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PERSPECTIVE

Pulling back the curtain on closing leverage

By Sandra Montgomery
and Michelle Iodice

MONTGOMERY

IODICE

The guidelines came in response to the increased volume of 'risky' leveraged finance transactions being entered into by these institutions. A key theme of these guidelines was that a company with leverage (or funded indebtedness of a borrower) exceeding six times EBITDA (earnings before interest, taxes, depreciation and amortization) was considered a risky investment in most industries.

In 2013, the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency issued guidelines applicable to federally regulated financing institutions under the Interagency Guidance on Leveraged Lending. The guidelines came in response to the increased volume of "risky" leveraged finance transactions being entered into by these institutions. A key theme of these guidelines was that a company with leverage (or funded indebtedness of a borrower) exceeding six times EBITDA (earnings before interest, taxes, depreciation and amortization) was considered a risky investment in most industries. Many unregulated lenders took note of this metric and closing leverage in the middle market began to retract in some cases.

Against this backdrop, in the years following the 2013 guidelines borrowers began utilizing increasingly aggressive methods of calculating adjusted EBITDA (based on EBITDA as described above, and adjusted upward by costs and expenses and other "addbacks" that are negotiated on a deal-by-deal basis). Many lenders were receptive to this in light of the competitive landscape for placing capital. Adjusted EBITDA is the standard metric for evaluating a company's profitability in leveraged financings, but it is not a GAAP accounting principle. As such, borrowers have significant flexibility to adjust the types of expenses and other items that may be added back in the calculation of adjusted EBITDA based on industry, company specific metrics and emerging market conventions.

This shift led to adjusted EBITDA valuations that were meaningfully higher than a borrower's actual EBITDA, which allows it to stay within moderate leverage ratio levels. This is because the leverage ratio of a borrower and its subsidiaries (calculated as funded debt divided by adjusted EBITDA) appears to be lower if adjusted EBITDA is inflated. Three addbacks to adjusted EBITDA that are highly negotiated are (1) extraordinary, unusual and non-recurring losses and expenses, (2) costs and expenses incurred in connection with loosely-defined restructurings and (3) cost savings and synergies.

The market has largely accepted the trajectory of allowing these addbacks in increasing capacity, and lenders have had limited success in returning to historical formulations of adjusted EBITDA. As a result of these factors, coupled with the increasing flexibility being provided to borrowers to incur additional indebtedness, lenders should consider that leverage at a market level is higher than previously contemplated and may quickly exceed what they intended to underwrite in certain transactions.

In October 2017, the Government Accountability Office determined that the guidelines were rules rather than guidelines. Rules are required to be subjected to congressional review, but guidelines are not. Since these rules were not subjected to congressional review, their enforceability was called into question. In September 2018, federal regulators clarified that the guidelines did not have the force of law and federal agencies would not take enforcement actions based on them. However, the leveraged lending market seemed to accept the cutoff point of 6.0 times as a meaningful metric of a risky transaction.

Over the past eight years, the Private Credit Group at Proskauer Rose LLP (PCG) has tracked deal data for 150 to 200 transactions per year. PCG's data shows that closing leverage for upper-middle-market transactions in 2018 was clustered around 5.5-5.99 times (the data discussed in this article is based on transactions in the upper middle market, defined as financings to borrowers with consolidated EBITDA in the range of $30 million to $49.9 million; the data is consistent with deal terms tracked by PCG and may not be indicative of overall market trends). This is generally consistent with closing leverage levels in 2017 and, based on transactions closed in the early part of 2019, PCG has not seen materials deviations from these levels so far this year. However, the formulations of certain addbacks to adjusted EBITDA, especially in light of the influx of certain upper-market deal terms into the upper middle market, necessitatea second look at this closing leverage number.

Non-recurring Items and Re-structuring Charges

Middle-market financing agreements generally contain an addback to adjusted EBITDA for cash extraordinary, unusual and non-recurring losses and expenses ("non-recurring items"). Borrowers frequently negotiate for uncapped capacity, but in certain middle-market transactions, this addback is capped based on a percentage of adjusted EBITDA for the current period. For transactions with such a cap, the percentage recognized as market in recent history was in the 20-25 percent range (either as a standalone cap or as a cap that is taken together with restructuring charges and cost savings and synergies addbacks). This has increased to a range of 25-30 percent, and remains constant in the early part of 2019.

