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Structuring Financial Covenants, EBITDA, Events of Default and MAC Clauses in Loan Documents

Maximizing Borrower Protection and Lender Remedies

TUESDAY, AUGUST 27, 2019

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

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FINANCIAL COVENANTS, EBITDA AND EVENTS OF DEFAULT IN COMMERCIAL LENDING

Structuring Effective Credit Agreement Provisions to Maximize Borrower Protection and Lender Remedies

Daniel J. Bursky
J. Christian Nahr
Ezra Schneck
August 27, 2019

Outline

- Key Conceptual Questions
- Why have Financial Covenants?
- What are Financial Covenants?
- Types of loans
- Key financial definitions and negotiated terms
- A View from the Trenches: Questions from Clients
- Securities laws consideration
- Equity cure rights

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Key Conceptual Questions

- Two key conceptual questions help guide the analysis and negotiation of financial covenants and financial covenant definitions. We will be returning to these questions throughout the presentation

Why am I testing this financial covenant?

What am I testing for?

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Why have Financial Covenants?

- Means of measuring **financial health** of a borrower
- Can serve as an **early warning trigger** that a company is distressed, may not be able to make future payments of principal and interest or may file for bankruptcy
- Gives lenders a **seat at the table** to participate in discussions prior to restructuring. May lead to **amendment fees** or **increased margin**
- Borrowers want **flexibility to run business** and work through a default without having to worry about liquidity issues resulting from increased interest expense or other lender requirements
- Without financial covenants, a Borrower that is financially unstable may still not default if it abides by covenants (doesn’t incur more debt, liens, make distributions, etc.)

What are Financial Covenants?

- Quantitative measurement of a particular financial metric

- Examples:
  - Maximum leverage ratio
  - Minimum fixed charge coverage ratio
  - Minimum net worth
  - Minimum liquidity
  - Minimum cash flow

Why am I testing this financial covenant?

What am I testing for?

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What are Financial Covenants?

What to test?

- Cash flow, earnings of company → leverage ratio
- Asset base, collateral protection → net worth or other balance sheet test
- Ability to pay interest / principal / taxes, etc. over next fiscal year → fixed charge coverage ratio
- Liquidity → excess availability test

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What are Financial Covenants?

Why am I testing this financial covenant?

What am I testing for?

What to test?

Leverage Ratio $= \dfrac{\text{[Net] Debt}}{\text{EBITDA}}$

Net Worth = Assets - Liability

FCCR $= \dfrac{\text{EBITDA}}{\text{Fixed Charges}}$

Liquidity = Cash + available revolver capacity

What are Financial Covenants?

- How to the various covenants change under the following circumstances? Test various scenarios, especially if any are a part of borrower's business plan
  - Change in interest rate environment?
  - Disposition or acquisition of a business line?
  - Change in tax rates?
  - Additional investment in foreign assets / decreased investment in foreign assets?
  - Drop in earnings?

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What are Financial Covenants?

- Incurrence covenants vs. maintenance covenants
  - Incurrence covenants govern whether a Borrower is permitted to take a certain type of **permissive action**, such as incur debt or pay a dividend. If the Borrower cannot meet the financial test, they can still comply with the credit agreement by refraining from taking action

  - Maintenance covenants are **mandatory "check-ins"** where the Borrower must demonstrate compliance with the covenant on a regular basis, regardless of whether it is taking any other action

    - Generally tested **quarterly**, but sometimes **monthly** or more frequently (particularly in a workout situation)

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What are Financial Covenants?

- Failure to abide by financial covenants can result in:
  - Event of default
  - Allows lenders to accelerate loans
  - Allows lenders to refuse to fund revolver
  - May trigger cross-default under other material agreements

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Types of loans

- The nature of financial covenants in a particular deal vary widely depending on the type of financing

Investment Grade
- No Maintenance covenants, or set at wide level
- No or limited incurrence covenants
- Limited addbacks

Asset Based Loans
- Fixed Charge Coverage Ratio (typically 1.00:1.00) maintenance test
- Excess Availability governor for incurrence tests

Cash Flow Loans
- Maintenance financial covenant
- Balanced add backs

Cov-lite Sponsor-backed
- Aggressive definitions
- Broad flexibility for borrower
- No maintenance financial covenant (term)
- Springing covenant for revolver

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Types of loans – cov-lite

No maintenance covenant for term loan. Term loan limited to incurrence-based covenants.

