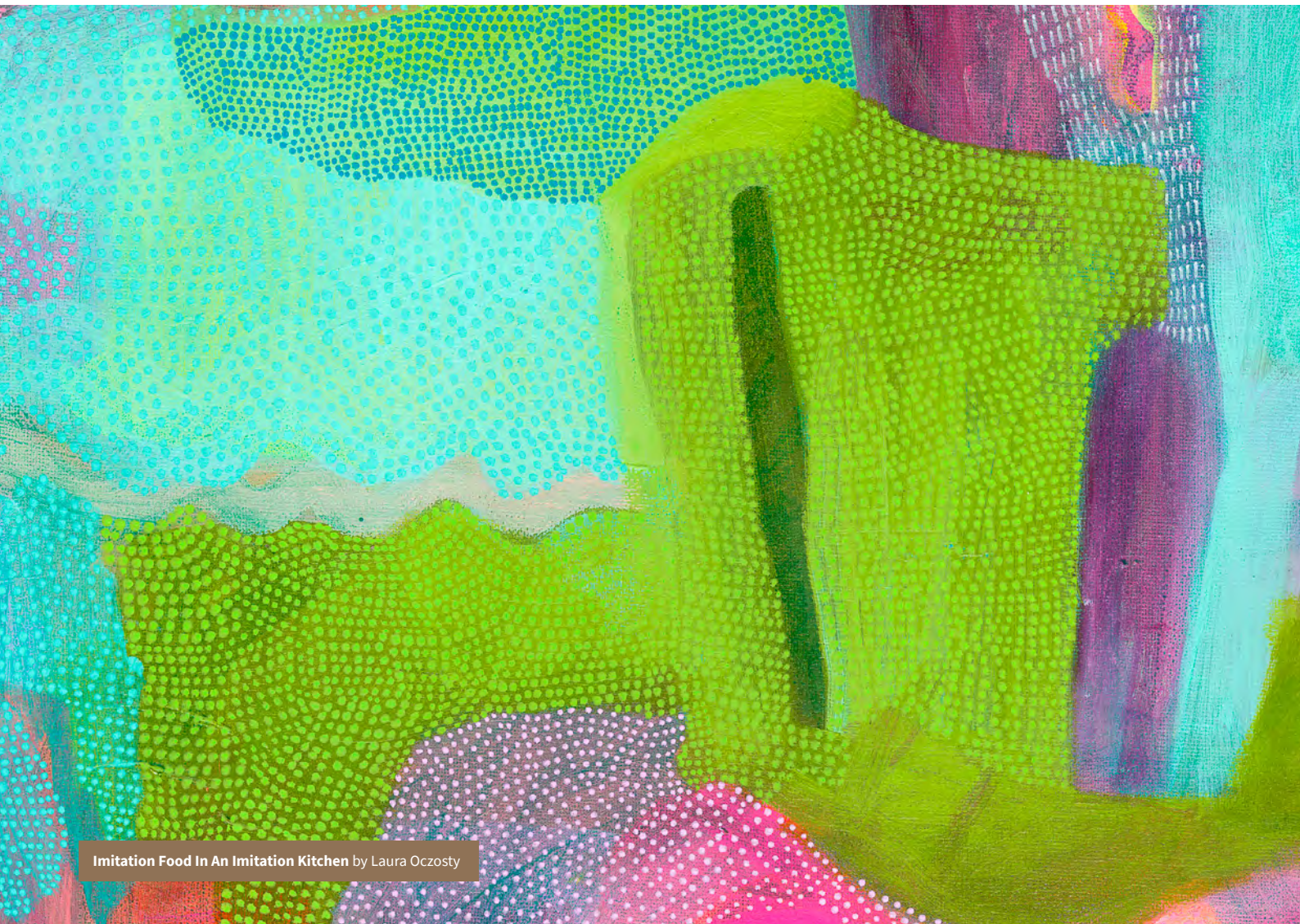


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COV-WHAT?

A SHORT PRIMER ON THE DIFFERENT APPROACHES BEING TAKEN TO FINANCIAL COVENANTS IN LEVERAGED FINANCE DEALS

WHAT'S IN A NAME?

