Financial Covenants (Part I)

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I. Financial Covenants: Some General Principles

a. What are Financial Covenants?

Financial covenants specify different financial metrics that are designed to measure a Borrower's cash flow, leverage, liquidity or net worth. It allows lenders to:

- Monitor changes in the Borrower's financial performance on a regular basis

- Limit the Borrower’s ability to take certain actions
- Provide an early warning of potential financial difficulty for the Borrower

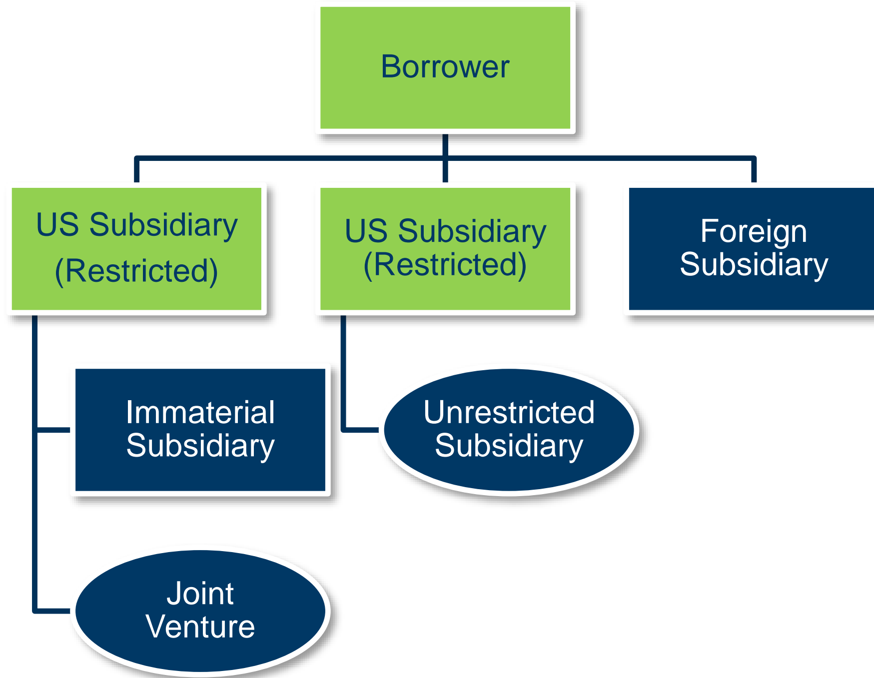
- Provide a means of imposing financial discipline on the Borrower

b. Which entities are included in the financial covenants?

Typically, financial covenants are calculated on a consolidated basis for the Borrower and its Subsidiaries and any holding company that is a Guarantor.

- The definition of "Subsidiaries" generally includes majority owned and controlled entities, although as we discuss in our next segment, earnings of minority-owned subsidiaries will be included in Consolidated Net Income to the extent it is actually dividended up to the credit parties.

- Financial covenants apply to Restricted Subsidiaries which includes Immaterial Subsidiaries and Foreign Subsidiaries.
- Financial covenants to do not apply to Unrestricted Subsidiaries
    - Lenders would prefer that the financial covenants be determined based solely on the financial performance of the Borrower and the Guarantors providing direct credit support.
    - Borrower's position is that calculating financial covenants for only a portion of the corporate organization is burdensome and deprives the Borrower of the benefit of material EBITDA contribution to the business.



Legend: **Green:** Credit Parties
Squares: Subject to Financial Covenants
Ovals: Not subject to Financial Covenants

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c. Perspectives

Borrowers' Views

Borrowers typically have the following reservations about financial covenants:

- The need to operate a business while remaining in compliance with its financial covenants can be a significant burden.
- In the case of a maintenance covenant, volatility in the Borrower's financial performance may result in a default when the Borrower's business is otherwise sound.
- Incurrence covenants may prevent a Borrower from taking actions that would otherwise make business or financial sense.

Lenders' Views

However, lenders consider the inclusion of financial covenants an important part of any loan agreement because:

- They are an important tool for monitoring changes in the Borrower’s financial health.
- They impose financial discipline on the Borrower.
- In the case of incurrence covenants, they preserve the status quo in effect at the time the lending decision was made.
- In the case of maintenance covenants, they provide the lenders with an early-warning system if the Borrower’s financial health deteriorates, which enables them to restructure the deal and call a default before the Borrower is on the verge of bankruptcy.

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II. Common Performance Based Covenants or Cash Flow Covenants

a. Leverage Ratio: This ratio is perhaps the most commonly used cash flow covenant. It calculates the financial leverage of a Borrower to measure its ability to service its debt.

- A leverage ratio covenant sets a ceiling above which the Borrower is in default.
- The appropriate ceiling is determined by the level of risk the lenders are willing to assume when a transaction is negotiated.
- The leverage ratio may be classified as either including total leverage, first lien leverage or secured leverage in cases where the capital structure allows for the incurrence of junior or unsecured indebtedness.

b. Interest Coverage Ratio: This ratio measures how easily a Borrower can pay interest on outstanding debt. It is determined by dividing consolidated EBITDA by consolidated interest expenses.

- The covenant sets a floor for the Borrower below which the ratio may not fall without creating a default (indeed, the lower the ratio, the higher the Borrower's interest expense burden).

c. <u>Fixed Charge Coverage Ratio</u>: This is the ratio of consolidated EBITDA (sometimes subject to adjustments) to consolidated fixed charges, which typically include all scheduled debt service (both with respect to principal and interest).

- Depending on the circumstances, these charges may also include, among others, taxes paid in cash, and certain lease expenses, capital expenditures and permitted dividends.
- This covenant also sets a floor for the Borrower below which the ratio may not fall without creating a default.
- This ratio is a measurement of the ability of a Borrower to maintain a minimum level of cash flow or earnings relative to specified expenses (i.e., “fixed charges”).

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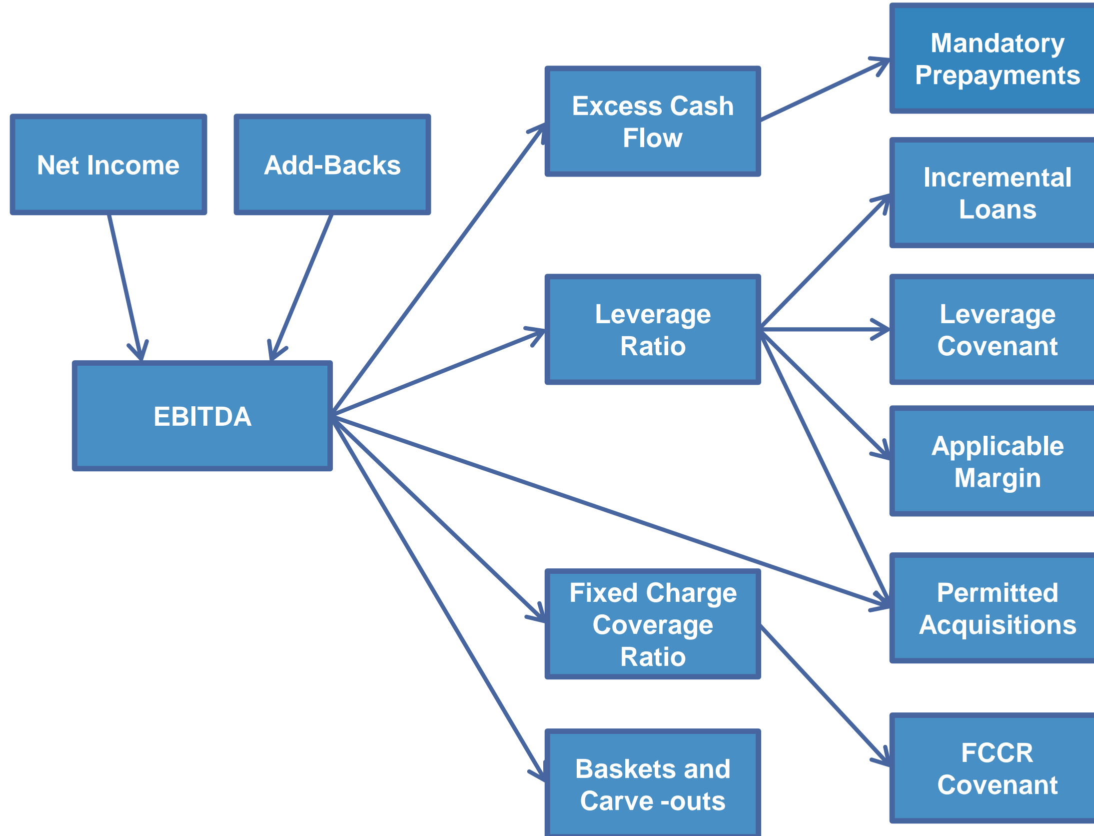
III. Application of Financial Covenants



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a. Financial covenants are generally separated into two main categories: Maintenance vs. Incurrence

- Maintenance financial covenants: As a measurement (on a recurring basis – e.g., monthly, quarterly, annually, etc.) of a Company's financial well-being, it (a) serves as an early warning sign of a deterioration in the Borrower's financial health, (b) encourages the parties to consider a restructuring before the Borrower defaults on a payment and (c) allows lenders to call a default before the Borrower files for bankruptcy.
- Incurrence financial covenants: As one of several conditions that must be met in order for a Borrower to take certain discretionary actions - e.g., make an investment, incur debt, or make dividends. If the proposed action would cause a breach of a financial covenant, the lenders may extract concessions in a consent or amendment, such as fees or other additional covenants or restrictions.

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Within each category, financial covenants can be further divided into two subcategories:

- Balance sheet covenants. These covenants measure the Borrower's equity and are more common in loan agreements for investment grade Borrowers which, traditionally, have stronger balance sheets and sufficient equity to repay the debt. Examples of balance sheet covenants are "net worth covenant" or "total debt to total capital ratio".

- Cash flow covenants. These covenants measure a Borrower's earnings capacity and are typically found in loan agreements for below investment grade Borrowers, where the cash flow generated from the Borrower's business is the primary source for repaying the debt. Examples of cash flow covenants are "leverage ratio", "interest coverage ratio" or "fixed charge coverage ratio".

i. Maintenance Covenants

Primary friction points in negotiating maintenance covenants include the following, and outcomes are generally dictated by the EBITDA size of the Borrower and the relative bargaining power of the Borrower and its lenders:

1. <u>Types of maintenance covenants</u>:

   a. Depending on factors such as the size of the deal, the competitiveness of the transaction, the identity of the Sponsor, and the nature of the target's industry, one or more of the following maintenance covenants may be required:

      i. A leverage ratio covenant (generally a total net leverage ratio covenant.

      ii. An interest coverage ratio covenant.

      iii. A fixed charge coverage ratio covenant.

      iv. One or more highly industry-specific covenants. In the software industry, one or more of the following covenant mechanics may sometimes be used:

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1. A minimum recurring revenue (or sometimes “bookings”) covenant – either as a standalone covenant or sometimes as the denominator component of a bespoke leverage ratio (where recurring revenue is used as the denominator in the ratio in lieu of EBITDA).

2. A total net leverage ratio where “Cash EBITDA” is used in the ratio in order to mitigate the effect of typical GAAP accounting treatment of deferred revenues.

b. Smaller deals tend to have more categories of maintenance covenants. For example, larger deals will rarely have a Fixed Charge Coverage Ratio. Also, larger deals may have very limited covenants or no covenants at all. These “covenant-lite” loans, to the extent a maintenance covenant is included, will only include a covenant on the revolver facility following the trigger of certain specific conditions.

