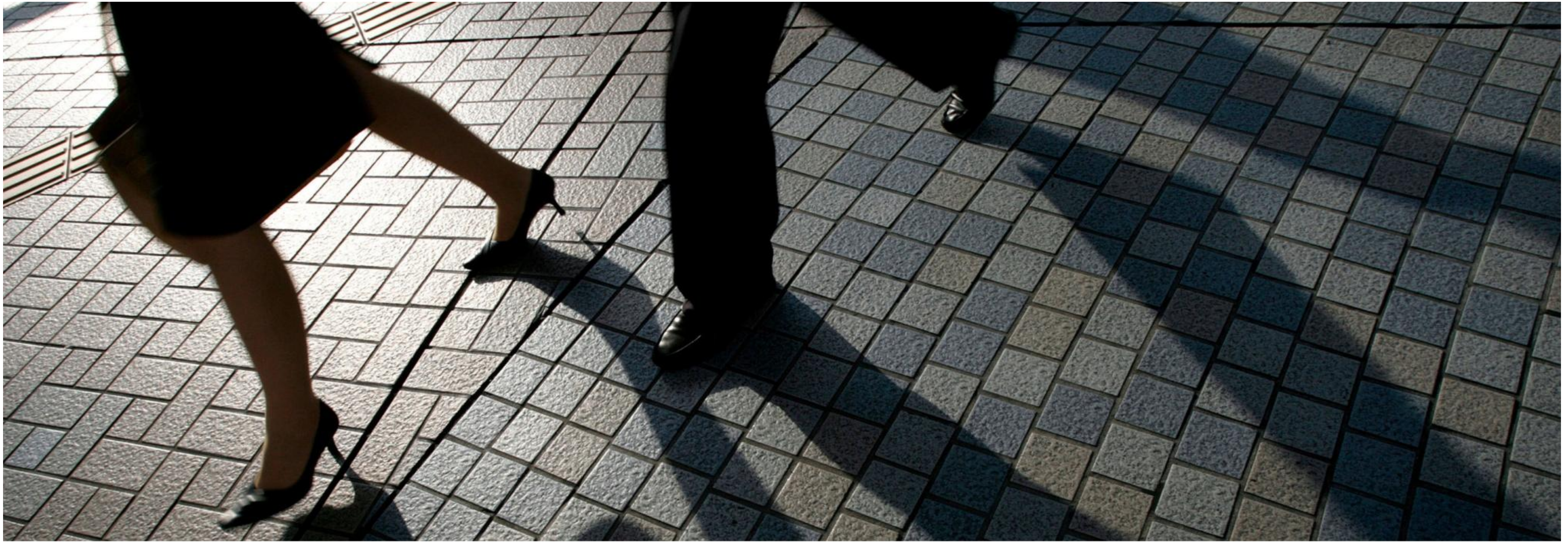

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Understanding and Negotiating Financial Covenants

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Agenda

- What are financial covenants?
- Types of financial covenants
- When are financial covenants tested?
- Consequences of breaches of financial covenants
- Limiting the impact of maintenance covenants
  - Equity cure rights
  - Covenant-lite loans
  - Springing financial covenants
- Leveraged finance transactions covenants
- Project finance financial ratios

What are Financial Covenants?

Financial covenants are financial metrics designed to allow lenders to:

- Monitor changes in the borrower's financial performance on a regular basis
- Limit the borrower's ability to take certain actions
- Provide an early warning of potential financial difficulty for the borrower
- Provide a means of imposing financial discipline on the borrower

Types of Financial Covenants

Two main types of financial covenants:

- Maintenance covenants
  - Serve as an early warning sign of a deterioration in the borrower's financial health
  - Encourage the parties to consider a restructuring before the borrower defaults on a payment
  - Allow lenders to call a default before the borrower files for bankruptcy
- Incurrence covenants
  - Prohibit a borrower from taking certain actions unless the borrower, after giving effect to the relevant action, remains in compliance with the financial covenants specified in the credit agreement
  - Event driven and not an issue unless a borrower wants to take a specific action
  - If the proposed action would cause a breach of a financial covenant, the lenders may extract concessions (e.g., fees or additional covenants/restrictions) in a consent or amendment

Types of Financial Covenants (cont.)

- Incurrence versus maintenance covenants
  - Incurrence covenants are typically found in high-yield indentures or can be embedded in the negative covenants in a credit agreement (e.g. permitting the borrower to incur additional debt)
    - Increasingly being used in credit agreements for certain types of borrowers
  - Maintenance covenants must be maintained at all times or at regular intervals (e.g., end of each fiscal quarter)
    - Typically based on financial models furnished to the lenders before the commitment papers are signed

Types of Financial Covenants (cont.)

