Proskauer Private Credit Academy

Fundamentals and Pitfalls of EBITDA and Leverage Ratios

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Private Credit Academy 2024

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Proskauer Academy 2024: Private Credit Building Block Series

- Program 1: How to Navigate Any Financing Process to a Successful Closing
- Program 2: Fundamentals and Pitfalls of EBITDA and Leverage Ratios
- Program 3: Incremental Debt Capacity, Terms and Conditions
- Program 4: Get to Know Your Credit Group and Collateral
- Program 5: Stop Leakage from Your Credit Group and Collateral
- Program 6: The Evolving Landscape of Liability Management Transactions

Program Outline

- A. Components of a Leverage Ratio
 - Leverage Ratio Basics
 - ii. Consolidated Net Income
 - iii. Consolidated EBITDA
 - iv. Funded Debt & Cash Netting
- B. Financial Maintenance Covenants and Cures



Components of a Leverage Ratio



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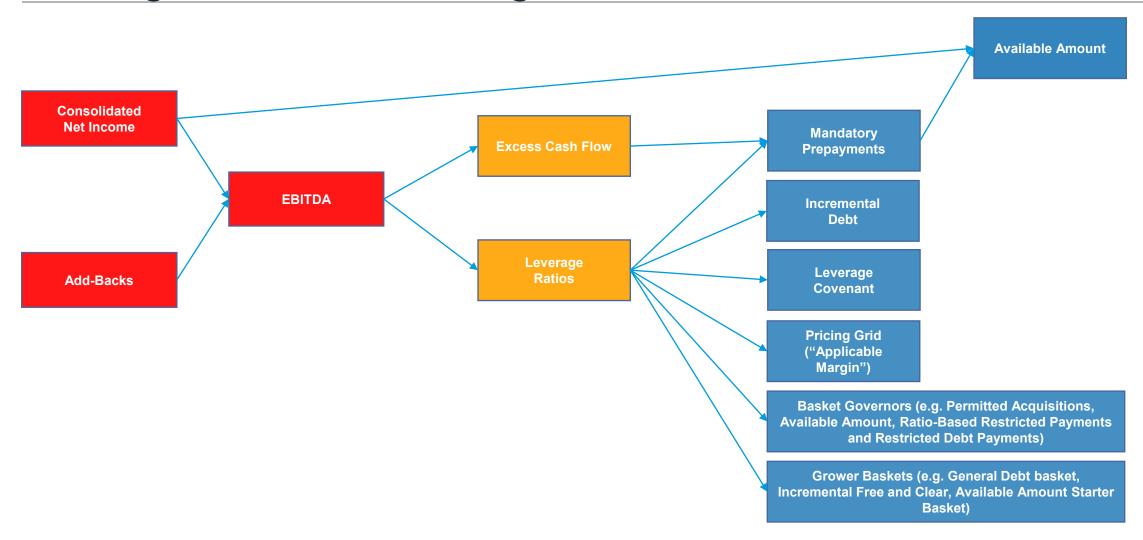
Leverage Ratio Basics

• Leverage Ratio equals (i) the principal/face amount of "Funded Debt" as of a test date divided by (ii) "Consolidated EBITDA" for the test period (often the last 4 Fiscal Quarters or a trailing 12 mo. period)

Leverage Ratio
$$=$$
 $\frac{\text{Funded Debt}}{\text{Consolidated EBITDA}}$

- "Funded Debt" subset of "Indebtedness"
- "Consolidated EBITDA" GAAP Consolidated Net Income plus addbacks and adjustments

Leverage Ratios in Credit Agreements





Consolidated Net Income (CNI)