"Springing" revolver covenant (i.e., only triggered if revolver is more than 35% drawn; inclusion of LCs is negotiated).

Cov-lite – a $300+ billion market

Covenant cushion set at 30-35% cushion to Borrower model.

Most common in syndicated transactions and customary for Sponsor deals.

Types of loans – cov-lite

How do cov-lite loans fare compared to traditional loans?

- Research published by Moody's in 2011 indicated that cov-lite loans did not have significantly higher rates of default or significantly lower recoveries than traditional loans for similarly situated borrowers in the downturn.
- But pre-downturn, a much smaller number of deals were cov-lite. So there may have been a selection bias where better credits, or better management, were able to syndicate a cov-lite deal.
- In a recent paper, Moody's expressed the view that the proliferation of cov-lite loans will lead to significantly higher rates of default or significantly lower recoveries in a down cycle.
- Only time will tell!

Why am I testing this financial covenant?

Types of loans – bonds and leveraged loans

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Convergence of bond and leveraged loan markets

- Traditionally, term loans were owned by banks and high yield bonds were owned by a much broader set of investors
- In the last ~20 years, the markets for high yield bonds and leveraged loans have converged. This is driven by a number of factors
  - First, traditionally term loans were held by banks. But with the proliferation of institutional investors, including CLOs, the syndicated term loan B market has grown by leaps and bounds
  - Concurrently, the high yield market continues to be dominated by institutional investors that are QIBS, with less and less demand from retail clients (144A-for-life deals)
    - Thus, many of the same institutional investors, or institutional investors with similar profiles, buy both high yield bonds and leveraged loans. H.Y. bonds and leveraged loans are of course different products, but there is substantial overlap on the buyside.
  - In addition, financial sponsors continue to seek to synchronize their loan and bond agreements

Types of loans – bonds and leveraged loans

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Convergence of bond and leveraged loan markets

- The convergence of the high yield bond and leveraged loan market explains many of the changes that have been borne out in the market place, including:
  - High yield bonds do not have a financial maintenance covenant→ growth of cov-lite term loans
  - High yield bonds allow for Ratio Debt on the basis of 2x Fixed Charge Coverage Ratio test → use a 2x Fixed Charge Coverage Ratio test, and not a closing date Total Net Leverage Ratio test to govern leveraged loans
  - High yield bonds allow for Restricted Payments based on 50% Consolidated Net Income builder → allow for an "Available Amount" or "Cumulative Credit" in leveraged loans

Why am I testing this financial covenant?

What am I testing for?

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Key financial definitions and negotiated terms

It's all 'bout that GAAP, 'bout that GAAP, no treble

- CNI, EBITDA, Fixed Charges, Excess Cash Flow and other terms all start with GAAP

- Common mistake is to jump to definitions and pages in a credit agreement or indenture. The first layer of analysis is understanding GAAP treatment

- Frozen GAAP v. Floating GAAP. Beware of changes in GAAP over time (i.e., lease accounting standards)

Key financial definitions and negotiated terms

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Consolidated Net Income

- Starts with **GAAP** - net income (or loss) of the Borrower and its Restricted Subsidiaries, determined on a consolidated basis in accordance with GAAP.
  - Tie in to financials – test covenants at Borrower level or Holding company level?

- Make a number of adjustments to GAAP
  - Unusual or non-recurring gains or losses net of taxes,
    - Historically, this CNI exclusion also included "extraordinary" items. Extraordinary was a GAAP term, which provided clarity to issuers as to whether a particular item could be excluded, but it was also very narrow. In contrast, "non-recurring" and "unusual" are not GAAP terms and can be interpreted more broadly, but there are situations where "non-recurring" exclusions seem to occur year after year, which could lead to some interpretive questions. Recently the GAAP rules were changed to eliminate "extraordinary" and some deals delete extraordinary or replace it with a another term such as "infrequent".

  - The portion of net income allocable to minority interests to the extent cash dividends are not actually received by the Company from such minority interest

Key financial definitions and negotiated terms

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Consolidated Net Income

- CNI adjustments to GAAP (con't)
  - Exclude the results of subsidiaries that have been designated as "unrestricted subsidiaries"
  - Gains or losses in respect of asset dispositions not in the ordinary course,
  - Gains or losses from discontinued operations,
  - Effects of adjustments due to purchase accounting,
  - Effects of foreign currency translation and transaction expenses,

Why am I testing this financial covenant?

