FINANCIAL COVENANTS

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FINANCIAL COVENANTS

• What are financial covenants?
• Building blocks for financial covenants
• Overview of Principal Financial Covenants
• Drafting and negotiating tips
WHAT ARE FINANCIAL COVENANTS?
WHAT ARE FINANCIAL COVENANTS?

- Financial benchmarks to ensure a company stays healthy.
- Measures financial health/operating performance of the business.
- First line of defense for lenders/investors (i.e. early warning signs that debt repayment is in jeopardy and leaves money for repayment)
- Two main categories: Incurrence and Maintenance
  - Incurrence: Permits certain action (e.g. debt incurrence or dividend) if financial benchmark is met. Failure to meet benchmark results in action being prohibited.
  - Maintenance: Tested periodically (e.g. quarterly) to ensure financial benchmark is met. Failure to meet benchmark likely results in default.
- Building blocks of financial covenants:
  - Balance Sheet of company – Assets and Liabilities
  - Income Statement of company – Cash Flow items
BUILDING BLOCKS

• The income statement
  • Consolidated net income
  • Earnings before interest, taxes, depreciation and amortization (EBITDA)
  • Fixed Charges

• The balance sheet
  • Assets
  • Liabilities
  • Equity/Net Worth
  • Indebtedness
BUILDING BLOCKS

• Adjustments to the building blocks
  • Dispositions and acquisitions
  • Annualization
  • Build Ups/Plug Numbers
THE INCOME STATEMENT

• Income statement sets out how much a company has earned or lost on its business during the period before the statement
  • Buying low and selling high
  • Buying high and selling low
THE INCOME STATEMENT

• Consolidated net income
  • What the borrower earns under GAAP
    • Accrued revenues less accrued costs
    • All kinds of noise in CNI—depreciation, amortization, tax accruals, and capital gains and losses
    • Because of noise, rarely used as a stand alone component of a financial covenant
    • In high yield used to determine dividend availability
  • Consolidated—the borrower and its subsidiaries
    • Joint ventures and other minority interests
    • Restricted v. Unrestricted Subsidiaries
THE INCOME STATEMENT

• Earnings before interest, taxes, amortization, and depreciation (EBITDA)
  • Earnings means consolidated net income
  • “Before” means “plus”
  • Simply lender’s way to measure cash flow available to pay interest expense and taxes
    • What’s in your check book to pay the bills
    • Capital expenditures don’t reduce net income
THE INCOME STATEMENT

• Earnings before interest, taxes, amortization, and depreciation (EBITDA) (cont’d):
  • Other non-cash items that reduce net income
    • Write downs of inventory or fixed assets
    • Mark-to-market activities
  • Cash items often added back anyway
    (Theory: measure ordinary operations)
    • Non-recurring items
    • Extraordinary items
    • Capital gains/losses from asset sales
THE INCOME STATEMENT

• Fixed Charges
  • Interest expense
  • Restricted Payments
    • Dividends
    • Stock buybacks
  • Capital expenditures (occasionally in bank deals, essentially never in high yield)
  • Scheduled principal payments (current maturities of long term indebtedness) (occasionally in bank deals, essentially never in high yield)
  • Lease Expense (occasionally in bank deals, essentially never in high yield)
Sample bank-style Consolidated Net Income definition:

“Consolidated Net Income” means, for any period and for any Person on a consolidated basis, all net income of such Person and its Restricted Subsidiaries for such period.
THE INCOME STATEMENT

• Sample high yield-style Consolidated Net Income definition:
• “Net Income” means, with respect to any specified Person, the net income (loss) of such Person, determined in accordance with GAAP and before any reduction in respect of preferred stock dividends, excluding, however:
  (1) any gain (or loss), together with any related provision for taxes on such gain (or loss), realized in connection with:
    (a) any Asset Sale;
    (b) the disposition of any securities by such Person or any of its Restricted Subsidiaries or the extinguishment of any Indebtedness of such Person or any of its Restricted Subsidiaries; and
  (2) any extraordinary gain (or loss), together with any related provision for taxes on such extraordinary gain (or loss).
THE INCOME STATEMENT