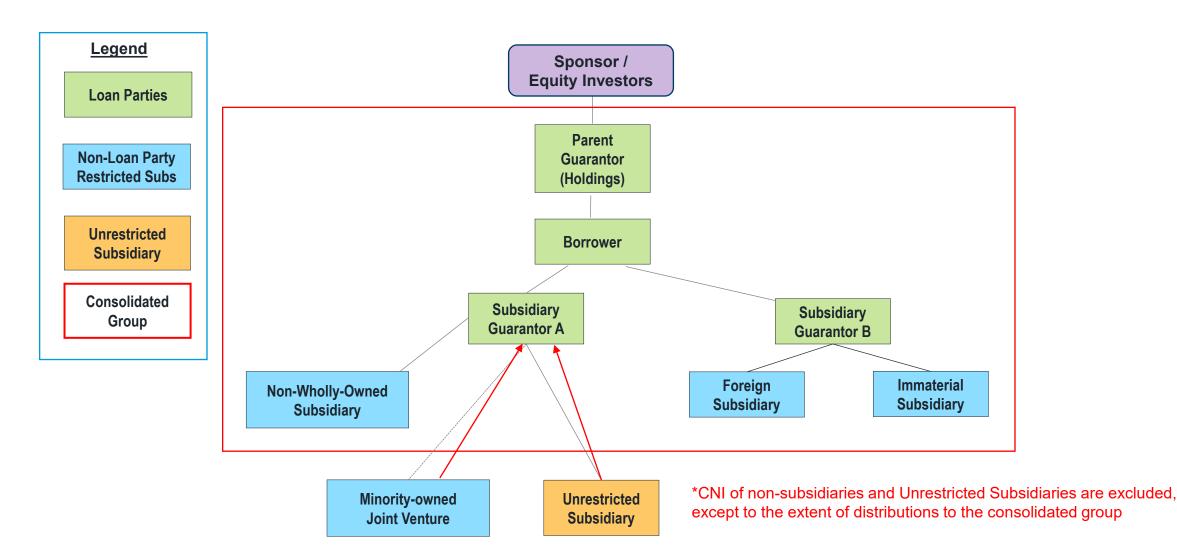
- Trailing 4 fiscal quarter net income (or deficit) of a <u>Person and its</u> <u>Consolidated Subsidiaries</u> calculated in accordance with GAAP, with <u>exclusions</u> for:
 - the net income (or deficit) of (i) any other Person that is not a Subsidiary in which the Person/Consolidated Subsidiaries has an ownership interest (e.g. joint venture or minority owned entity) or (ii) an Unrestricted Subsidiary, in each case, except to the extent that any such income is actually received by a Credit Party in the form of cash dividends or similar cash distributions
 - net income of any Subsidiary to the extent that the declaration of payment or dividends or similar distributions by such Subsidiary is not at the time permitted by the terms of any contractual obligation, governing document or applicable Law [Note: lender favorable exclusion]



More sponsor favorable forms may include further exceptions to CNI for items more traditionally added back to EBITDA (such as non-recurring charges)



"Consolidated Group" for Financial Definitions





EBITDA

- Earnings before Interest, Taxes, Depreciation and Amortization
 - Non-GAAP concept
 - Measure of core corporate profitability
 - Provides a more useful comparison across companies with different business models or in different industries
- "Consolidated EBITDA"
 - Consolidated Net Income <u>plus</u> Interest Expense <u>plus</u> taxes <u>plus</u> depreciation and amortization <u>plus</u>...15-30+ adjustments representing cash and non-cash items, past and projected items, realized and unrealized items.
 - Sponsors aim to maximize addbacks and adjustments. A higher "Consolidated EBITDA" computes a lower leverage ratio, with an equal amount of debt.



