Financial Definitions 101: The Borrower and Lender Perspectives on Financial Definitions and Calculations

October 10, 2024

NATIONAL ASSOCIATION of WOMEN LAWYERS

AMERICAN COLLEGE OF COMMERCIAL FINANCE LAWYERS

LSTA ADVANCING THE CORPORATE LOAN MARKET

KIRKLAND & ELLIS

DLA PIPER

Agenda

1	The Purpose of Financial Covenants / Ratios in Credit Agreements
2	The Versatile Leverage Ratio
3	Not All Debt is Equal
4	The Basic Principles of EBITDA
5	The Fixed Charge Coverage Ratio
6	Financial Maintenance Covenants: Testing & Methodology
7	Other Uses of Financial Covenant Ratios: Incurrence Flexibility
8	Panelists

The Purpose of Financial Covenants / Ratios in Credit Agreements

Financial Covenants: Quantitative Measurements of Particular Financial Metrics

WHY

- Give Lenders a general proxy for the value of a Borrower and what they may realize in a downside sale
- Monitor the strength and financial health of a business
- Evaluate a Borrower’s ability to repay its debt
- Provide early warnings of financial issues and potential payment defaults
- Give Lenders a seat at the table to participate in discussions prior to a restructuring

WHERE

- Maintenance covenants
- Incurrence-based covenant exceptions
- Reporting requirements

HOW

- Covenant levels are determined by reference to a bank model based on a Borrower’s past performance and projections
- Definitions calculated in a consolidated manner (Borrower and subsidiaries as a whole) according to GAAP*
- Anyone “above” the Borrower not providing a support commitment is excluded from the definitions as the assets of those entities do not inure to the benefit of the Borrower’s creditors
- In certain circumstances, subsidiaries who are not providing direct credit support in the form of guarantees or securities may also be excluded or their contribution to EBITDA capped
- The performance and indebtedness of unrestricted subsidiaries are generally excluded from financial covenant / ratio calculations

SO WHAT

- Failure to abide by financial covenants can result in: an event of default; Lenders accelerating loans; Lenders refusing to fund the revolver; limitations on the ability of a Borrower to execute its business plan

The Nature of Financial Covenants Will Vary Depending on the Type of Financing

INVESTMENT GRADE	ABL	CASH FLOW LOAN	COV-LITE
▸ No maintenance covenants (or set at a wide level) ▸ No (or limited) incurrence covenants (limited operational covenants)	▸ Fixed Charge Coverage Ratio springing covenant ▸ Excess Availability governor for incurrence tests	▸ Maintenance financial covenants	▸ Broad flexibility for a Borrower ▸ No maintenance financial covenant (term) ▸ Springing covenant (revolver)

Financial Covenants: What is Tested?

WHAT DO FINANCIAL COVENANTS TEST?

- **Leverage Ratio**
  - Debt: Adjusted EBITDA
- **Fixed Charge Coverage Ratio**
  - Operating Cash: Fixed Charges

The Versatile Leverage Ratio

Leverage Ratios — Overview

- Ratio of indebtedness to Adjusted EBITDA
  - “Adjusted EBITDA” is typically trailing four quarters | “Indebtedness” is the balance as of a specified date
- Regulates how much debt a Borrower and its subsidiaries can incur relative to EBITDA
  - Another layer of protection for Lenders beyond exceptions to negative covenants

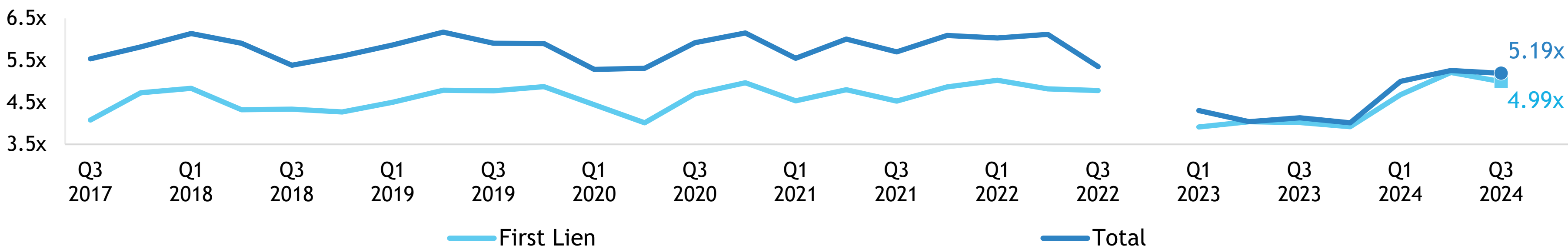
“Total Net Leverage Ratio”
As of any date of determination, the ratio of (a) the excess of (i) Funded Debt of the Loan Parties and their Subsidiaries as of such day over (ii) the amount of all [domestic] [unrestricted] cash and Cash Equivalents held by the Loan Parties [and their subsidiaries] as of such day [that are free and clear of all Liens (other than Permitted Liens)] to (b) Adjusted EBITDA of the Loan Parties and their Subsidiaries for the most recently completed Test Period ending on or preceding such date (and for which financial statements are delivered (or, in certain circumstances for which financial statement are available))

