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In Practice

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COVID-19 and the impact on financial covenants

In this In Practice article the authors examine the impact of COVID 19 on financial covenants. A borrower may seek to argue that financial ratios should be calculated on the basis of "EBITDAC", so that the effect of the Coronavirus is ignored.

INTRODUCTION

Since the escalation of the COVID 19 outbreak in the UK during March and April 2020, businesses across all sectors have been affected by issues flowing from customers and the workforce self-isolating and from staff having to work from home and adjust their usual working patterns. Many businesses have experienced severe interruptions in their supply chains and the financial sector has experienced market volatility not seen for over a decade. These unprecedented circumstances have resulted in borrowers and lenders alike closely examining the attendant impact on the financial covenant tests in loan documentation.

COVENANT LITE?

Lenders have traditionally relied on a range of maintenance financial covenants to enable them to monitor a borrower's financial condition and to pick up signs of distress at an early stage, thereby giving them a seat at the table on any restructuring discussions. However, lenders have increasingly relinquished some of the protection afforded by financial covenants and by the end of 2019 the vast majority of syndicated leveraged loans could be classified as "covenant-lite" – that is, loans with no ongoing maintenance financial covenants.

Nevertheless, not all loans to borrowers currently experiencing financial distress will be structured as cov-lite. In the mid-market it is still common to see club deals and bilateral facilities with at least one form of financial covenant. Even on larger deals, lower revenues resulting from COVID 19 could result in a breach of financial ratios which may impact on pricing or on a borrower's flexibility to undertake other activities (for example incurring new debt, paying dividends or making acquisitions).

IMPACT OF DRAWING DOWN EXISTING FACILITIES

Many borrowers have reacted to COVID 19 by drawing down liquidity facilities which, in times of normal trading, may have remained untouched. Some have elected to draw down their revolving credit facility (RCF) in full, despite the interest cost of doing so. This maximises liquidity in the business and guards against the risk that COVID 19-related events might constitute a Default which would allow lenders to block further drawings.

Drawing the RCF is likely to impact on financial covenants, including on cov-lite deals, where RCF lenders will typically benefit from a "springing" leverage covenant, triggered when the RCF is drawn to a certain level (typically around 40%). If there is a leverage financial covenant, "Borrowings" may be increased by any RCF drawing. Occasionally the document may state that RCF drawings are excluded from "Borrowings" for these purposes, but this would be unusual. The precise impact will depend on the detail of the financial covenant definitions. To the extent that only net debt, ie deducting cash or cash equivalents, is taken into account for the purposes of a leverage covenant calculation, there will be no adverse impact on ratios until the cash is actually spent. To the extent that gross debt is tested, the reverse is true. It will also be important, when maintaining RCF drawings, to ensure any "clean down" test is complied with, ie the requirement to reduce RCF drawings (net of cash on balance sheet) to zero for a short test period (usually five business days) each year.

SUBJECTIVE ELEMENTS IN FINANCIAL COVENANT DEFINITIONS

Over the past decade, well advised borrowers have succeeded in remoulding the rules for calculating earnings before interest, tax, depreciation and amortisation (EBITDA) by introducing a range of subjective elements which make it easier to game the related financial covenants.

EBITDA "add-backs" allow a borrower to boost notional operating profit. For instance, borrowers have increasingly been able to include projected (but as yet unrealised) synergies, such as cost savings likely to result from an acquisition or the implementation of a group initiative. Add-backs for non-recurring costs related to other events such as restructurings, reorganisations, start-up costs and business disruption events may now also be permitted. Consequently, a borrower may have considerable latitude to exercise its subjective judgement to ensure that financial covenants are complied with, even at a time of financial stress on the business.

EXCEPTIONAL ITEMS AND BUSINESS DISRUPTION PROVISIONS

In this context, borrowers may now seek to argue that the effects of COVID 19 on the business constitute an "exceptional item" which can be added back into EBITDA. This can be a difficult question to resolve, particularly given the bespoke (and at times ambiguous) drafting in financial covenant definitions. IFRS does not define what constitutes an exceptional item, so a borrower might seek to exploit this ambiguity to increase its flexibility in interpreting EBITDA. In many cases, a borrower will have succeeded in including a long, but explicitly non-exhaustive, list of items which are to be treated as "exceptional" and thus ignored when calculating EBITDA.

