same time, private equity has become a more significant factor in finance. These financial sponsors seek to increase the value of the companies they own to make a profit. LMEs often provide the sponsor-backed companies time to make improvements, so sponsor goals and creditor goals may not align.

Covenants in credit agreements and bond indentures lay out the terms and conditions of the debt for both the borrower and the lender. Outlining financial, operating, and reporting expectations, covenants have become notably less restrictive in recent years: Figure 1 shows that, as of 2024, over 90% of bank loans are "covenant lite"—typically meaning documentation that does not require maintenance covenants, which require regular financial tests.

Over time, sponsor-backed companies—those owned by private equity or venture capital, for instance—have supported increasingly loose covenant packages, allowing greater flexibility to the debtor in managing liabilities. These terms that were once viewed as pushing the envelope have become commonplace.

A sharp increase in rates from 2022 to 2023 made it more difficult for distressed companies to refinance debt, which, along with tighter bank lending standards, resulted in fewer syndicated opportunities. This dynamic added to issuer stress while maintaining heightened demand for deals. As stressed issuers began testing the lax covenants in their credit agreements, several LMEs went through legal proceedings, setting precedent going forward.

Key lessons so far

Several high-profile LMEs that were settled in courts in recent years had dramatic consequences for some credit investors and set legal precedence for certain types of transactions. From these, we have learned some lessons that inform our risk management analysis around LMEs.

Key Lessons

Assess Broad LME Risks	LME risk increases as the cost of capital rises and dollar prices on securities fall. When analyzing risk, our null hypothesis in every stressed situation is that an LME is going to occur. With respect to existing holdings, any security we own that is trading at a material discount to par is subject to real LME risk.
Account for Motives of Management Teams, Sponsors, and Controlling Shareholders	Management teams, sponsors, and controlling shareholders have financial incentives to protect a company's equity value. When presented the opportunity to do so via an LME, it is important to remember their incentives may not align with credit investors despite earlier intentions.
Potential LME Precursors	Small announcements around structuring and organizational structure are very important and may foreshadow what is to come. Any movement of assets or other reconstitution of a company's corporate structure needs to be highlighted as a potential precursor to an LME.
Near-Term Maturities Provide the Best Practical Protection	In our view, near-term maturity walls provide the most insulation from the worst iterations of LMEs. Having imminent maturities puts any potential asset transfers at risk of being deemed a fraudulent conveyance, complicating the transaction and narrowing the possible outcomes.
Being a Top Holder increases Odds of Inclusion	Being a significant holder of a particular issuer could facilitate inclusion in an LME transaction from the beginning. But this carries significant risk since the company could decide to structure something around existing creditors.

How do we navigate from here?

Risk analysis, which is central to active investing in high yield, has changed due to LMEs. The high yield team is increasingly focused on early mapping of LME risks in our high yield portfolios, while adjusting relative value calculations to better reflect the risk of an LME.

This includes outlining the "art of the possible" under existing and new credit agreements and indentures. In today's high yield markets, the risk of sudden default has largely been replaced with LME risk. Investors who do not analyze credits for LME risk could be taking on more risk than intended as the consequences of being an excluded creditor can be extreme.

We have built screens and processes to flag potential LME candidates in portfolios in an effort to preemptively highlight the credits at risk of an LME. Credits that are potential LME candidates would warrant additional scrutiny and—in certain cases—require underwriting analysis by our special situations team.

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