Syndicated LBO Leverage Rising…

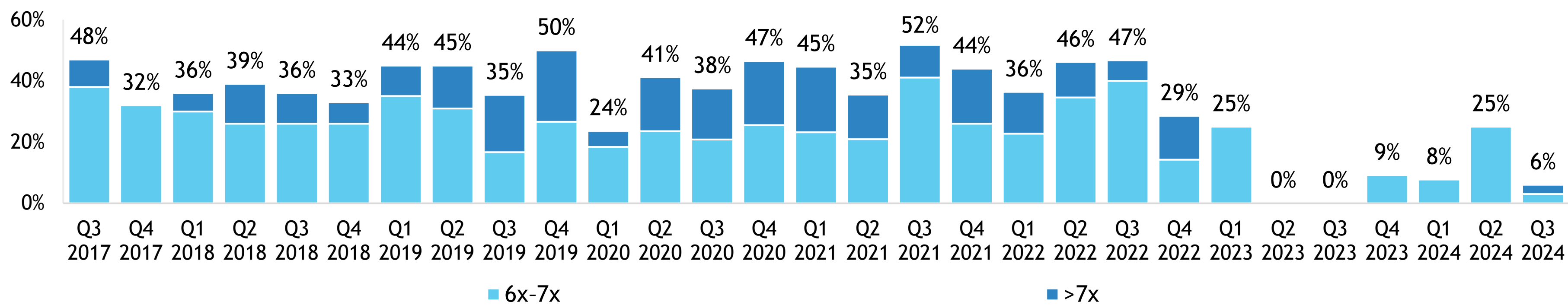
After the lower leverage levels seen in 2023, pro forma leverage levels for LBO-driven broadly syndicated loans rose steadily in H2 2024, driven by lower loan spreads, ongoing economic / earnings growth and increased competition from the private credit market, which has historically offered more flexibility with respect to leverage than the BSL market

- The average adjusted leverage for syndicated LBO loans was 5x first lien / 5.2x total in Q3 on a small sample of deals, down slightly from 5.2x / 5.3x in Q2 — a one and a half year high, per Covenant Review
- Notably, only 7% of M&A-driven BSL deals in Q3 were levered at 6x or higher — down from a 15-month high of 25% in Q2 — the highest percentage since Q1 2023
  - However, Vista's LBO of JAGGAER brought the first deal levered at 7x since January 2023, per Covenant Review
- On the flipside, 29% of M&A-driven BSL deals in Q3 were levered at 4x or lower — up from 25% in Q2

AVERAGE ADJUSTED LEVERAGE FOR LBO LOAN DEALS (FIRST LIEN VS. TOTAL)*



PERCENTAGE OF DEALS WITH LEVERAGE OF 6X OR HIGHER (M&A ONLY)



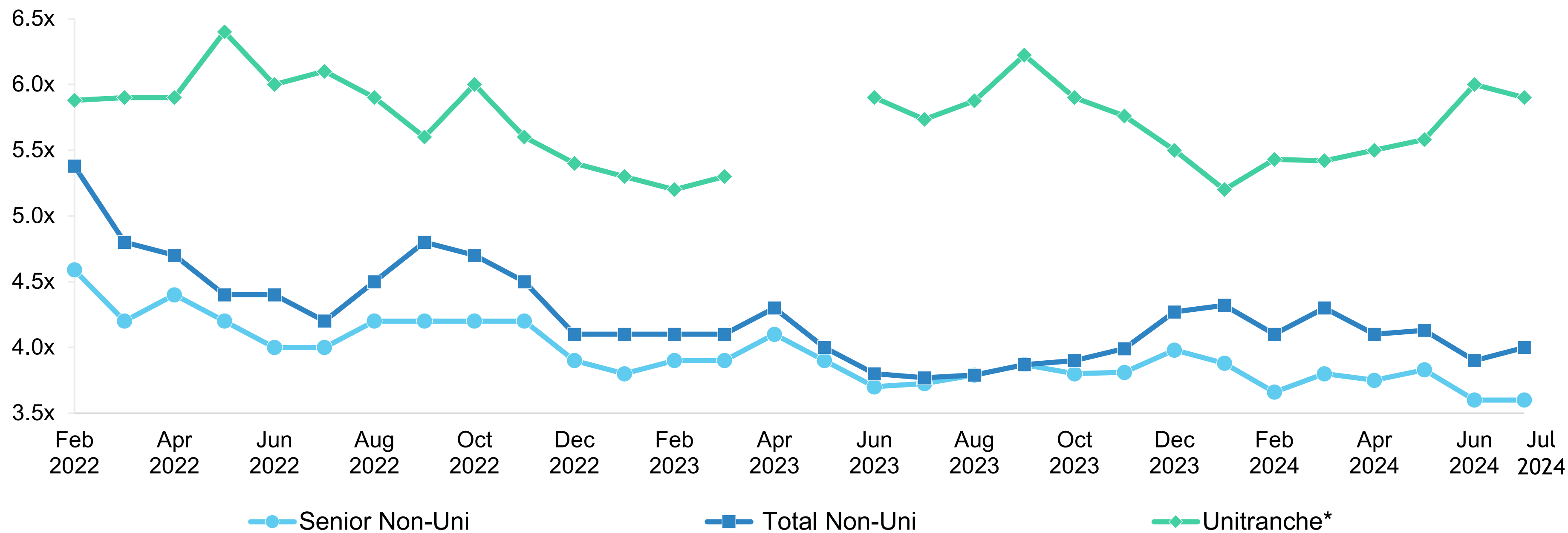
Source: LevFin Insights report, September 30, 2024
* Insufficient syndicated LBO loan data in Q3-Q4 2022 to determine averages

