Proskauer University

Proskauer

Proskauer University:
Private Credit Building Blocks Series

- Program 1
  - Introduction to Private Credit: Deal Process, Documentation, and Structure Considerations
- Program 2
  - Leverage Ratios: Fundamentals and Pitfalls
- Program 3
  - So You Thought You Were First?
- Program 4
  - Leakage: Plug The Holes BEFORE The Flood
- Program 5
  - Structural Risks: Sneaky Shenanigans
- Program 6
  - Key Market Terms and Commitment Letter Basics
- Program 7
  - Practical Exercise: Tricks to Quickly Spot Issues in Financing Grids

Leverage Ratios: Fundamentals and Pitfalls

Presented by:

Patrick D. Walling

Bharat K. Moudgil

March 2, 2023

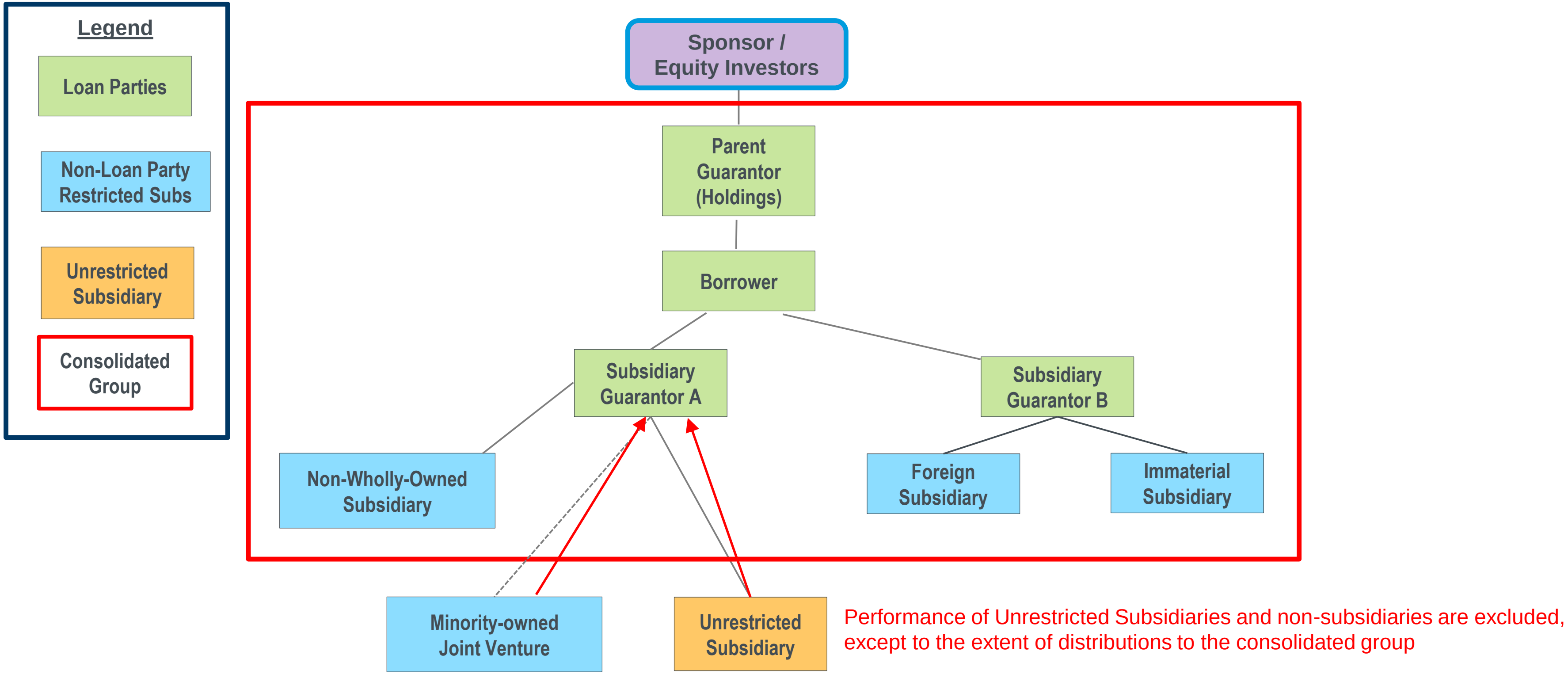
Proskauer

Outline of Topics

A. Cash Flow Leverage Ratios
   i. Consolidated Net Income
   ii. EBITDA
   iii. Funded Debt & Cash Netting

B. Financial Maintenance Covenants and Cures

Consolidated Group for Financial Definitions



Proskauer

Leverage Ratios

Proskauer

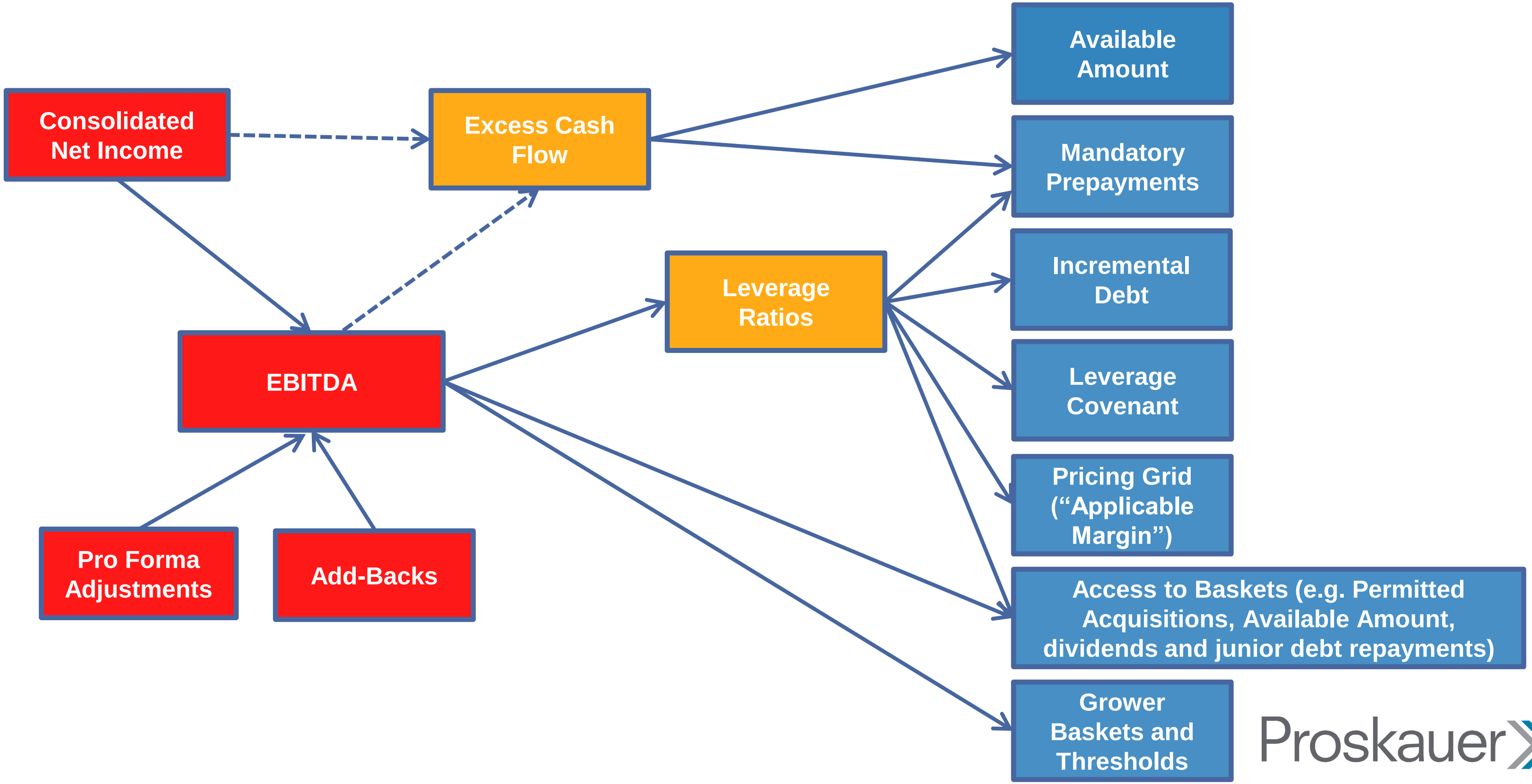
Leverage Ratios Basics

- We will be discussing cash flow leverage ratios, which compare the principal amount of corporate debt to the company's earnings

- $\text{Leverage Ratio} = \dfrac{\text{Funded Debt}}{\text{EBITDA}}$

- This is the most important financial metric in most financings
  - Fundamental underwriting criteria
  - By far, the most common financial maintenance covenant
  - Limits additional debt incurrence, as well as restricted payments, junior debt payments, and other material actions affecting the credit

