

MOODY'S RATINGS

New Developments in Covenants

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The background of the slide is a dark blue color with intricate, abstract patterns of lighter blue wavy lines. These lines form a complex, layered structure that resembles a topographical map or a series of overlapping waves, creating a sense of depth and movement. The lines are most prominent in the upper left and lower right corners, framing the central text.

Covenants – Background and Trends

Two Types of High-Yield Covenant Packages

Covenant / Provision	Full-package		High-yield lite (IG-style)
Restricted Payments (RPs)	✓		✗
Affiliate Transactions	✓		✗
Asset Sales	✓		✗*
Operating Line of Business	✓		✗
Debt Incurrence	✓		✗
Sale/Leasebacks	✓		✓
Mergers and Sales of Substantially All Assets	✓		✗
Limitation on Liens	✓		✓
Future Guarantee Requirement	✓		✓
Change of Control	✓		✓

Moody's HY Bond Covenant Quality Scoring

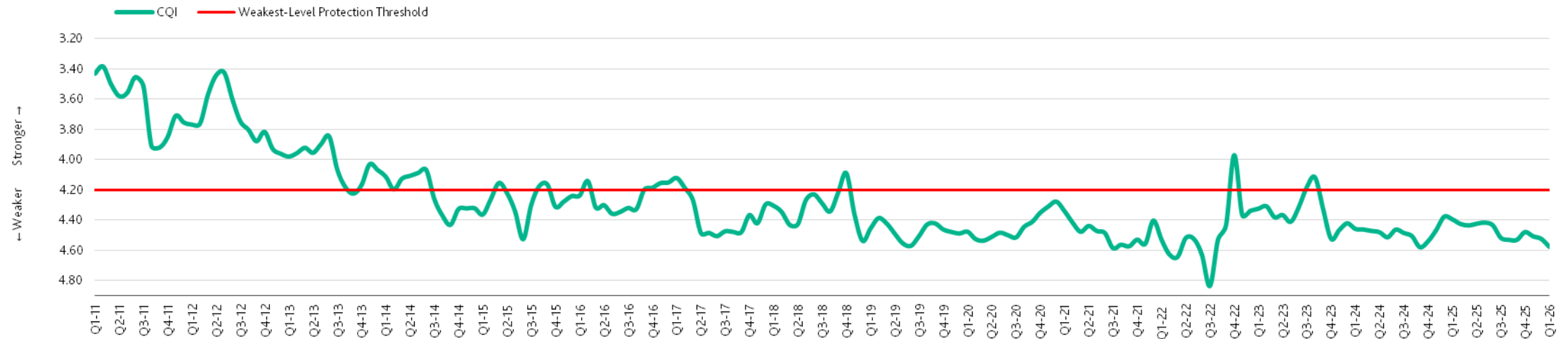
CQ Scoring Key

← Stronger										Weaker →											
CQ1		CQ2			CQ3			CQ4			CQ5										
Strong		Good			Moderate			Weak			Weakest										
Strong CQ Score < 1.80		Upper (↑) 1.80 ≤ CQ Score < 2.00			Lower (↓) 2.40 ≤ CQ Score < 2.60			Upper (↑) 2.60 ≤ CQ Score < 2.80			Lower (↓) 3.20 ≤ CQ Score < 3.40			Upper (↑) 3.40 ≤ CQ Score < 3.60			Lower (↓) 4.00 ≤ CQ Score < 4.20			Weakest CQ Score ≥ 4.20	

Covenants are not equipped to preserve value in distress

CQ Score for HY Bonds are mired in weakest-level

North American High Yield Bond Covenant Quality Indicator (CQI)

