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Latest in European Leveraged Finance – EBITDA addbacks

Introduction

Even though covenant lite has come to dominate European leveraged loan issuance in 2018, financial covenants are still hotly negotiated. As we wrote earlier in the year, most covenant lite loans will have a springing financial covenant (see our May 1 edition), and the regime for curing a breach of those covenants is as important for a borrower as in a 'fully-covenanted' deal (see our May 29 edition).

As well as the cure mechanic, there are other parts of the financial covenant provisions in a leveraged loan agreement that have been the focus of heavy negotiation in recent deals. Their importance to borrowers has arguably increased in the covenant lite era, because those provisions determine whether or not certain key future actions (like paying a dividend or raising additional debt) will be permitted.

Back to basics

A 'fully-covenanted' deal would historically contain a number of financial covenants, all tested quarterly on a last twelve months basis. In addition to a leverage test, there would be one or more 'coverage' tests: measuring cashflow or EBITDA to interest payments and/or debt service payments (i.e. interest plus principal). In many cases there would also be a capital expenditure covenant, limiting the borrower's annual capex spend to a certain fixed amount.

In the current market, most deals just have a leverage covenant, which would in the case of a covenant lite deal only be tested if the revolving facility is drawn above a certain threshold. However even if the threshold is not met, the leverage covenant could still be tested if the borrower wants to take any action which would trigger an incurrence test (for example, paying a dividend to the sponsor). That means the financial covenant definitions and mechanics are still the subject of intense negotiation, not least the borrower's ability to add certain line items back in its calculation of EBITDA.

EBITDA Addbacks

Leverage covenants will typically measure total debt (net of cash) on the covenant test date, against EBITDA for the 12 months ending on the last day of the immediately prior financial quarter. So in order to improve the leverage ratio a borrower can either reduce the debt number or increase the EBITDA number, or both.

Most credit agreements will specify that EBITDA for financial covenant purposes is calculated using the borrower group's consolidated operating profit before tax, which is then the subject of various adjustments. Many of those adjustments are not contentious, for example it would be customary to exclude both the positive and negative effects of extraordinary items. Similarly, the effect of any revaluation of assets is usually stripped out to the extent it would otherwise affect the profit and loss account. The idea being that EBITDA for covenant purposes should capture only the profits from the borrower's ordinary operations.

On a similar theme, certain costs and expenses actually incurred by the borrower would typically be added back (for example transaction fees). But European leveraged loan documents have also evolved to allow borrowers to add back projected improvements in operating results, even if those improvements have not been (and may never be) realized.

A financial sponsor which acquires a business through a leveraged buyout will normally have a detailed business plan, which will likely involve a series of potentially dramatic changes for the operations of the target business. That could involve an aggressive acquisition strategy, a cost-reduction plan or even a merger of the target business with another company the financial sponsor has acquired separately. The execution of that plan would be expected to have a (positive) effect on the financial performance of the target business, but that would not be reflected in the covenants until the various steps were actually taken and their effect started to flow through the accounts. The use of a properly-worded addback clause could allow those effects to be reflected in the financial covenant calculations even before the steps have been taken.

Genesis of the synergies addback

The synergies addback provision evolved from the acquisitions covenant. In a classic LMA style covenanted deal the borrower would usually be prohibited from acquiring other businesses, unless they were explicitly listed as a 'Permitted Acquisition'. In addition to any M&A transactions the borrower was already planning, that definition would also include a general basket allowing any other acquisitions to take place if certain criteria are met. One such criteria would be that the borrower would have to prove that, pro forma for the acquisition, a certain leverage ratio would be met or exceeded.

In strategic M&A (when one business buys another, as opposed to a leveraged buyout where the purchaser is a financial investor), much of the value is created by synergies – the interaction of the two organizations to create a bigger business which is worth more than the sum of the parts. That is often achieved through stripping out duplicative costs and creating economies of scale not available to the two business on their own.