Financial covenants may be further divided into balance sheet and cash flow covenants

- Balance sheet covenants: calculated using inputs from the borrower's balance sheet. Examples include:
  - Net worth covenant
  - Total debt to total capital ratio
- Cash flow covenants: calculated using inputs from the borrower's income statement. The most commonly used cash flow covenants are:
  - Leverage Ratio
    - This ratio is based on both the balance sheet and income statement
  - Interest Coverage Ratio
  - Fixed Charge Coverage Ratio
- Balance sheet vs. cash flow covenants
  - Balance sheet covenants are more typically used for investment grade borrowers
  - Cash flow covenants are more commonly used for non-investment grade borrowers and in deals where the borrower's cash flow is paramount for debt service

When are Financial Covenants Tested?

- Maintenance covenants are tested either at all times or at regular intervals (e.g., at the end of each fiscal quarter)
  - Market trend is to test on a quarterly basis
- Incurrence covenants
  - Tested at the time the borrower consummates a transaction
- Balance sheet covenants
  - Typically tested at the end of each fiscal quarter (i.e., when the balance sheet is prepared)
  - Can be tested at any time based on the borrower's most recent balance sheet
- Cash flow covenants
  - Typically tested at the end of each fiscal quarter (i.e., when the income statement is prepared)

Consequences of a Breach of Maintenance Covenants

- Automatic event of default (i.e., no grace period)
- Timing of breach
  - End of fiscal quarter versus delivery of financial statements
- Consequences for the borrower
  - Loss of liquidity (i.e., loss of access to the revolving credit facility)
  - Requirement to pay a default interest rate on loans
    - Market trend: Limits the payment of default interest rate to payment defaults
  - Potential to trigger a cross default under other indebtedness
  - Lenders have the right to accelerate the loans and demand repayment
  - Impact on letters of credit
    - Borrower may be required to cash collateralize existing L/Cs
    - Borrower cannot obtain new L/Cs or extensions of existing L/Cs
- Averting a breach
  - Equity cures
  - Including fewer covenants
  - Limiting when covenants apply
  - Waivers or amendments

Limiting the Impact of Maintenance Covenants: Equity Cures

- More prevalent in financial sponsor transactions
- Right of the borrower to use the cash proceeds from certain permitted equity issuances and/or equity contributions to cure a financial covenant default
  - Typically in the form of common equity, but can be qualified preferred equity
  - Amount of cash proceeds is applied to increase EBITDA
- Cure Period
  - From the end of the fiscal quarter until 10 to 15 business days following the date that financial statements are required to be delivered
- Standard Conditions
  - Limitations on number of cures for life of loan (typically 5)
  - Limitations on number of cures in any four fiscal quarter period (typically 2)
  - Limited to the dollar amount needed to cure the default
  - Contribution cannot also directly or indirectly reduce debt for purposes of calculating the financial covenant (avoid double counting)
  - EBITDA is only increased for purposes of calculating the financial maintenance covenant

Limiting the Impact of Maintenance Covenants: Equity Cures (Cont.)

- **Market trends**
  - Standstill provision: lenders cannot exercise remedies as a result of the financial covenant default until cure period expires (if lenders are notified of the intent to cure)
  - Borrower may not incur loans or request L/Cs until cure amount is received

Limiting the Impact of Maintenance Covenants: Covenant-Lite Loans

- Absence of maintenance covenants requiring the borrower to meet certain performance criteria
  - Incurrence-based covenant package similar to high-yield bonds
  - Prevalent in financial sponsor transactions in leveraged finance transactions
    - Covenant-lite loans are increasingly being used in certain project finance transactions
- Typically available when credit market conditions are borrower-favorable:
  - Low interest rate environment
  - Oversupply of capital by loan investors
- Reduces the borrower's risk of default
- In strong markets, there is little or no additional cost to the borrower for a covenant-lite loan

Limiting the Impact of Maintenance Covenants: Springing Financial Covenants

- Typical in covenant-lite transactions
- Applicable only to revolving credit facilities
- Borrower does not have to comply with maintenance covenants at any time that revolving credit outstandings are below a predetermined threshold
  - Impact of L/Cs on the threshold is a heavily negotiated topic
    - Exclude entirely versus exclude a negotiated amount
    - Exclude cash collateralized letters of credit