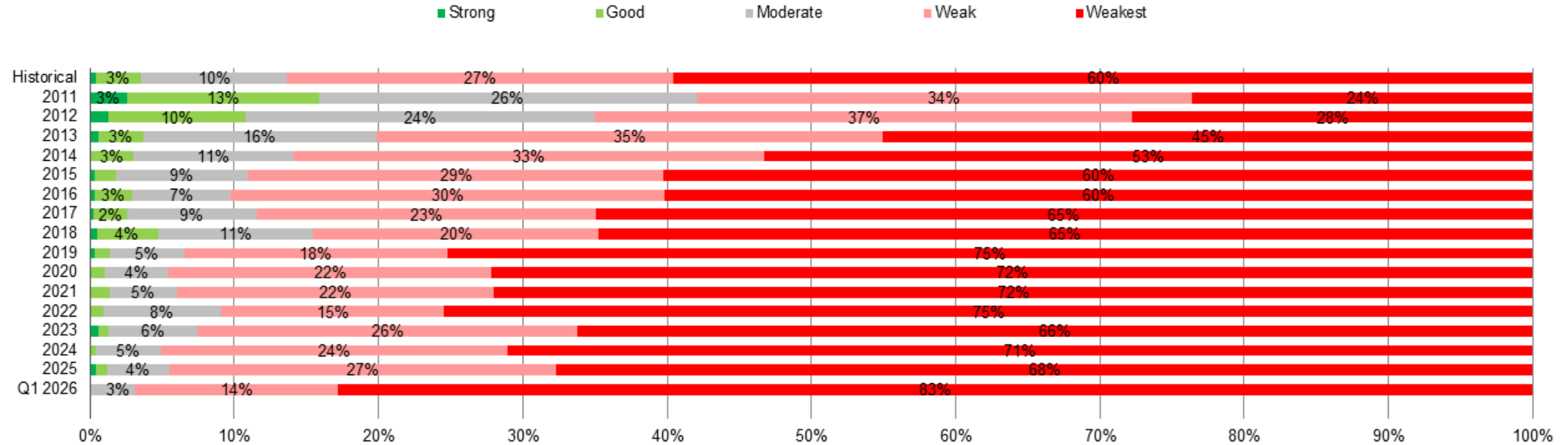


Source: Moody's Ratings

- Years of favorable market conditions (low interest and default rates) steered investors into high yield, diminishing allocation size and both motivation and ability to press for tight covenants.
- Once accepted, covenant flexibility has proven very difficult to reverse.
- Covenant flexibility permits but does not necessitate shareholder-centric behavior.

The percentage of bonds providing weakest-level protection has grown substantially