2. Number of step-downs to the covenant levels: Smaller deals tend to have more step-downs whereas the larger deals may have none or at most two step-downs.

3. Cushion off of Sponsor model: Financial covenants in smaller deals tend to have a smaller cushion off of the Sponsor model whereas larger deals will generally have larger cushions off of the Sponsor model.

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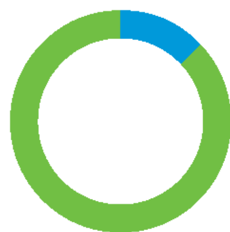
4. Financial Covenants

a. Prevalence of types of maintenance covenant by EBITDA band

- Total Leverage Ratio was present in 88% of deals. No change in the percentage of covenant lite deals.
- 80% of covenant lite deals have EBITDA greater than $50mm.
- 53% of deals with EBITDA greater than $50mm are “cov-loose”, in that they have cushions greater than 40%.



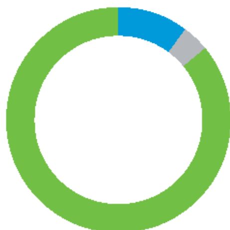
Covenant Lite Facilities 2016

- Cov Lite - 13%
- Fin Cov - 87%

Covenant Lite Facilities 2017

- Cov Lite - 13%
- Cov Loose - 14%
- Fin Cov - 73%

80% of Cov Lite deals EBITDA>$50mm



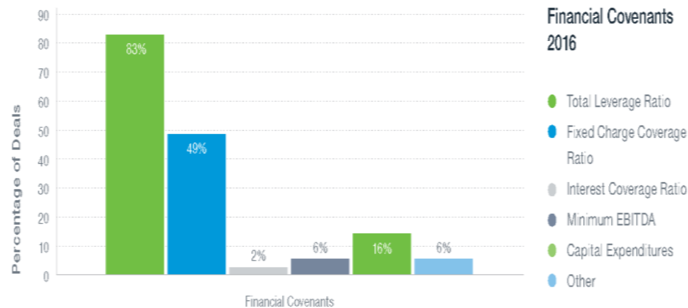
Covenant Lite Facilities 2017 (EBITDA $30mm-$49.9mm)

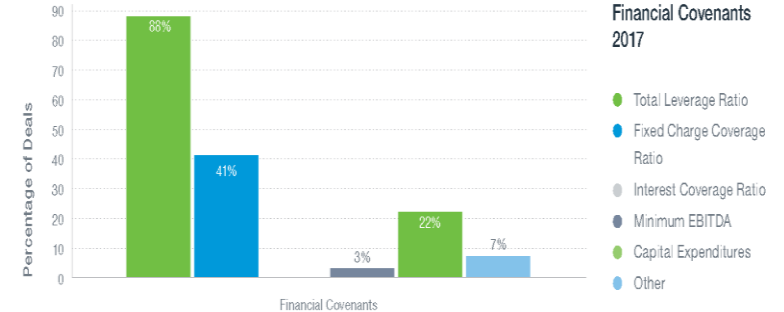
- Cov Lite - 10%
- Cov Loose - 4%
- Fin Cov - 86%

Covenant Lite Facilities 2017 (EBITDA ≥$50mm)

- Cov Lite - 40%
- Cov Loose - 53%
- Fin Cov - 7%

- Total Leverage Ratio was present in 88% of deals. No change in the percentage of covenant lite deals.
- 80% of covenant lite deals have EBITDA greater than $50mm.
- 53% of deals with EBITDA greater than $50mm are “cov-loose”, in that they have cushions greater than 40%.





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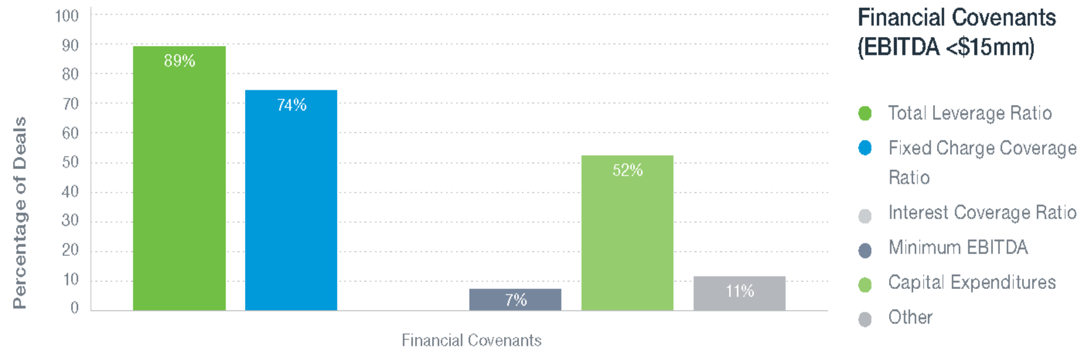
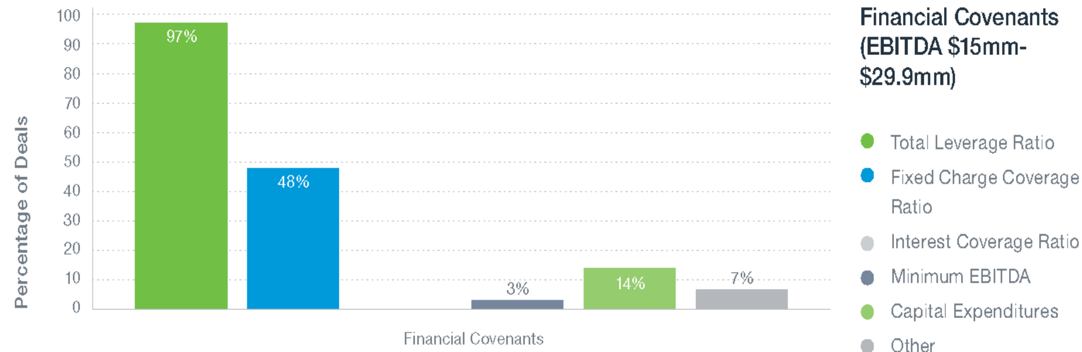
- Deals with lower EBITDA tend to have more financial covenants. As EBITDA increases, the number of deals with fixed charge coverage ratio and capital expenditure financial covenants steadily decreases.





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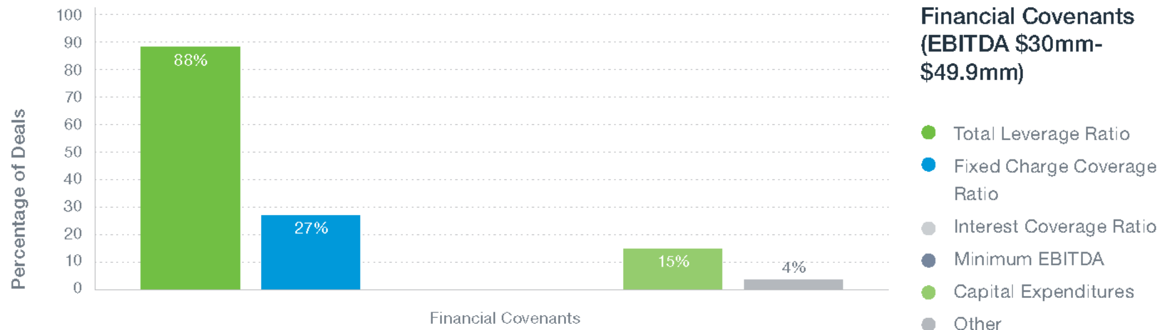
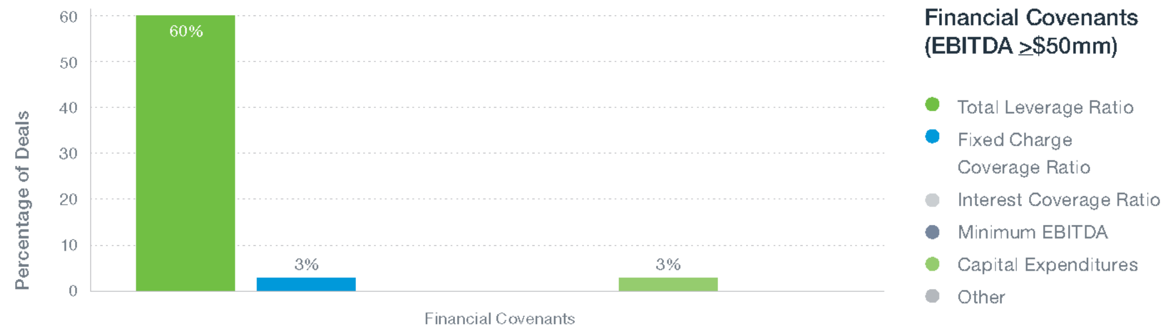
- Fixed Charge Covenant Ratios have significantly decreased in deals with EBITDA between $30mm and $49.9mm. In 2017, 27% of deals in this band had a fixed charge covenant, a decrease of nearly 25%.
- Only 60% of deals with EBITDA greater than $50mm have a total leverage ratio, the most common financial covenant.





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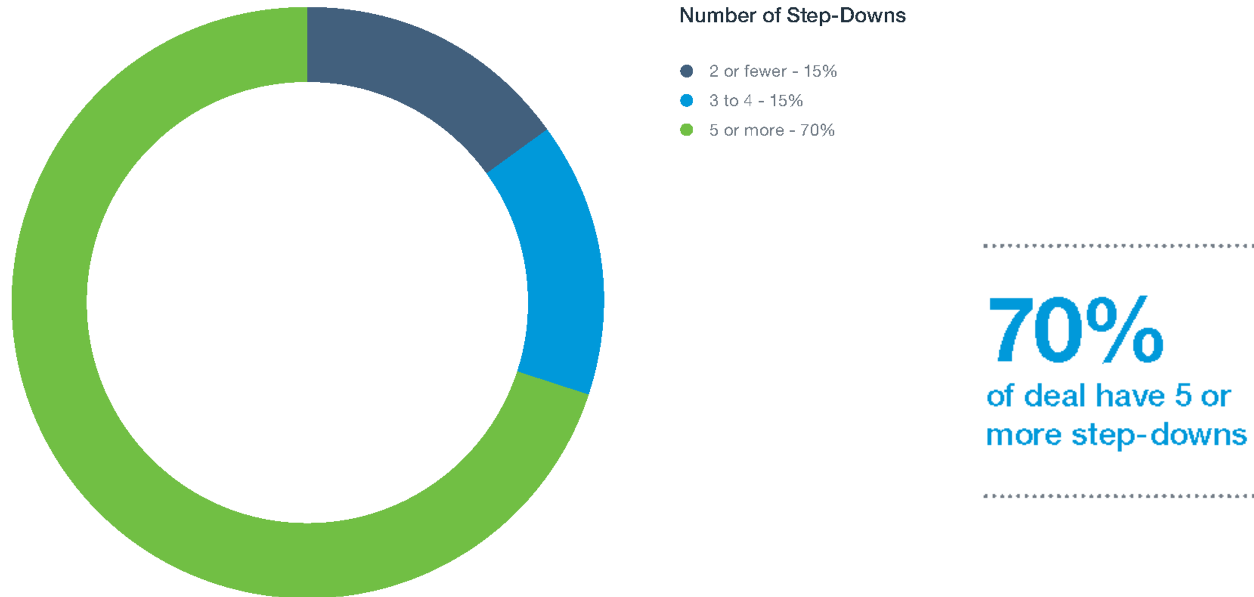
b. Step-downs by EBITDA band

- 70% of deals had 5 or more covenant step-downs, which represents an 8% decline since 1H 2017.
- 80% of deals with step-downs have EBITDA less than $50mm, consistent with 79% in 1H 2017.