Consolidated EBITDA

- Most adjustments are made <u>only to the extent deducted from (or excluded from) the calculation of CNI</u>, but this does <u>not</u> apply to certain adjustments such as:
 - anticipated run rate cost savings and synergies
 - addbacks set forth in a Sponsor model or a quality of earnings report delivered in connection with the Closing Date transactions or future acquisitions
 - Maturation adjustments for new locations or new customer contracts, and
 - the pro forma adjustment for acquisitions (allowing an increase to EBITDA assuming the acquisition occurred on the first day of the period rather than on the actual closing date thereof)
- Adjustments should made "without duplication" but be cognizant that addbacks may permit
 the same item to be added back through either a capped or uncapped provision
 - (e.g. certain restructuring costs could constitute extraordinary or non-recurring costs, so a Borrower may be able to select which addback to use for those items)



The Big Three

- Addbacks for (i) cash extraordinary and non-recurring items, (ii) cash restructuring costs, and (iii) run rate cost savings and synergies are the most highly negotiated addbacks. One or more will likely be subject to some formulation of a cap.
- A typical construct for a cap in the middle-market:
 - (i) restructuring costs and (ii) pro forma cost savings/synergies, capped together at 25% -35%+ of Consolidated EBITDA
 - extraordinary and non-recurring items are typically uncapped
 - Cap can be calculated before or after giving effect to such addbacks (typically calculated after giving effect, which results in a higher cap in \$ terms)



If you are seeking an effective cap for extraordinary items, be careful of other standalone addbacks that would have otherwise run through the capped addback (i.e. litigation expenses, transaction expenses, etc.)



Extraordinary, Non-Recurring and Unusual Items

- Extraordinary, non-recurring and unusual losses, charges and expenses are commonly added back to EBITDA, with a deduction for corresponding (i.e., extraordinary, non-recurring and unusual) gains and income
 - "Extraordinary": formerly a GAAP concept (no longer defined under GAAP following FASB ASU 2015-01)
 - Non-recurring and unusual are not GAAP concepts
 - Borrower-friendly forms may also include "exceptional, infrequent, special, one-time, single, non-ordinary course" losses, charges and expenses (none of which are GAAP concepts)
- Common to allow this add-back without any cap, except that:
 - Often subject to the combined capped in lower-middle-market transactions and distressed credits
 - Any cap is limited to cash items; non-cash items (of almost all kinds) are typically permitted to be added back without limitation



Be careful with respect to addbacks that represent ordinary course and recurring operating expenses (employee benefit charges, executive compensation, etc.)



Extraordinary, Non-Recurring and Unusual Items (continued)

- Do "extraordinary losses" include "lost revenue"?
 - COVID highlighted the issue of extraordinary or unusual "lost revenue". It is generally accepted that "lost revenue" is not a permitted addback, regardless of whether specifically excluded from this addback.
 - Addbacks are intended to be made "to the extent deducted from (or excluded from) the calculation of CNI". Lost revenue is not a component of Consolidated Net Income under GAAP.



Restructuring Charges

- Charges incurred in connection with a reorganization (undefined) and other similar events
- Typically capped
- The breadth of this add-back varies widely in the market; there are <u>dozens</u> of items which we have seen included in different versions of this add-back; listed items (e.g., severance and recruiting costs) may not be expressly related to restructurings
- Examples of Similar Events:
 - Inventory optimization programs
 - Closure or consolidation of facilities
 - Employee retention, severance, relocation or recruiting
 - Project start-up costs (sometimes subject to a sub-cap)
 - Implementation, replacement, development or upgrade of systems
 - Professional fees relating to any of the foregoing



Many restructuring costs can be classified as extraordinary/non-recurring items, which may be added back without a cap