• Sample high yield-style Consolidated Net Income definition (cont’d):
  • “Consolidated Net Income” means, with respect to any specified Person for any period, the aggregate of the Net Income of such Person and its Restricted Subsidiaries for such period, on a consolidated basis, determined in accordance with GAAP; provided that:
    (1) the Net Income of any Person that is not a Restricted Subsidiary or that is accounted for by the equity method of accounting shall be included only to the extent of the amount of dividends or similar distributions (including pursuant to other intercompany payments) paid in cash to the specified Person or a Restricted Subsidiary of the Person;
    (2) for purposes of the provisions of [dividend bucket] only, the Net Income of any Restricted Subsidiary shall be excluded to the extent that the declaration or payment of dividends or similar distributions by that Restricted Subsidiary of that Net Income is not at the date of determination permitted without any prior governmental approval (that has not been obtained) or, directly or indirectly, by operation of the terms of its charter or any agreement, instrument, judgment, decree, order, statute, rule or governmental regulation applicable to that Restricted Subsidiary or its stockholders;
    (3) the cumulative effect of a change in accounting principles shall be excluded; and
    (4) any non-cash impairment charges incurred subsequent to the Issue Date shall be excluded.
THE INCOME STATEMENT

- Sample bank-style Consolidated EBITDA definition:
- “Consolidated EBITDA” means, for any period, for any Person, on a consolidated basis, an amount equal to Consolidated Net Income for such Person and its Restricted Subsidiaries (other than Project Financing Subsidiaries) for such period:
- plus
  (a) the following to the extent deducted (or with respect to clause (vii) below, to the extent not otherwise included) in calculating such Consolidated Net Income,
  (i) (A) interest expense and (B) charges in connection with the payment, repayment redemption, defeasance, early retirement or refinancing of any Indebtedness;
  (ii) income tax expense,
  (iii) depreciation and amortization expense,
  (iv) losses from sales of assets outside the ordinary course of business,
  (v) non-cash extraordinary items and non-cash impairment charges,
  (vi) non-recurring noncash charges,
  (vii) cash distributions actually received from Unrestricted Subsidiaries and from Joint Venture Entities, and
  (viii) (A) unrealized losses in respect of derivatives resulting from mark to market activity, and (B) cash received in respect of gains from derivatives,
THE INCOME STATEMENT

• Sample bank-style Consolidated EBITDA definition (cont’d):
• minus
  – (b) the following to the extent included in calculating such Consolidated Net Income:
    (i) gains from sales of assets outside the ordinary course of business,
    (ii) income from Unrestricted Subsidiaries and from Joint Venture Entities; and
    (iii) (A) unrealized gains in respect of derivatives resulting from mark to market activity, and (B) cash paid in respect of realized losses on derivatives,
• Consolidated EBITDA for a Person for a consecutive four quarter period shall be calculated after giving effect, on a pro forma basis, to Acquisitions and Dispositions made by such Person or its Restricted Subsidiaries during such period (and subsequent to such period and on or before the date of incurrence of the Indebtedness giving rise to the need to calculate the Leverage Ratio) as if such Acquisitions or Dispositions occurred on the first day of the period.
THE INCOME STATEMENT

• Sample high yield-style Consolidated EBITDA definition:
  • “Consolidated Cash Flow” means, with respect to any specified Person for any period, the Consolidated Net Income of such Person for such period plus, without duplication:
    (1) an amount equal to any extraordinary loss plus any net loss realized by such Person or any of its Restricted Subsidiaries in connection with an Asset Sale or the disposition of any securities by such Person or any of its Restricted Subsidiaries or the extinguishment of any Indebtedness of such Person or any of its Restricted Subsidiaries, to the extent such losses were deducted in computing such Consolidated Net Income; plus
    (2) provision for taxes based on income or profits of such Person and its Restricted Subsidiaries for such period, to the extent that such provision for taxes was deducted in computing such Consolidated Net Income; plus
    (3) the Fixed Charges of such Person and its Restricted Subsidiaries for such period, to the extent that such Fixed Charges were deducted in computing such Consolidated Net Income; plus
THE INCOME STATEMENT

• Sample high yield-style Consolidated EBITDA definition (cont’d):
  (4) depreciation, depletion, amortization (including amortization of intangibles) and other non-cash expenses (excluding any such non-cash expense to the extent that it represents an accrual of or reserve for cash expenses in any future period) of such Person and its Restricted Subsidiaries for such period to the extent that such depreciation, amortization and other non-cash expenses were deducted in computing such Consolidated Net Income; plus
  (5) charges associated with fees and expenses, including professional fees, incurred prior to the Issue Date in connection with the modification of or preparation in connection therewith of Indebtedness of the Company that occurred prior to the Issue Date, to the extent such charges were deducted in computing such Consolidated Net Income; plus
  (6) cash received during such period related to mark-to-market activities; less
  (7) cash paid during such period related to mark-to-market activities;

provided, however, that for purposes of this definition, any mark-to-market earnings or losses shall be excluded from the calculation of Consolidated Cash Flow to the extent taken into account in calculating Consolidated Net Income for such period.
THE BALANCE SHEET

