IHS Markit

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Does that J. Crew loan covenant only come in an extra-small?

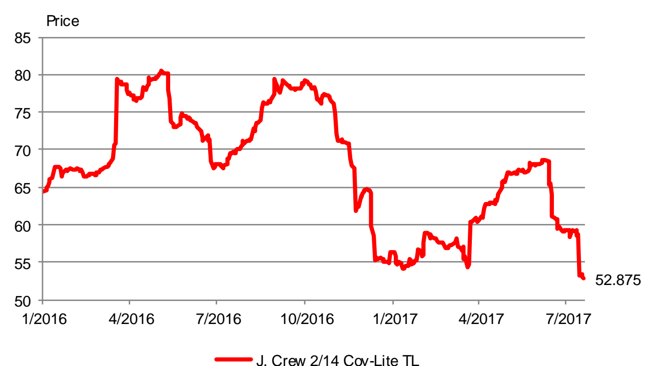
The increased financial distress in some segments of the retail clothing sector is resulting in some companies using creative ways to restructure their debt without filing for bankruptcy. For example, J. Crew recently initiated such a restructuring of its over $2 billion in debt through the transfer of over 70% of their trademark assets to a newly created foreign subsidiary J. Crew Cayman, with the intention of extending the maturity on certain debt by two years and then issuing unsecured debt from that subsidiary for use in buying back some of their distressed leveraged loans issued from a US entity. The company's actions were met with ire from some of their loan investors, given their belief that the disposition of property covenant should prevent such an action. One point of contention is whether the new Grand Cayman entity is legally an unrestricted subsidiary, which would permit the property to be transferred in comparison to a restricted one that would provide limitations on the transfer.

Effectively managing an ocean of covenants for a large leveraged loan portfolio improves investors' ability to quickly identify both favourable and detrimental covenants from their perspective. The rapid growth of covenant-lite or "cov-lite" loans continues to raise concerns in the loan market, with their widespread use leading some to lower recovery assumptions for defaulted loans given that those loans' borrowers may have more flexibility in the ability to transfer assets. The key determination for a cov-lite loan is the inclusion of a maintenance covenant, which routinely (typically quarterly) test the borrowers leverage ratio, interest coverage ratio, or some other financial measurement. It is important to be wary of maintenance covenants where the test is not considered particularly stringent, as those loans may provide limited levels of protection similar to typical cov-lite loans, while avoiding the classification due to the presence of that covenant. According to IHS Markit's Loan Covenant Library, 137 out of the 343 public retail, textile, and apparel sector loan facilities are currently cov-lite To make matters a bit more complicated, covenants can occasionally be changed as a result of amendments to the credit agreement so a loan could potentially be reclassified as cov-lite, as was the case with the 99 Cents Only Store TL-B2, which had a capital expenditure (maintenance) covenant that was removed as part of the most recent (second) amendment to the credit agreement. The potential for significant credit agreement amendments during the life of a loan is why a covenant database needs to be properly maintained with the latest amendments to be effective.

On July 11, J. Crew announced that it received tenders from 99.85% of the total outstanding principal amount issued by subsidiary Chinos Intermediate Holdings A, Inc., exceeding the required approval of 95% of their investors to extend the maturity in certain debt and move forward with the out-of-court restructuring plan. We note that they had just received a judgment in their favour on June 28 by the New York Supreme Court that prevented a group of its lenders from blocking their restructuring plan. Despite the set of outcomes in the company's favor, July has been a particularly difficult month for the company's cov-lite term loan, as prices have declined almost 11% since June 30 to 52.875 as of July 19 (**Figure 1**).

The next few months will be crucial for J. Crew and the broader loan retail sector, as other retailers may seek to implement a similar type of restructuring if the company is successful. Of course, not every company will have the flexibility within their covenants to transfer their intellectual property to an upstream subsidiary. The significant and subtle differences in covenants across the vast universe of loan issuers could have vastly different consequences for investors, which is why a robust, accurate, and actively maintained covenant library is an essential tool for both identifying lesser known structural protections that are beneficial as well as helping to avoid covenants that can work against the investor during times of distress.

Figure 1: J. Crew 2/2014 cov-lite term loan daily prices



Source: IHS Markit

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