

Why covenants matter: Safeguarding investor interests in private credit

HIGHLIGHTS

- **Covenants give lenders the right to engage with a borrower before problems reach the point of a payment default.**
- **When a borrower breaches a covenant, lenders can use the intervening period to understand the business, develop a recovery plan, and prepare for a restructuring if necessary. Without covenants, that window does not exist.**
- **Multiple maintenance covenants provide a more complete early warning system than a single covenant, capturing different forms of stress.**

What are covenants, and why do they matter?

It is a bad time for lenders to start negotiations with a borrower when their performance has declined to the point where they have stopped making payments. Yet in the upper middle market and broadly syndicated loan markets—where covenant-lite loans are now the norm—that is the position lenders can find themselves in. Covenant-lite is generally defined as a loan with no financial maintenance covenants, and most lenders in those segments have come to accept it as market standard. But covenants are a powerful tool for protecting investors, and their value becomes apparent when a borrower runs into difficulty.

A maintenance covenant is a contractual requirement that a borrower meets a defined financial test at regular intervals, typically quarterly. The most common are a leverage covenant (capping the ratio of debt to EBITDA) and a fixed charge coverage ratio covenant, which requires that operating cashflow covers fixed obligations by a defined margin. A breach of either gives the lender the right to engage, restrict the borrower's access to credit facilities, and demand a seat at the negotiating table. It is a fundamentally different position from that of a covenant-lite lender, who has no equivalent trigger until the borrower misses a payment, by which point the options for recovery are considerably narrower.

Many upper middle market lenders have been forced by competitive dynamics to increasingly offer covenant-lite loans and justify that by citing the size of the borrower. In our view, there is no size at which businesses stop being vulnerable, and no size at which covenants stop being valuable.

Equity support

In instances where one of our loans has experienced a serious covenant default, the borrower's private equity sponsor has injected additional equity to reduce leverage by paying down debt or provide liquidity to support the business. The covenant is what creates that outcome. Without it, there is no trigger, no formal engagement, and no power to request sponsor support.

The table below illustrates this. Two otherwise identical loans: each with a \$25 million EBITDA borrower, 4.0x leverage, a \$100 million total facility, and a \$25 million revolving credit line. One has a leverage covenant set at 5.20x debt/EBITDA; the other is covenant lite. A year later, EBITDA declines 30%.

(\$, MILLIONS)	LOAN WITH LEVERAGE COVENANT	COVENANT-LITE
AT CLOSING		
Closing EBITDA	\$25	\$25
Closing leverage	4x	4x
Total facility size	\$100	\$100
Revolving credit facility	\$25	\$25
Covenant (Debt/EBITDA)	5.2x	None
AFTER 30% DECLINE IN EBITDA		
EBITDA	\$17.5	\$17.5
Resulting leverage	5.71x	5.71x
CapEx	(\$4)	(\$4)
Cashflow before interest	\$13.5	\$13.5
Interest	(\$10)	(\$10)
Cashflow after interest	\$3.5	\$3.5
Tax impact	(\$0.77)	(\$0.77)
Free cashflow	\$2.73	\$2.73
Principal payments	(\$1)	(\$1)
Equity free cashflow	\$1.73	\$1.73
Revolver + available cash	\$1.73	\$26.73
LENDER POSITION		
Covenant breached?	Yes, at 5.71x	No
Revolver restricted?	Yes	No
Lender at negotiating table	Yes	No

For illustrative purposes only. There is no guarantee that actual lending transactions will have characteristics like this example. Transactions may differ materially from that depicted above based on numerous factors. Source: Principal Alternative Credit.

In the covenanted deal, the 30% EBITDA decline triggers a breach. The lender can immediately restrict the borrower's access to the revolving credit facility and engage the sponsor. In the covenant-lite deal, no breach has occurred. The borrower retains full access to the revolving credit facility, funded by the lender, with no obligation to engage.

To understand how bad things would have to get before the covenant-lite lender could have that same conversation, consider what the scenario looks like when liquidity is finally exhausted.