CQ Score by Level 2011-2026



North American Full Package Bonds January 2011 through March 2026

Source: Moody's Ratings

PE-sponsored bonds score worse at every debt instrument rating

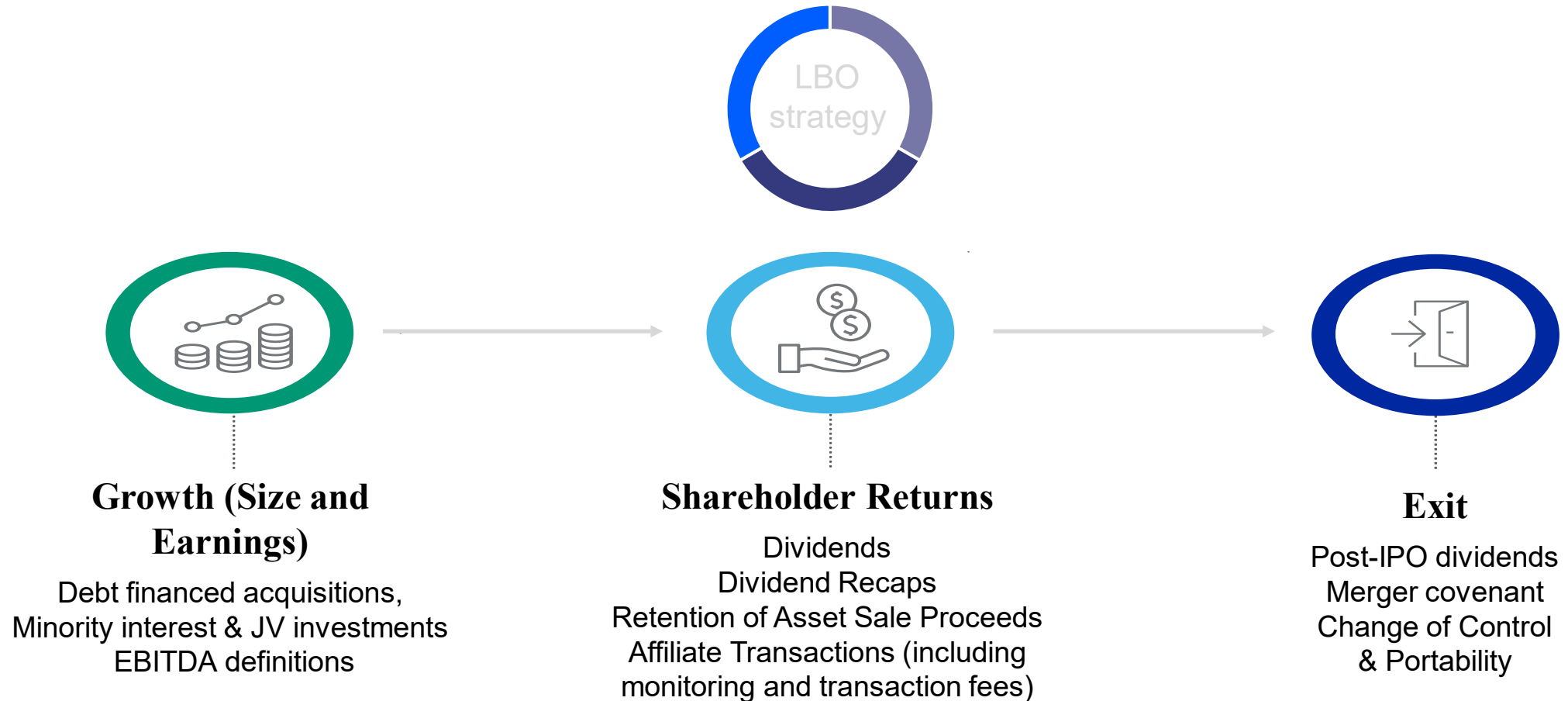
Debt Instrument Rating	PE CQ Score	% of PE B1 and below	Non-PE CQ Score	% of Non-PE B1 and below
B1	4.34	19%	4.13	36%
B2	4.47	38%	4.09	29%
B3	4.34	28%	3.98	28%
Caa1	4.21	9%	3.79	6%
Caa2 and below	4.79	6%	3.90	2%

North American Full Package Bonds January 2023 through March 2026

Source: Moody's Ratings

- PE bonds at every debt instrument rating average a CQ score in the weakest level
- Caa1 and below in PE is historically heavily populated with unsecured tranches from LBOs and M&A

In good times, covenants in PE-sponsored bonds facilitate the LBO strategy



In bad times, these same covenants preserve sponsor equity while increasing creditor risk



Permissive debt and liens covenants
Double Dips
Pari Plus



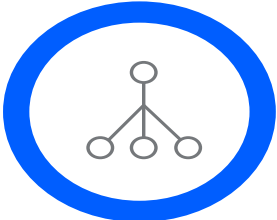
Liens dilution
Incremental Equivalent Debt
Inside Maturity Sublimits



Asset Transfer Risk
Asset transfers to non-credit parties



“Serta” Up-tiering Risks
Priming Debt (first lien recapitalization)