Leverage Ratios: Usage in Credit Agreements



Proskauer

Consolidated Net Income

Proskauer

What is Consolidated Net Income?

- The trailing 12-month net income (or loss) of a person and its consolidated subsidiaries calculated in accordance with GAAP
- In certain parts of the market, CNI under financing documents has remained close to GAAP, with only minor adjustments for items like changes in accounting principles
- In more Borrower-friendly credits, CNI is highly adjusted with 20+ exclusions that would otherwise be considered for add-backs to EBITDA
- Whether an item appears as an adjustment to CNI or EBITDA has a limited impact (e.g. calculation of ECF/Available Amount), but most important is to ensure that all adjustments are fully vetted and consistent regardless of where located
- All adjustments are made “without duplication” – but be wary of overlapping concepts that permit the same item to be added back through either a capped or uncapped provision

EBITDA

Earnings before Interest, Taxes, Depreciation and Amortization

- Non-GAAP concept measuring performance independent of certain income and expenses considered unrelated to core operations
  - EBITDA begins as CNI, to which adjustments are made to exclude gains and losses from interest, taxes, depreciation and amortization
  - EBITDA is often then further adjusted – resulting in what is sometimes referred to “Adjusted EBITDA” – but we will continue to call “EBITDA”
- It is common for EBITDA to contain 30+ adjustments, representing cash and non-cash, past and future, realized and unrealized items
- Most adjustments are made <u>only to the extent excluded from CNI</u>, but this does <u>not</u> apply to certain pro forma adjustments such as:
  - anticipated cost savings,
  - the impact of acquisitions and dispositions, and
  - the effect of new contracts or new locations

Capped Add-backs

A typical construct for a shared cap in the middle-market:

- Applies to a limited number of add-backs, including (1) restructuring costs and (2) pro forma cost savings/synergies
- In some cases, also covers cash extraordinary items
- Other material and non-standard add-backs, such as start-up costs, the pro forma effect of new contracts or customers, and business- or industry-specific adjustments may be included within this cap or separately capped
- 25% - 35% of EBITDA
- Usually calculated **after giving effect** to all add-backs (not “prior to” capped add-backs)
  - Common issue: calculated “after giving effect to” an equity cure included in such period

Proskauer

Illustrative Example of “Calculated Before/After”

Consolidated Net Income	$20.00
Uncapped adjustments	$5.00
Equity cure in prior quarter	$4.00
Amount of supportable capped adjustments	$15.00

Common Permutations	EBITDA
No cap	$44.00
25% cap, calculated before (excluding equity cure)	$35.25
25% cap, calculated after (excluding equity cure)	$39.00
25% cap, calculated after (including equity cure)	$40.00