What am I testing for?

Key financial definitions and negotiated terms

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Consolidated Net Income

- CNI adjustments to GAAP (con't)
  - Net income of a Restricted Subsidiary to the extent that the declaration of dividends by such subsidiary is not permitted due to its charter or any agreement or law,
    - This may preclude the inclusion of income at certain foreign subsidiaries which are often subject to statutory dividend blockages.
    - Foreign subsidiary credit agreements may also contain dividend restrictions. A compromise position is to exclude the foreign subsidiary net income from consolidated net income for purposes of calculating the Restricted Payment basket, but include it for calculating EBITDA pursuant to the Fixed Charge Coverage Ratio.
  - Non-cash compensation expense,
  - Non-cash interest expense to the extent no cash payment is due prior to maturity of instrument,
  - Writedown of assets from non-cash impairment charges (e.g., goodwill impairment),

Key financial definitions and negotiated terms

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Consolidated Net Income

- CNI adjustments to GAAP (con't)
  - Net gains resulting from the acquisition of securities,
  - Any gain or loss resulting from termination of an employee pension benefit plan,
  - The cumulative effect of a change in accounting principles, and
  - Fees and expenses relating to certain transactions (acquisitions, investments, dispositions, repayment of debt, etc.).

Key financial definitions and negotiated terms

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EBITDA

- EBITDA starts with Consolidated Net Income and, without duplication of CNI exclusions, adds back:
  - Interest
  - Taxes
  - Depreciation
  - Amortization

Why am I testing this financial covenant?

What am I testing for?

- EBITDA**R** = EBITDA, adjusted for rent expense

- Goal: EBITDA is a measure of core operating performance. Accordingly, effects of capital structure (i.e., size of interest payments), tax attributes and one-time items are excluded.

- EBITDA is NOT a measure of free cash flow

Key financial definitions and negotiated terms

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EBITDA

- In addition, EBITDA is often further adjusted for:
  - The full “run rate” amount of cost savings, operating expense reductions and cost synergies (not revenue synergies) for the LTM period, in each case resulting from actions with respect to which **substantial steps** have been **taken** or **reasonably expected** to be taken with [36] months.
    - Some facilities may reduce the 24 months to 18 months.
    - Cost savings add-back may be subject to a percentage of EBITDA (20-25%).
      - Sometimes these are “flex” items in committed deals.
    - Not required to actually achieve such savings.
    - Revenue synergies typically not included.
    - Only substantial steps need to be taken, process does not need to be completed.

Why am I testing this financial covenant?

What am I testing for?

Key financial definitions and negotiated terms

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EBITDA

- EBITDA adjustments (con't)
  - Write-offs, write-downs or other non-cash charges,
  - Restructuring charges,
  - Business optimization expenses,
  - Minority interest expense, and
  - Management, monitoring, consulting and advisory fees and related expenses to the Sponsor and the amount of any directors' fees or reimbursements.

Key financial definitions and negotiated terms

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Consolidated Fixed Charges

- Fixed charges can include:
    - Consolidated Interest Expense
    - Scheduled principal payments (ABL)
    - Cash taxes (ABL)
    - Payment of management fee to Sponsor (ABL)
    - Certain dividends and distributions (particularly if mandatory dividends) (ABL)
    - Payments on Capitalized Lease Obligations (ABL)
- In an ABL Fixed Charge Coverage Ratio test, EBITDA is reduced by unfinanced Cap Ex
- Borrowers/lenders may negotiate for including an adjustment as a deduct to EBITDA vs. fixed charge

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Key financial definitions and negotiated terms

Excess Cash Flow

- A percentage of Borrower's excess cash flow must be applied to pay down Term B Loans. Not applicable in bonds or most Term A Loans.