Cost Savings and Synergies

- "Run-rate" cost savings, operating expense reductions and synergies
 - Adjustments are not costs or expenses that reduce CNI;
 - Adjustments are expense reductions and cost savings from specific transactions such as acquisitions, dispositions, restructurings, operational changes and "cost savings and other initiatives"
 - Adjustments are projected by the Borrower in good faith; not supported by a third-party report or valuation
 - Lender favorable formulations will require a financial officer of the Borrower to certify that such cost savings are reasonably identifiable, factually supportable, and reasonably anticipated to result from actions taken in the lookforward period in the good faith judgment of the Borrower
 - Intended to be calculated, net of actual realized benefits to avoid double-counting amounts already included in CNI
 - Savings are calculated on "run-rate" basis (meaning the Borrower will extrapolate the amount of savings in future periods based on current rate of savings, despite the fact that the bulk of savings may be made upfront and trail off over time)
 - Typically limited to <u>cost</u> synergies; borrower-favorable formulations may permit <u>revenue</u> synergies (i.e., projections of increased revenues)
- Applies to (1) the Closing Date Transactions and (2) future transactions and initiatives
- <u>Typically capped</u>; but note the cap commonly excludes material items



Cost Savings and Synergies (continued)

- Negotiated Carve Outs to Cap:
 - Adjustments related to the Closing Date Transactions
 - Amounts supported by a Quality of Earnings report, which are typically permitted without a cap pursuant to a separate addback (subject to customary limitations)
 - Pro forma cost savings, so long as they comply with the SEC's Regulation S-X
 - Reg S-X was recently amended (effective January 1, 2021) and now permits optional "Management's
 Adjustments" for certain actions following an acquisition without a time limit for realization. Note "management
 adjustments" could also permit revenue synergies.
- "Look forward" Limitation (12 to 24 months).

...projected by the Borrower in good faith to result from actions (x) that have either been taken, or (y) [with respect to which substantial steps have been taken], [or that are expected to be taken] (in the good faith determination of the Borrower) within 18 months after [the date of the consummation of such acquisition, disposition or other transaction or the commencement of such initiative][the end of such test period]...

- In most formulations, **no** requirement that synergies/cost savings are realized within any time frame
- Consider the flexibility of the bracketed items



Other Pro Forma Adjustments

- Pro Forma Adjustments for Acquisitions & Dispositions
 - CNI will only include the financial results of acquired subsidiaries/business lines as of and following the date of acquisition (but not before) and the financial results of disposed subsidiaries/business lines until the date of disposition (but not after)
 - Consolidated EBITDA will reflect a pro forma adjustment for subsidiaries/business lines acquired during the test period, as if acquired on the first day of the test period
 - Reciprocal treatment should be included for disposed subsidiaries/business lines (as if disposed of on the first day of the test period)
- Pro Forma Basis Calculations:

...any other Investments so long as (x) at the time of any such Investment, no Event of Default shall have occurred and be continuing or would result therefrom and (y) after giving effect to such Investment, the Total Net Leverage Ratio, calculated on a Pro Forma Basis, is less than [__]:1.00;



"Pro Forma Basis" adjustments that mirror the cost savings and synergies add-back should be subject to the same combined cap



Sponsor Model and Quality of Earnings Reports

- Closing Date Sponsor Model and QoE Any adjustments included in these reports can typically be added back (uncapped)
- Post Closing QoE Reports Any adjustments included in these reports can
 typically be added back (uncapped); should be limited to QoEs (i) prepared by a
 nationally or regionally recognized firm (or other firm reasonably acceptable to
 Agent), (ii) prepared in connection with a Permitted Acquisition or similar
 Investment and (iii) delivered to Agent



Pay careful attention to sponsor model addbacks and QofE addbacks that refer to adjustments "of the type" included in these reports or adjustments "without regard to time periods and amount"

Other Deal/Industry Specific Consolidated EBITDA Adjustments

- "De Novo Locations"/Maturation Addbacks
 - Increase to Consolidated EBITDA by a specified plug number (representing typical mature location EBITDA) for each new location for a certain period following opening (12-24 mo.); per location plug reduced by actual earnings from such location to avoid duplication of amounts already in CNI
 - Typically capped either individually, or in an aggregate cap with other pro forma amounts
 - Often no corresponding deduction for closed locations
- Run-Rate Effect of New and Modified Contracts
 - Increase to Consolidated EBITDA to reflect the run-rate effect of incremental revenue or contract value from:
 - New contracts (and in some cases, letters of intent)
 - Modified contracts that increase volume or pricing
 - Typically capped either individually, or in an aggregate cap with other pro forma amounts
 - Often no corresponding deduction for terminated/reduced contracts
- Deduction for material capitalized costs (e.g., capitalized software costs)