Extraordinary, Non-Recurring and Unusual Items

- Extraordinary, non-recurring and unusual losses*, charges or expenses (whether cash or not) are commonly added back to EBITDA, with a deduction for corresponding gains or income
  - "Extraordinary": formerly a GAAP concept, but no longer defined under GAAP
  - Borrower-friendly forms include a plethora of other adjectives, none of which are defined under GAAP, including: exceptional, infrequent, special, one-time, single event, and outside the ordinary course

- Although this add-back was historically capped, and is **often capped today in lower-middle-market transactions or in distressed scenarios**, it is common in other parts of the market to allow this add-back without any cap
  - **Non-cash** extraordinary items are virtually always uncapped

*COVID highlighted the issue of one-time "revenue losses"; these are generally not adjusted

Restructuring Charges

- Charges incurred in connection with a reorganization of a company (as broadly defined), to the extent reducing CNI during the relevant period
  - Not a pro forma adjustment
- **Typically capped**; if capped, consider the impact of an uncapped extraordinary charges add-back, which will both be available for many items at the Borrower's discretion
- The breadth of this add-back varies widely in the market; there are dozens of items which we have seen included in different versions of this add-back
- Examples:
  - 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

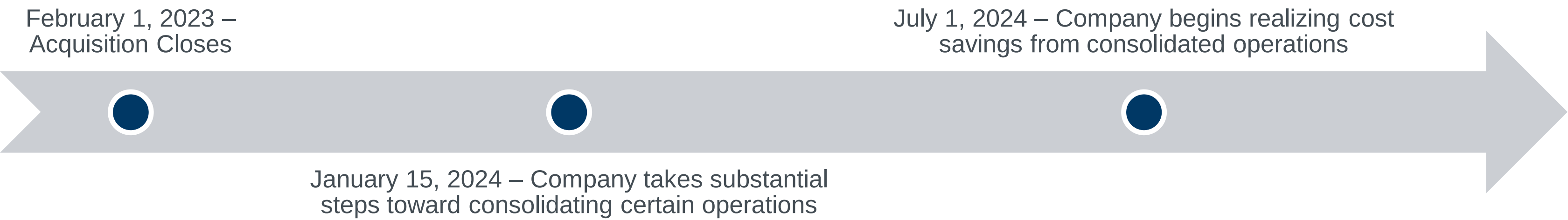
Cost Savings and Synergies

- “Run-rate” cost savings, operating expense reductions and synergies
- Not costs or expenses that reduce CNI; rather, anticipated expense reductions and cost savings from specific transactions such as acquisitions, divestitures, consolidations, or from operational changes or new initiatives
- Savings are calculated on “run-rate” basis, extrapolating the projected effects of current (or anticipated) actions into future periods
- Applies to (1) the Closing Date transactions, (2) future transactions and initiatives and (3) sometimes pre-closing actions (though typically covered by EBITDA “plug” numbers)
- **Typically capped**; but, the cap commonly excludes some material items that we will discuss

Cost Savings and Synergies (continued)

- "Look forward" period typically ranges from 12 to 24 months. Two questions:
  - When does that period begin: date of the action, or last day of the financial period?
  - To what does that period relate:
    - savings are expected to be realized?
    - actions are expected to be taken (i.e. completed)?
    - actions are expected to be commenced, committed, or substantial steps taken?
- Amounts represent projected savings, which should be reduced by actual realized benefits to avoid double-counting
- Usually limited to cost synergies, but a borrower-favorable version may permit the addition of anticipated **revenue synergies** (i.e. projections of increased revenues)
- Some loan documents require a financial officer of the Borrower to certify that such cost savings are reasonably identifiable, factually supportable, and reasonably anticipated to be realizable within the look-forward period in the good faith judgment of the Borrower

Illustrative Example of Operating Expense Reductions



- If the Credit Agreement includes a 12 month look-forward period:
  - for savings to be realized, no savings can be added back, because no savings will be realized by 2/1/24 (the one year anniversary of the action) or 3/31/24 (the one year anniversary of the end of the fiscal period in which the acquisition occurred)
  - for substantial steps to be taken, the full projected run-rate amount of savings can be added back, because substantial steps are expected to be taken prior to 2/1/24 (or 3/31/24)
    - The add-back would be included for the LTM fiscal period ending 3/31/23 and thereafter

