CLEARY GOTTLIEB

Latest in European Leveraged Finance – Mind the GAAP

Introduction

Even in a market where most loan agreements do not contain maintenance financial covenants (other than a springing covenant), European leveraged loan documents are still littered with accounting terminology. In addition to any springing financial covenant, incurrence tests will usually be based on either a leverage ratio or some form of coverage ratio (or both). Further, the borrower will be required to produce regular financial information for the lenders, and the loan agreement will spell out the basis of their preparation.

There have recently been some major changes to IFRS and local accounting frameworks. This bulletin explores the effect of the key changes from the perspective of a leveraged loan agreement.

1. Defining and using the Accounting Principles

Most leveraged loan agreements will contain a definition of 'Accounting Principles', which typically refers to generally accepted accounting principles in the relevant jurisdiction of the borrower, including IFRS. That definition is relevant for a number of purposes:

— A repeating representation and/or a covenant that any financial statements to be delivered to lenders under the loan agreement will be prepared in accordance with the Accounting Principles. These financial statements will form the basis for calculating key financial metrics used in the loan agreement (e.g. the definition of EBITDA will usually start from the amount reported by the borrower as its consolidated net income in the financial statements);

— Certain defined terms will cross-refer to the Accounting Principles in order to further specify what should or should not be included, for example:

- the definition of 'Financial Indebtedness' will often refer to the Accounting Principles in order to determine whether a transaction constitutes a finance lease and should thus be considered as debt;
- various constituent parts of the definition of EBITDA, Finance Charges, Cashflow, Capital Expenditures and other financial metrics will often be determined by reference to the Accounting Principles; and
- the lessor's title to an asset subject to a finance lease may be captured by the definition of "Security" or "Quasi Security".

2. The problem with leases

Under the old accounting standards, leases entered into by companies were treated as either operating leases or finance leases. A finance lease transfers substantially all the risks and rewards of ownership of the asset to the lessee, who is expected to possess the asset for virtually all of its economic life. An operating lease is anything which is not a finance lease. In broad terms, the old accounting rules treated finance leases as a form of secured debt, consistent with the economic purpose of the transaction.

More specifically, a finance lease would historically show up in the accounts as follows:

Operating leases were historically quite different – they only showed up in the P&L statement, where the full amount of the rent (and not just the interest component) was recorded as an expense. So they are literally 'off-balance sheet'.

By virtue of the reference to Accounting Principles, leveraged loan agreements incorporate this treatment.

Balance Sheet	P&L Statement
Asset (right to use the kit)	***Depreciation*** of the asset over time.
Liability (debt in the form of the capitalized value of lease payments)	***Finance charges*** (interest element of the lease payments).

3. IFRS 16

IFRS 16 came into effect on 1 January 2019, and will have a significant impact on the way companies account for leases. The distinction between an operating lease and a finance lease is eliminated, and the off-balance sheet treatment of most operating leases is likely to end – lease liabilities will have to be recognized for all leases. The portion of the rent not deemed to constitute interest will no longer be recorded as an expense for any leases. So a company's liabilities, net income and thus their EBITDA will increase, in some cases significantly.

Entities leasing high value assets (e.g. real estate, aircraft, ships) will be the most severely affected. PWC conducted a global lease capitalization study to assess the impact on more than 3,000 listed entities. They estimate that for the retail sector the median increase in debt will be 98%, with increases in reported EBITDA of up to 41%. Across all sectors the average increase in debt is likely to be around 22%, and EBITDA will increase 13%.

4. Freezing (and un-freezing) GAAP

So what does this mean for your average leveraged loan borrower?

— Absent language to the contrary, the implementation of IFRS 16 can have a dramatic unintended impact on the compliance by the borrower with a leveraged loan agreement:

- its leverage ratio may suddenly increase (or more rarely, decrease) because the increase in its debt may not be compensated for by a sufficient increase in EBITDA;
- existing operating leases may cause the borrower to breach negative undertakings on incurrence of debt (and, in some cases, with the negative pledge clause),

even in the absence of any substantive change in the financial condition or operations of the borrower.

— We would expect most leveraged loan agreements however to have a 'frozen GAAP' clause. This should specify that, in the event of a change in the accounting principles the covenants will continue to be calculated based on those used to produce the borrower's most recent audited annual accounts as at the closing date of the loan. This freezing may in some cases be triggered only at the option of the borrower (and/or the agent).

— There may also be a clause that specifies how the financial reporting will change if there is a change in accounting principles. Typically, if a set of financial statements are prepared on a basis different to the accounting principles used to prepare the 'original' financial statements, the borrower must report to the lenders a full description of the change, and deliver up a reconciliation to the original financial statements so that lenders can compare like with like. In some cases, where the loan agreement does not contain a "frozen GAAP" clause, it will provide for the borrower and the facility agent to negotiate a set of amendments to ensure that the adoption of a new accounting basis does not result in any alteration to the 'commercial effect' of the loan agreement. If they fail to agree those changes, the borrower would be required to produce a full suite of financial statements using the old Accounting Principles.

— The above clauses, however, may not be sufficient to avoid an unintentional breach by the borrower of provisions such as the debt covenant that do not depend on amounts reported in its financial statements. In more recent deals, therefore, there may be clauses specifically dealing with IFRS 16, and stating explicitly that any leases which would have been treated as operating leases under the old rules will continue to be treated the same way under the covenants. Loan agreements entered into after January 1, 2019 may still contain this language, effectively "freezing" lease accounting to a principle that was already superseded at the time of the deal.

— Some recent deals may contain 'cherry-picking' provisions, which could allow the borrower to take the benefit of certain accounting rule changes, but not the downside – effectively un-freezing the GAAP in certain circumstances.

Ultimately, the net effect of these provisions is that the difference between reported net debt and EBITDA under the new rules on the one hand, and the numbers used to calculate covenants under leverage loan agreements on the other, will continue to grow.

DEAL CONSIDERATIONS

1. What are the conditions for exercise of the flex right? ☐
2. Does the loan agreement define 'Accounting Principles' or 'GAAP'? ☐
3. Are finance leases defined by reference to the 'Accounting Principles' or by some other metric? ☐
4. Does the definition of Security or Quasi Security capture finance leases (or could it be read to do so)? ☐
5. How do the definitions of EBITDA and Net Debt deal with finance leases? ☐
6. Is there a restriction on Financial Indebtedness? If so, does it have a basket for finance leases? ☐
7. Is there a 'frozen GAAP' clause? If so, is it automatic or triggered by a notice (and if so, by whom) ☐
8. Is there a 'cherry-picking' clause? ☐

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