Financial sponsors realized that if they could take those synergies into account when calculating the leverage ratio to work out if the acquisition is permitted, the range of M&A options available to them would be much broader. A synergies addback started to appear in financial covenant provisions. It would usually look something like this:

> *"In connection with a Permitted Acquisition, EBITDA when tested on a pro forma basis shall reflect any increase or decrease projected by the Borrower in good faith as a result of reasonably identifiable synergies and net cost savings or additional net costs, as the case may be, realizable during the four quarter period following such Permitted Acquisition by combining the operations of such company or business with the operations of the Group."*

This formulation is fairly limited, because it only applies to Permitted Acquisitions when EBITDA is being calculated pro forma (i.e. it does not apply for the financial covenant test itself). Gradually the circumstances and purposes for which synergies could be taken into account when calculating the financial covenants expanded.

Recent developments

Originally the trigger for being able to add back a cost saving was limited to the consummation of a permitted acquisition or some other identifiable transaction. Some early deals also allowed synergies to be taken into account if the borrower undertook a 'material restructuring' of its business. Recent deals have adopted an even broader approach, allowing the effect of any 'group initiatives' or even just 'any action taken or expected to be taken' by the borrower to be reflected in the EBITDA calculation.

More importantly, the purposes for which the synergies and cost savings can be taken into account now usually include calculation of the leverage test for both the maintenance covenant (if there is one) and for incurrence purposes. For both maintenance and incurrence purposes usually the provisions will allow the borrower to assume that any cost savings arising or expected to arise as a result of the actions taken or expected to be taken had been realized on first day of the test period.

What are the limitations?

The prevalence of the synergies addback in recent deals, and the expansion in both its terms and its effect on both maintenance and incurrence financial covenants, has led to some limitations being imposed by lenders. Those broadly fall into the following categories:

What is the burden of proof?

The basic requirement in most deals is that cost savings which have not yet been realized must be projected by the borrower 'in good faith' and/or be 'factually supportable' in order to be taken into account for the financial covenant calculation. The lenders' concern here is that a borrower, in order to avoid a financial covenant breach, comes up with an unrealistic cost saving plan which is unlikely to have the desired result. In many cases the lenders will insist that cost savings for the purpose of the addback be the subject of some form of certification, either by the senior management (CEO or CFO) of the borrower, or by the borrower's auditors (or both). Usually the requirement for certification applies only where the projected cost savings exceed a certain threshold – either a dollar amount or a percentage of EBITDA.

When do the cost savings have to be realized?

Some cost saving initiatives may not have an impact on the borrower's financial performance for a considerable period of time. Lenders typically impose a cut-off point, whereby if the cost savings expected to result from a course of action are not reasonably likely to be realized within a certain period after the financial covenant test date, they may not be added back to EBITDA. Initially that period was 12 months, but we now often see a period of 18 to 24 months, and have seen 36 months in some cases.

Caps

Many deals impose a cap on the amount of cost savings that can be added back to EBITDA in respect of any one period. That cap could either be a set dollar amount, or a percentage of the EBITDA for the relevant period (pre-addback). In some cases it will be the greater of a fixed amount and the percentage of EBITDA. That percentage varies between 10 per cent and 25 per cent.

DEAL CONSIDERATIONS

1. Is there an EBITDA addback? ☐
2. Are the cost savings and synergies permitted to be added back limited to those arising from a limited set of circumstances (e.g. Permitted Acquisitions)? ☐
3. Do the addbacks get taken into account for both the maintenance financial covenant test, and any incurrence test? ☐
4. Are there any caps on the amount that can be added back in respect of any individual calculation period? ☐
5. Are the caps fixed numbers, or soft baskets style by reference to a percentage of EBITDA (or some other metric)? ☐
6. Do the cost savings have to be certified by management or the auditors? ☐
7. What is the timeframe within which the cost savings have to be realizable? ☐

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