Selected Common Addbacks

Sometimes capped:

- Cash expenditures related to Closing Date acquisition or future specified transactions (may be limited to a cap on "busted" transactions)
- Director Costs and Expenses Addback; Management Fees (may be capped by reference to what is permitted to be paid)

Typically uncapped:

- Non-cash items (may exclude write offs/write downs of accounts and inventory), other than non-cash items representing a future cash item
- Unrealized currency gains and losses
- Cash expenditures related to Closing Date acquisition or future specified transactions
- Business Interruption Insurance Proceeds
- Income attributable to minority interests of another in any non-wholly-owned Restricted Subsidiary
- Insurance/Indemnification payments received or expected to be received within a period time (but if not received within a specified time period, deducted in that future period)
- Costs or expenses relating to any incentive equity plan, stock option plan or any other management equity incentive
- Legal expenses and fees paid in connection with the Loan Documents
- Public company costs
- Earn-outs: they may be treated as additional compensation (expensed when incurred), or additional purchase price (fair value of the contingent earn-out is recorded as either a liability or equity at the acquisition date)

Funded Debt and Cash Netting

Funded Debt

- "Indebtedness" (or "Debt")
 - Applicable for the debt negative covenant; is defined very broadly
- "Funded Debt" (or "Total Debt")
 - Applicable for the numerator of leverage ratio calculations; defined more narrowly
 - debt for borrowed money
 - debt evidenced by bonds, debentures, notes or other similar instruments (not always included)
 - capitalized leases and purchase money debt
 - earnouts (to the extent a liability under GAAP vs. [5 BD-30 days] past due and payable)
 - letters of credit (if drawn and not promptly repaid)
 - Sometimes also includes the following:
 - "Disqualified Equity" (i.e. preferred equity that has debt-like features, including cash dividends and/or a maturity date)
 - Surety bonds, etc. (but only if drawn and not promptly repaid)
 - deferred purchase price of property or services
 - Accounts payable [90-120 days] past due



Types of Leverage Ratios

First Lien Leverage Ratio

- Funded Debt secured on a first-lien basis by the Collateral, or
- Funded Debt secured on a first-lien basis by any assets of the Consolidated Group
 - Note: this picks up capital leases, cash collateralized L/Cs and any first lien debt of non-Loan Parties (which are senior to the first lien loans)

Secured Leverage Ratio

- Funded Debt secured (with any priority) by the Collateral, or
- Funded Debt secured (with any priority) by any <u>assets</u> of the Consolidated Group
- Note: this picks up capital leases, cash collateralized L/Cs and any secured debt of non-Loan Parties (which are senior to the first lien loans), as well as junior secured loans of the Loan Parties

Total Leverage Ratio

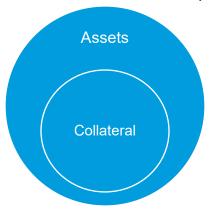
All Funded Debt

In each case, the first option is more Borrower-friendly, and the second option is more Lender-friendly



Secured Leverage Ratios

- Secured by "Assets" vs. "Collateral"
 - More meaningful distinction in businesses with large foreign component (where non-Loan Party debt may be incurred) or that is capital-lease heavy (note that assets subject to capital leases are often excluded from "Collateral").