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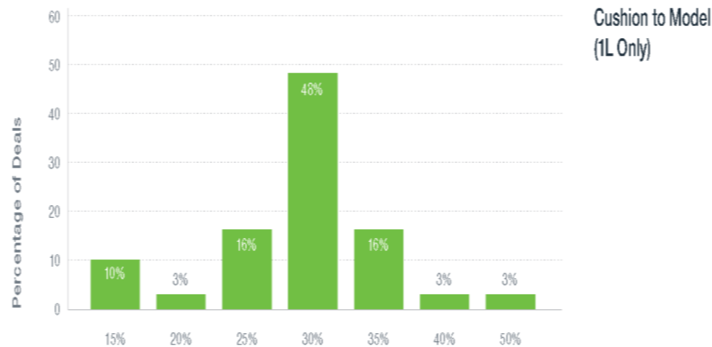
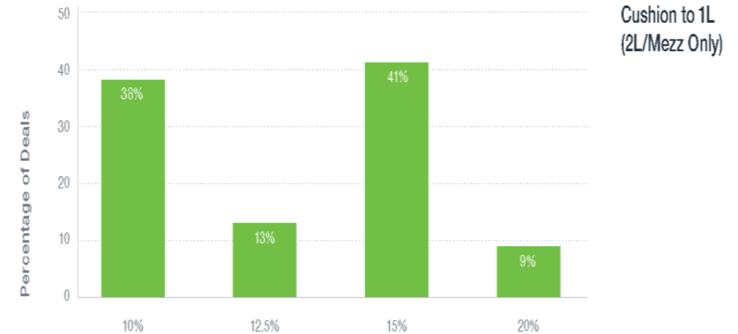
c. Cushions by EBITDA band

i. As an absolute matter 2L/mezz cushion to 1L

- The cushion to model is typically between 25% and 35%, with 30% being the most common cushion.
- The most common cushion to the 1L is either 10% or 15%.





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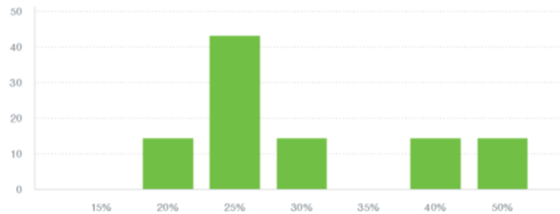
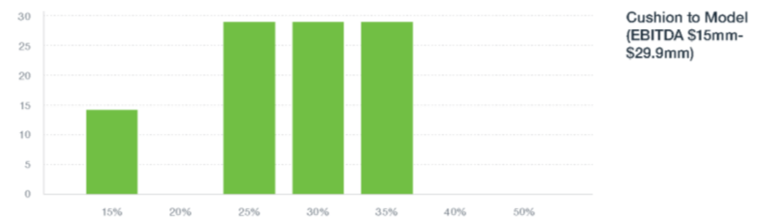
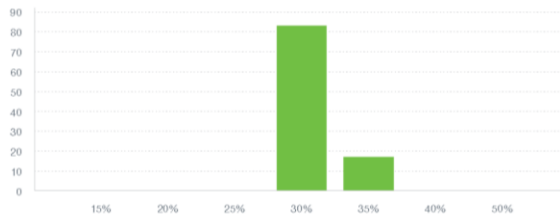
d. Cushion to Model

- The majority of deals have a cushion between 25%-35% to the model. The most common cushion to model for deals with EBITDA less than $15mm is 25%.
- The most common cushion to model for deals with EBITDA between $30mm and $49.9mm is 30%.

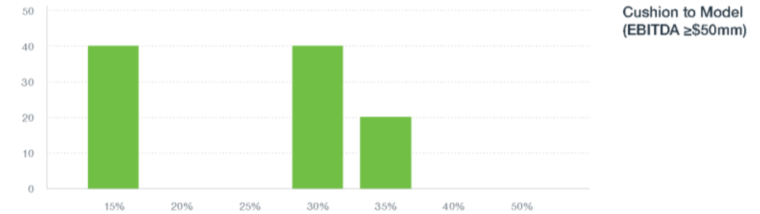


Cushion to Model
(EBITDA <$15mm)





Cushion to Model
(EBITDA $30mm-
$49.9mm)



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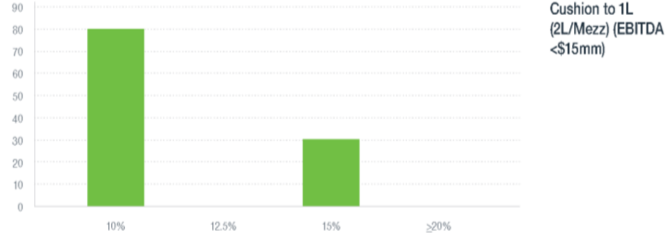
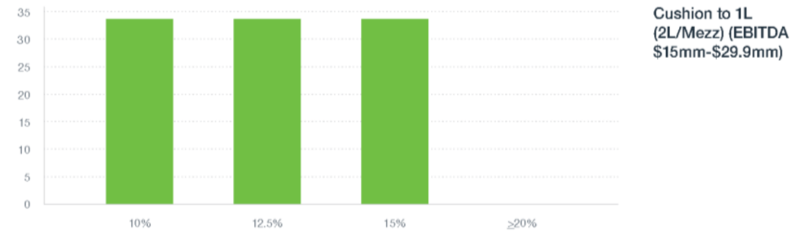
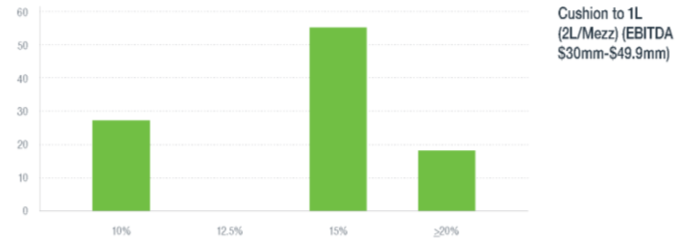
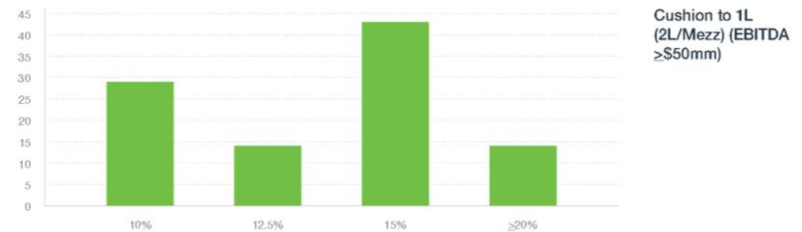
e. Cushion to 1L

- The cushion to the 1L tends to increase as EBITDA increases.
- The most common cushion to the 1L for deals with EBITDA less than $15mm is predominantly 10%.









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ii. Incurrence Covenants

1. Types of incurrence covenants:
    a. Leverage Ratio: The type of leverage ratio used can depend on a variety of factors, such as:
        i. In the context of debt incurrence and related permitted liens, the ability to incur multiple tranches of debt with differing security profiles (e.g., first lien, second lien, unsecured). In these cases, the leverage test chosen will often be first lien leverage, secured leverage or total leverage, as applicable.
        ii. Generally, depending on the bargaining power of the parties and the size of the deal, the leverage test may be set at either (w) closing date leverage, (x) the current maintenance leverage level, (y) the lesser of both measurements, or (z) in smaller deals, the lesser of both measurements with a 0.25x ratchet applied to the current maintenance test.
        iii. In larger deals, in the context of accretive/"EBITDA positive" transactions, such as investments (including investments constituting "Permitted Acquisitions"), a leverage test will be abandoned altogether, or replaced with a so-called "no worse than" or "dollar more" leverage test.

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a. Leverage Ratio: The type of leverage ratio used can depend on a variety of factors, such as: (cont'd)

   iv. Given that the leverage maintenance test will usually be set at a level above closing date leverage, but will then ratchet down to a level below closing leverage in most deals, Borrowers and Lenders can have complex incentives to prefer one suite of tests over another over the course of a given deal.

   v. Other incurrence tests can also be utilized depending on the size of the deal, but are not as ubiquitous as a leverage-based metric.

b. Fixed Charge Coverage Ratio: In larger deals, in the context of debt incurrence, a less restrictive fixed charge coverage test may replace a leverage test when incurring unsecured incremental debt.

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2. Prevalence by Negative Covenant Type:

Negative Covenant Type	Incurrence Covenant Type
Investments (including permitted acquisitions)	Leverage ratio, or none in larger deals
Debt	Leverage ratio, or (for unsecured debt incurrences) FCCR in larger deals
Restricted Payments	Leverage ratio

b. Consequences of a breach of a Financial Covenant.

A breach of a maintenance covenant on the date it is tested is typically an immediate default. By contrast, because incurrence covenants must be tested and satisfied on a pro forma basis as if the proposed action had been taken, the only consequence of failing to satisfy these covenants is that the Borrower cannot take the action that would have caused it to breach the covenant.

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i. Equity Cures:

Equity cure provisions allow the Sponsor or other Borrower's equity holders to infuse equity into the Borrower to boost EBITDA if the Borrower is facing a financial covenant breach. Such provisions are most useful to Borrowers owned by private equity sponsors because of the relative ease with which private equity sponsors can inject cash into one of their portfolio companies.

1. Characteristics of an Equity Cure:

- Equity infusion will typically be in the form of common equity but can be qualified preferred equity
- The cure period begins from the end of the fiscal quarter until 10 to 15 business days following the date that financial statements are required to be delivered
- Number of cures during life of loan may be limited (typically 5)
- Number of cures in any four fiscal quarter period may be limited (typically 2) and, in smaller deals, consecutive cures may not be permitted
- Limited to the dollar amount needed to cure the default

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- In smaller deals, the contribution may be required to pay down the debt; however, it cannot also directly or indirectly reduce debt for purposes of calculating the financial covenant (avoid double counting).
- In larger deals, in the event the contribution is used to pay down the debt, the concurrent debt reduction will not be accounted for in the period the equity cure is made, but will be accounted for all other relevant periods (see further explanation below).
- EBITDA is only increased for purposes of calculating the financial maintenance covenant

Example 1: Debt prepayment using cure proceeds does not reduce debt numerator for four quarters. Assume equity cure proceeds are used to repay debt in Q1, and that no defaults occur in Q2-Q4.

	Each quarter prior to the default quarter	Q1 (pre-equity cure)	Q1 (post-equity cure)	Q2 Post-Cure	Q3 Post-Cure	Q4 Post-Cure
Debt	$700	$700	$700	$700	$700	$700
EBITDA	$100	$93.33	$100	$100	$100	$100
Leverage (required)	7.00x	7.00x	7.00x	7.00x	7.00x	7.00x
Leverage (actual)	7.00x	**7.50x**	7.00x	7.00x	7.00x	7.00x

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Example 2: Debt prepayment using cure proceeds does not reduce debt numerator for one quarter. Assume equity cure proceeds are used to repay debt in Q1, and that no defaults occur in Q2-Q4.

	Each quarter prior to the default quarter	Q1 (pre-equity cure)	Q1 (post-equity cure)	Q2 Post-Cure	Q3 Post-Cure	Q4 Post-Cure
Debt	$700	$700	$700	$693.33	$693.33	$693.33
EBITDA	$100	$93.33	$100	$100	$100	$100
Leverage (required)	7.00x	7.00x	7.00x	7.00x	7.00x	7.00x
Leverage (actual)	7.00x	**7.50x**	7.00x	6.98x	6.98x	6.98x

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IV. Fundamental Components to All Financial Covenants

Financial covenants are meaningless unless the definitions that make up such covenants are well negotiated.