• Shows book solvency of the company
THE BALANCE SHEET

• Assets
  • Book value of what the company owns
  • Long term v. short term assets
  • Tangible v. intangible assets
  • Total Assets/Consolidated Net Tangible Assets
THE BALANCE SHEET

• Liabilities
  • Book value of what the company owes
  • Current liabilities v. long-term liabilities
THE BALANCE SHEET

• Equity/Net Worth
  • Assets minus liabilities

• Tangible Net Worth
  • Net Worth minus intangibles
  • goodwill, trademarks, patents, unamortized debt discounts and expenses and other like intangibles
THE BALANCE SHEET

• Indebtedness
  • Debt for borrowed money
  • Deferred purchase price for sales or services
  • Capital leases
  • Letters of credit and surety bonds
  • Guaranties of or security for debt of others
  • Mandatorily redeemable preferred stock
  • Hedging obligations
  • Off-balance sheet obligations and other liabilities

• Net Debt
THE BALANCE SHEET

Sample definitions:

• “Consolidated Net Worth” means, with respect to any specified Person as of any date, the assets of such Person less the liabilities of such Person all as determined on a consolidated basis in accordance with GAAP.

• “Consolidated Tangible Net Worth” means, as of any date of determination, for any Person on a consolidated basis, (a) the Consolidated Net Worth as of such date minus (b) goodwill, trademarks, patents, unamortized debt discounts and expenses and other like intangibles as of such date;

• “Consolidated Net Tangible Assets” means as of any date of determination, the Total Assets of the Partnership and the Restricted Subsidiaries as would be shown on a consolidated balance sheet of the Partnership and the Restricted Subsidiaries prepared in accordance with GAAP as of that date less applicable reserves reflected in such balance sheet, after deducting the following amounts: (a) all current liabilities reflected in such balance sheet, and (b) all goodwill, trademarks, patents, unamortized debt discounts and expenses and other like intangibles reflected in such balance sheet.
Sample Definitions (cont’d):

- **Indebtedness** means, as to any Person at a particular time, without duplication, all of the following, whether or not included as indebtedness or liabilities in accordance with GAAP:
  
  (a) all obligations of such Person for borrowed money and all obligations of such Person evidenced by bonds, debentures, notes, loan agreements or other similar instruments;
  
  (b) to the extent not paid on or prior to the fifth Business Day after the due date therefor, all payment obligations of such Person arising under letters of credit, bankers’ acceptances, bank guaranties, surety bonds and similar instruments;
  
  (c) all obligations of such Person to pay the deferred purchase price of property or services (other than trade accounts payable in the ordinary course of business);
  
  (d) indebtedness (excluding prepaid interest thereon) secured by a Lien on property owned or being purchased by such Person (including indebtedness arising under conditional sales or other title retention agreements), whether or not such indebtedness shall have been assumed by such Person or is limited in recourse;
  
  (e) capital leases;
  
  (f) the greater of the voluntary or involuntary liquidation value of, plus any accrued and unpaid dividends on, any preferred Equity Interests of such Person redeemable at the option of the holder thereof; and
  
  (g) all Guaranties of such Person in respect of any of the foregoing.
ADJUSTMENTS TO THE BUILDING BLOCKS

- Acquisitions and Dispositions
- Annualization
- Buildups
- Plug Numbers
- Kitchen sink
  - Transaction costs
  - Litigation settlement costs
ADJUSTMENTS TO THE BUILDING BLOCKS

• Acquisitions and Dispositions
  – Bank-style pro forma adjustment clause:
• Consolidated EBITDA for a Person for a consecutive four-quarter period shall be calculated after giving effect, on a pro forma basis, to Acquisitions and Dispositions made by such Person or its Restricted Subsidiaries during such period (and subsequent to such period and on or before the date of incurrence of the Indebtedness giving rise to the need to calculate the Leverage Ratio) as if such Acquisitions or Dispositions occurred on the first day of the period.
ADJUSTMENTS TO THE BUILDING BLOCKS