Private Credit Unitranche LBO Leverage Rising As Well

Unitranche LBO levels remained elevated in July, with software deals for mid-size Borrowers continuing to make up a substantial portion of loans

- Average leverage levels on unitranche LBOs ticked down slightly to 5.9x in July from 6x in June, showing an increase this summer since the 5.4x – 5.6x levels in March through May, per KBRA DLD
- First lien leverage levels for non-unitranche LBOs held steady in July at 3.6x, per KBRA DLD
- Total non-uni leverage remained largely steady in July at 4.0x, up from 3.9x in June; leverage has been hovering around 4.0x since November, per KBRA DLD

PRIVATE DEALS — LBO LEVERAGE



Sources: KBRA DLD, July 31, 2024
Averages are based on a 90-day rolling basis. LBO only deals; KBRA DLD in 2024 revised the definition of unitranche to >=4.5x (on an all-senior basis) to reflect the current market
* Missing unitranche line indicates insufficient data during that time period

Not all Debt is Equal

Leverage Ratios

What Type of Indebtedness is Tested?

Borrowers want leverage ratios to be limited to indebtedness for borrowed money but typically will include other forms of debt (*e.g.*, capital leases, purchase money indebtedness and drawn letters of credit)

- Leverage ratios may test:
  - Senior Secured Indebtedness (*i.e.*, “First Lien Leverage”)
    - First Lien Leverage may be further limited to indebtedness secured by the collateral on a pari passu basis with the credit agreement obligations
  - All Secured Indebtedness (*i.e.*, “Secured Leverage Ratio”)
  - All Indebtedness (*i.e.*, “Total Leverage”)
- If used for incurrence tests, leverage ratios should compare “apples to apples”

Leverage Ratios

What Constitutes "Indebtedness" for Purposes of Calculating the Leverage Ratio?

CONSIDERATION	PRO-BORROWER	PRO-LENDER
All Indebtedness	No, limit tested indebtedness to funded indebtedness or indebtedness for borrowed money	Yes, include all indebtedness for any amount that might be payable by the Borrower and its subsidiaries
Deferred Purchase Price and Earn-Outs	Earn-outs should not be included at all or until they are earned, due and owing and not paid (for a period of time)	Include to the extent GAAP requires the recording of a liability or maximum payout
Letters of Credit	Only included to the extent of any drawn and unreimbursed amounts	Yes, whether drawn or undrawn
Capital Lease Obligations	Typically included	Yes
Guarantees of Indebtedness	No, contingent obligations should not be included (if guarantees are included, it should be limited to guarantees of indebtedness otherwise included)	Yes

Leverage Ratios

Cash Netting

- The amount of indebtedness is decreased by the amount of cash on the balance sheet
  - Allows a Borrower to receive credit for cash on the balance sheet when calculating leverage ratios
- Key to understand whether financial covenant levels are set taking into account projected cash balances
- Lenders may set caps or minimum levels
  - Maximum cash that may be netted to encourage the company not to sit on large cash balances
  - Minimum amount below which cash may not be netted to account for working capital needs
- Lenders may only permit cash to be netted if (i) deposited in accounts subject to DACAs in favor of the agent, (ii) domestic cash or (iii) cash maintained by the Borrower or a guarantor

The Basic Principles of EBITDA

Purpose

EBITDA and its Impact on Financial Covenants

- EBITDA starts with consolidated net income and certain adjustments are made, including: ITDA; transaction-related costs and expenses; cost and expenses of business optimization, permitted acquisitions, dispositions and investments; synergies and cost savings; restructuring charges; adjustments described in a Sponsor Model / QofE and other (catch-all for non-delineated activities)
- The negotiation between Lenders and Borrowers will focus heavily on the “add-backs” to reach Adjusted EBITDA

Maximum Leverage Ratio	Debt: EBITDA / Recurring Revenue	Larger Adjusted EBITDA number **decreases** ratio
Minimum Fixed Charge Coverage Ratio	EBITDA: Fixed Charges	Larger Adjusted EBITDA number **increases** ratio

Adjusted EBITDA

Adjusted EBITDA is the cash flow generated by the Borrower and its subsidiaries in the ordinary course of business

General Principles

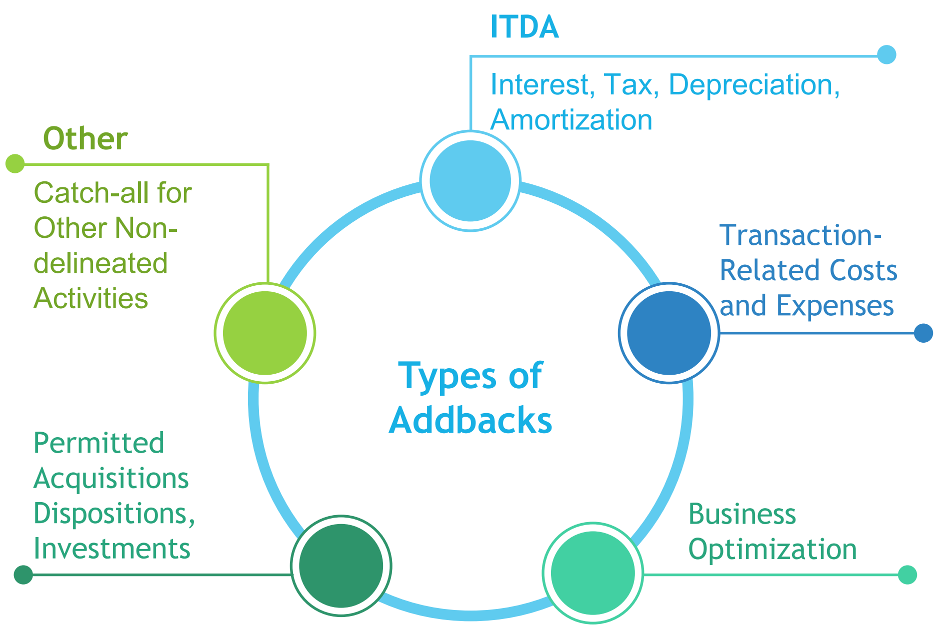
- The financial covenant definitions, including the definition of Adjusted EBITDA, must be consistent with the model upon which financial covenant levels are based
- Non-GAAP term
- The goals of adjustments are to:
  - Calculate cash flow from ordinary operations
  - Eliminate non-ordinary course and non-recurring items
  - Make pro forma adjustments for operational changes such as acquisitions, dispositions and restructurings