Primary Financial Covenants

The financial covenants included in a credit agreement vary depending on the nature of the transaction:

- Leveraged finance transactions
- Project finance transactions
- Real estate transactions

This presentation does not cover real estate transactions

Leveraged Finance Transactions: Consolidated Net Income

Consolidated net income (or loss) of the borrower is subject to certain common exclusions (avoid double counting with the definition of Consolidated EBITDA) with a goal to achieve a number that can be used to determine the borrower's ordinary course operating cash flow that will be available to service debt:

- Extraordinary items
- Gains or losses attributable to asset dispositions outside of the ordinary course
- Net income (or loss) of any person that is not a subsidiary or that is accounted for under the equity method of accounting
  - Exception with respect to dividends or distributions actually paid in cash to the borrower or a subsidiary
- Net income (or loss) of any person accrued prior to the date such person becomes a subsidiary or is merged with the borrower or a subsidiary
  - Other than in the case of pro forma calculations
- Net income of a subsidiary (other than a guarantor) to the extent that the declaration or payment of a dividend or distribution of such net income is not at the time permitted by operation of its charter or any other agreement or instrument

Leveraged Finance Transactions: Consolidated EBITDA

Consolidated EBITDA is the proxy for cash flow generated by the borrower in the ordinary course of business that can be used to service debt

- Simplistic definition: Consolidated Net Income of the borrower *plus* total interest expense *plus* taxes *plus* depreciation expense *plus* amortization expense
- This definition is heavily negotiated as it is used, among other things, to calculate many of the financial covenants
- Specific adjustments are made as EBITDA is expected to reflect the cash flow generated from ordinary course operations of the borrower

Leveraged Finance Transactions: Most Commonly Used Financial Covenants

- **Maximum Leverage Ratio**: the borrower may not exceed a specified ratio of Total Debt to Consolidated EBITDA
    - Leverage tests can be structured to apply to total debt, first lien debt or secured debt
    - Consolidated indebtedness is often measured net of "unrestricted" cash on hand
        - Some transactions cap the amount of cash that can be netted against the amount of indebtedness
    - The definition of "indebtedness" used for purposes of calculating the leverage ratio is often narrower than the definition that is applicable to the negative covenant that limits debt incurrence. For financial covenant purposes, indebtedness will often be limited to:
        - The principal amount of indebtedness for borrowed money
        - The principal component of capitalized lease obligations
        - The face amount of outstanding L/Cs
            - Often limited to the face amount of unreimbursed L/Cs
        - Guarantees of obligations that otherwise qualify as indebtedness (without duplication of items already included as indebtedness)
- **Minimum Interest Coverage Ratio**: the borrower must maintain at least a specified ratio of Consolidated EBITDA to Interest Expense
    - Interest coverage tests can apply to total interest expense or be limited to cash interest expense
    - Interest expense is sometimes calculated net of interest income
        - Lenders want to avoid "double counting" interest income as it is also included in the calculation of Consolidated EBITDA

Leveraged Finance Transactions: Most Commonly Used Financial Covenants (Cont.)

- Two heavily negotiated points:
  - Reduction of interest expense by an amount equal to the borrower's interest income
  - Exclusion of non-cash interest expense

- **Minimum Consolidated Fixed Charge Coverage Ratio:** the borrower is required to maintain at least a specified ratio of Consolidated EBITDA to an agreed definition of fixed charges
  - In some deals, certain fixed charges (such as capital expenditures) may be subtracted from Consolidated EBITDA in the numerator rather than included in the fixed charges in the denominator
  - Most commonly found in asset-based revolving credit facilities
  - Fixed charges typically include:
    - Scheduled principal installments of debt
    - Unfinanced capital expenditures
    - Interest expense paid in cash
    - Dividends paid in cash
    - Taxes paid in cash

Leveraged Finance Transactions: Common Adjustments to EBITDA

- Minority Interest Expense: represents the share of net income attributable to the owners of minority (or non-controlling) interests in less than wholly-owned but consolidated subsidiaries of the borrower
  - Rationale: 100% of the indebtedness of these entities would be reflected on the balance sheet of the borrower and included in the numerator in the calculation of the leverage ratio. The income attributable to minority owners would be available to service this debt
- Gain (or loss) from discontinued operations (or operations or assets disposed of outside of the ordinary course of business)
- Extraordinary, non-recurring or unusual items
  - Adjustments for non-recurring items is often a sensitive issue as “non-recurring” is not a GAAP concept and offers the borrower a lot of room for manipulation
  - As a result, the amount of non-recurring expenses that can be added back in the calculation of EBITDA will often be subject to a negotiated cap
- Non-cash gains or losses (examples include non-cash, stock-based compensation, unrealized foreign currency gains or losses, purchase accounting adjustments and gains or losses resulting from the write-up or write-down of assets)
  - Treatment of accruals for future cash payments
  - Exclude amortization of prepaid expenses

Leveraged Finance Transactions: Common Adjustments to EBITDA (Cont.)

