KEY POINTS

- As EBITDA does not have a standard accounting meaning, it has to be defined for the purposes of a particular transaction and accordingly leaves itself open to heavy negotiation.
- In the current market, add-backs and adjustments to EBITDA are on the rise.
- Not all maintenance covenants are created equally, and an understanding of each of their components is central to determining their true value.

Spotlight

Authors Francis Booth and Susan Whitehead

The evolving fiction of EBITDA in the European leveraged finance loans market

EBITDA first rose to prominence in the US leveraged buy-out craze of the 1980s and has since formed the key metric of leveraged finance transactions across the world. In this Spotlight article, we focus on its evolution in the European loans market and explore how financial covenant and certain other protections in loan documentation have been eroded in recent years as a result of those changes.

THE HISTORIC ROLE OF FINANCIAL COVENANTS

The Loan Market Association's (LMA) standard form facilities agreement for leveraged acquisition finance transactions contains a suite of financial covenants, encompassing:

- a cashflow cover test (being the ratio of cashflow to debt service);
- an interest cover test (being the ratio of EBITDA to finance charges (interest and fees) calculated either on a gross or net basis); and
- a leverage test (being the ratio of EBITDA to total debt calculated either on a gross or net basis).

EBITDA (see the Box opposite) is a key component of all of these tests, with the "cashflow" definition deriving from it. This is despite the fact that EBITDA is not a recognised metric under either GAAP or IFRS accounting standards.

The financial covenants outlined above (known as "maintenance tests", as they oblige the borrower to maintain a certain standard of financial performance over the life of the loan) are designed to enable the lenders to monitor the borrower's financial performance against its agreed financial projections (known as the base case model) on which the transaction has been designed. Put simply, the amount of debt and servicing costs of that debt are prefaced on the business being able to perform as projected.

Maintenance tests examine the financial performance of the business quarterly on a rolling, retrospective 12-month basis. Any significant dip in financial performance as against the financial projections would cause a breach of one or more of the financial covenants. The resulting event of default would give the lender a seat at the table to explore with the borrower and its financial advisers exactly what has gone wrong and how best that could be rectified. As such, the financial covenant tests are intended to be an early warning system for the lenders.

The theory is straightforward, and practice has also shown maintenance covenants to regularly perform the role for which they were intended. Restructuring lawyers will confirm that, historically, virtually all distressed deals defaulted first as a result of a breach of their financial covenants, and this breach has given lenders the opportunity to act early. On the other side of the table, private equity sponsors understandably look to avoid having a portfolio business breaching its covenants and allowing the lenders potentially to accelerate the loan and enforce their security on the back of that default. A key area of focus of negotiations on loan documentation has therefore always been the terms of these financial covenants, and the definition of EBITDA which underpins them.

SPONSOR NEGOTIATION OF FINANCIAL COVENANT TERMS

The last few years have seen European leveraged loan documentation terms on sponsor-backed leveraged finance transactions incorporate increasing levels of flexibility for borrowers and corresponding reduced levels of control for lenders. The reasons for this are well-documented, chief among them being the sizeable increase of liquidity in the debt markets. In this borrower-friendly environment, sponsors have been able to benefit from competition between lenders, debt fund and bank alike, to incorporate documentation terms for their portfolio companies previously seen only in the more liquid US loans market, such terms having their own roots in the more flexible world of the high-yield bond.

At the larger end of the European leveraged finance market, one consequence has been that maintenance financial covenants have been replaced by incurrence tests, commonly termed "cov-lite" facilities. By way of illustration, a leverage incurrence test, for instance, would prohibit the borrower group from incurring indebtedness unless on the date the particular indebtedness is incurred, and taking that new debt into account, the leverage ratio would not then exceed the prescribed ratio.

"EBITDA" is an accounting acronym which stands for:
Earnings **B**efore **I**nterest **T**axation **D**epreciation **A**mortisation

This definition supports an accounting calculation which is at face value designed to show the extent to which a business is making profits before taking into account costs and charges incurred by it relating to financing costs, tax charges and accounting treatment. The resulting number should show the extent to which a business is generating trading profits sufficient to support it servicing debt.

EBITDA is a key concept in leveraged finance transactions both in the loans market and in the high yield bonds market (although the latter is outside of the scope of this article).

SOME DEALS RETAIN A MAINTENANCE LEVERAGE TEST

On a cov-lite deal, if the facilities incorporate a revolving credit facility (RCF), a residual leverage maintenance test may remain. This would likely be a "springing" test, which would only be operative during those periods of time when an agreed threshold amount of the RCF has been drawn down by the borrowers. That RCF draw down threshold has been subjected to upwards pressure in recent years. When first introduced it was set around the RCF being drawn at least 25% but it is now commonly significantly higher and can be seen as high as 40%.

