Rethinking covenant monitoring for a new era of private credit

Private credit is enduringly popular among institutional investors, but the landscape has changed significantly over the past decade. To navigate it safely, LPs need to ensure their GPs are prepared to monitor covenants closely.

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The private credit market is flourishing, with approximately $1.7TN AUM of private credit assets. Over the past 15 years, the demand among LPs has grown as the asset class evolved from a specialty product into a mainstream source of financing.

While the appeal is mainstream, the requirements are not. Private debt is unrated and less liquid, and the terms are more flexible, all of which add to its opacity and unpredictability. As a result, the manager's diligence in credit surveillance and quality of their in-house expertise needs to be a central consideration for investors.

The role of covenant monitoring

Covenants protect the investment by ensuring the borrower adheres to a set of conditions that are designed to minimise credit risk. Strict compliance is crucial to maintaining loan performance and trust between lenders and borrowers. Advanced covenant monitoring plays a pivotal role in early detection of potential covenant breaches, enabling lenders to practice proactive management to avoid costly defaults and foster close relationships between lenders and borrowers.

Greater diligence is needed

Covenants can be complicated, and when they are captured in nonstandard agreements and unstructured documents, it's easy for breaches to go unnoticed.

At a time when market and interest volatility are placing greater stress on borrowers, GPs must bring greater diligence to the task of monitoring adherence. But it's not just macroeconomic factors that are driving the need for more vigilance, a number of trends specific to private credit are also adding to the level of risk involved.

Heavier covenant requirements

Previously, covenant-lite loans with far fewer restrictions on the borrower (and fewer protections for the lender) were available to more middle and upper market issuers, especially as part of highly leveraged buy-out activity. The influx of tightened banking regulations and more restrictive capital charge requirements has spurred banks and broadly syndicated lenders to abandon underwriting and lending to all but the most stable and highest-rated credits and tighten up their requirements considerably. But now that issuers must go to the private credit market where these more restrictive covenants are in place, many lenders who have been used to treating covenants as a largely pro forma arrangement are struggling to put in place the systems and resources needed to monitor and enforce them.

Less experienced lenders

The consistently favourable returns that private credit has generated is attracting a wider range of lenders than ever before, especially in the higher for longer rate environment. While they may be experienced and capable asset managers, they may not have as much experience with this particular asset class. As a result, they may not fully understand the burden that covenant monitoring will place on their organisation or have the appropriate talent and resources in place to be able to monitor covenant adherence on a regular basis on behalf of their investors.

Less sophisticated borrowers

With a saturated middle market, direct lenders are going downmarket to find further opportunities. While some of these prospects are sponsor-backed, many are engaging with a lender and encountering covenants for the first time. The documentation and calculations they submit need to be carefully reviewed to ensure they align with the requirements and restrictions outlined in the credit agreements.

Rise in asset-based lending

A growing number of lenders seeking to expand their private debt portfolio are adding asset-based loans to their portfolios. These loans involve more complicated covenants that can be daunting for less experienced lenders. Additional requirements include the net orderly liquidation value (NOLV), which requires a borrower to maintain a minimum value for certain assets and perform regular third-party appraisal and affirmative covenants, which require borrowers to maintain insurance coverage, submit financial statements, maintain specific financial thresholds and grant the lender broader access to information or assets.

Protect your private debt investment

Economic volatility and the growing diversity of lenders and borrowers in private debt is creating a need for investors to ensure that their managers have resources in place that allow them to monitor covenants carefully, including:

- Conduct borrower-level tracking, which involves tracking covenants against each borrower's unique financial landscape.
- Conduct deviation analysis to pinpoint and address covenant variance promptly.
- Conduct reporting and analytics to identify covenant issues and trends across the portfolio.
- Have a system in place that proactively notifies them of the statuses of affirmative, negative and event-based covenants.
- Automate the early detection of potential covenant breaches, enabling proactive asset management.
- Track the dates that reports, and financial packages are received to ensure the borrower is submitting them on time.
- Maintain a document repository that consolidates relevant documents and creates an audit trail.
- Share relevant covenant documents and reports with leverage facility providers.
- Maintain historical data to enable the GP to make lending decisions based on past outcomes with specific borrowers.
- Consult with covenant experts, either internal or outsourced.

In house expertise and human diligence alone is often not enough to support the level of monitoring required for modern covenants: technology and managed services must play a central role in streamlining this time-consuming activity and providing better visibility into covenant statuses, trends and performance.

At S&P Global, our private debt solution offers an end-to-end workflow that drives the private debt lifecycle, including bespoke covenant monitoring that caters to each loan's distinct parameters. Through integrated technology and managed services, we help managers consolidate and track loan data and documentation and gain insight into the health of the debt portfolio.

A large and growing portion of the market is now using these advanced technologies to manage private debt. Of the approximately $1.7 trillion AUM of private credit assets outstanding in the market, about one-quarter ($435 billion AUM) already flows through our software solutions.

The future of private debt

Covenants have always played an important role in managing risk for private credit, but this capability will become even more important in the months and years ahead. As the popularity of this asset class grows, it will represent a larger percentage of the portfolio, and new and more complex debt structures will become part of the mix. Add to this higher-for-longer interest rates, the increased use of payment-in-kind toggles and fast-evolving regulatory requirements, and the ability to manage tight adherence to covenants will be more important than ever. By ensuring managers are prepared to conduct thorough, proactive, ongoing covenant monitoring, investors can ensure their capital allocations are adequately protected.

Learn more: www.spglobal.com/CovenantMonitoring