ELFA *Insights*
Volume 8

Increased Transparency on Covenant Capacity is Essential to Good Governance by Leveraged Finance Borrowers

Executive Summary

- Covenant innovation in the leveraged finance market has increased significantly over the past decade, while disclosure about covenant capacity and related risks remains largely unchanged.
- Complex calculation mechanics and bespoke financial definitions make it difficult – if not impossible – for investors to calculate capacity for a company to pay dividends, incur debt, or trigger portability, among other things.
- This uncertainty has troubling implications, as disclosure of material information to creditors is essential to their ability to price risks as efficiently as possible and to determine the strength of governance by borrowers.
- Transparency in communication with stakeholders falls squarely within the governance principle of ESG, and information about covenant capacity is not a "nice-to-have" element of disclosure for investors.
- ELFA proposes including key metrics and other information in a Best Practice Guide on Covenant Transparency that borrowers can use to support strong governance in this area.
- These include disclosure on "EBITDA" as defined under the covenants, the amount of outstanding debt captured by the "Indebtedness" definition, Restricted Payments capacity, and flexibility for a borrower to disapply IFRS 16 to calculations under its covenants.
- ELFA is also conducting a survey of investors in order to gather a broad market view on how covenant capacity impacts their decision to invest, or remain invested, in a particular instrument.
- The public consultation and investor survey will be open until 6pm on 17 July. Comments can be sent to Sabrina Fox, Executive Adviser to ELFA, and investors can take the survey by clicking here.

Introduction

Covenant innovation in the leveraged finance market has increased more during the last three years than in the entire previous decade. There are a number of factors driving this trend. Ongoing central bank support of the economy has kept interest rates low and liquidity pouring into the market, creating higher demand for yield. In the meantime, advisers to borrowers have used clients' competitive advantage to engineer increased covenant flexibility through various means, including by way of novel and bespoke provisions.

This increased complexity has made it increasingly difficult – and in some cases impossible – for investors to determine the ability of a company to take various actions under the indenture. There has also been a growing trend toward borrowers taking disparate approaches to these provisions, and less breadth and granularity in disclosure.

Complex calculation mechanics and counter-intuitive defined terms present particularly problematic sources of flexibility, as the increased divergence from accounting provisions and figures in reported financials create significant uncertainty about the precise levels of capacity to incur debt, pay dividends, and trigger portability, among other things. The proliferation of these terms is problematic from a transparency and governance perspective, as investors cannot price risks that they cannot quantify.

Further, this lack of transparency has troubling implications for principles of good governance by borrowers. ELFA believes that the increased focus by investors on ESG metrics extends to transparency with respect to covenant capacity, as the ability of a company to take various actions under the covenants is central to investors' analysis of the risk inherent in any given deal, and to their decision about whether to invest.

We highlight in this note some of the provisions that can make analysing covenant risk an arduous and uncertain task for investors, and urge borrowers to be more forthcoming about capacity under their covenants. To support better disclosure, we propose including key metrics and other information in a Best Practice Guide on Covenant Transparency, which companies and their advisers can use to disclose accrued and potential capacity at issue and on a periodic basis, using the defined terms and calculation mechanics as provided in the indenture.

The Evolution of Covenant Flexability and Financial Definitions

Previous Standard	Current Standard
EBITDA Add backs	
- "CNI" adding back non-cash, non-recurring items - Pro forma add-backs capped and subject to time horizon - Calculations based on objective criteria, compliance certificate	- Expansive, bespoke add-backs - Rarely subject to caps, time horizons for realisation - No compliance certificate requirements
Deinition of "Indebtedness"	
- Included most debt for borrowed money - Could be matched to financials	- Excludes significant categories of debt - Exclusions may include RCFs, debt incurred for working capital
Timing and manner of calculations	
- Calculations made as of the last day of the most recent fiscal quarter for which financial statements available	- Calculations made as of date of entry into definitive agreement, including an LBO of the issuer

Clear and current information is necessary to price risk

Investors in the leveraged finance market are accustomed to pricing risk. Until fairly recently, the ability of an investor to quantify the risk presented by covenant provisions was mostly a matter of marrying up the terms of a company's covenant definitions with the nearest line of a company's financial statement. Below are three examples for why this is no longer the case.

"EBITDA" add-backs

"EBITDA" as defined by the covenants has always been the most hotly negotiated provision in the indenture, but until just a few years ago it was based on "Consolidated Net Income" adding back non-cash and non-recurring items in order to approximate actual cash available on a run-rate basis.

Pro forma add-backs for synergies, or the issuer's best estimate of the positive effects resulting from certain actions taken (or that would be taken in the future), were typically capped and subject to a time horizon for realisation (usually 12-18 months). Often these calculations were required to be based on objective criteria, for example, accounting standards for preparing pro forma financial statements, and submitted to the indenture trustee with a compliance certificate.

Over time, add-backs have become much more expansive, and the caps and objective certification requirements have all but disappeared. Where previously EBITDA was primarily relevant in calculating debt capacity, the figure is now used for almost every permission under a typical covenant package, as it is referenced in nearly all metrics across the debt, liens, restricted payments, asset sale, and change of control covenants.