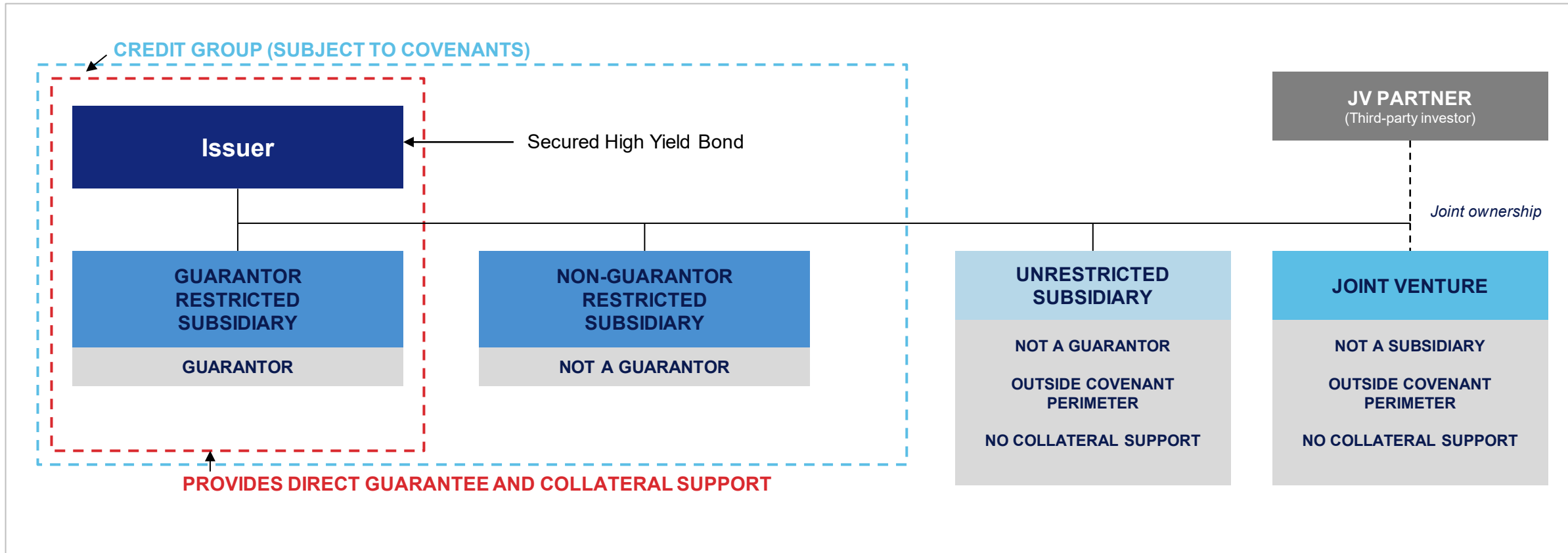


Risky acquisitions / LOB expansion

Adjusted EBITDA – one definition to rule them all

RP Builder Basket	Permitted Business Investments	General Liens Carve-out
Upfront Credit to RP Income Basket	General Investments Carve-out	Secured Credit Facility Debt
Accessing Accumulated Credit	\$1 Debt Test	Merger Test
General RP Carve-out	Non-guarantor sublimit under \$1 debt test	Affiliate Transactions Safe Harbor
Ratio-Based Restricted Payments	Credit Facility Debt Carve-out	Change of Control Portability Clause
Employee Equity Repurchases	Debt-Financed Capex	Asset Sale Step Down
Investments in Unrestricted Subsidiaries	Non-Guarantor and Foreign Subsidiary Debt Carve-outs	Designated Non-Cash Consideration
Ratio-Based Investments	General Debt Carve-out	Excess Proceeds Offer Trigger
Investments in JVs	Debt-Financed Acquisitions	General Asset Sales Carve-out

Simplified Corporate Structure Chart



- Unrestricted entities are excluded from financial ratio definitions & calculations
- Assets transferred to unrestricted subsidiaries are beyond the reach of bondholders

Key takeaway: Are there any assets (or even a line of business) that should be required to be retained by the Issuer and guarantors?

