

# Credit Unit Class TAMIM Fund

At 30 June 2019

## PROJECTED YIELD: 8.1% p.a.

This month we do a fairly technical deep-dive into some of the structuring that is taking place with loan covenants. Remember loan covenants are one of the key mechanisms that provide lenders with protection when lending money as they are normally good predictors of actual or imminent stress within in a business. The weakening of covenant protections is reflective of the current global lending environment where interest rates remain stubbornly low resulting in strong demand for credit and investors chasing yield.

A broad-based assessment of loan covenants shows that they are at their weakest level on record, with Moody's writing that "our scores reflect weaker protections on a year-over-year basis in nearly every risk category we assess. Given the breadth and depth of covenant weakness, existing loans are in uncharted territory".

What Moody's is referring to are more than just maintenance covenants on interest coverage and leverage: covenant assessments also analyse most-favoured-nation provisions, mandatory prepayments from asset sales, exceptions to negative covenant restrictions, restricted payments clauses, definition and scope of allowable EBITDA adjustments, leakage of assets from the collateral pool, caps on investments in or transfers to unrestricted subsidiaries and affiliates, the ability to add senior pari-passu or priority debt, lien dilution by non-guarantor subsidiaries, etc. In other words, the means by which lenders try to prevent issuers and their legal counsel from diminishing lender rights and protections. These are the protections that loan investors are now surrendering at a record pace.

### Loan investors waving the white flag: Moody's loan covenant quality score is the weakest on record

5.0 = weakest covenant quality



Source: Moody's. Q4 2018.

### Monthly Return Stream

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec	YTD
2018	-	-	-	-	-	-	-	-	-	0.46%	0.38%	1.02%	1.87%
2019	0.60%	0.54%	0.84%	0.62%	0.61%	1.25%							4.54%

Note: Returns are quoted net of fees and assuming quarterly distributions are not reinvested. Past performance is no guarantee of future performance.

The information provided should not be considered financial or investment advice and is general information intended only for wholesale clients (as defined in the Corporations Act). The information presented does not take into account the investment objectives, financial situation and advisory needs of any particular person nor does the information provided constitute investment advice. Under no circumstances should investments be based solely on the information herein. You should seek personal financial advice before making any financial or investment decisions. The value of an investment may rise or fall with the changes in the market. Past performance is no guarantee of future returns. Investment returns are not guaranteed as all investments carry risk. This statement relates to any claims made regarding past performance of any Tamim (or associated companies) products. Tamim does not guarantee the accuracy of any information in this document, including information provided by third parties. Information can change without notice and Tamim will endeavour to update this document as soon as practicable after changes. Tamim Funds Management Pty Limited and CTSP Funds Management Pty Ltd trading as Tamim Asset Management and its related entities do not accept responsibility for any inaccuracy or any actions taken in reliance upon this advice. All information provided in this document is correct at the time of writing and is subject to change due to changes in legislation. Please contact Tamim if you wish to confirm the currency of any information in the document.

### Key Facts

<b>Investment Structure:</b>	Unlisted unit trust
<b>Minimum investment:</b>	A\$100,000
<b>Applications:</b>	Processed monthly
<b>Redemptions:</b>	Quarterly, with 30 days notice
<b>Unit pricing frequency:</b>	Monthly
<b>Distribution frequency:</b>	Quarterly
<b>Management fee:</b>	1.25% p.a.
<b>Performance fee:</b>	Nil
<b>Lock up period:</b>	18 months
<b>Buy/Sell Spread:</b>	+0.20%/-0.20%
<b>Exit fee:</b>	Nil
<b>Administration &amp; expense recovery fee:</b>	Up to 0.35%
<b>Unsecured debt limit:</b>	5% of Fund assets

### NAV

	Buy Price	Mid Price	Redemption Price
AU\$	\$1.0069	\$1.0049	\$1.0029

### Contact

<b>Bradley Hill</b>	bradley@tamim.com.au	0424 333 790
<b>Darren Katz</b>	darren@tamim.com.au	0405 147 230

# Credit Unit Class TAMIM Fund

At 30 June 2019

## PROJECTED YIELD: 8.1% p.a.

To further understand the degree of unilateral surrender, consider the following three issues: covenant carve-outs in default, EBITDA add-backs and collateral stripping.

### **Covenant carve-outs in default**

Loan covenants historically stipulated that borrowers could only use carve-out clauses to engage in certain corporate actions if they were not in default and had not experienced an “event of default”. This protection is becoming rarer as more loans weaken/eliminate this requirement, increasing the possibility of a “Hail Mary” transaction at the 11th hour. Moody’s: “When borrowers can make restricted payments, investments, junior debt prepayments or incur new debt even after default, all lenders can do is hope for a satisfactory outcome”.

### **EBITDA add-backs**

Coverage and leverage measures are artificially boosted by increasing use of “EBITDA add-backs”. This refers to the practice of companies adding back non-recurring expenses and assumed merger synergies/cost savings to earnings, thereby artificially enhancing any measure derived from EBITDA:

- According to S&P, the use of EBITDA add-backs has increased from 10% of all deals to around 30%. In terms of magnitude, S&P reports that such add-backs range from 10%-15% of unadjusted EBITDA. However, according to Moody’s, some deals allow add-backs up to 20%-30% of unadjusted EBITDA, and some deals have no caps at all
- Fitch’s Covenant Review reports that 35% of middle-market loan issuers used EBITDA add-backs. While assumed synergies were usually capped at 10%-15% of unadjusted EBITDA, in some cases there were also no caps, just as Moody’s reported
- According to S&P, around half of all M&A loan issuance in 2017 and 2018 had leverage above 6.0x once the benefits of assumed synergies are excluded
- Moody’s analysed how successful European companies have been in achieving assumed cost savings. They found that only 45% of EBITDA add-backs were achieved on average, and that nearly 20% of issuers didn’t achieve any of their projected add-back targets

### **Collateral stripping**

Recent reported cases of “collateral stripping” refer to financial sponsors transferring collateral beyond the reach of senior creditors, either to holding companies or related

affiliates outside the collateral pool. They have been infrequent so far, but when/if the economy turns, this kind of activity could increase due to the laxity of “restrictive payment” and other covenants outlined above.

All things considered, these trends don’t argue for higher default rates, those will be determined by the depth of whatever recession occurs. But in our view these trends argue for lower loan recoveries on defaults that eventually occur.

In the covenant food fight between issuers and lenders, issuers are winning, hands down.

Note: Returns are quoted net of fees and assuming quarterly distributions are not reinvested. Past performance is no guarantee of future performance.

The information provided should not be considered financial or investment advice and is general information intended only for wholesale clients (as defined in the Corporations Act). The information presented does not take into account the investment objectives, financial situation and advisory needs of any particular person nor does the information provided constitute investment advice. Under no circumstances should investments be based solely on the information herein. You should seek personal financial advice before making any financial or investment decisions. The value of an investment may rise or fall with the changes in the market. Past performance is no guarantee of future returns. Investment returns are not guaranteed as all investments carry risk. This statement relates to any claims made regarding past performance of any Tamim (or associated companies) products. Tamim does not guarantee the accuracy of any information in this document, including information provided by third parties. Information can change without notice and Tamim will endeavour to update this document as soon as practicable after changes. Tamim Funds Management Pty Limited and CTSP Funds Management Pty Ltd trading as Tamim Asset Management and its related entities do not accept responsibility for any inaccuracy or any actions taken in reliance upon this advice. All information provided in this document is correct at the time of writing and is subject to change due to changes in legislation. Please contact Tamim if you wish to confirm the currency of any information in the document.