"Indebtedness" definition

The "Indebtedness" definition used to include all debt for borrowed money, which could be matched to financial debt on a balance sheet. Now many deals exclude significant liabilities from the "Indebtedness" definition, including debt incurred under a revolving credit facility, or incurred for the purpose of working capital.

Timing and manner of calculations

Previously, most calculations were made as of the last day of the most recent quarter for which financial statements were available. Now many deals include terms that allow management to calculate covenant capacity as at the date of entry into a definitive agreement with respect to a transaction – including in some cases the company's own LBO. Many deals also contain flexibility that allows the issuer to calculate debt capacity upon receipt of a commitment to incur debt, and do not require that the issuer re-calculate capacity at the time the debt is actually incurred. Management can choose to make the calculations as of one date, then elect to change to a different date if figures improve, with no requirement to disclose any of these calculations or elections to investors.

Since the beginning of 2019, it has become even more difficult to calculate EBITDA, Indebtedness, and other metrics under the covenants. Despite the change in IFRS accounting presentation resulting from the promulgation of IFRS 16 by the IASB, borrowers often have discretion under their covenants about whether, and to which provisions, to apply IFRS 16; others will permit the negative effect of IFRS 16 to be excluded from any calculation under the covenants. This can result in hugely different outcomes, yet no borrower is required to report these figures in its offering materials, financial statements, or financial reports.

Obsucured covenant capacity presents a material risk that cannot be priced

While it is certainly the case that capacity has been increased through larger baskets and growers and higher leverage ratios, these aspects of covenant flexibility are less problematic from a transparency perspective than the mechanics underlying the calculations of such capacity.

For example, a 5x leverage ratio cap calculated using defined "EBITDA" and "Indebtedness" and incorporating other calculation flexibility embedded in the agreement might actually provide closer to 7x worth of debt capacity as derived from financial statement metrics. If such deviations are to exist, then investors should have access to these calculations in order to properly assess the potential risks inherent in this higher level of capacity.

Together with the definitional flexibility resulting in greater capacity, complex calculation mechanics have become common, giving management significant scope to decide when, and how, to calculate that capacity. The definitions, calculations and related elections made by management described above are not required to be disclosed to investors.

This lack of transparency in certain instances has resulted in higher levels of volatility following company announcements of certain transactions, such as dividends or additional debt incurrence or transfers of assets outside restricted groups. This is simply because the size and scope of a corporate action, let alone if one is permitted at all, can surprise investors when they are left in the dark about covenant capacity (both at the outset of a deal and on an ongoing basis) and the underlying metrics and mechanics.

> *A 5x leverage ratio calculated using flexibility embedded in the agreement might actually provide closer to 7x worth of debt capacity when calculated from financial statement metrics.*

This uncertainty is inappropriate, as the only way an investor can price risk accurately is to understand the position of the instrument in the capital structure and how this can change over time, whether by way of debt incurrence, dividend payments, asset sales or otherwise.

We are now seeing the consequences of weak covenants in recent contentious restructurings and such instances clearly illustrate the detrimental impact of such covenants for creditors. The contentiousness of some recent covenant disputes highlights how difficult it is for investors to reach even a basic understanding as to what their protections are under the agreements at any given moment.

This complexity is only growing – recently, a deal contained provisions that extended a carry forward / carry back calculation flexibility from the typical immaterial baskets to any basket calculated on an annual basis, making estimates of capacity under any given basket at any given time impossible to determine.

> *Without substantive changes to the status quo, ELFA expects that higher uncertainty around the degree of creditor protection will lead to a higher risk premium for high yield debt.*

Further, the deal would allow management to freeze EBITDA derived from certain transactions at its highest level for the purpose of determining capacity under baskets derived from a fixed amount and an EBITDA grower, without providing any mechanics for investors to understand what proportion of consolidated EBITDA had been derived from the applicable transactions, leaving them completely in the dark about how to calculate the cornerstone figure of the covenant package.

These opaque provisions have effectively eroded the fundamental principles of capital structure and security for creditors. Without substantive changes to the status quo, ELFA expects that higher uncertainty around the degree of creditor protection will lead to a higher risk premium for high yield debt.

There is a simple solution to this problem – borrowers should disclose covenant capacity components and calculations both at the outset of a deal and on an ongoing basis. Only management is aware of the assumptions and elections that they have applied to calculate capacity under the covenants, and these are facts that should be shared with investors.

Bringing transparency to covenant calculations is essential to good governance

Transparency about covenant capacity should not be a "nice to have" element of disclosure. The ability to obscure covenant capacity does not reflect good governance, as it puts lenders at an information disadvantage to other stakeholders.

Something as basic as whether, and to what extent, a company can transfer assets to an Unrestricted Subsidiary, or incur debt that will prime existing lenders, or sell the company to another owner without triggering a Change of Control put offer requirement, should not be left to investors' best estimate.