(\$, MILLIONS)	COVENANT-LITE—LIQUIDITY EXHAUSTION POINT
EBITDA	(\$10.00)
CapEx	(\$4.00)
Cashflow before interest	(\$14.00)
Interest	(\$10.00)
Cashflow after interest	(\$24.00)
Tax impact	\$0.00
Free cashflow	(\$24.00)
Principal payments	(\$1.00)
Equity free cashflow	(\$25.00)
RLOC + cash	\$0.00

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EBITDA would need to deteriorate to -\$10 million before the covenant-lite lender reaches the same point of urgency. At that stage, free cashflow is deeply negative, the revolving credit facility has been fully drawn, and the sponsor—now focused on the viability of the business itself—is less inclined to invest new equity. The lender with a covenant in place has used the intervening period constructively. The covenant-lite lender has not had the same opportunity to act before enterprise value erodes.

Repricing

A covenant breach can also create economic opportunity for lenders, provided enterprise value remains intact. Between amendment fees, facility re-pricings, exit fees, and the economics available on priming facilities, covenant breaches can contribute to returns in situations that are managed well.

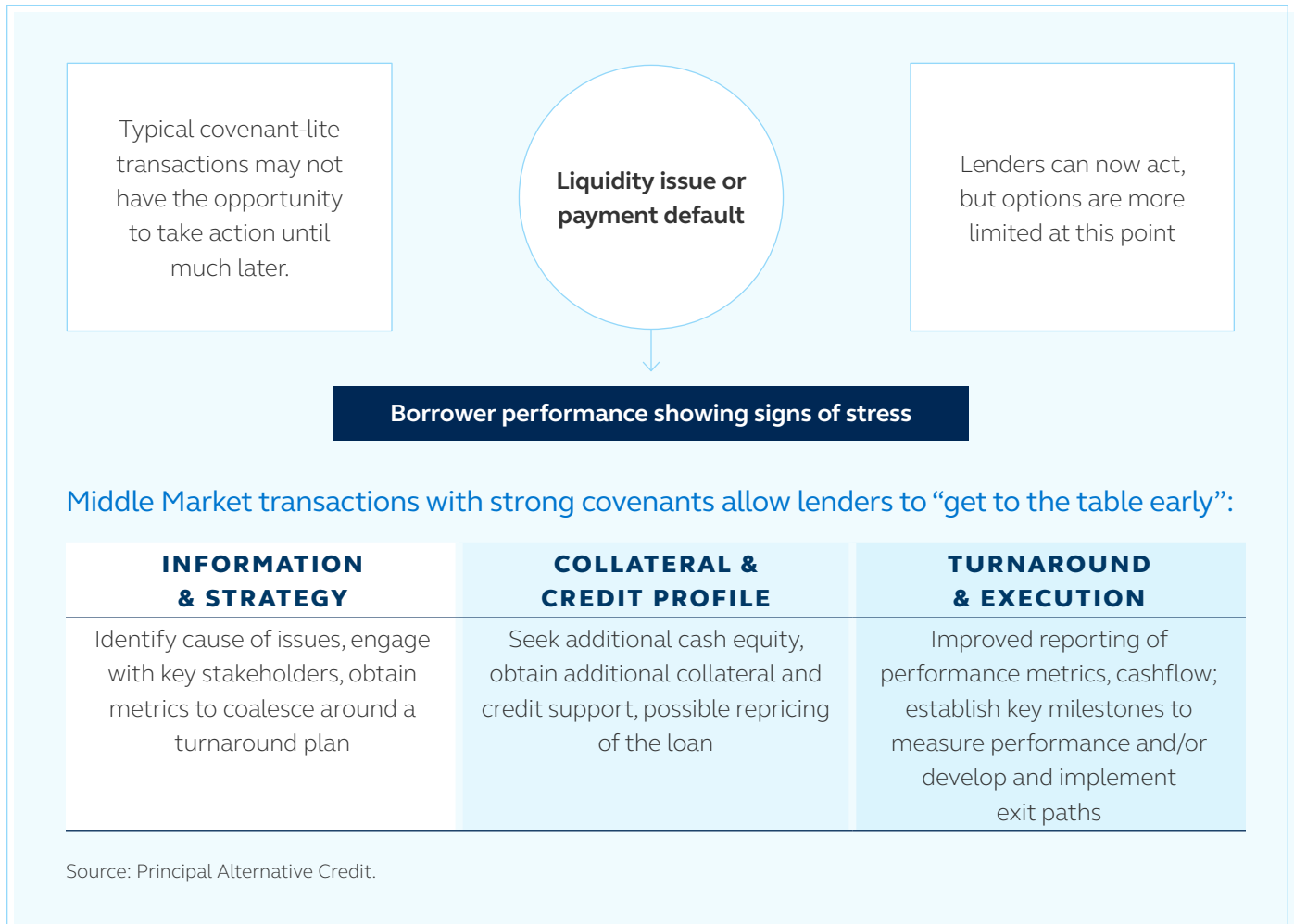
Contractual default interest rates are typically 200 basis points above original deal spreads. Priming facilities—where a lender provides new money with priority claims ahead of existing debt—have been structured at 2x or more liquidity preference, meaning the priming lender recovers twice their investment before other lenders participate. Such arrangements are complex but can offer incremental returns in stressed situations.