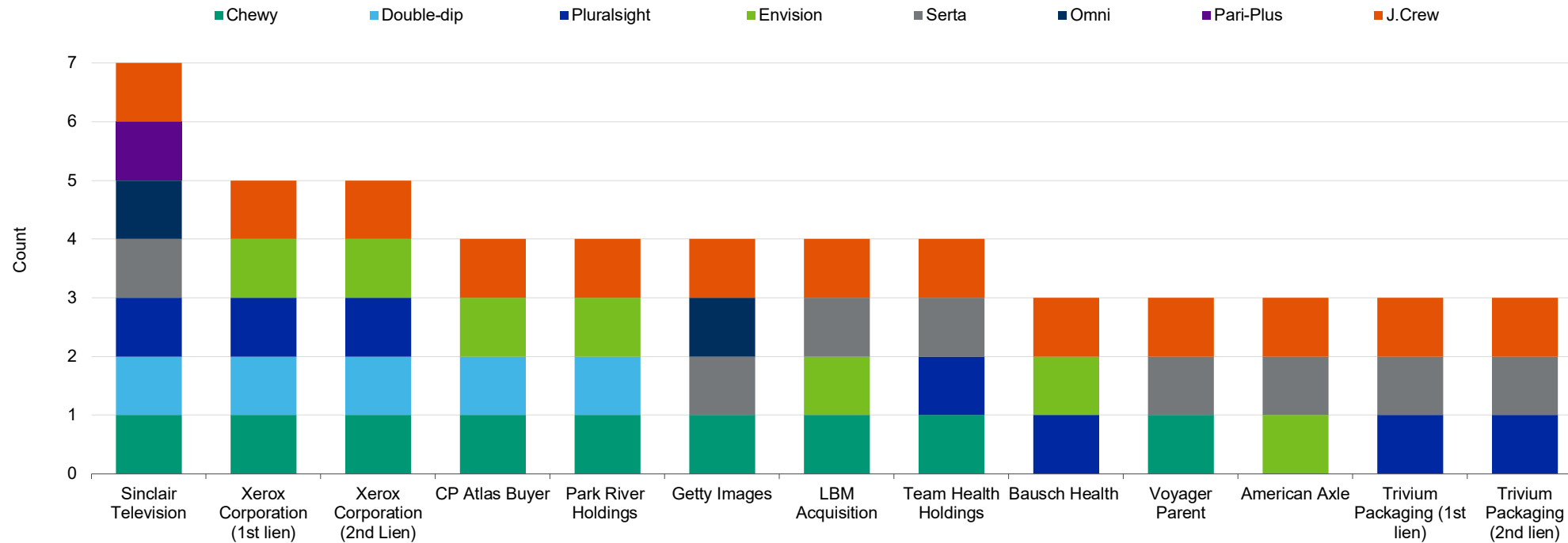
Key LMT protections

Some deals have become synonymous with aggressive LMTs and the protections designed to curb them – yet sponsors continue to find room to maneuver.

Protection	Landmark case	What it prevents
Loss of value	J.Crew	Prevents raising liquidity via asset transfers (<i>drop-down</i>)
Loss of value	Envision	Gives clarity to investors on drop-down capacity
Loss of value	Pluralsight	Prevents asset transfers to non-guarantor restricted subsidiaries and the use of preferred equity to bypass J.Crew-style debt caps
Loss of value	Xerox	Prevents asset transfers to JVs and other non-controlled entities
Loss of guarantees	Chewy	Prevents financial engineering with the sole purpose of releasing guarantors
Loss of priority	Serta	Prevents altering creditor hierarchy (<i>uptiering/priming</i>)
Loss of recoveries	At Home	Prevents creditors from having dual claims on the same collateral (<i>double dip</i>)
Loss of voting rights	Incora/Wesco	Prevents vote rigging