ELFA supports its members and the market with tools to facilitate transparency

ELFA provides key information about new issue covenants quickly via our partner institutions, resources for investors to educate themselves on covenant flexibility, and a platform for investors to connect with each other.

ELFA's New Deal Disclosure Questionnaire encourages engagement on covenant capacity during the marketing stage for a new deal. We also publish tools to support robust disclosure on an ongoing basis, tailored to the issues that investors are most focused on during the current crisis, with our COVID-19 Best Practice Guide for Disclosure.

> "Respect of Capital Providers: Creditors, including disclosures of the most relevant bank covenants (with definitions and calculation when appropriate), explicit debt ranking and guarantees / subordination.
>
> *- PRI ESG in Credit Risk & Ratings Project Initial Discussion Guide*"

This information is critical to an investment decision, and transparency in this respect falls squarely within the governance principle of ESG. ESG considerations are a central focus for many market participants, and clear and open communication with capital providers is a key tenet of good governance.

Indeed, the PRI included covenant definitions and calculations as a discussion and disclosure point in the governance metrics in its guide for engagement between issuers and analysts.[1]

Management has a duty to operate the business responsibly – not just for the benefit of shareholders, but so that capital providers can be repaid.

At the very least, investors should be able to assess the company's ability to take certain material actions in the context of its ownership, business plan, and financial condition in order to make informed investment decisions.

As such, clear covenant capacity should be included among the material information, along with financial results, that is provided to lenders in marketing materials and ongoing financial reports.

Reorg, one of our partners, provides Covenant Tearsheets to our members that set out aggregate covenant capacity (to the extent this can be calculated) and other key information for new deals, delivered to investors prior to roadshow meetings to support effective engagement by investors with management on covenant terms. ELFA also provides educational resources to our members, including webinars on calculating priming debt capacity under bonds and loans.

The best protection against coercive liability management tactics (e.g. in an aggressive or urgent restructuring scenario) is early engagement among creditors, and ELFA provides a platform for investors to find others holding the same instrument.

These tools help investors assess and manage covenant risks. However, these tools cannot replace transparency by borrowers about covenant capacity so that investors can accurately price risk. Management often are the only ones possessing the information that impacts the level of capacity under the covenants. Without management input and increased disclosure, investors are left to produce their own best estimates of these figures, and these can vary widely from management's calculations.

[1] The PRI's initial discussion guide, developed as part of its ESG in credit risk and ratings project, can be accessed here.

ELFA launches for public consultation a best practice guide to support disclosure on key financial definitions and calculations; commences investor survey on material information to investment decisions

In order to support greater transparency and more effective engagement regarding covenant capacity, ELFA is proposing key metrics and other information to include in a Best Practice Guide on Covenant Transparency that borrowers can use to support strong governance in this area. We are launching the resource to the market for a two-week period of public consultation and discussion so that market participants can share their views on these proposed best practice covenant disclosure guideline topics.

Details about Public Consultation on Best Practice Guide for Covenant Transparency

We propose including the following key metrics and topics for disclosure in the best practice guide:

- "EBITDA" as defined under the covenants for all instruments in the borrower's capital structure, accompanied by disclosure that clearly delineates add-backs for synergies and other pro forma adjustments made by management; if an issuer thinks it is appropriate to disapply recent regulator guidance on EBITDAC, this should also be disclosed and the COVID-19 adjustments made clear
- The amount of outstanding debt as captured by the "Indebtedness" definition, along with disclosure on any material liabilities that are excluded from the calculation, including pre-IFRS 16 operating leases
- Restricted Payments capacity, including build-up basket capacity calculated using "Consolidated Net Income" / EBITDA / Excess Cashflow as defined by the covenants where capacity is back-dated, disclosed at the outset of a deal and on an ongoing basis, including any flexibility that the company has to convert dividend capacity to secured debt capacity
- Any flexibility for the borrower to disapply IFRS 16 to any calculations under the covenants, the related pre-IFRS 16 figures, along with any related elections that the borrower has made in this regard during the previous reporting period

The public consultation begins today and will close to comments on 17 July 2020. Send any comments to Sabrina Fox, Executive Adviser to ELFA, sfox@elfainvestors.com.

Details on Investor Survey

We are also conducting a survey of investors in order to gather a broad market view on how covenant capacity impacts their decision to invest, or remain invested, in a particular instrument. If you are an investor and would like to complete the survey, click here. All responses will be anonymous, and only aggregate results will be presented to the market.

We will share the results of this survey, and anonymised comments received our public consultation, with the market in a follow-up report to one that we expect to publish, along with the Best Practice Guide to Covenant Transparency, in the autumn.

About the European Leveraged Finance Association

The European Leveraged Finance Association (ELFA) is a professional trade association comprised of European leveraged finance investors from over 30 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit the ELFA website: www.elfainvestors.com.

Our Mission Statement:

ELFA seeks to create a more transparent, efficient, and resilient leveraged finance market while acting as the voice of its investor community. To that end, our diverse forum of investors engages with other industry professionals in order to educate and to promote best practices and transparency.