The local leveraged finance market has shifted in recent years with a willingness from some lenders prepared to offer “cov-lite” terms. What does that mean? There are really four categories of deals:¹

Covenanted	A deal with at least one maintenance financial covenant (usually a net leverage ratio, sometimes also an interest cover ratio or fixed charge cover ratio and more rarely a debt service cover ratio or an annual capex covenant). Historically set with headroom to the lender financial model and stepping down (or up) to enforce some de-leveraging over the life of the loan
Cov-Loose	A Covenanted deal with way more headroom than normal (whether because of day 1 headroom, lack of stepdowns, the ability to adjust EBITDA beyond recognition and/or very infrequent testing (eg annually in some Asian deals)). We often hear the complaint that a deal is covenant loose because if EBITDA has declined to the point where the leverage ratio is tripped (remembering there is no amortisation in these deals) the Borrower has long ceased to be able to service cash interest
Cov-Lite	A deal with a ‘springing’ financial covenant if certain conditions are met – eg the revolver on a TLB deal – see below
No-Covenant	A deal with no maintenance financial covenant at all (not even a spring) – eg a 2L TLB

The relaxation on financial covenants for non-Covenanted deals is generally also accompanied with greater general flexibility for sponsors (eg on acquisitions, debt incurrence, etc) – so can be an attractive package for Sponsors (but for a price!)

COV-LITE

What are the key features of a cov-lite deal?

- **The covenant ‘springs’** – this means that it only tested on a calculation date if the testing condition is satisfied at that time.
 - The testing condition is a matter for negotiation – the general principle is that your working capital facility is drawn above an agreed metric (the thinking being that the borrower is experiencing a level of financial distress if it can’t manage its working capital to get below this level).
 - For Sponsor deals, there are various business levers which can be pulled to make sure the testing condition is never met. There are also documentation points around components of the test and when you test (eg can you retest post calculation date and pre compliance certificate delivery?).
- **Only a sub-set of lenders have the benefit of the covenant** – those lenders (in a TLB, the revolving capital facility lenders) are the only ones who can (i) agree amendments/waivers to the financial covenant and (ii) call an event of default for breach. Even if the covenant has sprung and the compliance certificate shows a breach of the required level, if the RCF lenders do not elect to accelerate, then the term lenders have no rights. All the more reason for Sponsors to stay close to their RCF Lenders!

HISTORY, A LESSON

Historically, when a firm handshake and an old school tie were the only necessary pre-conditions to being a leveraged finance banker, deals had covenants and:

- there were at least 2;
- they were tested at all times (although query how that worked practically); and
- if breaches were going to be cured, it was done by paying down debt.

For a brief period prior to the GFC, these rules were relaxed in our markets, the number of covenants were reduced and (for example) EBITDA cures were fairly common for top tier sponsor deals. According to those previously referred to old school bankers, this led to untold disasters (including the GFC) and terms were wound back in lenders’ favour.

WHERE ARE WE NOW

In Australian leveraged finance land:

- Covenanted deals are found in the mid-market
- Competitive bank processes and non ‘mega’ unitranche are trending towards Cov-Loose (ish)
- RCFs in TLBs and some very bespoke ‘Aus Style’ TLBs are Cov-Lite
- ‘Mega’ unitranche and the term loan tranches of TLBs are No-Covenant

In Asian markets, the vast majority of deals are still Covenanted or Cov-Loose – as the investor base is predominantly commercial banks as the institutional investor market has not taken off in Asia in the same way as in US, EU and Australia. There are a number of reasons for this but the main factor is the low pricing that sponsors can obtain in Asia given the low costs of capital and high levels of liquidity from Asian banks – particularly when sponsors tap the “onshore” market as is increasingly the case. The differential in pricing is such that the Sponsors are willing to accept more restrictive (although still pretty loose) terms because the price of flexibility is higher.

WHAT'S NEXT

Our US and EU colleagues have observed that the better credit borrowers have access to Cov-Lite loans, meaning those borrowers only able to access Covenanted loans can be worse performing credits – so counterintuitively lenders with a mandate requiring a covenant can end up with relatively worse book. We operate in different markets (with different competing products) so interesting to see if this will apply here.

For now, being Covenanted opens the universe of potential lenders that can participate in a transaction. However, the ability to agree to a Cov-Lite or No Covenant deal (even if reluctantly) remains a competitive advantage for the large cap Private Credit houses in Sponsor led deals where they are competing against other products (or smaller private credit houses).

Sponsors will continue to weigh up flexibility versus price and Lenders need to be eyes open on understanding the runway that the covenant choice provides them.



¹ Incurrence covenants (ie you can incur additional indebtedness so long as, pro forma for that incurrence and the use of such proceeds, your leverage ratio does not exceed an agreed threshold) are a topic for another day.





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