Whilst there has been pressure from sponsors to remove maintenance tests even in the mid-market, most of these deals have not been done on a cov-lite basis. This is largely because, in the mid-market, there is no significant secondary debt market (and the documentation often restricts transfers in any event) so it is important to lenders that they have financial covenant protections, since they do not have the option to just trade out of an underperforming loan. What has changed is that it is now uncommon to see a full suite of maintenance tests as found in the LMA standard form. The vast majority of deals in the mid-market now contain only one financial covenant – the leverage test – and are often referred to as being "cov-loose" deals.

Most lenders take comfort from the continued existence of the leverage test in the documentation for the reasons explained above. However, some of these tests are formulated in such a way that they are highly unlikely to be triggered before such time as the business goes into payment default (that is, has become unable to pay interest or other servicing costs related to the loan). At the Debtwire Mid-Market European Forum in June one panellist commented that "frankly the leverage test is often not worth the paper it is written on these days!".

The downside to the incurrence test is that it is only tested at the point the borrower wants to raise debt which would otherwise be prohibited and is not routinely monitored. If the incurrence test was satisfied at the relevant time, that debt does not have to be reduced back down should earnings later fall such that the leverage ratio is then breached. At face value, a maintenance leverage test does not have these disadvantages.

BUT HOW EFFECTIVE IS THAT MAINTENANCE TEST?

Not all maintenance covenants are created equally, and an understanding of each of their components is central to determining their true value.

First, there is the question of the level at which the test is set. As explained earlier, the expectation is that the borrower will perform more or less in line with the base case model. The key question is how much tolerance (commonly referred to as "headroom") is built into that test. How much worse than the base case model does the business have to perform before the financial covenant should be breached, bearing in mind that the model put forward by the sponsor is in itself likely to be somewhat conservative? 20% headroom above the base case model was once seen to be the norm, though to lenders in today's market that degree of control may seem a distant memory. 40% headroom on more highly-levered deals is no longer unusual, and some recent deals have seen cushions rising as high as 50%.

Less obvious perhaps to those not so familiar with this type of transaction is the impact of the negotiated changes to the financial definitions sitting behind the leverage test. Whist serious thought should be given to the types of "cash" allowed to be netted off against the debt side of the ratio in the context of a net leverage test (to ensure that the "net" debt number is realistic in enforcement scenario), it is the complex adjustments to EBITDA which really merit exploring further.

EBITDA ADD-BACKS AND OTHER ADJUSTMENTS

As stated above, EBITDA is itself an accounting fiction. It is an attempt to define and calculate the "business as usual" profits of the business by excluding the effects of borrowings, tax, accounting adjustments and one-off events (exceptional items). As EBITDA does not have a standard accounting meaning, it has to be defined for the purposes of a particular transaction and accordingly leaves itself open to heavy negotiation.

Exceptional items

In particular, what is or is not an "exceptional item" in accounting terms is not capable of being comprehensively defined by reference simply to the expression "exceptional item". In order to ensure that particular items which impact their profits will be counted as exceptional items, borrowers may look to include a long list of items which will be treated so as not to reduce EBITDA. This list requires thought as to whether all items are really appropriate. For example, some sponsors may request that loss-making "business as usual" contracts be treated as exceptional items on the basis that their loss-making nature makes them unusual. Alternatively, borrowers may rely on a generic definition of exceptional items and benefit from that lack of specificity to allow themselves further flexibility. Sometimes it may be appropriate for the amount of losses which can be treated as being exceptional for this purpose to be capped.

Proforma adjustments

It is likely that a portfolio company will look to acquire additional businesses during the life of the debt facilities and most facilities agreements will contain an incremental facility (usually uncommitted) which is designed to be drawn down to help the business to fund such acquisitions. As a result, the EBITDA definition has evolved over time to take account of the potential for an acquisition to be made during a rolling 12-month covenant testing period.

The most common way of doing this is for the EBITDA definition to be refined for the purpose of the leverage test by creating a "proforma EBITDA" definition to be used in the leverage test in place of plain EBITDA. Those adjustments give proforma effect for any acquisition which has been made in the relevant testing period. This means that the earnings of a business acquired at any time during the period will be treated as if earnt for the whole 12-month period. If debt has been incurred to fund that acquisition, this is a logical adjustment because without it the borrower would very likely be in breach of the leverage test. The corollary of this is that where any disposals of business have been

Biog box

Francis Booth is a senior associate at Hogan Lovells in their acquisition finance team, specialising in sponsor-backed leveraged finance. Email: francis.booth@hoganlovells.com

Susan Whitehead is a senior consultant at Hogan Lovells in their acquisition finance team. Email: susan.whitehead@hoganlovells.com

made during the period, those earnings will be excluded for the whole testing period.

