"EBITDAC" is an Inappropriate Metric for Calculations of Covenant Capacity under Leveraged Finance Agreements

The impact of the COVID-19 outbreak on economic data has become increasingly clear over the past few weeks, but its longer-term toll on the world's economies remains far from certain. While the effect on businesses differs from sector to sector, no company is unaffected by the crisis, and the damage to many due to a precipitous drop in revenues will take months, if not years, to recover from.

The precipitous decline in revenues and earnings has left most businesses scrambling for additional liquidity via payment deferrals, revolver drawdowns and additional borrowings. For the majority of sub-investment grade companies, the amount of debt that a borrower can incur will be limited by applicable covenant provisions in their outstanding bonds and loans. Additional debt capacity under these covenants will generally depend on calculations that incorporate "EBITDA" as defined under the applicable agreements. Unfortunately, the erosion of covenant quality in leveraged credit markets has allowed borrowers to broaden the definition of EBITDA via numerous exclusions and add-backs, such that the figure that an analyst derives from the borrower's P&L can be far different from the number the borrower employs in covenant calculations.

Several third-party advisory firms, research providers, and news publications have recently highlighted language in covenant-defined EBITDA calculations that could be interpreted in a manner that would allow management to add back losses relating to disruptions caused by the COVID-19 outbreak and related government-enforced lockdowns. This generously redefined version of ex-COVID EBITDA has come to be known as "EBITDAC".

ELFA believes that calculating debt capacity using EBITDAC is inappropriate, as it would allow companies to incur indebtedness, including debt that primes existing investors, against backward-looking metrics stripped of the effects of the pandemic only to wind up with more leverage against an uncertain post-COVID level of forward earnings and cash flow. It is by no means guaranteed that EBITDAC reflects forward-looking operating trends, and as such it should not be relied on as a calculation metric for any purpose under debt documents.

Instead, debt issuers should allow existing covenants, including standard definitions interpreted in line with their plain language and in the spirit in which they were drafted, to operate as intended. If borrowers wish to obtain additional funding and need to increase their debt capacity in order to do so, they should seek waivers to existing terms from their current creditors.

Further, new deals coming to market for both bonds and loans should take into account the potential impact of the COVID-19 outbreak on future earnings, and disclosure should be explicit about the basis of calculations for future debt incurrence, dividend payments, and other actions based on EBITDA.

The full impact of the pandemic is still uncertain, making compliance with the letter and spirit of restrictions in debt documents even more crucial in order to protect lenders, and the wider market, against potential future credit deterioration caused by a reliance on fictitious figures.

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.