- Acquisitions and Divestures
- Cost Savings

Common Adjustments to EBITDA (Cont.): Pro Forma Treatment of Acquisition and Divestitures

- Most financial covenants are calculated to give pro forma treatment to certain specified transactions
  - Generally limited to acquisitions and divestitures of a business unit or subsidiary
- Most important when calculating the maximum leverage ratio
  - Acquisition-related debt will immediately appear on the balance sheet but the target's historical operating results will not appear on the income statement, thus creating the appearance of a higher leverage ratio
  - The historical results of a significant divesture remain in the historical financial results thereby resulting in the appearance of a lower leverage ratio
- Not necessary to make pro forma adjustments for minimum interest coverage or fixed charge coverage, but many CFOs prefer consistency in calculations

Common Adjustments to EBITDA (Cont.): Pro Forma Cost Savings Adjustment

- Adjustment reflects expected cost savings that result from specific actions or events (e.g., acquisition, divestitures and operational initiatives) designed to reduce the borrower's expenses on an ongoing basis
  - Plant closure
  - Headcount reduction
  - Operating improvement
- Subject of heavy negotiation as these adjustments are completely under the control of the borrower and can be subjective
  - Timing of the action
    - Taken during the relevant test period versus "expected" or "committed to be taken"
    - Action must be taken within a specified period of time following the trigger event (e.g., 12 or 18 months)
  - "Actually realized" versus "projected to be realized"
    - Projected results should be "net of actual benefits realized" to avoid double counting
  - Factually supportable and reasonably identifiable
    - Brings in an S-X standard that the adjustment must be quantifiable
  - Subject to an overall cap (e.g., 15% of EBITDA (before giving effect to cost saving adjustments))
    - Cap sometimes combined with other adjustments (e.g., restructuring charges)

Project Finance Transactions: Most Commonly Used Financial Ratios

Financial ratios in project finance transactions:

- Test the debt capacity of the project
- Test the project's ability to generate revenue in amounts that are sufficient to meet its operating costs and repay the debt on a current basis (now and in the future)

Types of financial ratio tests commonly used in limited recourse project finance:

- Debt to Equity Ratio
- Debt Service Coverage Ratio
  - Historical DSCR – backward looking debt service coverage ratio
  - Projected DSCR – forward looking debt service coverage ratio
- Loan Life Coverage Ratio

These ratios are all based on the cash flow from one project or a portfolio of projects.

Uses of financial ratios:

- Conditions Precedent
- Distribution Conditions
- Financial Covenants / Events of Default

Project Finance Transactions: Debt to Equity Ratio (DTE)

Purpose of the DTE

- Snap shot test to assess the dependence of project on debt
- Lenders expect the project's sponsors to provide a "cushion" if the project experiences difficulties
  - Equity takes the first "slice" of loss in a foreclosure scenario
- Sponsors' equity contributions must be of a level that provides sufficient comfort to the lenders
- It measures the amount of equity required to be committed by the sponsors to a project.
  - Low risk projects may have a DTE ≥ 90:10
  - High risk projects may have a DTE ≥ 50:50 (unusual to see ratios lower than 50:50)
  - Typical DTE is 70:30

When is the DTE Tested?

- Typically not an ongoing ratio requirement
- Comes into play at specific milestones (for example, at each drawdown or at key stages of project development such as completion of construction phase)
  - As a condition precedent to each drawdown
    - "The Borrower shall have certified in the relevant drawdown request that the Debt to Equity Ratio following such disbursement will not exceed 70:30"
  - As a condition to Project Completion or Term Conversion
    - "On the Term Conversion Date … the Debt to Equity Ratio shall not exceed 70:30"

Project Finance Transactions: Debt Service Coverage Ratio (DSCR)

Purpose of the DSCR

- Tests the ability of the project company's cash flows to adequately cover its debt service obligations over a particular period
- It is the ratio of net operating cash flow in any relevant period to principal and interest payments falling due in that period
- The greater the multiple of net revenues to debt service, the greater the "cover" for the lenders (e.g.,1.5:1 is better than 1:1)

Over What Period is the DSCR Tested?