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a. Definition of Indebtedness as Used in the Leverage Covenant

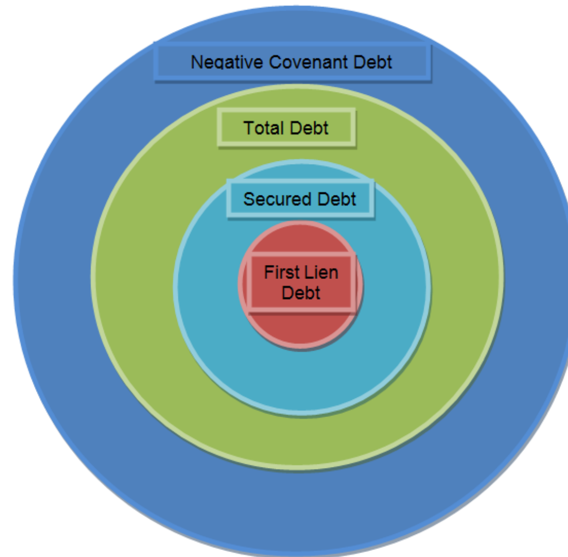
The definition of indebtedness as used in the leverage covenant (commonly defined as “Funded Debt” or “Total Debt” or “Total Funded Indebtedness”) typically includes borrowings (or funded indebtedness), whether by loans or issuance and sale of debt securities (and including reimbursement obligations with respect to L/Cs). In some cases this also includes other transactions that are not strictly borrowings, but are nevertheless methods of raising money or create financial liabilities akin to borrowings. What is included in this latter category varies from loan agreement to loan agreement. Examples of the items that may be included are:

- Obligations concerning the deferred purchase price of property or services (excluding ordinary course trade debt).
- The principal component of capitalized lease obligations and sale and lease-back transactions.
- Various payment obligations with respect to mandatorily redeemable preferred stock.
- Obligations of third parties secured by assets of the Borrower and its subsidiaries.
- Guarantees of obligations that otherwise qualify as indebtedness.

As deals get larger, the list above will be further reduced or excluded in its entirety.

Funded Debt may also be further narrowed depending on the type of leverage ratio test.

- First Lien Leverage Ratio includes Funded Debt that is secured on a first lien basis.
- Secured Leverage Ratio includes Funded Debt that is secured.
- Total Leverage Ratio includes all Funded Debt.



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i. Negotiation Points:

- Cash: Funded Debt of the Borrower is often measured net of cash on hand (a net debt concept, for instance, would allow the Borrower to draw on any revolving credit facility it may have and keep the cash without impacting compliance with its financial covenants).
  - Is ALL cash on hand included in this calculation?
    - For sponsor-friendly deals, all cash on hand will be included in this calculation regardless of whether such cash is in deposit accounts subject to control agreements in favor of the lender and without regard to a dollar cap.
    - For lender-friendly deals, the cash, in order to be included in this calculation, (a) will have to be in deposit accounts subject to control agreements in favor of the lender, (b) may be subject to a dollar cap, or (c) if a control agreement is not required, the cash may have to be held by a subsidiary that is permitted to transfer such cash to the Borrower without incurring tax consequences.

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- Hedge Obligations: The termination value of obligations under interest and currency hedge contracts is counted as indebtedness.
- L/Cs: Obligations with respect to L/Cs and guarantees are treated as indebtedness before the L/Cs are drawn or the guarantees called on (in which case indebtedness would not be limited to funded indebtedness).
- Trade Payables: All trade payable vs. overdue (by 90-120 days) trade payables.
- Earn Outs: Several standards are present in the market for determining whether an earnout is included in the numerator of the leverage ratio:
    1. Most Lender-favorable: On the date the acquisition is consummated, any earnout is included in the debt numerator, in an amount equal to the maximum possible amount of the earnout. This approach is commonly seen only in smaller credits.
    2. GAAP approach:
        a. In 2007, Statement of Financial Accounting Standards 141(R) (which is codified as FASB ASC Topic 805, Business Combinations) made relatively dramatic changes in how acquiring companies are required to account for earnouts.
        b. Under prior accounting rules, any post-closing earnout obligations was accounted for at the time the contingency was resolved (e.g., at the time the future event occurred or conditions were met and the payment became certain).

c. Under FASB ASC 805, the fair value of an earnout is required to be recorded as a liability on the balance sheet of the purchaser on the date of the acquisition if additional assets (such as cash) will be transferred to the seller (or within the equity section of the balance sheet when additional equity interests will be transferred to the seller).

d. Furthermore, FASB ASC 805 provides that earnouts recognized as a liability must be re-measured to fair value at each reporting period until the contingency is resolved. To the extent there is a change in fair value, the change must be recognized in the income statement (as a gain or a loss in earnings). Contingent consideration recorded in equity is not required to be re-measured.

e. If the initial measurement of fair value of a given earnout is lower (or higher) than the payment that is to be made, the results can be unusual. For example, if the fair value measurement is less than the payment to be made, a loss will be recorded in earnings. The anomaly is that the purchaser is recording a loss while the acquired business is presumably performing better than the parties expected. Conversely, if the fair value measurement is higher than the payment, a gain is recorded. Again, it is counterintuitive that the purchaser records a gain even though the acquired business does not perform to expectation.

3. Most Borrower-favorable:

   a. Earnouts will either not be included in the leverage numerator at all, or will only be included "when due and payable," or, in some larger competitive deals "if due and payable and not paid within [__] days".

   b. Such a standard is an attempt to move earnout treatment toward a more "pre-FASB ASC 805" standard, although the "when due and payable" standard, from a timing perspective, would arguably count earnouts as debt at a later point in time (i.e., when actually due and payable), as opposed to "at the time the contingency was resolved" (e.g., at the time the future event occurred or conditions were met and the payment became certain), which was the pre-FASB ASC 805 standard.

4. Rather than applying the above approaches in a one-size -fits-all manner, care should be taken to ensure that earnouts are treated properly in different contexts. For example, one may be comfortable with a Borrower-friendly treatment of earnouts in a maintenance covenant context, but not in a context where leverage is being used to calculate the quantum of acquisition debt financing that can be incurred (particularly when the acquisition is structured with large earnouts in mind).

5. Calculation of earnouts as debt and the impact on leverage: Examples:

- Example 1:

Fact pattern: $10 of earnouts incurred on day 1. Earnout is "all-or-nothing," based on an achievement of an EBITDA benchmark, to be measured on day 30, with a payout on day 45.

Example 1: On day 2, Borrower wants to take an action requiring compliance with a 6.0x total net leverage ratio.

	Earnouts not debt	Earnouts only debt when due and payable	GAAP standard (pre-FASB ASC 805)	GAAP standard (post-FASB ASC 805)	Maximum possible earnouts included in debt day 1
Earnouts	$10	$10	$10	$10	$10
Other Debt	$595	$595	$595	$595	$595
TTM EBITDA	$100	$100	$100	$100	$100
Leverage Condition (required)	6.00x	6.00x	6.00x	6.00x	6.00x
Leverage (actual)	5.95x	5.95x	5.95x	6.05x[1]	6.05x
Can action be taken?	Yes	Yes	Yes	No	No

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- Example 2:

Fact pattern: $10 of earnouts incurred on day 1. Earnout is "all-or-nothing," based on an achievement of an EBITDA benchmark, to be measured on day 30, with a payout on day 45.					
Example 1: On day 31, Borrower wants to take an action requiring compliance with a 6.0x total net leverage ratio.					
	Earnouts not debt	Earnouts only debt when due and payable	GAAP standard (pre-FASB ASC 805)	GAAP standard (post-FASB ASC 805)	Maximum possible earnouts included in debt day 1
Earnouts	$10	$10	$10	$10	$10
Other Debt	$595	$595	$595	$595	$595
TTM EBITDA	$100	$100	$100	$100	$100
Leverage Condition (required)	6.00x	6.00x	6.00x	6.00x	6.00x
Leverage (actual)	5.95x	5.95x	6.05x	6.05x[2]	6.05x
Can action be taken?	Yes	Yes	No	No	No

[2] Assumes that "fair value" of earnout is equal to its maximum value.

- Example 3:

Fact pattern: $10 of earnouts incurred on day 1. Earnout is “all-or-nothing,” based on an achievement of an EBITDA benchmark, to be measured on day 30, with a payout on day 45.					
Example 1: On day 45, Borrower wants to take an action requiring compliance with a 6.0x total net leverage ratio.					
	Earnouts not debt	Earnouts only debt when due and payable	GAAP standard (pre-FASB ASC 805)	GAAP standard (post-FASB ASC 805)	Maximum possible earnouts included in debt day 1
Earnouts	$10	$10	$10	$10	$10
Other Debt	$595	$595	$595	$595	$595
TTM EBITDA	$100	$100	$100	$100	$100
Leverage Condition (required)	6.00x	6.00x	6.00x	6.00x	6.00x
Leverage (actual)	5.95x	6.05x	6.05x	6.05x[3]	6.05x
Can action be taken?	Yes	No	No	No	No

[3] Assumes that “fair value” of earnout is equal to its maximum value.

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Financial Covenants (Part I)

The Private Credit Group

Kristen V. Campana, Partner

Vincenzo P. Lucibello, Partner

Sandra L. Montgomery, Partner

May 10, 2018

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Financial Covenants (Part II)

Proskauer
University

Presenters:

Kristen Campana **Vincenzo Lucibello** **Sandra Montgomery**

Proskauer»

October 10, 2018

Consolidated Net Income

- **<u>Consolidated Net Income</u>:** Consolidated Net Income is derived from the income statement. As opposed to the balance sheet, the income statement calculates net income or loss over a range of time.
  - Defined as: The net income (or loss) attributable to the Borrower and its Restricted Subsidiaries for such period determined on a consolidated basis in accordance with GAAP.
- Revenue – Expenses = Income

Income Statement for Apple Inc (AAPL)

$ 116.12 ▲ 0.01 (+0.01%) Volume: 14.67m 11:44 AM EST Nov 12, 2015

Statement: Income Statemer View: Annual

Income [+] in Millions of Dollars

	09/2015	09/2014	09/2013	09/2012	09/2011
Operating Revenue	233,715	182,795	170,910	156,508	108,249
Adjustments to Revenue	N/A	N/A	N/A	N/A	N/A
Cost of Revenue	128,832	104,312	99,849	84,569	62,617
Gross Operating Profit	**93,626**	**70,537**	**64,304**	**68,662**	**43,818**
Selling/General/Admin Expense	(14,329)	(11,993)	(10,830)	(10,040)	(7,599)
Research & Development	(8,067)	(6,041)	(4,475)	(3,381)	(2,429)
EBITDA (Operating Income Before Depreciation)	**84,505**	**61,813**	**55,756**	**58,518**	**35,604**
Depreciation & Amortization	(11,257)	(7,946)	(6,757)	(3,277)	(1,814)
Operating Income	**73,248**	**53,867**	**48,999**	**55,241**	**33,790**
Interest Income	2,921	1,795	1,616	1,088	519
Other Income, Net	(903)	(431)	1,156	(566)	(104)
Total Income Before Interest Expense (EBIT)	**73,248**	**53,867**	**48,999**	**55,241**	**33,790**
Interest Expense	(733)	(384)	(136)	–	N/A
Income Before Tax	**72,515**	**53,483**	**50,155**	**55,763**	**34,205**
Income Taxes	(19,121)	(13,973)	(13,118)	(14,030)	(8,283)
Minority Interest	–	–	–	–	–
Net Income from Continuing Operations	**53,394**	**39,510**	**37,037**	**41,733**	**25,922**
Net Income from Discontinued Operations	–	–	–	–	–
Net Income from Total Operations	**53,394**	**39,510**	**37,037**	**41,733**	**25,922**
Normalized Income	53,394	39,510	37,037	41,733	25,922
Extraordinary Income/Loss	–	–	–	–	–
Special Income/Charges	–	–	–	–	–
Income from Cum. Effect of Acct Change	–	–	–	–	–
Income from Tax Loss Carryforward	–	–	–	–	–
Other Gains	–	–	–	–	–
Total Net Income	53,394	39,510	37,037	41,733	25,922

Consolidated Net Income (cont'd)

- Start with Gross Revenue or Total Sales
  - Minus the direct costs of the goods or services sold, which includes employee salaries
  - Minus any certain ordinary course adjustments, such as assumed returns, to get to:
    - Gross Operating Profit
  - Minus general overhead expense for the costs associated with the business but not directly attributable to producing the goods or services, often called SG&A (selling, general and administrative expenses), which may include management salaries, advertising, insurance, expenses of auditors and consultants and research and development, to get to:
    - Net Income

Consolidated Net Income (cont'd)

- Other Customary Adjustments to "Consolidated Net Income": In order to normalize Consolidated Net Income and remove items that increase Consolidated Net Income but do not provide a benefit to the Credit Parties from the perspective of the Lenders, Consolidated Net Income is calculated without giving effect to certain items. As a technical matter, these items are either (i) deducted from the calculation of Consolidated Net Income after previously increasing Consolidated Net Income or (ii) added back into the calculation of Consolidated Net Income after previously decreasing Consolidated Net Income.