Conflict Between Lenders and Sponsors

- Lenders want to base financial covenant calculations on actual "clean" EBITDA, or realized cost-savings, and true extraordinary non-recurring expenses

Pro Forma Basis

- Adjustments to EBITDA reflecting significant events on a pro forma basis, as if they had occurred on the first day of the applicable calculation period
- Adjusted EBITDA should be calculated on a pro forma basis for incurrence covenant purposes



Consolidated EBITDA

TYPES OF ADDBACKS

- Related to any acquisition funded by the financing
- Permitted acquisitions, dispositions, investments, restricted payments and other capital transactions (whether or not closed)
- Business optimization and resulting cost savings or synergies (often subject to a cap)
- Restructuring or implementation (*e.g.*, technology) charges
- Non-recurring
- Directors' fees and expenses paid or accrued
- Management fees
- Equity cure amount
- Indemnification and third party reimbursements (either already reimbursed or likely to be reimbursed within a period of time)
- Non-cash charges
- Other adjustments (*e.g.*, unusual, extraordinary, exceptional, infrequent and special)
- Quality of Earnings and Sponsor Model ("of the type")
- Environmental matters and litigation (including settlements)
- Plug numbers

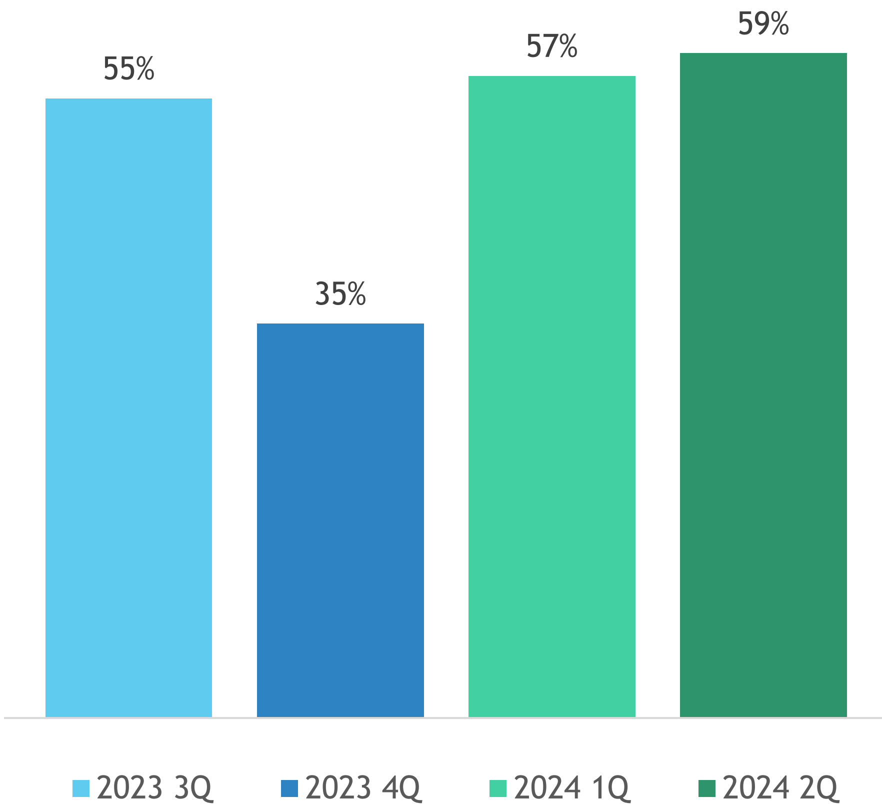
Consolidated EBITDA