- Typically 50% of ECF must be swept, with step-downs to 25% and 0% at 0.5x and 1.0x below closing date levels

- EBITDA and CNI are both (adjusted) income statement numbers. ECF is an (adjusted) cash flow number
  - Cash from (used in) operating activities
  - Cash from (used in) investing activities
  - Cash from (used in) financing activities

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Key financial definitions and negotiated terms

Excess Cash Flow

- Borrowers want to structure the ECF definition to make sure that every non-cash addback to EBITDA / exclusion from CNI is deducted from ECF

- Borrowers want to deduct as many cash uses as possible. If the so-called "available amount" or "builder basket" is based on retained ECF, a more balanced approach may be called for. Lenders will reply that use of cash may be OK but should come from Borrower's share of retained ECF and not reduce Lender's ECF payment (i.e. certain restricted payments)

- Calculation of ECF on partial year can get tricky

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Key financial definitions and negotiated terms

Excess Cash Flow

- Some key deductions (subject to certain exceptions, i.e., other than if financed with long-term debt)
    - Working cap adjustments (increases ECF if working cap is positive)
    - Cap ex
    - Repayments of long-term debt
    - Permitted Acquisitions and investments
    - Certain restricted payments
    - Contractually committed amounts required to be applied within X days after year end to cap ex or permitted acquisitions
- $-for-$ reduction for voluntary repayments of first lien term loans (in some recent deals, other items also included in $-for-$ deduct)

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Key financial definitions and negotiated terms

Pro Forma Basis

- Financial definitions generally calculated on Pro Forma Basis to give full effect to:
  - Dispositions
  - Acquisitions
  - Incurrence of Indebtedness
  - Extinguishment of Indebtedness
  - Designation of subsidiary as restricted / unrestricted

A View from the Trenches – Real-Life Questions!

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- Company forgot to take an addback in a prior quarter. Are they stuck?
- Company found a new synergy! Can that be included in EBIDTA?
- Company is suing a seller for breach of reps and warranties in an acquisition agreement. Company took a $50M loss related to acquisition.
- Company realized that they have not properly accounted for overhead in calculating COGS (cost of goods sold) and is taking a 1-time retrospective charge.
- Company wants to change its revenue recognition policies, but this will cause a disconnect in how revenues were earned in Q1 and Q2 vs. Q3 and Q4.
- Company is building out a new plant. Can they include the anticipated revenue costs of building out the plant?
- Can start-up costs be added back to EBITDA?

Securities laws consideration

Use of Non-GAAP Financial Measures

- **Regulation G** and **Item 10 of Regulation S-K** regulate disclosure of non-GAAP financial measures. This includes disclosure of CNI, EBITDA, etc.

- The SEC is very focused on this and has recently released additional guidance. Public companies should make sure securities counsel is looped into presentations that are distributed to lenders that report these numbers.

- Generally speaking, Regulation G and Item 10 of Regulation S-K require:

  - Present the **most directly comparable GAAP** financial measure.

  - GAAP measure should be given prominence.

  - Provide a **reconciliation** from the most directly comparable GAAP metric to the non-GAAP metric

Securities laws consideration

SEC Pro Forma Rules

- **Regulation S-X** contains pro forma rules.
- These pro forma rules are not necessarily identical to the pro forma rules that govern a credit agreement or indenture, although some credit agreements and indentures only allow pro forma adjustments that are compliant with Reg S-X.
- Generally speaking, Reg S-X (Pro forma adjustments) includes adjustments which give effect to events that are:
    - Directly attributable to the transaction
    - Expected to have a continuing impact on the registrant, and
    - Factually supportable

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Equity cure rights

- Borrower defaulted….now what?
- Equity cure rights allow equity owners of Borrower to inject equity capital into the Borrower. The equity is considered additive to EBITDA and "cures" the financial covenant default.
  - In some middle market deals, EBITDA reduces indebtedness. This loses the multiplier effect.
- Equity cure rights often may be exercised for a period of time AFTER quarter end and AFTER financials required to be reported
- Rationale: if equity investor is willing to put in more $$, then there is still equity value left and lenders will be made whole.
- Limited to 4/5 times over the life of loan / no more than 2 cures in any 4 quarter period
- EBITDA gross-up limited to amount needed to cure default
- EBITDA gross-up only applies to maintenance tests and not to incurrence tests
- No revolver draws during period prior to funding the equity cure

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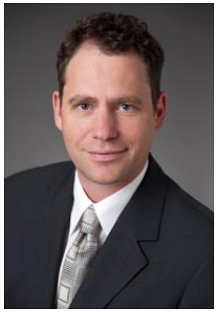
Today’s presenters



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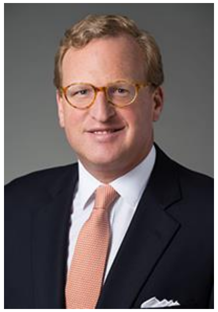

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