
Negotiating EBITDA and Financial Covenants in Middle Market Loan Agreements

WEDNESDAY, OCTOBER 23, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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What is Middle Market?

- Borrower Size:
 - Less than \$500 million in annual revenue or \$15 million to \$100 million in EBITDA
- Loan Amount:
 - Traditional Middle Market: up to \$100 million
 - Large middle market: up to \$500 million
- Defining Market characteristics:
 - Club Deals (relationship lending)
 - Buy and hold mentality

Why EBITDA? Cash Flow Lending

- Lender is focused primarily on Cash Flow in making credit decision (secondary focus on assets)
- Most Common Cash Flow Ratios:
 - Fixed Charge Coverage Ratio
 - Leverage Ratio
- EBITDA is a modified Cash Flow calculation that gauges recurring operational strength.
 - EBITDA is more “comparable” when evaluating different companies than cash flow from operations, which is impacted by several factors that differ across companies (interest, tax, working capital).
 - EBITDA is viewed as best proxy for cash-generating power on a comparable basis.
 - EBITDA measurement is backward looking and generally covers past twelve months. This “flattens” the numbers so that companies with seasonal businesses can stay in compliance.

EBITDA

Simplified Income Statement – Steps	Description
Revenue	Proceeds from Sales
(COGS)	Costs of Goods Sold (an expense)
(SG&A)	Sales, General and Administrative (an expense)
[EBITDA]	Not a GAAP concept, but would fit in here
(Depreciation)	A non-cash expense for current calculation period resulting from capitalizing past expenditures rather than expensing
(Interest Expense)	Amounts to be paid in connection with debt financing (an expense)
(Taxes)	(an expense)
Net Income	The “Bottom Line” and where we start with an EBITDA definition. “Net Income” will itself be a defined term, starting from the GAAP concept of net income and making adjustments from there.
<i>Distributions / Capitalized Outlays (such as CapEx)</i>	<i>Uses of cash that are not expenses for purposes of determining net income and thus not add-backs.</i>

EBITDA 101 - Don't Forget Net Income

- Starting Point – Net Income:
 - Net Income is derived from the Income Statement
- Determine Net Income
 - Normalizing Adjustments (losses added or gains subtracted)
 - Gains or losses from sales of fixed assets
 - Discontinued operations
 - Extraordinary gains or losses
 - Changes in accounting principals
 - Unrealized gains or losses

EBITDA Add-Backs: Concepts

In general, you can argue for an add-back if the item in question is:

- A non-recurring charge (will not affect sustainable operational strength)
- A non-cash expense that is an accounting convention (for example, depreciation and amortization)
- An expense that is determined by capital structure (interest)
- An expense that does not have to be paid or might not be paid under different ownership (management fees)

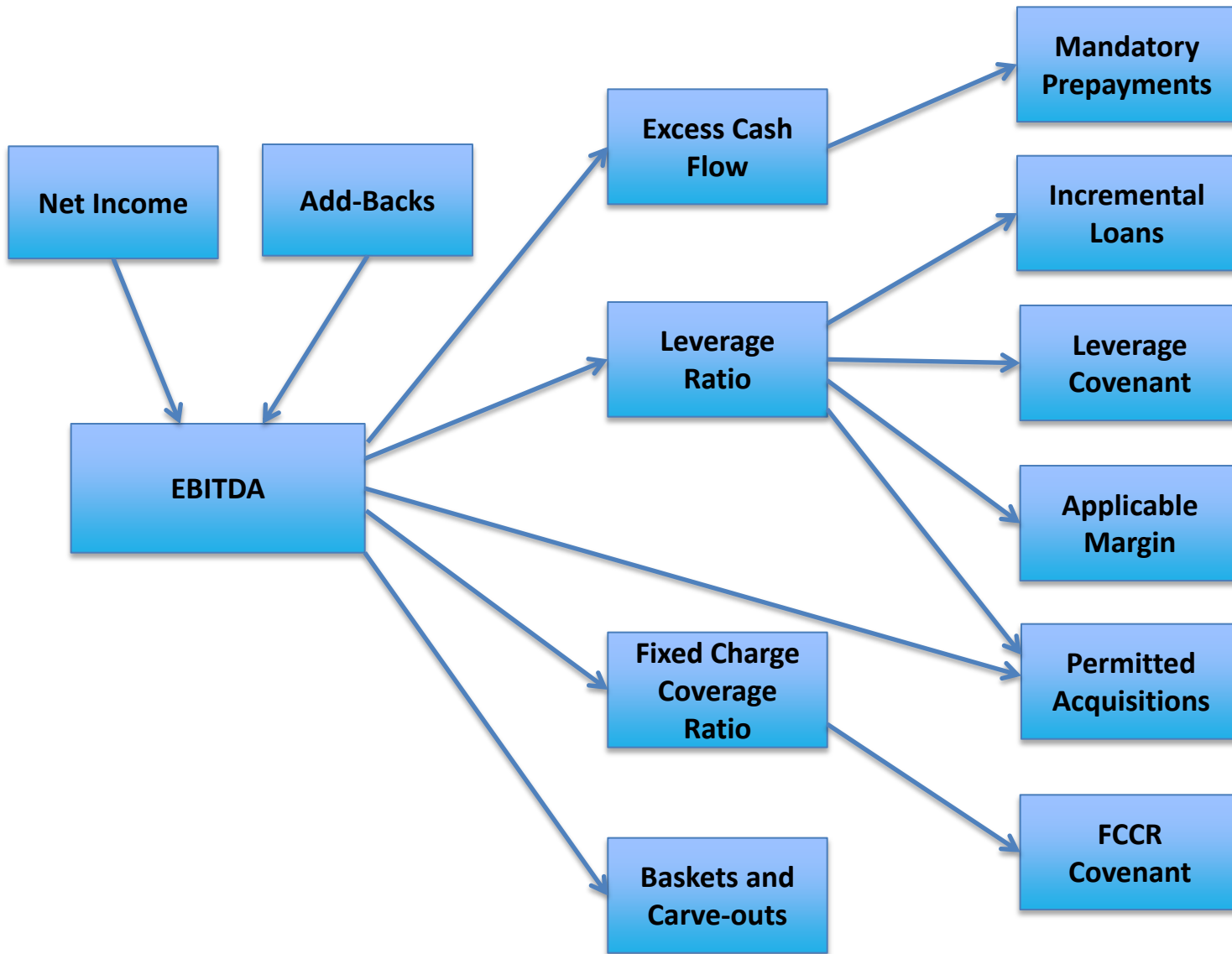
These expenses distort the measurement of a Borrower's ability to generate operational cash flow on a go-forward basis.