COST SAVINGS

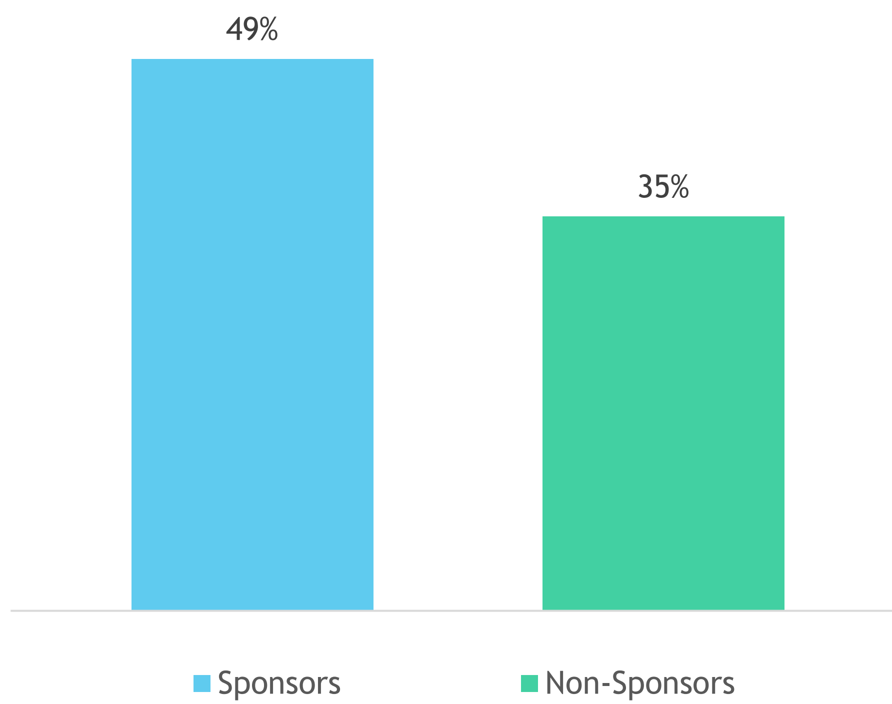
- A Borrower is allowed to strip cost out of the business
- Are prospective in nature and added back to Adjusted EBITDA on a "**pro forma**" basis as cost has been stripped, not part of the Borrower's operations going forward
- Events giving rise to cost savings:
  - Acquisitions (or commencement of a business line)
  - Dispositions of a business, lines of business, restricted subsidiaries or operations
  - Restructurings
  - Operational improvements and / or initiatives
- Market flex provisions may apply
- "**Run rate**" adjustments for new contracts, increased volume or pricing
- Although such expenses may fit under a generic addback for "**extraordinary, unusual, infrequent or non-recurring items**", this addback is rather nebulous in its applicability
- If permitted, may be limited to **20** to **40%** of consolidated EBITDA to the extent certified to by CFO plus unlimited amounts if in accordance with Regulation S-X, a QofE, the Sponsor Model or otherwise approved by the agent

Pro Forma Cost Savings / Synergies

AGREEMENTS WITH UNCAPPED ADD-BACKS FOR COST SAVINGS & SYNERGIES (SPONSORS)



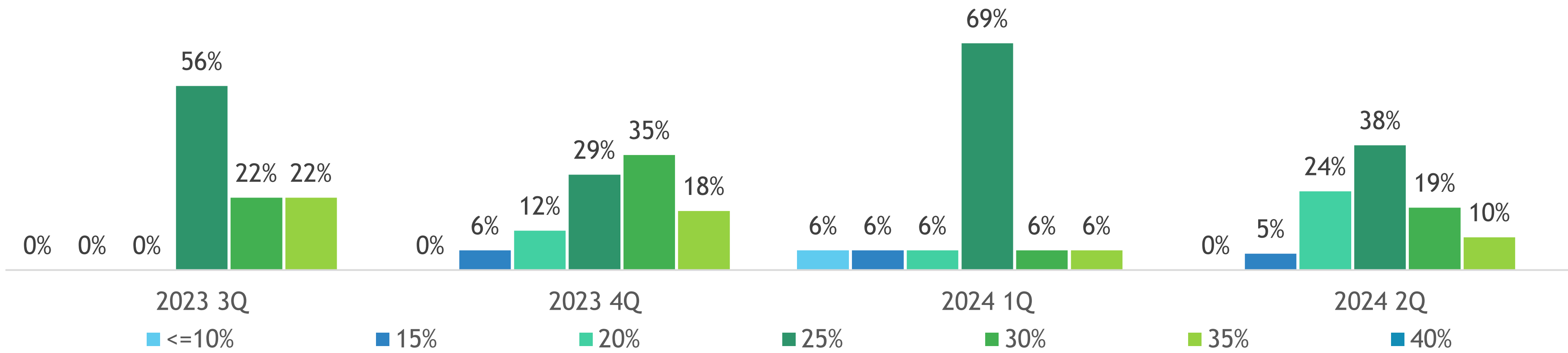
AGREEMENTS WITH UNCAPPED ADD-BACKS FOR COST SAVINGS & SYNERGIES, L4Q



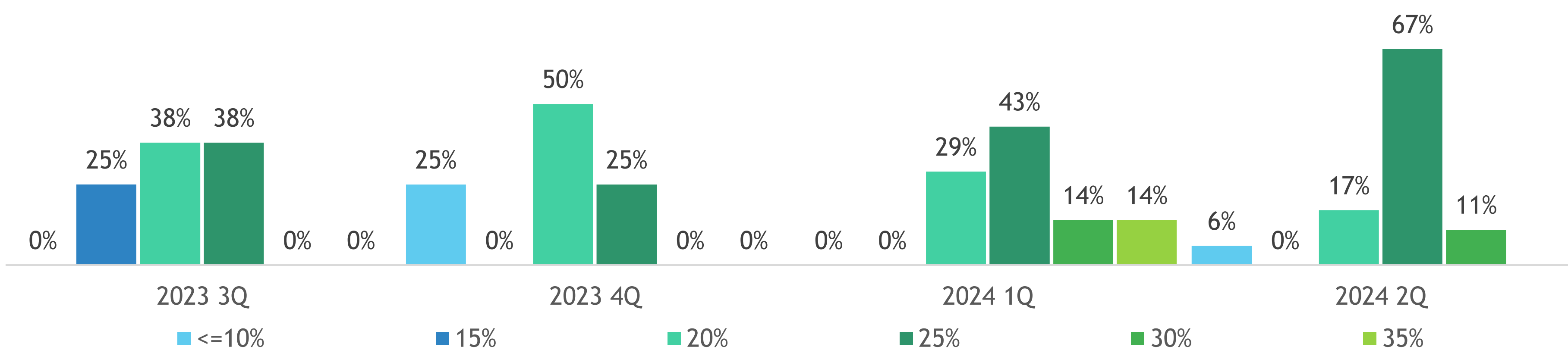
Sources: Xtract Research, State of the Loan Market – 2Q 2024

