# Extra Credit: Unpacking Credit Covenants

Brian Carney, CIM | Portfolio Manager, Global Credit

Kevin Minas, CFA, CAIA | Institutional Portfolio Manager

MAWER

Be Boring. Make Money.™

Credit covenants are contractual clauses in loan or bond agreements that impose obligations on a borrower or place limits on specific actions, such as restricting additional debt or requiring financial disclosures. These covenants are essential as they help lenders and investors manage risk and ensure borrowers maintain financial discipline. For borrowers, they shape operational flexibility and access to capital. Assessing covenant packages is an important part of our credit research process at Mawer because of how it impacts risk management assessments, comparative analysis between credits, and ultimately our investment decision making.

There are 4 main categories of credit covenants: **Affirmative Covenants, Negative Covenants, Financial Covenants and Events of Default.**

In the high yield bond and leveraged loan markets Affirmative and Negative Covenants are standard, although their terms may vary in degree of rigidity or flexibility. Financial Covenants, particularly maintenance covenants, are a key feature of leveraged loans but are typically absent in high yield bonds which rely more on incurrence-based tests. Events of Default appear in both structures; however, leveraged loans often provide more creditor-friendly remedies and stricter triggers.

| Covenant Type | What It Covers | Purpose | Example(s) | Leveraged Loan vs. High Yield Bonds |
|---|---|---|---|---|
| **Affirmative Covenants** | Actions the borrower must take | Ensure transparency and maintain lender trust | Provide audited financials, maintain insurance | Common in both |
| **Negative Covenants** | Actions the borrower cannot take | Limit riskier behavior or asset leakage | Cannot take on new debt, limit asset sales | Common in both |
| **Financial Covenants** | Set quantitative tests tied to performance | Monitor financial health; trigger lender rights | Maintain < 4.0x leverage; > 2.0x interest coverage | Leveraged Loans |
| **Events of Default** | Define when the lender can enforce remedies | Protect creditors in serious or recurring breaches | Missed payment, covenant breach, bankruptcy filing | Common in both but stricter in Loans |

Investment grade issuers typically have the benefit of lighter covenant packages than high yield borrowers. Common investment grade covenants include:

- **Negative pledge:** Prevents the issuer from granting liens on assets to secure other debt without equally securing existing creditors
- **Change of control:** May trigger a rating downgrade or an offer to repurchase debt at par
- **Limitations on mergers or asset sales:** Often tied to maintaining the surviving entity's creditworthiness

Below are a few examples of real-world scenarios that illustrate how ambiguous or loosely drafted covenants have been creatively (or controversially) navigated by borrowers. Each of these examples have spawned eponymous "blockers" which lenders subsequently put in place to prevent repeat offences. As markets evolve, these blockers have become common in the fixed income markets.

M

## J.Crew (2016) "Trapdoor" Asset Transfer

**What happened:**

J.Crew transferred valuable intellectual property (e.g., brand trademarks) to an unrestricted subsidiary

The move relied on unused capacity in the "investments" basket of its credit agreement

This shifted collateral beyond the reach of secured creditors, without triggering a default

**Impact/Outcome:**

Creditors were blindsided and had limited contractual protection against the maneuver

The transaction caused widespread concern among investors and market participants

## Serta Simmons (2020) "Uptier" Exchange

**What happened:**

Serta issued new super-senior debt to a select group of lenders, improving their claim priority

Non-participating lenders were subordinated, despite no formal restructuring or consent

The company used the "open market purchase" language in its loan documents to justify the deal

**Impact/Outcome:**

Legal battles followed and 5th Circuit ultimately ruled a covenant breach had occurred

Serta Simmons filed for Chapter 11 in 2023

## Chewy/Petsmart (2017) Collateral Carve-out Via Distribution

**What happened:**

PetSmart distributed 20% of Chewy's equity to its parent company, outside of lenders' collateral package

The move was executed using capacity in the "restricted payments" basket

Although technically permitted, it reduced the value of the collateral securing PetSmart's debt

**Impact/Outcome:**

Creditors initiated lawsuits claiming the transaction eroded their credit protections

The situation highlighted a key weakness in covenant drafting around equity carve-outs

Became a case study for why lenders need tighter control over distributions and asset transfers , without triggering a default

M

In addition to broadly understanding credit covenants, there are three other key areas to understand when analyzing covenants in practice:

**Capital structure seniority**

- In the leveraged loan market, the vast majority of instruments are senior secured, often secured by substantially all assets of the borrower and guarantors
- In contrast, the high yield bond market includes a mix of senior secured and senior unsecured debt, with a smaller portion being subordinated or second lien
- According to J.P. Morgan research, over 90% of leveraged loans completed in recent years are senior secured and roughly 60 – 70% of high yield bonds are senior unsecured
- Understanding debt seniority is essential for assessing recovery prospects and evaluating covenant packages

**Builder baskets and the role of pro forma EBITDA**

- Builder baskets allow issuers to grow capacity for restricted payments or investments over time, often based on a percentage of consolidated net income or pro forma EBITDA
- These baskets accumulate value as the company performs well financially, which can increase the issuer's flexibility to pay dividends, make acquisitions, or transfer assets
- Pro forma EBITDA (including add-backs for cost savings, synergies, and non-recurring items) plays a critical role in marketing transactions, as it directly influences leverage ratios, capacity calculations, and investor perception of covenant compliance
- Aggressive or loosely defined add-backs can materially inflate EBITDA, expanding capacity under covenants and reducing perceived language

**Understanding U.S. vs. Canadian disclosure**

- U.S. disclosure practices provide more consistent and detailed access to credit agreements and trust indentures, especially for SEC registered issuers
- It is common to find full loan agreements, amendments and indentures on EDGAR
- In contrast, Canadian companies are less likely and not obligated to publicly disclose full credit documents, making covenant analysis more challenging
- Analysts covering Canadian credits often rely on press releases, prospectus-level summaries, and investor relations outreach to piece together capital structure terms

Covenants aren't just fine print—they are the foundation of a security's true risk profile. When crafted well, they act as guardrails that help preserve value and limit downside for lenders. But when they are too lenient, important protections can quietly disappear. It is important to always ask: what could the borrower do that might leave a lender exposed?

# Disclaimers

Mawer Investment Management Ltd. provides this publication for informational purposes only and it is not and should not be construed as professional advice. The information contained in this publication is based on material believed to be reliable at the time of publication and Mawer Investment Management Ltd. cannot guarantee that the information is accurate or complete. Individuals should contact their account representative for professional advice regarding their personal circumstances and/or financial position. This publication does not address tax or trust and estate considerations that may be applicable to an individual's particular situation. The comments are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.

All statements, other than statements of historical fact, included in this report that address activities, events or developments that Mawer expects or anticipates will or may occur in the future, including such things as anticipated financial performance, are forward looking statements. The words "may", "could", "would", "should", "believe", "plan", "anticipate", "expect", "intend", "forecast", "objective" and similar expressions are intended to identify forward looking statements. All opinions contained in forward looking statements are subject to change without notice and are provided in good faith but without legal responsibility. Mawer has no intention of updating any forward looking statements whether as a result of new information, future events or otherwise, except as required by securities legislation.

Past performance does not guarantee or indicate future results. All financial investments involve an element of risk. The value of investments may rise and fall so you may get back less than originally invested. Investors should consider the risks, including lower returns, related to currency movements between their investing currency and the portfolio's base currency, if different. Investors should be aware that forward-looking statements and forecasts may not be realized.