J.Crew blocker appeared in 32% of 2025 bonds, up from 20% in 2024

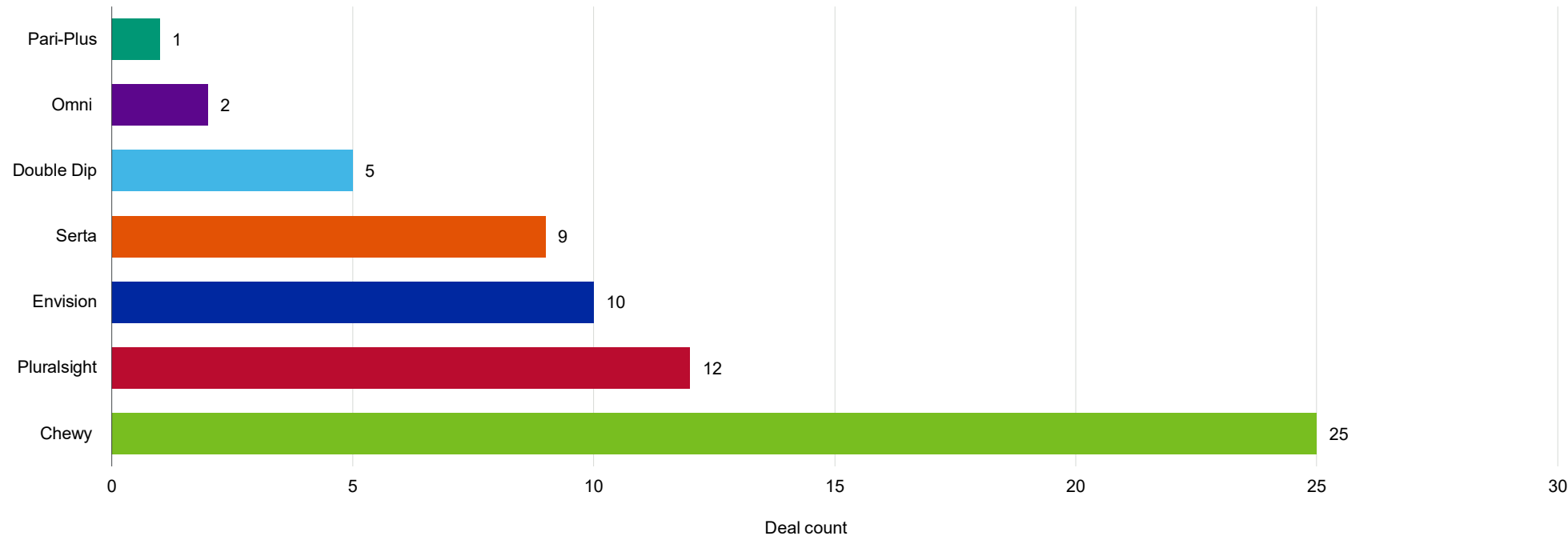
Among bonds that include a J.Crew blocker, 26% feature a total of three or more blockers.



Source: Moody's Ratings

After J.Crew, Chewy, Pluralsight, and Envision were the most common LMT blockers in 2025

Prevalence of non-J.Crew blockers based on sample of 158 full-package NA high-yield bonds



Source: Moody's Ratings

Top of Market Weaknesses Persist

- **Top of market weaknesses, but also LME protections, are making their way into LBO bonds**
- **Focus on restricted payments covenant sets the stage for dividend recaps that can leave issuers susceptible to market volatility**
- **Incurrence covenants continue to erode, but incrementally**

Sponsors continue to target covenants that support the "good times/ bad times" strategy

Dividend Recaps – Permissive bonds include no barriers to accessing the RP income basket, which features alternate builder baskets and new additions for proceeds from sale/leasebacks and sales of A/R and also permit asset disposition proceeds to finance permitted payments and investments

Debt - Top of market deals maximize debt which can structurally subordinate and share in or prime the bondholders' liens, including by stacking growth baskets and financial ratio tests

Fungibility - Carve-out reallocation across RPs, investments, debt, liens and asset sales

LMT Blockers - J. Crew asset transfer blocker is common even in PE sponsored bonds, but other blockers feature less often and unevenly

Key takeaway: Top of market flexibilities make difficult the calculation of how much capacity an issuer has to pay dividends, transfer assets or dilute or subordinate the investors' claims, including when facing distress.

Thank you

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