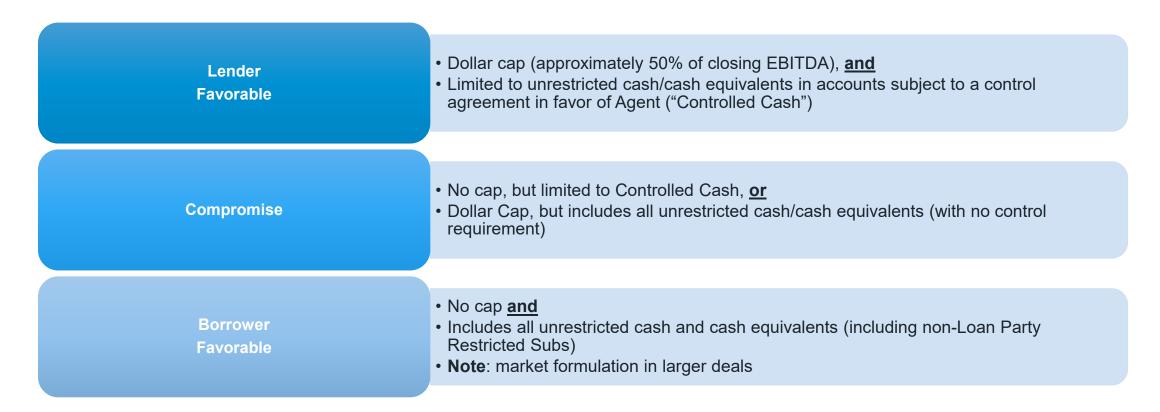


- Ratio Based Debt Incurrence
 - Note that where debt may be incurred based on a ratio incurrence test and secured by non-Collateral assets, careful consideration should be given as to which ratio should apply. If a secured leverage ratio applies and such debt is secured only by non-Collateral, the incurrence would be "leverage neutral".



Cash Netting

$Leverage\ Ratio\ =\ \frac{Funded\ Debt\ \mathit{minus}\ Unrestricted\ Cash\ and\ Cash\ Equivelants}{EBITDA}$



Financial Maintenance Covenants and Cures

Financial Maintenance Covenants

- Maximum [Total] Net Leverage Ratio
 - Typically tested quarterly
 - May be static or tighten over time (i.e., step-downs)
 - Rarely, the covenant may also loosen with certain re-leveraging events (i.e. an acquisition or permitted debt incurrence)
 - Cov-Lite deals may include a First Lien Net Leverage Ratio; springing structure based on revolver usage
- Other Less Common Maintenance Covenants (more common in smaller / lender favorable deals and work-outs / restructurings)
 - minimum Fixed Charge Coverage Ratio (FCCR)
 - maximum Capital Expenditures
 - minimum Liquidity
 - minimum EBITDA
 - maximum Recurring Revenue Leverage



Equity Cures

- Upon a default under the financial maintenance covenant, the Borrower can cure the default by receiving cash proceeds of equity contributions to/equity issuances of the qualified equity of Holdings
 - The cash proceeds are applied on a dollar-for-dollar basis to increase Consolidated EBITDA in an amount sufficient to bring the Borrower in compliance with the financial maintenance covenant
 - Cure will not increase Consolidated EBITDA for any other purposes
 - Cure proceeds will not decrease leverage (by debt repayment or cash netting) in cure quarter



More sponsor favorable forms may permit subordinated debt to be provided by the Sponsor in lieu of equity.



Equity Cures (continued)

- Typical terms:
 - Cure may be made during the default quarter or after, but prior to the date that is [10-15] BDs following the date the applicable financial statements are delivered
 - No over-cure
 - Cap on number of cures over the life of the facility (typically 4-5)
 - No more than 2 cures in any 4 quarters, or no 2 consecutive cures (more lender favorable deals)
 - No requirement to advance additional loans during the cure period, but all remedies are stayed as a result of the financial covenant breach
- The cure proceeds are generally permitted to be retained by the Borrower for working capital (in some more lender favorable deals, may be required to prepay loans)



More sponsor favorable forms may give credit to prior equity contributions that are not otherwise applied (including contributions made prior to the quarter in which the financial covenant breach occurred)



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