Consolidated Net Income (cont'd)

- Customary deductions from Consolidated Net Income:
  - Effects of Corporate Structure.
    - Net income attributable to an entity that is not a Restricted Subsidiary (e.g., a joint venture or Unrestricted Subsidiary) or that is accounted for by the equity method of accounting, except to the extent a cash dividend of such amount has been paid to a Credit Party or Restricted Subsidiary.
      - Equity Method of Accounting – The equity method is used when a company has significant control over an entity that it has invested in (e.g., 20% or more of the entity's stock is considered significant control). The Company records the investment at cost and the value of the investment is periodically adjusted, which will increase or decrease Consolidated Net Income, to reflect the company's share of the profits and losses recognized by the investment in that period.

Consolidated Net Income (cont'd)

- Customary deductions from Consolidated Net Income: **(cont'd)**
    - Net income of any Subsidiary (other than a Credit Party), to the extent that a restriction or limitation on the payment of dividends or the making of other distributions to a Credit Party exists.
    - Net income of any other person arising prior to such other person becoming a Credit Party or merging or consolidating into a Credit Party (subject to exceptions for the purposes of pro forma calculations).
  - Unrealized gain attributable to hedging obligations or other derivative instruments.
  - Cumulative effects of changes in accounting principles that increase Consolidated Net Income.
- Customary addbacks to Consolidated Net Income.
  - There would be corresponding addbacks to each of the items mentioned above for any net losses, unrealized losses, or cumulative effect of changes in accounting principles that decrease Consolidated Net Income.

Adjusted EBITDA

- **Adjusted EBITDA:** Adjusted EBITDA starts with Consolidated Net Income. In reviewing the income statement, there is transition from where the statement reflects the ordinary course earnings of the business to the effects of financial activities and extraordinary events. The negotiations around the Adjusted EBITDA definition are intended to at once capture and limit those non-ordinary course activities.
- What is EBITDA? - Earnings before Interest, Taxes, Depreciation and Amortization (Not a GAAP concept).

Calculation of Basic EBITDA

- Calculation of Basic EBITDA → Consolidated Net Income:
  - Plus: Interest Expense determined in accordance with GAAP (e.g., interest coupon paid on borrowed money) and may include:
    - Losses on hedging obligations or other derivative instruments.
    - Interest capitalized during such period and net costs under Interest Rate Contracts for such period.
    - Fees, charges, commissions, discounts and other similar obligations (other than reimbursement obligations) with respect to letters of credit, bank guarantees, and bonds (whether or not matured).
    - Add-back for consolidated interest income and gains related to hedging obligations or other derivative instruments.
    - Interest recognized in connection with capital lease obligations.

Calculation of Basic EBITDA (cont'd)

- Calculation of Basic EBITDA → Consolidated Net Income: **(cont'd)**
  - Plus: Taxes payable based on income, profits, revenue or capital, including foreign withholding taxes.
  - Plus: non-cash items of Depreciation and Amortization.
    - Depreciation: the periodic charge against the value of tangible capital assets acquired in earlier periods. Depreciation represents a way of expensing the up-front costs of long-term assets over time. A company may choose to apply a straight line methodology or the company may apply a more rapid or accelerated depreciation schedule.
    - Amortization: The same concept as depreciation applied to non-tangible assets such as goodwill.

Calculation of Basic EBITDA (cont'd)

- Plus: non-cash items of Depreciation and Amortization. **(cont'd)**
  - **Example**: A company builds a building expected to be used in the business for 30 years. Expensing all of the costs of the building in year 1 significantly distorts the income of the company for purposes of measuring financial performance of the company, so earnings look worse in year 1 than they should and better than they should in the following years. Instead, the cost is run through the income statement to reduce current earnings over time via depreciation.
  - In theory, if you have a company that has a steady outflow of capital expenditures, there should be alignment between the current use of cash for such capital expenditures and the depreciation expense related to past capital expenditures.

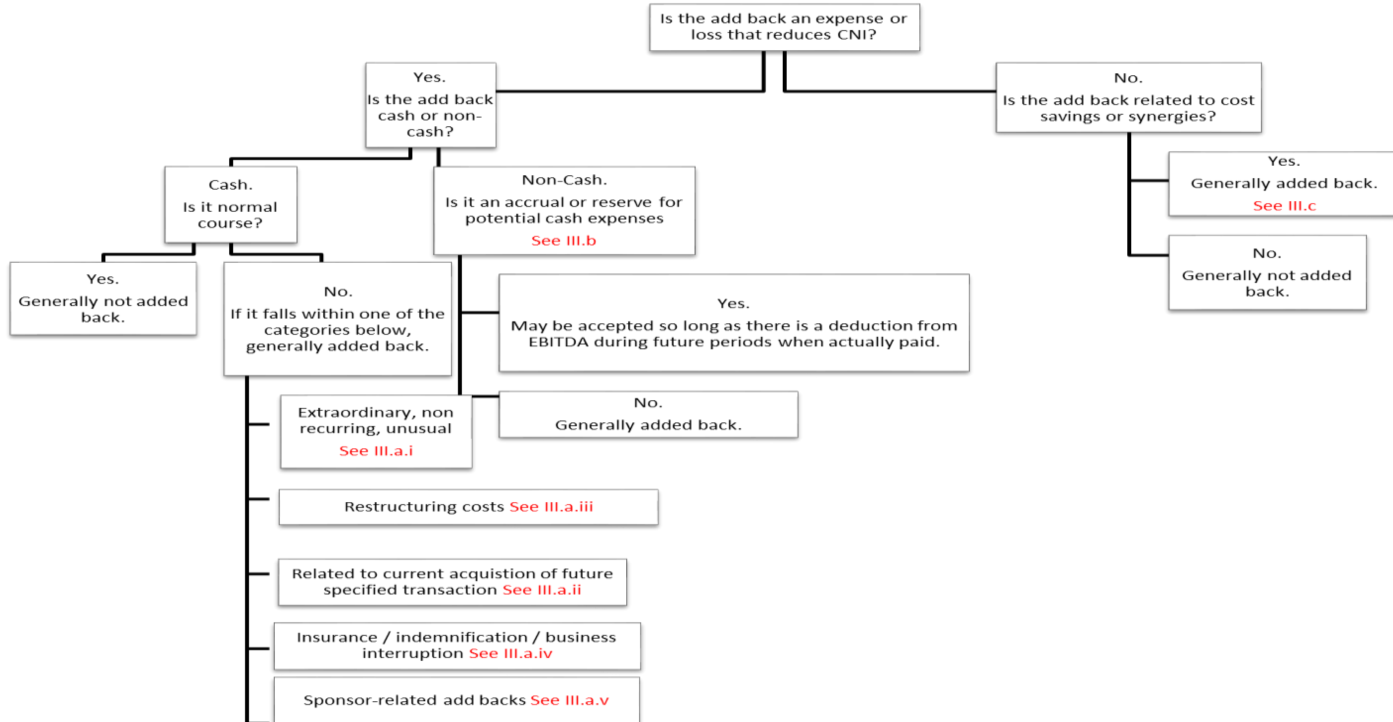
EBITDA vs. Adjusted EBITDA

- Getting from EBITDA to Adjusted EBITDA.
  - Adjusted EBITDA is a modified definition of EBITDA, which includes a long and heavily negotiated list of adjustments.
  - Adjusted EBITDA is used to measure cash flow for the Borrower and its subsidiaries in the ordinary course of business (e.g. as a base for the “Excess Cash Flow” calculation).
- Relationship of CNI and Adjusted EBITDA in respect to deductions and addbacks. Beware of double-counting in Consolidated Net Income and in Adjusted EBITDA.

EBITDA Addbacks

- Addbacks can appear in the definition of Consolidated Net Income or in the definition of Adjusted EBITDA. Consequently, an addback in Adjusted EBITDA for a particular item is only available to the extent such item reduced Consolidated Net Income (and was not already added back through the definition of CNI). Similarly a deduction in Adjusted EBITDA for a particular item is only available to the extent such item increased Consolidated Net Income (and was not already deducted though the definition of CNI).
- Additionally, addbacks and deductions in Adjusted EBITDA (or CNI) should be without duplication of any other addbacks or deductions, as applicable.
- Conceptual Flow Chart Describing Standard Acceptable vs. Standard Unacceptable Addbacks →

Addback Flow Chart



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In Depth Look at Select Addbacks

- Cash expenses or losses that reduce Consolidated Net Income.
  - Extraordinary, unusual and non-recurring losses or expenses (with a corresponding deduction for extraordinary, unusual and non-recurring gains or income) are common exceptions as both cash and non-cash addbacks.
    - "Extraordinary" items used to be a GAAP concept but it is no longer defined under GAAP, similar to "non-recurring" items. As a result, these items are subject to interpretation.
    - Sample Addback:
      - *"All (i) extraordinary (as defined under GAAP prior to the effectiveness of FASB ASU 2015-01) losses or expenses for such period and (ii) all other unusual or non-recurring losses or expenses for such period up to an aggregate amount not to exceed, with respect to this clause (ii) [$[__] in the aggregate for such period][[__]% of Consolidated Adjusted EBITDA for such period]"*

Dealing with “extraordinary, unusual and non-recurring items”

- There are generally three approaches to dealing with “extraordinary, unusual and non-recurring items”:
  - **Sponsor Friendly:** allow for an unlimited/uncapped addback for these items.
  - **Less Sponsor Friendly:** provide an unlimited addback with respect to “extraordinary items” (to the extent defined under GAAP as in effect prior to the effectiveness of FASB ASU 2015-01), but to provide an overall cap to the “non-recurring and unusual” items. In some deals, the capped portion of this addback will be part of a larger aggregate cap which includes the cost savings/synergies addback and/or the restructuring charges addback (each discussed below). In the event “extraordinary items” are not deemed to be defined under GAAP as in effect prior to the effectiveness of FASB ASU 2015-01, then “extraordinary items” may be included in the same cap for the “non-recurring and unusual” items.