Another customary addback to adjusted EBITDA is for cash restructuring charges. Restructuring charges are one-time costs and expenses incurred in connection with the restructuring of a borrower and its subsidiaries, and restructurings may even include acquisitions, investments or divestitures that do not materially impact the business. Similar to non-recurring items, this addback neutralizes the impact of costs and expenses were actually incurred. Consistent with non-recurring items, borrower-friendly transactions may permit uncapped addbacks for restructuring items. However, most often, addbacks for restructuring charges in the middle market are taken together with non-recurring items and/or cost savings and synergies and subject to the range of caps described above.

Cost Savings and Synergies

The cost savings and synergies addback may be the most heavily negotiated addback to adjusted EBITDA in middle-market financings. Cost savings and synergies represent the ongoing economic impact of restructurings. This addback is unique in that it does not represent items previously deducted from the calculation of net income, but represents projected future expense reductions and cost savings. The addback is generally available for synergies that are expected to be realized within 12 to 24 months after the consummation of a "specified transaction," and in some cases is available with respect to actions "committed to be taken" or "expected to be taken" within that period, which gives a borrower even more flexibility to recognize synergies that have not yet occurred.

A borrower-friendly formulation of this addback will be unlimited or uncapped, and subject only to a "good faith" certification by the borrower that these synergies will be realized. In most middle-market financing agreements, the addback will be subject to a percentage-based cap, taken together with non-recurring items or restructuring charges. This cap has historically been within the 20-25 percent range. PCG's data shows that in 2018, 75 percent of upper-middle-market deals had a cap on run rate synergies of 25 percent or greater. This is generally consistent with data collected so far in 2019.

A handful of other factors tacitly increase the potential impact on leverage of addbacks for non-recurring items, restructuring charges and cost savings. It is becoming more common to calculate the caps on these addbacks after giving effect to the addback on adjusted EBITDA (rather than before giving effect to it). Mathematically, this permits a borrower to take a larger addback without increasing the percentage of the cap. Borrowers also continue to push for additional addbacks to consolidated EBITDA for items that would otherwise fall under the general addback for non-recurring items and restructuring costs (e.g. costs and expenses incurred in connection with permitted acquisitions or discontinued operations). Finally, in deals where the cap on non-recurring items has fallen away but the cap on restructuring charges has not, certain restructuring charges may be properly added back though the non-recurring items addback due to the overlap in these classifications which circumvents a well negotiated cap on restructuring charges.

The "run-rate" cost savings feature is also a particularly powerful tool for borrowers in the context of the cost savings addback, permitting the extrapolation of financial results into future periods based on the assumption that current cost-saving conditions and results will continue. Although run-rate measurements may be appropriate in some cases, many cost 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 overstate future cost reductions. In addition to this, synergies consistent with Article 11 of Regulation S-X (applicable to the reporting of pro forma financial information) promulgated by the U.S. Securities and Exchange Commission, supported by a financial model prepared by the borrower prior to the closing date or set forth in a third-party quality of earnings report, may be permitted to be added back without limitation in excess of the agreed cap.

Conclusion

PCG's data shows that lenders in the upper-middle-market band of the private credit market target a closing leverage moderately inside six times, a trend which has appeared to continue in 2019. However, caps on certain addbacks to adjusted EBITDA are growing, and even disappearing in limited cases. This provides a blurred view of a borrower's profitability and a degraded basis for calculating leverage in a manner that approximates actual risk. Additionally, upper-market debt incurrence terms (including formulations of incurrence terms that are based on leverage ratios and/or adjusted EBITDA) continue to appear regularly in middle-market transactions, providing borrowers with increased opportunities to incur debt and take other actions that lenders may not view as accretive to a borrower's business. In light of these undercurrents, lenders should consider that the effective closing leverage at a market level is greater than it appears on its face and may not provide a complete picture of underwriting risk in a particular transaction.

Sandra Montgomery *is a partner in The Private Credit and Finance Groups at Proskauer Rose LLP. Sandra represents first-and second-lien senior lenders, mezzanine investors, and equity sponsors in senior debt, mezzanine and private equity financing arrangements, particularly those involving private sources of capital. Her areas of focus include acquisitions, recapitalisation and other leveraged financings, cash flow and asset-based financings, debtor-in-possession and exit financings, cross-border financings, unitranche and mezzanine financings, restructurings and other innovative, first-in-kind transactions.*

Michelle Iodice *is an associate in The Private Credit Group at Proskauer Rose LLP. Michelle concentrates her practice on complex financing transactions, including unitranche, first and second-lien, secured and unsecured mezzanine, holdco and other forms of private credit in connection with leveraged buyouts, acquisition financings and recapitalisations, among other purposes. She has experience representing a diverse group of lenders in transactions across a wide range of industries.*