EBITDA 101 – The Basic Add-Backs

- The gimmies:
 - By definition: Interest / Tax / Depreciation / Amortization
 - Current transaction fees and expenses (can be capped and have an incurrence time limit)
 - Non-cash charges (in addition to depreciation/amortization) but not accruals
- The asks:
 - Equipment lease payments (the portion that is equivalent to interest payments on financed equipment)
 - Extraordinary, unusual or non-recurring losses
 - Future fees and costs in connection with Permitted Acquisitions, Permitted Dispositions and Permitted Debt
 - Future amendment fees
 - Management fees
 - Restructuring and integration expenses
 - Realized or anticipated cost savings (“synergies”)

Restructuring / Cost Savings

- Leveraged Acquisitions
 - Cost savings add backs (pro forma)
 - Adjustments for permitted acquisition / disposition (pro forma)
 - Restructuring Charges (one time add-back)
- Cost Savings v. Restructuring
- Cost Savings Standards:
 - “actually realized”, “already taken”, “committed to be taken”, “expected to be taken”
 - Timing requirements
 - Regulation S-X
 - Agent Consent / Dollar Amount Caps



Cash Flow Ratios

- Leverage Ratio

$$\frac{\text{Funded Debt}}{\text{EBITDA}} = \text{Leverage}$$



Testing risk of insolvency from adverse changes in business.

- Fixed Charge Coverage Ratio

$$\frac{\text{EBITDA}}{\text{Fixed Charge}} = \text{FCCR}$$



Testing ability to generate operating cash to service non-operating needs of the company.

Drafting Financial Covenants: Dates and Periods

- **Balance sheet items are measured as of a given date**, for example, “Funded Debt as of the last day of each fiscal quarter.”
- **Income statement items are measured for a given period**: “Interest Expense for the twelve-month period ending on the last day of each fiscal quarter.”
- Watch out when mixing terms within a definition, for example: “Leverage Ratio” means the ratio of (a) Total Funded Debt **as of** the last day of each Measurement Period to (b) EBITDA **for the twelve-month period ending on** the last day of each Measurement Period.
- **There is no such thing as EBITDA “as of” a given date**, unless your EBITDA definition requires a date as an input and properly translates that date into a period.

Drafting Financial Covenants: Inputs and Outputs

For precision and clarity, financial covenant definitions normally require one or more inputs. For example:

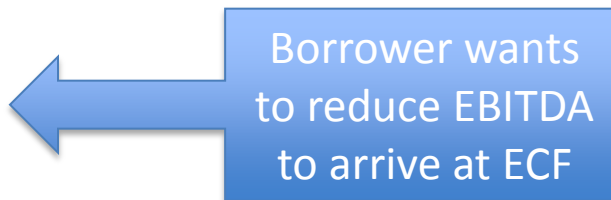
- “EBITDA” **of any Person for a given period** means Net Income **of such Person** plus, to the extent reflected as a charge in calculating such Net Income, (a) depreciation and amortization **of such Person**, (b) Interest Expense **of such Person**, and (c) Taxes **accrued by or attributable to such Person, in each case for such period.**

Now we must supply the requested inputs when we use the term in another definition or in an operative provision, like this:

- “Permitted Acquisition” means an Acquisition having all of the following characteristics ... (h) EBITDA **of the proposed target entity for the twelve-month period ended on the last day of the month prior to closing of the Acquisition** shall be greater than \$0.