Catching problems early and setting up for recovery

While many borrowers who breach a financial covenant do not ultimately restructure, a breach that occurs early on during financial difficulties allows the lender to negotiate for items beyond the economic benefits described above.

Lenders can require more frequent and granular reporting, including quarterly cashflow forecasts, to understand the business's liquidity position and identify additional sources of funding if required. They can also request information on backlogs, pipeline, and other key operational metrics, and enjoy direct access to management. This enables the lender to develop a turnaround plan while the business still has the time, resources and enterprise value to execute one.

If a restructuring is necessary and lenders need to transition from creditors to business owners, months of close engagement with management and time taken to understand the business make that transition considerably smoother. Covenant-lite lenders, kept on the sidelines without access to management or the same level of information, face a far steeper learning curve at exactly the moment when speed and information matter most.



The case for two covenants

A single covenant offers meaningful protection. In our view, two offer considerably more.

Each helps identify a different form of stress. A leverage covenant is sensitive to deterioration in earnings relative to debt. But a company that spends heavily on capital expenditure, or one whose interest costs have risen sharply, may show relatively flat leverage while its cashflow position weakens significantly. The FCCR covenant captures this scenario, measuring whether the business can generate sufficient cash to cover its fixed obligations, including interest, lease costs, and scheduled debt repayments.

Together, these covenants provide a more complete early warning system. A borrower who appears healthy on a leverage basis may already be showing strain on a cashflow basis, and vice versa. Requiring both gives the lender confidence that emerging stress will be captured from multiple vantage points, and that the lender will be at the negotiating table before liquidity becomes an issue.

What the data shows: Covenants and recovery rates

The importance of covenants to recovery outcomes is supported by data. In a September 2025 report, Moody's found that lenders recovered an average of 57% on first-lien covenant-lite loans between 2023 and mid-2025, compared to 66% on loans that included financial maintenance covenants.^{*1} That is consistent with the longer-term trend, with S&P analysis showing that between 2010 and 2023, covenanted loans saw recovery rates of 72%, 11% higher than recoveries for covenant-lite loans.^{*2}

Size is also a factor, with the prevalence of one or more covenants in core middle and lower-middle market transactions boosting recoveries. According to S&P, loans extended to lower middle market firms (with less than \$175 million in debt) recovered an average of 83% versus 76.4% for core middle market loans (debt between \$175 million and \$350 million) and 68.4% for larger transactions (over \$350 million in debt).^{*3}



QUESTIONS ADVISORS SHOULD ASK

When evaluating private credit, advisors should look carefully at the composition of their portfolio and consistency of their approach through market cycles, specially in periods when pressure to accept weaker terms is acute.

Four questions are worth asking:

- Does the manager require financial maintenance covenants on every deal? If not, what share of their portfolio is covenant-lite?
- Does the manager typically require two covenants rather than one?
- Has that approach been maintained through periods of intense competition?
- What does the manager's track record look like when covenants have been breached?

^{*1} Moody's, 'No relief in sight for cov-lite loan recoveries,' September 2025

^{*2} S&P Global, 'Is covenant-lite really a drag on loan recoveries,' February 2024

^{*3} S&P Global, 'US recovery study: Supportive markets boost loan recoveries,' December 2025

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