• Acquisitions and Dispositions
  – High-yield style pro forma adjustment clause:
  • In the event that the specified Person or any of its Restricted Subsidiaries incurs, assumes, guarantees, repays, repurchases, redeems, defeases or otherwise discharges any Indebtedness (other than ordinary working capital borrowings) or issues, repurchases or redeems preferred stock subsequent to the commencement of the period for which the Fixed Charge Coverage Ratio is being calculated and on or prior to the date on which the event for which the calculation of the Fixed Charge Coverage Ratio is made (the “Calculation Date”), then the Fixed Charge Coverage Ratio shall be calculated giving pro forma effect to such incurrence, assumption, guarantee, repayment, repurchase, redemption, defeasance or other discharge of Indebtedness, or such issuance, repurchase or redemption of preferred stock, and the use of the proceeds therefrom as if the same had occurred at the beginning of the applicable four-quarter reference period.
ADJUSTMENTS TO THE BUILDING BLOCKS

• **High-yield style pro forma adjustment clause (cont’d):**

In addition, for purposes of calculating the Fixed Charge Coverage Ratio:

1. acquisitions that have been made by the specified Person or any of its Restricted Subsidiaries, including through mergers or consolidations, or any Person or any of its Restricted Subsidiaries acquired by the specified Person or any of its Restricted Subsidiaries, and including any related financing transactions and including increases in ownership of Restricted Subsidiaries, during the four-quarter reference period or subsequent to such reference period and on or prior to the Calculation Date shall be given pro forma effect in accordance with Regulation S-X under the Securities Act as if they had occurred on the first day of the four-quarter reference period and Consolidated Cash Flow for such reference period will be calculated on a pro forma basis;

2. the Consolidated Cash Flow attributable to discontinued operations, as determined in accordance with GAAP, and operations or businesses (and ownership interests therein) disposed of prior to the Calculation Date, shall be excluded;

3. the Fixed Charges attributable to discontinued operations, as determined in accordance with GAAP, and operations or businesses (and ownership interests therein) disposed of prior to the Calculation Date, shall be excluded, but only to the extent that the obligations giving rise to such Fixed Charges will not be obligations of the specified Person or any of its Restricted Subsidiaries following the Calculation Date; and

4. if any Indebtedness that is being incurred on the Calculation Date bears a floating rate of interest, the interest expense on such Indebtedness shall be calculated as if the rate in effect on the Calculation Date had been the applicable rate for the entire period (taking into account any Hedging Obligations applicable to such Indebtedness, but only for such period of time as equals the then remaining term of such Hedging Obligations as of the Calculation Date).
ADJUSTMENTS TO THE BUILDING BLOCKS

• Annualization
  – 4x, 2x, and 4/3x

• Buildups
  – One, two, three, then four thereafter

• Plug Numbers
  – Agreed pro forma amounts for combined historical financials

• Kitchen Sink
  – Transaction costs
  – Litigation settlement costs
  – Anything else that’s not in the model
OVERVIEW OF PRINCIPAL FINANCIAL COVENANTS
OVERVIEW OF PRINCIPAL FINANCIAL COVENANTS

• Balance Sheet
  • Minimum Net Worth/Tangible Net Worth
  • Maximum Debt to Capitalization
  • Maximum Debt to Net Worth/Tangible Net Worth
  • Minimum Current Ratio (i.e. current assets to current liabilities)
• Income Statement
  • Minimum Interest Coverage Ratio
  • Minimum Debt Service Coverage Ratio
  • Minimum Fixed Charge Coverage Ratio
  • Minimum EBITDA/Net Income
• Combined Income Statement/Balance Sheet
  • Maximum Debt to EBITDA
  • Maximum Senior Debt to EBITDA
BALANCE SHEET

• Minimum Net Worth/Tangible Net Worth
  • Start with fixed minimum based on percentage of actual at close
  • Build up from (1) positive CNI, usually 50%, and (2) equity raises
  • Effect is to limit distributions and increases in leverage over time
  • Example:

    Shall not permit the Tangible Net Worth as of the end of any fiscal quarter to be less than (a) $240,000,000, plus (b) an amount equal to 50% of the Consolidated Net Income for each fiscal quarter ending after December 31, 2009 (with no deduction for a net loss in any such fiscal quarter), plus (c) 75% of the Equity Issuance Proceeds from any Equity Issuance consummated after the Effective Date, plus (d) 75% of the increase in the Stockholders' Equity resulting from the conversion after the Effective Date of any Convertible Senior Notes into common stock of the Parent.
BALANCE SHEET

• Maximum Debt to Capitalization
  • Typically only financial covenant in investment grade bank deals
  • Capitalization is usually total debt plus net worth
  • Example:

The Borrower will not permit the outstanding principal amount of Consolidated Net Debt, as of the last day of any fiscal quarter, beginning with the last day of the fiscal quarter in which the Closing Date occurs, to exceed 60% of Total Capitalization as of such date.
BALANCE SHEET

• Maximum Debt to Net Worth/Tangible Net Worth
  • Least common of the balance sheet tests
  • Example:

  The Borrower will not permit, as of the last day of any fiscal quarter, the outstanding principal amount of its Indebtedness on such date to its Net Worth on such date to exceed 5.00 to 1.00
BALANCE SHEET

• Minimum current assets to current liabilities
  • A test of borrower’s liquidity
  • Typical level is one to one
  • Example:

The Borrower will not permit, as of the last day of any fiscal quarter, the ratio of its current assets to current liabilities to be less than 1.0 to 1.0
INCOME STATEMENT

• Minimum Interest Coverage Ratio
• Consolidated EBITDA for the trailing four quarters (LTM or TTM) to interest expense for the same period
  • Example:
    The Borrower shall not permit as of the last day of any fiscal quarter, (a) in the case of the fiscal quarter ending June 30, 2010, the ratio of (i) Consolidated EBITDA to (ii) Consolidated Interest Expense, in each case for such fiscal quarter, (b) in the case of the fiscal quarter ending September 30, 2010, the ratio of (i) Consolidated EBITDA to (ii) Consolidated Interest Expense, in each case for the two fiscal quarter period then ended, (c) in the case of the fiscal quarter ending December 31, 2010, the ratio of (i) Consolidated EBITDA to (ii) Consolidated Interest Expense, in each case for the three fiscal quarter period then ended and (d) in the case of any fiscal quarter ending after December 31, 2010, (i) Consolidated EBITDA to (ii) Consolidated Interest Expense, in each case for the four fiscal quarter period then ended to be less than 2.00 to 1.00.
INCOME STATEMENT

• Minimum Debt Service Coverage Ratio
  • Usually the hurdle for distributions in project finance (the “cash trap”)
  • Cash available for debt service
    • In project finance, cash in less cash out
    • In corporate bank finance, Consolidated EBITDA
  • Interest and fees plus scheduled principal reductions
  • Example:

  For the four (4) Fiscal Quarters ending on a Payment Date the ratio of (i) Cash Flow Available for Debt Service during such period to (ii) Debt Service during such period shall have been 1.75 to 1.00 or higher.
INCOME STATEMENT

• Minimum Fixed Charge Coverage Ratio
  • Used as a maintenance test in leveraged bank credits
  • Used as debt incurrence and restricted payments covenants in high yield
    • Example:

"Fixed Charge Coverage Ratio" means with respect to any specified Person for any period, the ratio of the Consolidated Cash Flow of such Person and its Restricted Subsidiaries for such period to the Fixed Charges of such Person for such period.
INCOME STATEMENT

• Minimum EBITDA/Net Income
  • Typically only seen in highly leveraged or distressed credits
  • DIP financings often have some variation tied to a budget
  • Bad covenant for a borrower to manage
COMBINED INCOME STATEMENT/BALANCE SHEET

• Maximum Debt to EBITDA
  • Most common leverage test in bank financings
  • The “leverage ratio” as the bankers call it
  • Example:
    The Borrower shall not permit as of the last day of any fiscal quarter the ratio of (a) Consolidated Indebtedness as of such date to (b) Consolidated EBITDA for the period of four fiscal quarters ending on such date to exceed 5.00 to 1.00.
COMBINED INCOME STATEMENT/BALANCE SHEET

• Maximum Senior Debt to EBITDA
  • Same as Debt to EBITDA except subordinated debt subtracted from the numerator
  • Another variation is Secured Debt to EBITDA
  • Both are used for leveraged credits with a combination of senior, usually secured, bank debt and subordinate or high yield debt
DRAFTING AND NEGOTIATING TIPS

• Use formulas
• Use white space
• Use consistent breaking up of clauses with letters and numbers
• Make sure the results are logical
  • Greater than versus less than
  • Minimum versus maximum
• Strive for consistency across credit facilities with same borrower
• Person versus a specific entity
DRAFTING AND NEGOTIATING TIPS

• Use the company’s actual balance sheet and income statement to test terminology and coverage
• Compare components to the model
• Kitchen sink approach to EBITDA
• Covenant fall aways in cross over credits
• Changes in GAAP
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