Pro Forma Impact of Acquisitions & Dispositions

- As a starting place, CNI of subsidiaries before they are acquired or after they are disposed of are excluded
- But, pro forma effect is given to the EBITDA of targets acquired during the financial period, as if acquired on the first day thereof, and EBITDA attributable to disposed subsidiaries, business units, lines of business or divisions is likewise deemed lost as of the first day of the period
- Be wary of two issues:
  - Acquired and disposed EBITDA are not reciprocal in all cases – allowing actual results for disposed EBITDA but pro forma effect for acquired EBITDA
  - "Pro Forma Basis" adjustments that mirror the cost savings and synergies add-back but lack associated protections (such as a cap)

Run-Rate Effect of New and Modified Contracts

- Permits adjustments to reflect the full 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
- Contracts may be with existing customers or new customers
- May include amendments to existing contracts
- This add-back is Borrower-favorable and a minority position in the market
- **Typically capped** – either individually, or in an aggregate cap with other pro forma amounts – and required to be certified by an officer of the Borrower
- Rarely is there a corresponding requirement to deduct for the run-rate impact of contract losses and adverse contract changes

Proskauer

"New Unit" or "De Novo Locations"

- Increases EBITDA by a specified plug number – representing typical mature location EBITDA – for each new location or unit for a certain period following opening (typically 12-24 months)
- This amount is reduced by actual earnings from such location
- Particularly common in consumer facing businesses with multiple locations – retail, restaurants, gyms, etc.
- **Typically capped** – either individually, or in an aggregate cap with other pro forma amounts

Sponsor Model and Quality of Earnings

- Generally, all adjustments included in the model and the quality of earnings report delivered for the Closing Date may added back **without being subject to any cap**
- A Borrower-favorable version adds back, without a cap, not only the specific adjustments in the model or QoE, but also adjustments **"of the type"** found in the model or QoE – disregarding the "amounts" and "time periods" therein
- Borrowers commonly also want the flexibility to include, without caps, adjustments – possibly, "of the type" – in any QoE prepared by a reputable firm in connection with a post-closing acquisition or other investment
  - If other items (cost savings, restructuring charges, etc.) are capped, consider whether cap should apply to future QoE reports as well

Regulation S-X

- Many credit agreements permit add-backs related to pro forma cost savings in connection with a acquisitions to be **uncapped** so long as they comply with the SEC's Regulation S-X
- Prior to its recent amendment (effective January 1, 2021), among other restrictions Reg S-X did not permit adjustments for actions of management planned for after the acquisition, among other limitations
- Now, among other changes, Reg S-X permits "Management's Adjustments" for post-closing actions without a time limit for realization
- Accordingly, it is now common to eliminate Reg S-X as an exception to the cost savings cap, or otherwise use the pre-amendment Reg S-X as the relevant standard

Other Common Addbacks

- Sometimes capped:
  - Cash expenditures related to Closing Date acquisition or future specified transactions
  - Director Costs and Expenses Addback
  - Litigation losses
- Typically uncapped:
  - Insurance/Indemnification payments received or expected to be received (but if not received within a specified time period, deducted in that future period)
  - Losses on sales of receivables in connection with a securitization facility
  - Unrealized currency gains and losses
  - 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”, used for the debt negative covenant, is defined very broadly
- A different definition (often “Funded Debt” or “Total Debt”), used in the numerator of leverage calculations, is defined more narrowly to include the following:
  - debt for borrowed money
  - debt evidenced by bonds, debentures, notes or other similar instruments
  - capitalized leases and purchase money debt
- Funded Debt should include “Disqualified Equity” (i.e. preferred equity that has debt-like features, including cash dividends and/or a maturity date)
- Funded Debt also sometimes includes the following:
  - letters of credit, surety bonds, etc. (but only if drawn and not promptly repaid)
  - earn-outs and similar continent payment obligations, typically only if overdue and unpaid, and deferred purchase price of property or services