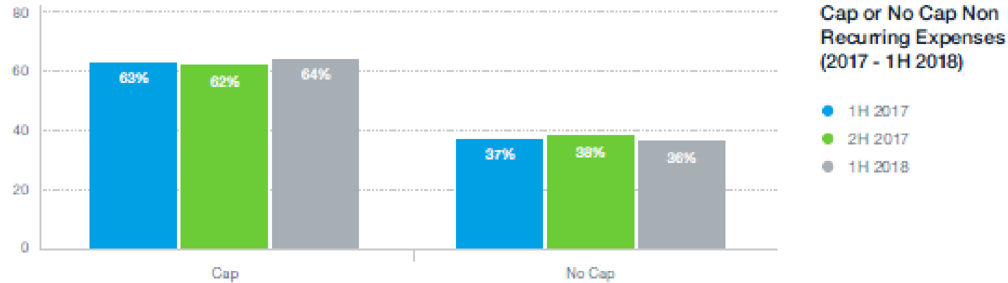
Dealing with “extraordinary, unusual and non-recurring items” (cont’d)

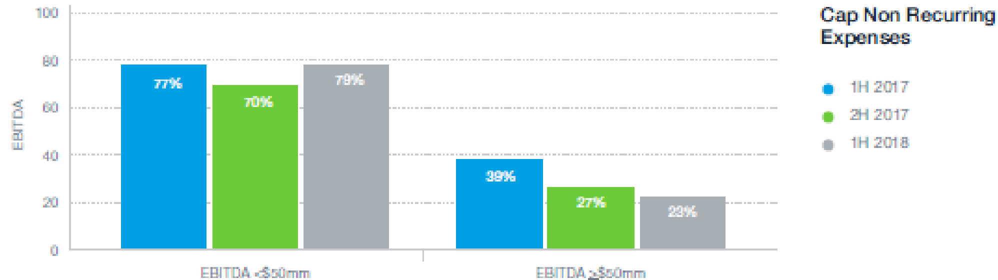
- There are generally three approaches to dealing with “extraordinary, unusual and non-recurring items”: **(cont’d)**
  - **Lender Friendly:** list specific “non-recurring” items that may be added back to EBITDA, subject to limitations and (sometimes) capped amounts. Common addbacks include:
    - Amendment or other modification fees for debt documentation.
    - Unusual and non-recurring operating expenses like the adoption of new financial reporting, accounting or information systems.
    - Employee relocation costs.
    - Curtailments in pension and retirement benefit plans.
    - Gains or losses attributable to non-ordinary course asset dispositions.
    - Losses on the early extinguishment of debt.
    - Foreign currency translation gains or losses.

How addback can be abused

- Many restructuring costs are non-recurring items. If Adjusted EBITDA permits an uncapped addback for extraordinary, unusual and non-recurring items, but applies a cap to addbacks for restructuring costs, this addback could be used to circumvent the cap on addbacks for restructuring costs.

How addback can be abused (cont'd)





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Cash expenditures related to current acquisition or future specified transactions

- These specified transaction expenditures are a type of "non-recurring" costs and expenses, but are generally permitted through a separate addback (especially when "non-recurring" costs and expenses are subject to a cap).
- What is this addback intended to include?
  - Three groupings of transactions are usually covered:
    - In an acquisition financing, the Closing Date acquisition of the primary target (the "Primary Acquisition").
    - Permitted Acquisitions, Permitted Investments, incurrence of indebtedness, dispositions and other related transactions that occur following the Closing Date (collectively, the "Specified Transactions").
    - "Busted" deals (also known as dead deals).

Sample Addbacks

- *“Out-of-pocket costs, fees, charges and expenses arising in connection with the Closing Date Acquisition, any transaction that is or would be a Permitted Acquisition, other permitted investment, issuance of equity interests or incurrence of permitted Indebtedness, in each case, whether or not consummated; provided that the addbacks under this clause [__] shall not exceed $1,500,000 in the aggregate for the applicable period in the case of costs, fees and expenses arising in connection with transactions that are not consummated”*
- *“Fees, costs and expenses incurred in connection with the Closing Date Transactions, a Qualifying IPO, a Disposition permitted by Section [__], any Permitted Acquisition (including, without limitation,[fees, costs and expenses incurred with respect to any shareholder litigation in connection with such Permitted Acquisition (but only to the extent such Permitted Acquisition involves the acquisition of a public company) and any settlement relating thereto)][fees, costs and expenses, including, but not limited to attorneys’ fees and amounts paid in settlement or otherwise, arising in connection with any litigation arising in connection with a Permitted Acquisition, whether or not consummated] or any IP Acquisition to the extent incurred within [__] months after the applicable transaction date [, and with respect to the Transactions in an amount not to exceed $__________to the extent not incurred on the Closing Date]”*

Common Friction Points – Point 1

- Litigation Expenses: a conservative formulation of the limitation on litigation costs permitted to be added back is limiting such costs to shareholder litigations in consummated Permitted Acquisitions and similar permitted transactions. In larger deals, litigation costs are permitted to be added back in connection with any litigation arising in connection with Permitted Acquisitions and similar permitted transactions, whether or not they are consummated.

Common Friction Points – Point 2

- Dollar Caps & Time Caps:
  - Primary Acquisition/Closing Date Transactions:
    - Costs and expenses incurred on or prior to the Closing Date:
      - In larger deals, costs and expenses incurred on or prior to the Closing Date are generally not subject to a cap. In smaller deals costs and expenses incurred on or prior to the Closing Date may be subject to a cap to be agreed based on the flow of funds prepared in connection with closing.

Common Friction Points – Point 2 (cont'd)

- Primary Acquisition/Closing Date Transactions: **(cont'd)**
  - Costs and expenses incurred after the Closing Date:
    - In larger deals, costs and expenses related to the Primary Acquisition but incurred after the Closing Date may be permitted without limitation or may be permitted to be added back regardless of when such costs and expenses are incurred following the Primary Acquisition. If a time limitation has been imposed on these post-closing costs and expenses then the amount is generally not subject to a dollar cap. In smaller deals, there is generally a dollar cap on post-closing costs and expenses related to the Primary Acquisition, with a time limitation on incurring such post-closing fees also imposed.
    - When the post-closing expenses are limited by when such expenses are incurred, a wide time range (3-18 months) is seen, with many deals settling in the 9-12 month range.

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Common Friction Points – Point 2 (cont'd)

- Post-closing Specified Transactions:
  - In larger deals, the costs and expenses related to Specified Transactions are generally not dollar capped, nor are they generally subject to a time limitation. However, to the extent a time limitation is imposed, similar to post-closing costs and expenses related to the Primary Acquisition the same wide time range (3-18 months) is seen, with many deals settling in the 9-12 months range.

Common Friction Points – Point 2 (cont'd)

- Post-closing Specified Transactions: **(cont'd)**
  - The "all third-party costs and expenses" approach: In first-tier sponsor deals and upper market deals, the Sponsor may request an uncapped addback for "all third-party out-of-pocket transaction costs and expenses of the Credit Parties and their Subsidiaries that were associated with the Primary Acquisition and any Specified Transaction." Sponsors argue that if this approach is acceptable with respect to Closing Date costs and expenses related to the Primary Acquisition, then it should also be applied to costs and expenses of Specified Transactions. Also, sponsors will request that such costs and expenses of Specified Transactions should be permitted regardless of whether such transactions are consummated because Sponsors have no incentive to overspend real dollars to achieve an addback.
    - Busted deals: In middle market and smaller deals, busted deals may be subject to a "per-period" cap or a "per-busted deal" cap.

How Could This Addback be Abused?

- **<u>Example</u>**: When the "all third-party costs and expenses" approach is adopted, reductions in headcount and related severance payments may be included as part of the all third party costs and expenses. These could also be considered restructuring costs and non-recurring items. If there is a cap for non-recurring or restructuring caps but no cap on Specified Transaction costs and expenses, the sponsor may strategically addback the reductions in headcount and related severance payments made in connection with an acquisition under the unlimited cap for Specified Transaction costs and expenses in order to maximize the other available addbacks.

Restructuring Costs

- What is this addback intended to include? – Restructuring charges are <u>one-time</u> charges incurred in connection with a reorganization of a company, reducing net income for the period during which they are incurred. This addback is not applied on a pro forma basis. As a result, this addback provides no benefit beyond neutralizing the impact of the relevant expenses in the calculation of EBITDA during that period.
- Generally, restructuring charges may include:
  - Inventory optimization programs and the closure or consolidation of facilities.
  - Employee retention, severance or relocation.
  - System establishment.
  - Excess pension charges.

Sample Addback

- *“Restructuring costs, charges, expenses or reserves, including costs related to the closure and/or consolidation of facilities, costs, charges and expenses attributable to discontinued operations, retention charges, contract termination costs, retention, recruiting, relocation, severance and signing bonuses and expenses and system establishment costs in connection with the Closing Date Transactions and costs in connection with Permitted Acquisitions and other permitted Investments; <u>provided</u> that such amounts (i) shall be reasonable and documented, (ii) shall not exceed 25% of Consolidated Adjusted EBITDA for such period (taken together with cost savings, synergies, and extraordinary non-recurring and unusual costs and expenses, and calculated prior to giving effect to such addbacks) and [(iii) are incurred within 6 months of the closing date of such Closing Date Transactions or Permitted Acquisition or permitted Investment, as applicable]”*

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Example

- Borrower, a sports equipment manufacturer, decided to downsize and eliminate its hockey equipment division following a merger of 2 of its biggest competitors in the hockey equipment space that would create economies of scale so large Borrower would be unable to compete. Within the past twelve months, the Borrower closed 3 manufacturing plants dedicated to the now discontinued hockey equipment, sold remaining inventory and dedicated equipment for pennies on the dollar and laid off 200 employees. In connection with this, Borrower's Consolidated Net Income was reduced by $3,500,000 as a result of the cost of terminating the plant leases, realizing losses on the inventory and equipment and severance payments. In connection with this shift in strategy, Borrower has also invested an additional $1,000,000 into its advertising campaign for this season's soccer and baseball equipment, resulting in another $1,000,000 reduction to Borrower's Consolidated Net Income. Adjusted EBITDA prior to any adjustments for restructuring charges, cost savings, or extraordinary items is $13,000,000. What is the impact of this addback?

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Example Answer

- $3,250,000 will be available ($13mm x 25%) so, Adjusted EBITDA increases to $16,250,000 and Borrower is left with a negative impact of $250,000 to Consolidated Net Income from the restructuring. The additional marketing costs are not included as a restructuring cost due to the fact that they are not "one time" in nature and have continuing go forward benefit to Borrower irrespective of the reorganization.

How is This Addback Capped

- In larger deals, restructuring costs are uncapped. As deals become smaller, restructuring costs may get capped (sometimes taken together with cost savings, synergies, and extraordinary or non-recurring and unusual costs and expenses) (a) at a percentage (i.e. 20-35%) of Adjusted EBITDA, calculated prior to or after giving effect to such addback, or (b) by a specific amount. To the extent a percentage cap is included for restructuring costs (or cost savings, synergies and extraordinary or non-recurring items) sponsors will prefer to have the percentage apply after giving effect to such addback because the amount of the addback would be greater.

How Can This Addback be Abused

- Because a restructuring charge is a "one-time charge," this charge could also be characterized as a "non-recurring item." As a result, a cap included for restructuring charges may become meaningless if the "non-recurring" addback is uncapped.
- Overly aggressive accruals of costs.
- Including operating costs for which no addback is otherwise available (e.g., marketing costs, the costs of purchasing new personal computers, or additional/future operating costs of an acquired entity) as restructuring costs.
- Manipulation of when the charge is recognized (when the decision to restructure is made, when it becomes a liability under GAAP, or when actually paid in cash).