Pro Forma Cost Savings / Synergies

CAP ON EBITDA ADD-BACKS FOR COST SAVINGS & SYNERGIES (SPONSORS)



CAP ON EBITDA ADD-BACKS FOR COST SAVINGS & SYNERGIES (NON-SPONSORS)



Sources: Xtract Research, State of the Loan Market – 2Q 2024

The Fixed Charge Coverage Ratio

Overview of Fixed Charge Coverage Ratio

- Measures a Borrower's ability to pay regular recurring fixed charges **in cash** on a periodic basis
- Borrowers / Lenders negotiate what qualifies as "fixed" charges and as a deduction to EBITDA for determining "cashflow"
  - Borrower will want to only include recurring amounts **required** to be paid and limit fixed charges to recurring items that cannot be modified as a result of changes in operations or production
  - Candidates for inclusion in FCCR are cash interest, scheduled amortization, cash taxes, cash management fees and cash distributions
  - If using EBITDAR, rent can be a fixed charge, but note that it is not a "wash" if the covenant is greater than 1:1

Overview of Fixed Charge Ratio

"Fixed Charge Coverage Ratio"

Means with respect to any Person for any period, the **ratio of (a) the Adjusted EBITDA of such Person and its Subsidiaries for the trailing twelve month period as of the end of such period, minus the sum of** (without duplication) (i) all income tax liabilities paid in cash including any Permitted Tax Distributions, net of interest income (excluding (A) net income taxes paid from the proceeds received in connection with any Permitted Disposition or any asset disposition consented to by the Required Lenders, (B) any tax liabilities in respect of income which was excluded from Adjusted EBITDA and (C) any tax liabilities to the extent such Person is entitled to indemnification for such liabilities or receives a purchase price reduction respect thereto), plus (ii) nonfinanced Maintenance Capital Expenditures made in cash by such Person and its Subsidiaries during such period **to (b) the Fixed Charges for the trailing twelve month period as of the last day of such period**. For any period ending after the Closing Date and prior to the first anniversary of the Closing Date, the amounts described in (x) clauses (a)(i) and (ii) above shall only include liabilities incurred after the Closing Date and (y) clause (b) shall be the amounts incurred after the Closing Date annualized on the basis of a 365 day year; provided, that any amount incurred in connection with a Permitted Acquisition shall not be annualized

"Fixed Charges"

Means, with respect to any Person for any period, the **sum of** (without duplication) (a) **all amortization payments** (excluding, for the avoidance of doubt, any earnout payments and all mandatory prepayments) with respect to Funded Indebtedness of such Person and its Subsidiaries [scheduled to be] paid in cash during such period (as such schedule may have been reduced by the amount of any prepayments of such Indebtedness), **plus (b) Net Interest Expense** payable in cash of such Person and its Subsidiaries during such period (excluding (i) closing or amendment fees and expenses, (ii) any fees and expenses paid in connection with the Closing Date and (iii) any commitment, underwriting, arrangement or similar fees, in each case to the extent constituting Net Interest Expense)

Fixed Charge Coverage Ratio

What Constitutes "Fixed Charges" for Purposes of Calculating the Fixed Charge Coverage Ratio?

CONSIDERATION	PRO-BORROWER	PRO-LENDER
Management Fees / Expenses	No, if must include, limit to quarterly advisory fee to the extent paid in cash	Yes, including quarterly advisory fees, transaction fees, "ops" fees, expenses reimbursements and indemnities
Debt Issuance Expenses, Amendment Costs, Commitment Fees	No, they are not recurring	Yes, it is a use of cash
CapEx	No, but very difficult to achieve in middle market; if required, should be limited to unfinanced maintenance CapEx	Yes, unfinanced typically ok since coming from outside source of cash
Restricted Payments / Dividends	No, they are neither recurring nor required	Yes, use of cash not reflected in EBITDA (like CapEx)
Cash Taxes	Yes, but only relating to income in OCB (*i.e.*, not relating to non-recurring events or for which Borrower receives indemnity / purchase price reduction)	Yes, and in a flow-through structure, should not include cash distributions

Covenant Calculation — Annualization and Build-Up

ANNUALIZATION	STRAIGHT BUILD-UP	PLUG NUMBERS
▶ Typically used for interest and amortization ▶ **Method:** — 1Q after the closing date, multiply that quarter's amount by 4 — 2Q after the closing date, multiple the past two quarters' amount by 2 — 3Q after the closing date, multiply the past three quarters by 4/3 and use the actual trailing 12 months thereafter	▶ Preferred method for CapEx and tax amounts ▶ Use only amounts incurred since the closing date	▶ Provide pre-agreed amounts for historic periods in the credit agreement which are "rolled off" as the company has actual figures post-closing ▶ Provides the greatest amount of certainty when setting the covenant levels