Types of Leverage Ratios

- First Lien Leverage Ratio measures either:
  - 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
- Secured Leverage Ratio measures either:
  - Funded Debt secured (with any priority) by the Collateral, or
  - Funded Debt secured (with any priority) by any assets of the Consolidated Group
- Total Leverage Ratio measures either:
  - Funded Debt that is not secured by the Collateral, or
  - Funded Debt that is unsecured

- In each case, the first option is more Borrower-friendly, and the second option is more Lender-friendly
- Debt secured by assets other than Collateral is actually <u>senior</u> to the first lien debt to the extent of those assets

Cash Netting

- Any leverage ratio can be measured either gross or net of cash on-hand
- If cash is to be netted, which cash and how much may be netted?

Best
- Dollar cap (approximately 50% of closing EBITDA), **and**
- Limited to cash over which we have a perfected first-priority lien by control (DACA)

Better
- No cap, but limited to controlled cash, **or**
- Cap, but including all unrestricted cash (with no control requirement)

- No cap **and**
- All unrestricted cash and cash equivalents

Financial Maintenance Covenants and Cures

Proskauer

Financial Maintenance Covenants

- Most credits have a single financial maintenance covenant, which is an EBITDA-based leverage ratio tested quarterly
- A maintenance covenant may be static, or tighten over time (i.e. step-downs); rarely, the covenant may also loosen with certain re-leveraging events
- But in some front-end financings and many work-outs and restructurings, additional covenants may be included, such as:
  - minimum Fixed Charge Coverage Ratio (FCCR)
  - minimum Liquidity
  - minimum EBITDA
  - maximum Capital Expenditures
  - maximum Rent-Adjusted Leverage
  - maximum Recurring Revenue Leverage

Equity Cures

- Upon a default under the financial maintenance covenant, the Borrower will have a period of time to cure the default by having additional equity issued in exchange for cash
- The proceeds of the equity cure are applied to increase EBITDA in an amount sufficient to bring the Borrower in compliance with the financial maintenance covenant (no over-cure)
- Typical terms:
  - 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
- The cure proceeds may be required to prepay the term loans

Presenters

Patrick D. Walling
Partner
+1-617-526-9732
pwalling@proskauer.com

Patrick D. Walling is a partner in the Corporate Department and a member of The Private Credit Group.

Patrick represents private credit providers in transactions spanning the full range of the middle market, including unitranche, recurring revenue, second lien, mezzanine, holdco and preferred equity. He has broad experience representing a diverse group of specialty finance companies, private debt funds, business development companies, sovereign wealth funds, insurance companies and other private sources of capital. Patrick has represented lenders in cash flow as well as asset-based transactions across a wide range of industries, including technology, healthcare, retail, professional services, business services, aerospace, sports, logistics and education, to support transactions that include acquisitions, growth capital investments, refinancings, recapitalizations, restructurings and special situations.

Bharat K. Moudgil
Partner
+1-310-284-4537
bmoudgil@proskauer.com

Bharat K. Moudgil is a partner in the Corporate Department and a member of the Private Credit Group. He has experience acting for lenders on a wide range of transactions, including senior secured, mezzanine and second-lien financings.

Bharat focuses his practice on corporate finance transactions and represents a wide array of credit providers, including private debt funds, BDCs, banks, and other investors in connection with acquisition financings, restructurings, recapitalizations and other financings.

Bharat has industry experience in a wide range of sectors including software and technology, healthcare and business services.

During law school, Bharat served as managing editor of the University of Pennsylvania Journal of Constitutional Law, and was a judicial intern for the Honorable James S. Moody of the United States District Court, Middle District of Florida.

Leverage Ratios: Fundamentals and Pitfalls

Presented by:

Patrick D. Walling

Bharat K. Moudgil

March, 2, 2023

Proskauer

Scan here to access more of Proskauer's private credit resources