How Can This Addback be Abused (cont'd)

- Since this addback can also be applicable for the initial transactions, it could be applied to bloat EBITDA significantly immediately following the Closing Date (which would, for example, give the Borrower immediate room under incurrence tests based on closing date leverage).

Insurance/Indemnification Payments

- What is this addback intended to include?
  - Cash expenses, charges or losses that impact consolidated net income, but are payable or reimbursed by an unaffiliated third party such as through insurance or reimbursement obligation in a contract.
  - Proceeds of business interruption insurance (the bulk of which generally represents and replaces earnings not made in an applicable period) which have been received or will be received within a period of time.
  - The rationale for why these types of charges are allowed as an addback is because a third party will ultimately be responsible for their payment. As a result, it would be punitive to reduce the consolidated net income of the borrower by such charges.

Insurance/Indemnification Payments (cont'd)

- Sample Addback:
  - *"Business interruption insurance proceeds received in cash during such period (to the extent not otherwise included in Consolidated Net Income) or reasonably expected to be received within 120 days of the end of such period; provided that (i) any amount added back pursuant to this clause for amounts reasonably expected to be received within 120 days of the end of such period shall be added back in the period during which the lost income related to such business interruption insurance proceeds was incurred and (ii) any amount so added back but not received within such 120 period shall be subsequently deducted from the calculation of Adjusted EBITDA"*

How Can This Addback be Abused?

- In order to avoid any abuse of these addbacks, we ring-fence them as follows:
  - The addbacks should be limited to expenses, charges or losses in connection with events permitted under the Credit Agreement.
  - There should be a "good faith" requirement with respect to the Credit Parties' belief that the expenses, charges or losses will be reimbursed within the specified time period. Smaller deals will require actual payment by the insurer or the third party in order for the addback to be permitted whereas the larger deals permit the addback if the reimbursement is expected to be made within a period of time (i.e. 180 days or 360 days).
    - Lenders should be careful to ensure that the time the addback is recognized is not too far from the time the payment is to be received. Otherwise, the borrower may take advantage of an addback in an instance when the related payment is not expected to be received until much later in time.

How Can This Addback be Abused? (cont'd)

- In order to avoid any abuse of these addbacks, we ring-fence them as follows: **(cont'd)**
  - Finally, if such expenses, charges or losses are not reimbursed within such specified time period, such amounts should be deducted in the applicable future periods in calculating EBITDA.
  - Additionally, with respect to the addback for proceeds of business interruption insurance, the addback needs to be limited to amounts not already included in consolidated net income to avoid double credit for these proceeds.

Sponsor-Related/Director Costs and Expenses

- What is this addback intended to include?
- Sponsor-related addbacks generally include:
  - Management fees paid in cash (and potentially accrued) during a period.
  - Indemnification amounts and out-of-pocket expenses paid in cash or accrued by the Credit Parties during a period.
  - Directors' fees and expenses accrued (or to the extent not accrued in any prior period) paid to the directors by the Credit Parties during such period.

Sponsor-Related/Director Costs and Expenses
(cont'd)

- Sample Addbacks:
  - *"Permitted Management Payments to the Sponsor or its Controlled Affiliates during such period by the Borrowers and/or their Subsidiaries and Restricted Payments permitted to be paid under the Credit Agreement to the extent paid by Parent in cash or accrued during such period"*
  - *"All indemnification amounts and reasonable out of pocket expenses paid in cash or accrued (plus any unpaid indemnification amounts and reasonable out of pocket expenses accrued in any prior period) to the extent permitted under Section [__] of the Credit Agreement"*
  - *"Directors' fees and expenses accrued, or to the extent not accrued in any prior period, paid to the directors during such period by the Borrowers and each of their respective Subsidiaries; provided, that the aggregate amount included in Consolidated Adjusted EBITDA under this clause in such period of the Borrowers shall not exceed $200,000"*

How Can This Addback be Abused and Capped

- How can this addback be abused?
  - Potential for abuse of these items is low as they are generally subject to sufficient restrictions in the restricted payment section of the negative covenants in a Credit Agreement.
- How is this addback capped?
  - Permitted management payments:
    - Payment of management fees are capped and subject to payment conditions in the restricted payment covenant, so the addback should be limited to management fees that (x) were paid (and permitted to be paid) under the Credit Agreement and (y) have accrued and would be permitted to be paid under the Credit Agreement. This addback should specifically refer to the scheduled management payments so that other distributions to the Sponsor or additional fees taken by the Sponsor under other baskets in the restricted payment covenant are not picked up in the addback.

How Can This Addback be Abused and Capped
(cont'd)

- How is this addback capped? **(cont'd)**
  - Indemnification/Out-of-pocket expenses:
    - These are generally uncapped in the restricted payment covenant, but out of pocket expenses should be limited to "reasonable" out of pocket expenses.
  - Directors' Fees and Expenses:
    - In middle market deals, director compensation is traditionally capped in the negative covenants. In the alternative, a cap on director compensation can be contained in the addback to EBITDA so payments are not prohibited, but would not receive EBITDA credit in excess of a certain amount. In larger deals this is not capped but is limited to "customary" and/or "reasonable" fees and expenses.

Non-Cash Expenses or Losses That Reduce Consolidated Net Income

- What is this addback intended to include?
- A non-cash expense or loss is an expense or loss that is recorded on the income statement of a Company in a particular accounting period and reduces Consolidated Net Income but for which there was no associated cash outlay in such period.
  - Examples of non-cash expenses or losses.

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Non-Cash Expenses or Losses That Reduce Consolidated Net Income (cont'd)

- Examples of non-cash expenses and losses include:
  - Adjustments resulting from the application of purchase accounting and accounting changes or restatements.
  - Impairment of goodwill and other long term intangible assets.
  - Unrealized losses (or minus unrealized gains) (to the extent not subtracted from consolidated net income).
  - Non-cash items related to management equity plans, supplemental executive retirement plan or stock option plans.
  - Non-cash adjustments related to the valuation of earn-out obligations or hedging transactions.
  - Amortization and depreciation are also non-cash expenses but are covered by other addbacks to EBITDA.

How Can This Addback be Abused and Capped

- How can this addback be abused?
  - Non-cash expenses that are an accrual or reserve for potential cash expenses:
    - Non-cash expenses that are an accrual or reserve for a future or potential cash expense could be double counted upon the recognition of the associated cash expense in Consolidated EBITDA if such non-cash expense was permitted to be added back. In middle-market and larger deals, an addback for non-cash expenses that are an accrual or reserve for future or potential cash expenses will be permitted, but (i) the associated cash expenditures should be required to be deducted from EBITDA during the future periods in which they are actually made and (ii) any over accrual of such amounts should be deducted from EBITDA during that same period the payment is made. This addback is controversial in smaller deals because it allows a Sponsor credit for expenses before they are paid and potentially for amounts in excess of what will eventually be paid.

How Can This Addback be Abused and Capped
(cont'd)

- How can this addback be abused? **(cont'd)**
  - Write-downs and write offs:
    - In deals where Accounts and Inventory are significant, non-cash expenses should not include, in any case, write-downs, write offs or reserves with respect to Accounts and Inventory.
- How is this addback capped?
  - There are two approaches to addbacks for non-cash charges that reduce consolidated net income:
    - First Approach (preferred by Sponsors and more common with first tier Sponsors and/or in larger deals): permit a generic addback for all/any non-cash items.
    - Second Approach (preferred by lenders and more common in smaller deals): itemize the non-cash charges the Lenders are willing to permit an addback for, which may even be dollar capped in some cases.

Cost Savings and Synergies

- What is this addback intended to include?
  - "Cost savings and synergies" are not costs or expenses that reduce consolidated net income, instead, they represent the economic impact of the "restructurings" (i.e., specific transactions such as acquisitions, divestitures, operational consolidations or new initiatives, which are expected to reduce expenses) undertaken by the company which led to the "restructuring charges" discussed above.
  - This addback will also include terms like "run rate" cost savings, operating expense reductions, restructuring charges, operating improvements and other similar concepts.

Cost Savings and Synergies (cont'd)

- What are "run rate" cost savings?
  - "Run Rate" refers to the extrapolation of financial results into future periods based on the assumption that current conditions and results will continue. Run rate cost savings would be calculated by taking cost savings anticipated in any particular quarter and applying that same amount to each future quarter captured by the addback.
    - Example: Borrower realized $1,500,000 of cost savings in Q1 2017 as a result of layoffs following the reorganization of its business at the end of the prior year. Its "run rate" cost savings for 2017 related to these layoffs will be $6,000,000 ($1.5mm x 4).

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Cost Savings and Synergies (cont'd)

- How can "run rate" cost savings be abused?
  - Although "run rate" measurements may be appropriate for some types of expense reductions, many costs reduction initiatives initially achieve a large amount of expense reductions by focusing on the easiest savings first. In such a case, a run rate may not provide an accurate picture of future cost reductions, since future reductions will be in areas that are more difficult to achieve.

Cost Savings and Synergies (cont'd)

- Unlike actual charges, these amounts are "projected amounts" (or anticipated cost savings). "Projected amounts" should be reduced by actual realized benefits.
- This addback is generally available with respect to actions already taken, and those "committed to be taken" or "expected to be taken" after the test period.
- Additionally, cost savings and synergies are added back to EBITDA on a pro forma basis as if the "restructuring action" that triggered the savings and synergies had been taken at the beginning of the relevant test period, which further increases the impact that cost savings and synergies addbacks can have on EBITDA.

Cost Savings and Synergies (cont'd)

- This addback will be available in connection with the Closing Date transaction. In larger deals, the addback will also be available after the Closing Date in connection with any restructurings, cost savings initiatives, strategic initiatives and other initiatives whether or not undertaken in connection with a specific transaction. As deals become smaller, this would be limited to acquisitions, mergers, amalgamations, and dispositions permitted by the credit agreement or it would not be permitted at all.

Sample Addback

- *"Cost savings, "run rate" cost savings, operating expense reductions and synergies expected to be realized in connection with any Specified Transaction (calculated on a Pro Forma Basis as though such cost savings, operating expense reductions and synergies had been realized on the first day of such period and as if such cost savings and synergies were realized during the entirety of such period), net of the amount of actual benefits realized during such period from such actions (and expected to be realized within [12][24] months after the consummation of such Specified Transaction); provided that (x) (1) a duly completed certificate signed by a Responsible Officer of the Borrower Representative shall be delivered to the Administrative Agent, certifying that such cost savings, operating expense reductions and synergies are reasonably identifiable, factually supportable, and reasonably anticipated to be realizable in such timeframe in the good faith judgment of the Borrower Representative in connection with such Specified Transaction, or (2) such cost savings, operating expense reductions and synergies are determined on a basis consistent with Article 11 of Regulation S-X promulgated under the Securities Act of 1933 and as interpreted by the staff of the Securities and Exchange Commission, or (3) are supported by the Sponsor Model delivered to the Administrative Agent prior to the Closing Date or a third-party quality of earnings report (such third-party to be reasonably agreed to by the Administrative Agent), and (y) no cost savings, operating expense reductions and synergies shall be added pursuant to this clause to the extent duplicative of any expenses or charges otherwise added to Consolidated EBITDA, whether through a pro forma adjustment or otherwise, for such period; provided that all amounts added back pursuant to this clause (together with the amounts of Restructuring Costs) shall not exceed, in the aggregate [20%][35%] of Consolidated EBITDA (calculated [prior to/after] giving effect to such Restructuring Costs and adjustments under this clause)"*

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Sample Addback (cont'd)

- The sample provision on previous slide sets an overall cap on cost savings, operating expense reductions and synergies and also requires that one of three prerequisites are met in order for it to be a valid addback (1. Certification by the Borrower; 2. Compliance with Reg S-X; or 3. Inclusion in the Sponsor Model delivered prior to the Closing Date or a QoE provided in connection with a Specified Transaction following the Closing Date).