- Primarily relevant for FCCR
- When a credit facility is initially put into place, Lenders want to pro forma the trailing 12 months
- Different ways to build up the components of financial definitions
  - Method of build-up should match bank model created by the Sponsor to ensure covenant levels are set appropriately

Financial Maintenance Covenants: Testing & Methodology

Financial Covenants: The Lender Protection

Maintenance Covenants

- Borrower must demonstrate regular covenant compliance **(mandatory)**
- Periodically-tested
  - "As of" a date (month, **quarter** or year-end)
  - Some covenants may be tested at all times
- Equity cure rights
  - Include number of cures, consecutive vs non-consecutive, calculation of debt prepaid going forward, interaction of senior and sub covenant cures

Springing Covenants

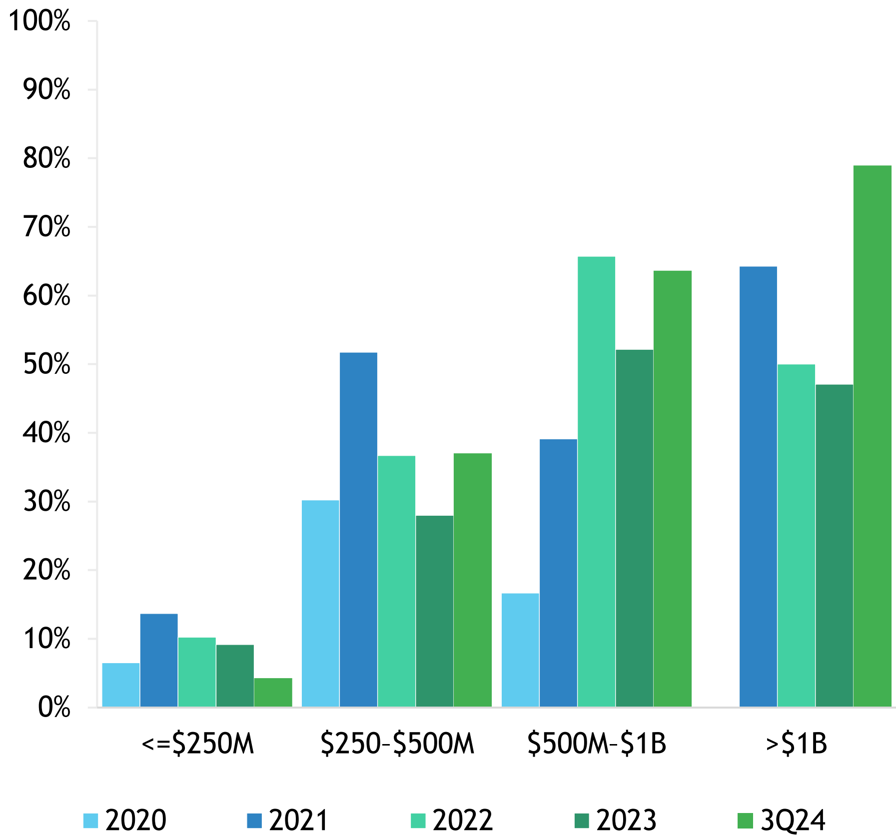
- Tests that "spring" upon the occurrence of a certain future event
- Found in cov-lite transactions and ABL facilities
- **Typically apply to revolving credit facilities** and **only if** certain conditions are met
  - *e.g.*, revolver usage exceeds a certain % as of the last day of a fiscal quarter or exceeds the threshold for a number of consecutive days
  - The test may also be based on the average use of revolver during the period

Covenant Calculation Methodology

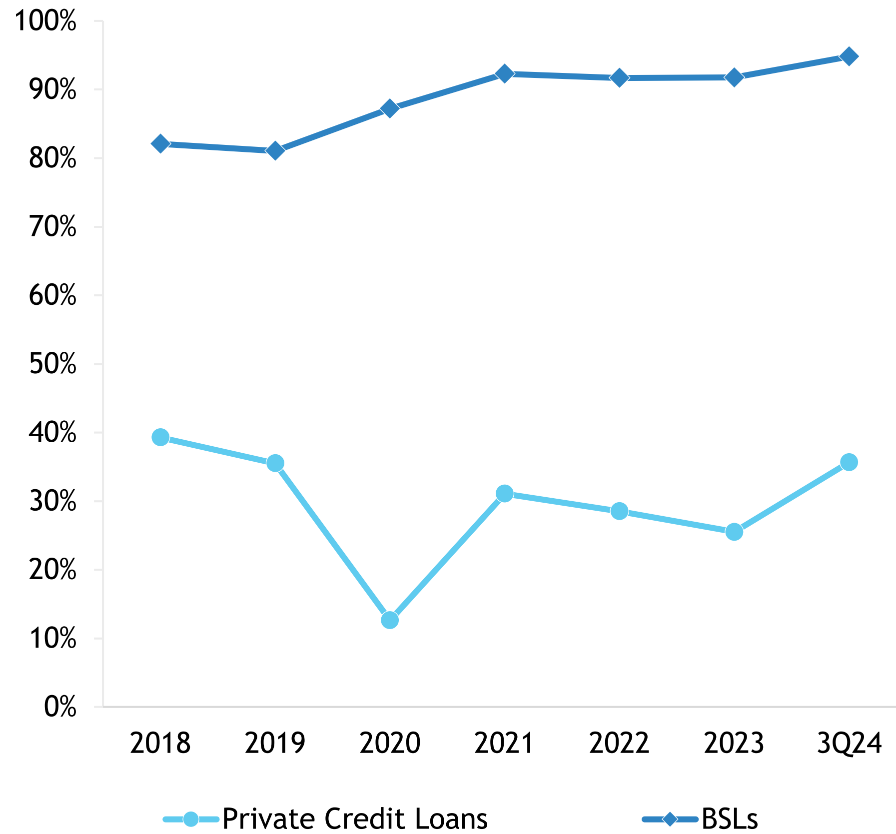
Testing Periods	▶ Generally tested quarterly for maintenance covenants — Some Lenders may push for monthly covenants ▶ Incurrence tests may calculate *pro forma* covenants on a last 12 month basis, even if covenants are tested quarterly ▶ Incurrence tests calculated off of financial statements "delivered" or "available"
Cushion	▶ Typically set at 25 – 40% EBITDA cushion off Sponsor's bank case projections
Step Up / Down	▶ Historically Lenders have tied covenants closely to the projections with several small step ups / downs ▶ Current trend is to adjust levels less frequently (*e.g.*, annually or set at a static single level)
Who is in the Group	▶ Contribution from non-loan parties may be limited ▶ Ensure debt and fixed charges of "excluded subsidiaries" are excluded to the extent their EBITDA is excluded