- Can be calculated based on actual financial performance or on a projected basis
- Typically tested over a 12 (or 6) month "Calculation Period"
  - "Historical DSCR" (i.e., backward-looking DSCR)
    - Typically calculated for immediately preceding Calculation Period only (i.e., the actual ability of the borrower to cover debt in the preceding 12 months ending on a particular Calculation Date)
  - "Projected DSCR" (i.e., forward-looking DSCR)
    - can be for the next Calculation Period (i.e., the projected ability of the borrower to cover debt in next 12 months from a Calculation Date); or
    - for each Calculation Period to final maturity of the loans (i.e., the projected ability of the borrower to cover debt during each of the 12 months to final maturity)

Project Finance Transactions: Debt Service Coverage Ratio (Cont.)

When is the DSCR Tested?

- As a condition precedent to financial close/ first drawdown
  - The base case model needs to demonstrate a minimum (and sometimes average) projected DSCR level for each Calculation Period to final maturity
  - Lenders want comfort that, at least on day one, the project economics stack up through to the scheduled final date for repayment of loans (financial due diligence)
- As a condition to distributions to sponsors
  - The latest calculation or forecast demonstrates that backward looking DSCR and forward looking DSCR are both above minimum thresholds
  - Intended to give the lenders comfort that the project company (i) had sufficient “cover”/ earned sufficient excess cash flow over the last Calculation Period and (ii) will have sufficient “cover” during the forthcoming Calculation Period
- As a condition to Project Completion / Term Conversion
  - Forward looking DSCR is at least equal to the forward looking DSCR for each testing date through to final maturity as was set out in the base case model delivered at financial close
  - Lenders get comfort that the project as built meets the ratio levels as set out in the original base case model

Project Finance Transactions: Debt Service Coverage Ratio (Cont.)

- As a condition to incurring additional debt
  - Forward looking DSCR (following incurrence of the new debt) is at least equal to the forward looking DSCR for each Calculation Period through to final maturity demonstrated in the base case model delivered at financial close
  - Lenders want comfort that their debt service cover levels will not be negatively impacted as a result of the incurrence of the new debt
- Financial Covenant / Event of Default
  - Sometimes an Event of Default if backward looking DSCR or forward looking DSCR is below a minimum threshold
  - Typically resisted by sponsors; will at least require an equity cure right

Project Finance Transactions: Loan Life Coverage Ratio (LLCR)

Purpose

- Measure of the value of the loan compared to the value of the project for the period from testing date to final maturity
- Loan is valued by reference to outstanding debt on a particular testing date. Project is valued by reference to the net present value (NPV) of the income the project company may earn from the project
- By its nature, LLCR tests ability of the project to service debt all the way out to final maturity, smoothing out any short term dips or spikes
- Gives comfort to the lenders that an enforcement sale of the project today will cover the outstanding debt
- LLCR is the ratio of discounted net operating cash flow over the term of the loan to principal amount of the loan outstanding on calculation date

How and Where Used in Credit Agreements

- Condition precedent to drawdowns:
  - LLCR required to be above a minimum threshold
- Completion testing:
  - LLCR at least equal to the LLCR in the base case model delivered at financial close
  - Assumptions: “net revenues” amended to take into account the actual technical parameters demonstrated during the completion test
- Incurrence of replacement debt
  - LLCR at least equal to the LLCR in the base case delivered at financial close
  - Assumptions: “debt outstanding” amended to take into account the proposed replacement debt

Project Finance Transactions: Summary of Uses of Financial Ratios

	DTE / LLCR	Projected DSCR	Historical DSCR
Condition Precedent	Often	Very Often	N/A
Distribution Condition	Sometimes	Sometimes	Very Often
Financial Covenant	Sometimes	Sometimes	Sometimes

Questions

Relevant Practical Law Resources Available with a *Free Trial* to Practical Law

- Practice Note, Loan Agreement: Financial Covenants
- Standard Clause, Loan Agreement: Financial Covenants
- Practice Note, Boosting EBITDA: The Cost-Savings Add-Back
- Practice Note, Covenant-lite Loans: Overview
- Practice Note, Project Finance: Sources of Available Financing

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Eric Klar is a partner in White & Case LLP's Bank Finance Practice. He primarily focuses on advising major financial institutions in a variety of lending transactions. As partner for financial institutions, he is involved in all aspects of deal structure and in the negotiation and documentation of such lending transactions.

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