Synergies

In most transactions the adjustments will normally extend further to include cost synergies "reasonably anticipated" to be achieved within 12 months (or, on more aggressive deals, as much as 24 months) from that acquisition which would boost the proforma EBITDA number further, despite the costs savings resulting from such synergies having not yet been realised at the point of testing. To protect them from excessively optimistic projections on the part of the borrower, lenders typically benefit from a financial limit on such synergies, as well as, in certain cases, third party diligence and verification of material synergies.

When the concept was first introduced, cost synergies which could be included in the calculation of EBITDA were normally capped at no more than 5%-10% of unadjusted EBITDA. This gave lenders some comfort that even if such costs savings might not be achieved in reality, at least the extent to which they could affect the leverage covenant would be limited. Over the past few years, this cap has gradually risen to 15% and often 20%. Some deals at the upper end of the market contain no cap at all.

As regards any verification of those synergies as being reasonably achievable, earlier documentation provided for the CFO to have to verify the numbers and, if the synergies were above a certain threshold, those synergies would also have to be reviewed and verified by an independent firm of accountants. In the current market, CFO verification may only be required when claimed synergies become sizeable (for instance, above a threshold of 5% or more of EBITDA) and the threshold for independent review by accountants has also grown from a starting point of 5% to up to 10% on many deals. It should also be borne in mind that in practice it will be a difficult exercise for an accountancy firm to investigate and verify these types of synergies. Wording is often inserted to say that the accountants simply have to conclude that the claimed synergies are "not unreasonable".

The list of "trigger events" which can give rise to such synergies has also developed in recent years in favour of the sponsors. Initially, it was only the completion of an acquisition, a clearly defined and quantifiable event, which would allow cost savings to be anticipated. More recently, the list of trigger events has expanded significantly to include concepts as broad as restructurings, reorganisations, new contract wins, operating improvements and group initiatives, allowing the CFO far more scope to make a subjective assessment of what cost savings may be taken into account, potentially resulting in an increase in EBITDA.

Some transactions go even further and allow the CFO to increase EBITDA by taking into account "revenue synergies" which the business believes it will realise as a result of the given event. Lenders remain more concerned about such inclusions on the basis that revenue synergies are harder to quantify, and therefore more open to speculation on the part of the company. Nevertheless, the ability for the CFO to include revenue synergies on transactions has increased in recent times, although often subject to the types of caps referred to above.

Whatever is agreed concerning EBITDA add-backs on a particular transaction, the lenders may require transparency and accordingly require the borrower to explain and specify in the compliance certificate to be delivered as part of the quarterly financial reporting package if exceptional items and synergies have been included in the calculation of EBITDA for that particular testing period. Where a borrower's business is exposed to forex fluctuations it may also be appropriate for the parties to specify how such fluctuations are to be treated for the purposes of financial definition calculations. Consistency in this will be important.

THE BROADER IMPACT OF EBITDA

The above adjustments which could have the effect of enhancing EBITDA are not relevant solely to those deals which contain a maintenance leverage test. On a cov-lite deal, the borrower will be equally eager to increase the EBITDA number for the purpose of any springing leverage test and for the incurrence tests.

Further, the EBITDA definition has relevance beyond financial covenants, whether maintenance or incurrence in nature. In order to prevent potential value leakage from the group on which the lenders have based their credit assessment, deals across the large cap and mid-markets contain negative covenants to prevent businesses from making acquisitions, disposing of assets, granting guarantees and security, making loans, and other activities. These types of activities will be restricted unless they fall within a list of specific exceptions (colloquially referred to as "permissions") or, failing that, within a specified financial cap or basket. Whilst the level of the basket will be set by reference to a fixed amount at the time a deal is signed, it is now widely accepted that such baskets will grow as EBITDA increases, allowing the borrower further flexibility. If lenders have accepted that adjustments can be made to EBITDA for the purposes of the financial covenants, it may be hard for them to argue against the borrower using the adjusted EBITDA figure (rather than "actual" EBITDA) when calculating any expansion of such baskets.

"BEWARE OF FALSE KNOWLEDGE; IT IS MORE DANGEROUS THAN IGNORANCE"

George Bernard Shaw's famous quote is apt, although he is unlikely to have foreseen it being used in this particular context. Potential lenders should ensure they study both the EBITDA definition itself and the places within the documentation where that term is used so as to understand how robust the financial tests really are. Armed with that knowledge, it is then easier to decide whether the risk/reward ratio for that particular transaction is an attractive proposition and, in the case of a deal containing a maintenance leverage test, whether that test is capable of meeting the lenders' objectives for its inclusion, and justifying the corresponding pricing, in the first place. ■

Further Reading:

- Incremental facilities: another example of European and US loan market convergence (2017) 3 JIBFL 151.
- The evolution of "soft cap" covenant baskets in the European loan market (2016) 5 JIBFL 285.
- LexisPSL: Banking & Finance Practice note: common financial covenants.