The Rise of Cov Lite

COVENANT-LITE SHARE OF NEW ISSUE PRIVATE CREDIT LOANS BY INITIAL LOAN AMOUNT, 2020 – YTD 2024



COVENANT-LITE SHARE OF NEW-ISSUE PRIVATE CREDIT VS. BROADLY SYNDICATED FIRST LIEN LOANS



Sources: Covenant Review, October 4, 2024

Other Uses of Financial Ratios: Incurrence Flexibility

Financial Covenants: Incurrence-Based Covenant Exceptions

Incurrence-Based Covenant Exceptions

- Tests triggered by specific events
- Govern whether a Borrower may take certain types of permissive actions (*e.g.*, incur additional debt)
  - If a Borrower fails to meet the financial test, it can still comply with the credit agreement by refraining from taking action
- Tested on a pro forma basis (*i.e.*, after giving effect to the transaction to be tested and certain other actions)
- Calculation of financial covenants for incurrence tests can differ from how they are calculated for maintenance covenants (*e.g.*, including earn-outs in FCCR for incurrence purposes, but not for maintenance covenant purposes)

Limited Condition Transaction ("LCT")

Limited Condition Transaction

- A Limited Condition Transaction ("LCT") provision permits a Borrower to test the, or certain exception in a, credit agreement ***at the time it executes an acquisition agreement versus at the time of making the investment (and incurring the related debt)***
  - The applicable leverage ratio will be tested as of the last test period (for which financials have been delivered / are available as of signing) pro forma for the investment and related incurrence of debt
  - It often requires that the acquisition be a "***no financing out***" deal
  - Other conditions (*e.g.*, the making of representations or the absence of an event of default) shall also be tested
- Eliminates the risk that between signing and closing (reported) EBITDA deteriorates at the buyer or target BUT also often allows a Borrower to retest on more favorable financials (and therefore incur incremental debt)
- Once elected, the transaction is deemed to have occurred during the intervening time for subsequent incurrence testing
- Also may be used to make ***restricted payments, restricted debt payments or asset dispositions subject to ratio incurrence or capped by baskets subject to a percentage of EBITDA / Total Asset***

Navigating the Consummation of an Acquisition under a Credit Agreement

- Acquiring another business will constitute an "investment" under a Borrower's credit agreement and therefore be regulated by the negative covenants
  - A Borrower is going to prefer incurring the investment pursuant to an uncapped exception (*i.e.*, the ratio incurrence exception or "Permitted Acquisition" exception (where the target will become a loan party))
    - The ratio exception is often based on "total net leverage" pegged to the closing leverage (but may include a "no worse" than prong), which will be calculated pro forma for the acquisition and related transactions (*e.g.*, incurrence of debt)
    - Borrowers may also look to use baskets that are capped to a dollar amount, which generally grows based on the pro forma Adjusted EBITDA of the Borrower
- If an acquisition is debt financed, a Borrower will need to rely on an exception to the debt (and liens) negative covenants
  - Debt may be incurred under the "accordion" in a credit agreement, which is an uncommitted facility that allows a Borrower to incur indebtedness based on:
    - First lien net leverage ratio
    - Secured net leverage ratio
    - Total net leverage ratio / interest coverage ratio
- Use of the LCT (at time of signing a purchase agreement) provides certainty that a Borrower may consummate the acquisition and incur the debt

Panelists

Panelists

		
Kira Mineroff, Partner & Moderator	Michelle Kilkenney, Partner & Panelist	Heather Waters Borthwick, Partner & Panelist
DLA PIPER	KIRKLAND & ELLIS	DLA PIPER
1251 Avenue of the Americas New York, NY 10020 51 John F. Kennedy Parkway Suite 120 Short HIlls, NJ 07078-2704 +1-212-335-4932 kira.mineroff@us.dlapiper.com	300 N. LaSalle Drive Chicago, IL 60654 +1-312-862-2000 mkilkenney@kirkland.com	1251 Avenue of the Americas New York, NY 10020 +1-212-335-4845 heather.watersborthwick@dlapiper.com

nawl.org