Financial covenant definitions may also include business disruption event provisions. Such clauses are triggered by exceptional events, such as an act of god, terrorism or (possibly) a pandemic, which negatively

In Practice

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affect the performance of the business during the relevant covenant testing period. The impact on the covenant calculations will be that, if EBITDA for the relevant period is lower than would be required to meet the financial covenant test, the borrower can instead elect to replace that EBITDA with the EBITDA from the corresponding period in the previous year.

WHEN DOES A BREACH OCCUR?

In most cases, a financial covenant breach will only occur when the borrower actually delivers the relevant Compliance Certificate evidencing such non-compliance (normally 45 days after the test date). Even so, a lender might try to argue that, once it becomes clear that a breach will occur, subject only to the effluxion of time required to deliver the Compliance Certificate, this of itself constitutes a material adverse change (MAC) Event of Default (EoD) and that there is no need to wait until a Compliance Certificate is actually delivered to call the EoD.

It will be important for a borrower to check the definition of "Material Adverse Effect" (MAE) to determine whether this argument could apply. A strong borrower will typically have ensured that any potential effect on financial covenant compliance should be explicitly disregarded when determining whether there has been a MAE based on the financial condition of the Group. In addition, ideally (from a borrower's perspective), the MAE definition will focus solely on the borrower's ability to fulfil payment obligations, rather than other obligations under the Finance Documents or the ability to comply with the financial covenants.

EQUITY CURE PROVISIONS

Should a breach of a financial covenant occur, an equity cure right is a right for the shareholders to invest additional equity or subordinated debt into the Group to cure that breach. The terms of the equity cure will specify how the new equity is to be treated for the purposes of the financial covenant calculations. If the covenant is satisfied once retested, taking into account the additional equity injected, the covenant breach will be effectively "cured".

The standards applicable to equity cures have been loosened in favour of borrowers in recent years. Traditionally, borrowers have had the opportunity to cure a ratio breach, with the cure amount used to notionally reduce total net debt. A stronger position increasingly obtained by borrowers is for the cure amount to be added to EBITDA for the purposes of covenant calculation, which is more flattering to the relevant ratio.

Key points for a borrower to focus on will include:

- Timing deadlines for an equity cure being implemented.
- How the cure amount is to be applied?
- Whether there is a requirement to repay debt using any portion of the equity cure amount and whether there is a restriction on "over cures"?
- How the equity cure amount is treated for future financial covenant tests once injected; is the relevant cash required to be retained by the business?
- Restrictions on equity cure rights in terms of quantum and number per financial year or in consecutive testing periods?

In practice, it is relatively rare for an equity cure to be made in isolation and strictly following the prescribed provisions of the document. More often than not, an equity injection will be made by shareholders as part of a wider discussion with the lenders to secure further future flexibility, such as re-cutting the financial covenant ratios.

Many facilities now also include so called "deemed cure" provisions which provide that, if the lenders do not take enforcement action in relation to a financial covenant breach until after the next test has occurred, and the subsequent test is passed, they cannot take action in relation to the original breach which occurred in relation to that first period.

ASSET BACKED FACILITIES

Given the potential impact of COVID 19 on interconnected supply chains and revenue streams, borrowers under asset backed facilities may find that recent events have significantly reduced the "borrowing base" against which liquidity facilities are tested. Depending on the nature of the facility, this could trigger increased reporting obligations, onerous restrictions on cash management and compliance with additional financial ratio tests.

IMPACT OF A FINANCIAL COVENANT BREACH

Under an LMA-style loan agreement, if the Majority Lenders instruct the Agent to do so, an EoD entitles the lenders to accelerate the facilities and take enforcement action. However, lenders will be acutely aware that enforcement leading to a formal insolvency process is typically destructive of value as compared to a consensual solution. In this context, it will be important to consider other options in terms of debt restructuring and re-pricing.

Even if the debt under a facility is not accelerated, it will also be important for parties to understand the potential impact of an EoD in terms of triggering margin increases and prohibitions on other previously permitted actions. Whilst an EoD is continuing, the lenders may also have the ability to transfer debt more freely, meaning that the borrower could lose its veto on debt transfers to competitors or speculative "loan to own" investors. Where there are multiple facilities in place for a borrower, an EoD under one facility also risks cross defaulting its other facilities. ■

Further Reading:

- The evolving fiction of EBITDA in the European leveraged finance loans market (2018) 10 JIBFL 603.