Additional Cost Savings/ Synergies and Reg S-X

- The more Sponsor-friendly formulation of this addback may not have an overall cap and may require a certification by the Borrower similar to the one in the sample provision. However, in the event a cap is included, the following will be permitted as additional categories of cost savings/ synergies over and above the cap:
  - Addbacks determined on a basis consistent with Reg S-X (this carve out, although included, is generally not actually employed by the Sponsors due to reasons to be discussed).
  - Addbacks set forth in the Sponsor Model delivered prior to the Closing Date.
  - Addbacks set forth in a Quality of Earnings Report prepared by a third party acceptable to Agent in connection with the initial Closing Date acquisition and Specified Transactions that may occur after the Closing Date.

Additional Cost Savings/ Synergies and Reg S-X
(cont'd)

- What is Reg S-X and how does it work?
  - Regulation S-X is applicable to public companies and describes the circumstances in which pro forma financial statements should be presented in SEC filings in the context of "business combinations, acquisitions and dispositions," and provides guidance for their preparation. Article 11 of Regulation S-X contemplates that pro forma adjustments to a filer's income are limited to adjustments that give effect to events that are (i) directly attributable to the transaction, (iii) factually supportable and (iii) expected to have a continuing impact on the filer's income statement. Regulation S-X adjustments don't include those adjustments due to actions expected to be taken after the business combinations, acquisitions and dispositions (including, for example, termination of employees, closure of facilities and other restructuring charges), which are usually the source of most of the cost savings.

Additional Cost Savings/ Synergies and Reg S-X

(cont'd)

- What is Reg S-X and how does it work? **(cont'd)**
  - Relying on Regulation S-X has several pros and cons because (1) the regulation contains certain technical compliance requirements that are extremely burdensome to meet for non-public companies, (2) Lenders do not (or do not have the internal know-how and processes established to) confirm Reg S-X compliance on an ongoing basis, and (3) generally only evaluate or test it when a dispute/litigation on the nature of the addback arises.

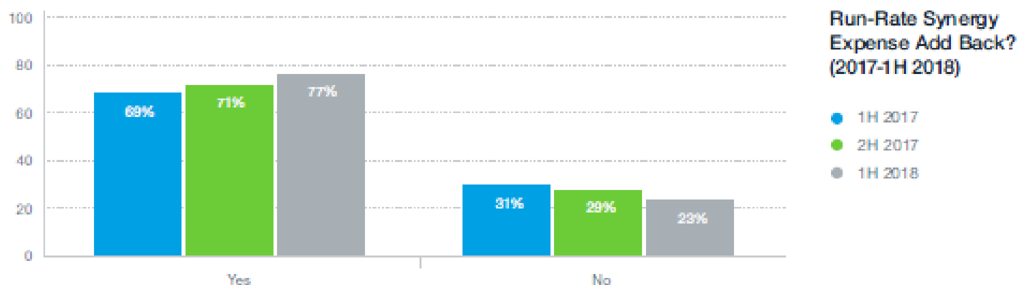
How Can This Addback be Abused and Capped

- How can this addback be abused?
  - (i) subjective adjustments or overly aggressive or optimistic estimates of cost savings and synergies that are determined by the Borrower and difficult to verify from a Lender's perspective, (ii) improper use of "run rate" cost savings as noted above, and (iii) over-recognition of cost savings and synergies (or manipulating when the cost savings and synergies are recognized) in light of the addback's application to future events "contemplated to occur." Similar to Restructuring Costs, since this addback is applicable for the initial transactions, it could be applied to bloat EBITDA significantly immediately following the Closing Date (which would, for example, give the Credit Parties room under incurrence tests based on closing date leverage).

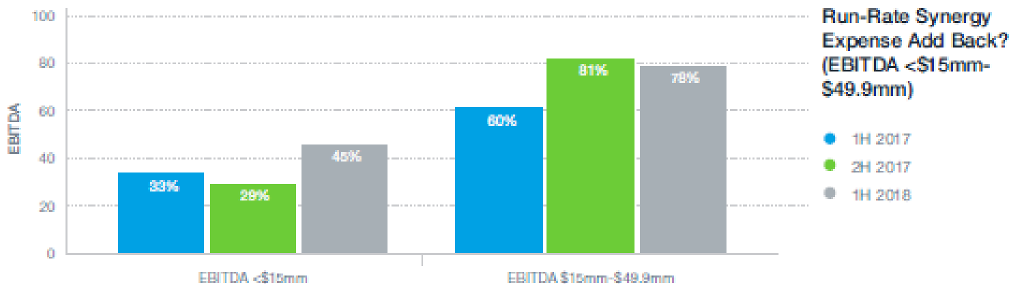
How Can This Addback be Abused and Capped
(cont'd)

- How is this addback capped?
  - The addback for "cost savings and synergies" should be limited to cost savings/synergies to be achieved within a specified time period following the "restructuring" or other Specified Transaction (generally within 12-24 months following such transaction). The addback should also be limited to items "projected in good faith to be realized" and "reasonably identifiable" and/or "factually supportable" and certified as such by the Borrower. Addbacks are also permitted if they (x) are calculated in compliance with Reg S-X or (y) are included in the Sponsor Model or a QoE report prepared by a third party. Cost savings and synergies are generally capped (either individually or taken together with restructuring costs, and extraordinary non-recurring and unusual costs and expenses) at a percentage (i.e., 20-35%) of Adjusted EBITDA, calculated prior to or after giving effect to such addback. Addbacks (i) permitted under Regulation S-X and (ii) set forth in the Sponsor model or a QoE may be permitted in excess of the cap in more Sponsor-friendly formulations of this addback.
  - Any other addback for "cost savings and synergies" would require Agent or Required Lender consent.

How Can This Addback be Abused and Capped
(cont'd)



* In deals with EBITDA greater than $50mm, run rate synergy expenses are almost universally added back



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Example of EBITDA Calculation

- OpCo, Inc. has Consolidated Net Income of $20,000,000 for the trailing 12 month period, as well as the addbacks listed below.

Interest Expense	1,500,000.00
Taxes	2,500,000.00
Depreciation	1,500,000.00
Amortization	1,000,000.00
Non-Cash Charges	500,000.00

- In addition, OpCo, Inc. reports for such period (i) extraordinary non-recurring and unusual costs and expenses of $1,700,000, (ii) costs and expenses incurred in reorganizing the Company related to the Closing Date Transaction of $1,400,000 and (iii) cost savings/synergies related to the Closing Date Transaction expected to be realized within 9 months of $1,000,000 per fiscal quarter. OpCo, Inc.'s Credit Agreement permits the addbacks in (i) – (iii) up to <u>25%</u> of Adjusted EBITDA (calculated prior to giving effect to such addbacks). What is Adjusted EBITDA?

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Example of EBITDA Calculation (cont'd)

- **Step 1:** Consolidated Net Income less Interest, Taxes, Depreciation and Amortization and Non-Cash Charges
- **Step 2:** Determine Cap on Additional Addbacks
  - 25% x $27,000,000 = $6,750,000

Consolidated Net Income	20,000,000
Interest Expense	1,500,000
Taxes	2,500,000
Depreciation	1,500,000
Amortization	1,000,000
Non-Cash Charges	500,000
Total	27,000,000

- **Step 3:** Determine Cost Savings Synergies
- Since expected cost savings/synergies will be recognized at the beginning of the period, the cost savings/synergies of $1,000,000 per fiscal quarter will be recognized for each of the four quarters in such trailing 12 month period, totaling $4,000,000

Example of EBITDA Calculation (cont'd)

- **Step 4:** Add in extraordinary ($1,700,000) and reorganization ($1,400,000) costs, up to cap. Would have been $7,100,000 if not capped.
- Additional Takeaways: Assuming $120,000,000 of financing, the difference of $29,750,000 (Adjusted EBITDA less Cost savings & Synergies) vs. $33,750,000 in EBITDA changes the leverage ratio from 4.03x to 3.55x. If incurrence tests were pegged off of closing date leverage with synergies, there is immediately room to incur more leverage or potentially the capacity to take certain actions (make investments, make restricted payments, pay subordinated debt) without a real improvement in the leverage of the Company.

Income	**20,000,000**
Interest Expense	1,500,000
Taxes	2,500,000
Depreciation	1,500,000
Amortization	1,000,000
Non-Cash Charges	500,000
Total	27,000,000
Cost Savings & Synergies	4,000,000
Extraordinary, etc.	1,700,000
Reorganization Charges	1,050,000
Adjusted EBITDA	33,750,000

Pro Forma Calculation of Financial Covenant Definitions

- What is "pro-forma" calculation?
  - A "pro-forma" calculation is a calculation done after giving effect to a particular event or transaction assuming that such event or transaction has occurred at the beginning of the relevant test period. Recognizing an event or transaction at the beginning of a period increases the impact of such event or transaction on EBITDA. Events that are given "Pro Forma Effect" in a Credit Agreement typically include (i) dispositions of all or substantially all Equity Interests in any Restricted Subsidiary or any division, product line, or facility used for operations of the Borrower or any of its Restricted Subsidiaries (which shall be excluded for the full period), (ii) purchases or other acquisitions of all or substantially all of the property and assets or business of any Person, or of assets constituting a business unit, a line of business or division of such Person, or of all or substantially all of the Equity Interests in a Person (shall be included for the full period) and (iii) indebtedness incurred or retired in connection with specified transactions.

Pro Forma Calculation Example

- When are covenants calculated on a pro forma basis?
  - Covenants that operate as “incurrence tests” are generally tested on a pro forma basis (after giving effect to the proposed action). If the Borrower fails to satisfy any covenant in connection with an incurrence test, the Borrower will not be permitted to take such proposed action. This can be contrasted with a maintenance covenant, which is not tested on a pro forma basis.
- Specified Transactions:
  - Specifically consider scope of what constitutes a “Specified Transactions” to which “pro forma” calculation is applied. – Specified transactions generally include (i) incurrence or repayment of debt, (ii) Permitted Acquisitions (or other similar Investments or designation of a Subsidiary as a Restricted Subsidiary), (iii) disposition of divisions or lines of business or dispositions that result in an entity no longer being a Restricted Subsidiary and (iv) Restricted Payments. This list should include all transactions and events that require EBITDA or a financial covenant to be tested on a Pro Forma Basis.

Pro Forma Calculation Example (cont'd)

- Cost savings/synergies
  - As discussed above, when Pro Forma effect is given to Specified Transactions the calculations may include cost savings and synergies relating to the Specified Transactions (calculated on a pro forma basis as though such cost savings and synergies had been realized on the first day of the period). Cost savings and synergies applied in this context should be subject to the same qualifications, limitations and caps as the addback to EBITDA and should not be permitted in addition to the cost savings and synergies addback to EBITDA.

Caps on Pro Forma Calculations

- Pro forma calculation should be subject to the same qualifications, limitations and caps as are set forth in Adjusted EBITDA (including cost savings/synergies, as noted in (b)(ii) above), and should not be permitted in addition to existing qualifications, limitations and caps.

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Financial Covenants (Part II)

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