Other Uses of EBITDA

- Determining covenant carve-outs
 - Go/no-go baskets
 - Build baskets
 - Pro-forma compliance tests
- Pricing grids
- Mandatory prepayments
 - Excess cash flow sweep



Increasing EBITDA

- Equity cures
 - Limited ability for sponsor to boost EBITDA to satisfy financial covenants
- Permitted Acquisitions – retroactive effect
 - Borrower wants to offset increased debt load with retroactive credit for incremental EBITDA

Pro Forma EBITDA

- Calculating EBITDA for acquisitions
 - Adjusted EBITDA – Used to add acquisition target EBITDA to calculation. Target acquisition is a way to boost EBITDA (this is because EBITDA does not include long-term investments which are captured through depreciation/amortization) (i.e. cost of acquisition will not come out of income statement on day 1).
- Annualizations and Plug Numbers
 - Plug Numbers: EBITDA for the months prior to acquisition close, to the extent used in calculating ratios, can be agreed upon in advance.
 - Annualization: Post-closing EBITDA maybe “annualized” to gross the figure up to the equivalent of a full fiscal year (for example, one fiscal quarter x 4 or three fiscal quarters x 4/3).

Sample EBITDA Add-Back Language

“EBITDA” shall mean, for any measurement period, the sum of the following determined on a consolidated basis, without duplication, for Borrowers and their Subsidiaries: (a) Net Income for such period **plus** (b) the sum of the following to the extent deducted in determining Net Income for such measurement period: (i) income tax expense, (ii) interest expense, (iii) depreciation expense, (iv) amortization expense...

Current Transaction Expenses:

To the extent not capitalized, the amount of all non-recurring expenses, fees, costs and charges incurred [within [●] months after the Closing Date] in connection with the Credit Agreement; [provided, that such amount shall not exceed \$[●]].

Future Transaction Expenses:

To the extent not capitalized, the amount of all non-recurring expenses, fees, costs and charges incurred in connection with any [proposed or actual] permitted acquisition, any [proposed or actual] issuance of debt or equity, any [proposed or actual] asset disposition or investment permitted hereunder, or any proposed or actual amendment, modification or refinancing of any indebtedness; [provided, that such amount shall not exceed \$[●] in any measurement period][shall be incurred within [●] months after the date of the applicable transaction].

Sample EBITDA Add-Back Language

Non-Cash / Accounting Expenses:

- (a) non-cash stock based compensation expense;
- (b) goodwill write-offs and write-downs;
- (c) purchase accounting adjustments; and
- (d) any other non-cash charges (other than any such non-cash charge to the extent that it represents an accrual of, or reserve for, cash expenditures in any future period).

Restructuring Expenses:

The amount of business optimization expenses and other restructuring charges (which, for the avoidance of doubt, shall include the effect of inventory optimization programs, plant closure, retention, severance, systems establishment costs and excess pension charges); provided, that with respect to each business optimization expense or other restructuring charge, Borrower shall have delivered to the Agent an officers' certificate specifying and quantifying such expense or charge] provided, that such amount shall not exceed during any measurement period [[●]% of EBITDA][$[\$[\bullet]]$ for such measurement period]].

Sample EBITDA Add-Back Language

Operating Expense Reductions:

The amount of cost savings, operating expense reductions and cost synergies projected by Borrower in good faith to result from actions taken or committed to be taken no later than [●] months after the end of such measurement period (calculated on a pro forma basis as though such cost savings, operating expense reductions and cost synergies had been realized on the first day of such measurement period for which EBITDA is being determined and as if such cost savings, operating expense reductions and cost synergies were realized during the entirety of such measurement period), net of the amount of actual benefits realized during such measurement period from such actions; [provided, that such cost savings and synergies are reasonably identifiable and factually supportable]; [provided, that the aggregate amount of cost savings, operating expense reductions and cost synergies added back pursuant to this clause, for any period shall not exceed [[●]% of EBITDA][\\$ [●] for such measurement period]].

Sample EBITDA Add-Back Language

Unusual / Extraordinary / Non-Recurring Expenses

The amount of unusual, extraordinary or non-recurring losses; [provided, that the aggregate amount of add backs made pursuant to this clause for any measurement period shall not exceed [[●]% of EBITDA][\\$ [●]] for such measurement period].

Management Fees

The amount of management, consulting, monitoring, transaction and advisory fees and related expenses paid to the Sponsor (or any accruals related to such fees and related expenses) during such measurement period; [provided, that such amount for any measurement period shall not exceed [[●]% of EBITDA][\\$ [●]] for such measurement period].

Miscellaneous Add-Backs

The amount of any foreign currency translation gains or losses.

The amount of business interruption insurance.

The amount of reimbursed amounts pursuant to the indemnification provisions of purchase agreements.