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Covenantive Easing (Last of a Series)

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As we wrap up our special series on how credit agreement terms are eroding, we asked our distinguished team of lawyers from Morgan Lewis: What should we expect, as issuers and credit providers, to come up in deals with financial covenants?

“Financial maintenance covenants are often included in loan documents, even in larger deals,” said Matthew Schernecke. “They’re frequently set at 25%-40% cushions to a sponsor’s model. It’s becoming unusual to see significant step-downs in financial covenant levels over the loan term.

“We see a net leverage ratio covenant in most deals that have a financial covenant,” he continued, “permitting the borrower to net unrestricted cash in calculating leverage. In smaller deals, we push for limits on the amount of cash that may be netted. We also push for only netting cash in controlled accounts, not all unrestricted cash.”

As we’ve noted in this series, many covenant carve-outs or exceptions are tied to *pro forma* leverage ratio calculations. Defining “pro forma” is as much art as science. “The Ebitda of a target and debt incurred in connection with an acquisition may be treated as if it had been in place as of the first day of the relevant trailing period with synergies taken into account,” Schernecke said.

Readers of this space won’t be surprised that defining Ebitda is one of the most hotly negotiated of all credit document elements. It’s omnipresent in financial test calculations, both for maintenance covenants and ratio-based baskets. Even in smaller middle-market deals, the definition of Ebitda contains a number of add-backs.

“Aside from customary add-backs for things like management and consulting fees and transaction expenses, including for unconsummated deals, there are many add-backs based on future events not readily traceable or verifiable by a lender,” said Kate Weinstein.

“Extraordinary, non-recurring and unusual expenses are added-back, often without any cap,” Weinstein said. “Unsurprisingly, lenders often resist that formulation. Synergies add-backs give sponsors a significant degree of latitude to include ‘run rate’ numbers premised on actions that may not yet even have been taken.”

Ian Wenniger explained: “A sponsor could say there was a run rate synergy effect of $40 million for purposes of its Ebitda calculation if in good faith it projected realizing an anticipated $10 million of cost savings (already an inherently nebulous concept) in each of the four upcoming quarters.

“Issuer-favorable synergies add-backs,” he went on, “don’t require specific actions to be taken or for actual realization of the proposed synergistic activities. And they may allow up to 24 months of runway for those anticipated cost savings to be realized.”

When taken with the cushion on the sponsor’s model in setting covenants, the scope or looseness of Ebitda add-backs can drive much wider cushions in the final numbers.

It’s evident a common theme amid today’s covenantive easing is that transactional flexibility is key for borrowers. These provisions reflect that sponsors are often successful in negotiating for this elbow-room. As long as the current market lasts.