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Executive Summary

- While Europe at last seems to be emerging from the plight of COVID-19, the pandemic could be poised to leave a more permanent impression on leveraged finance markets in the form of overly broad pandemic-related EBITDA adjustment clauses.
- In a previous Insights report, titled "'EBITDAC' is an Inappropriate Metric for Calculations of Covenant Capacity under Leveraged Finance Agreements", we warned the market about the dangers of such a development.
- The report highlighted the risks inherent in such a provision, as it would allow companies to incur indebtedness…against backward-looking metrics stripped of the effects of the pandemic" potentially leaving them with more leverage int an uncertain post-COVID operating environment.
- In this report, we revisit companies' use of "EBITDAC" adjustments in financial reporting and update the market on the emerging trend of inserting new clauses to create a "pandemic-proof" EBITDA in U.S., and now also European, leveraged finance documents.
- The ELFA reiterates its warning that such an approach sets a dangerous precedent that could seriously increase the risk of credit deterioration caused by debt incurred in reliance on purely hypothetical figures.

The history of EBITDAC, and its re-emergence

Investors first expressed concerns about leveraged finance borrowers excluding the effects of the COVID-19 pandemic when calculating EBITDA for covenant purposes under leveraged loans and high yield bonds last year. The term "EBITDAC" (earnings before interest, taxes, depreciation, amortisation and coronavirus) emerged in March 2020, first as tongue-in-cheek speculation by social media accounts and journalists. It later materialised in the ongoing reporting of some companies as the pandemic continued.

The ELFA spoke out against the use of EBITDAC for covenant purposes, noting that "[i]t is by no means guaranteed that EBITDAC reflects forward-looking operating trends, and as such it should not be relied on as a calculating metric for any purpose under debt documents." Our commentary inspired other organisations and regulators to warn against its use.

Despite this, 9fin have noted that a number of borrowers have taken the position that they can add back COVID-related costs/expenses – and in some cases even lost revenues – under broad EBITDA addback language in their existing documentation, including under clauses for any "extraordinary", "exceptional", "unusual", "non-recurring" or "one-off" items (as described in 9fin's report "Whatever Happened to EBITDAC?").

The leeway afforded to creditors in the broad drafting of permitted EBITDA add-backs provides them with ample room to depict EBITDA to their benefit and thereby avoid having to seek leniency from creditors through amendment and waiver processes. While such processes can be costly and time consuming for borrowers, they at least shed some light on the true state of the borrowers' financial condition rather than masking it with discretionary and hypothetical adjustments.

Indeed, some issuers have explicitly taken advantage of such broad and intentionally ill-defined terms. According to our partners at 9fin, the offering memorandum for Coty's April 2021 stated that the company's existing credit agreement permitted it to make an adjustment to EBITDA of more than $500 million for "[e]xtraordinary and unusual losses due to the effect of the COVID-19 pandemic", most of which was comprised of the "estimated contribution impact of lost revenue and earnings". In other words, Coty appears to have relied on a generic addback for "extraordinary, unusual or non-recurring items" under its credit agreement.

Given the significant variation in the scope of ongoing reporting, it can be difficult for investors to determine what is being included in COVID-related EBITDA adjustments, let alone the basis on which the borrower is adding these amounts back. This makes it even more challenging for investors to dispute these calculated amounts. We wait to see wonder whether or not companies will continue to rely on "non-recurring"/ "one-off"-type language to make COVID-related EBITDA adjustments as the pandemic's effects continue into the second year.

In some deals launched since the start of the pandemic, borrowers have included COVID-related adjustments (costs and expenses as well as, in some cases, lost revenues) in their marketing EBITDA figures. These adjustments have subsequently been embedded into their documentation under limbs to the definition of EBITDA allowing adjustments made in the Base Case Model or used in calculating opening EBITDA as presented in the offering memorandum.

Freezing EBITDA for covenant calculation purposes

In some cases, borrowers have approached lenders to make amendments to existing deals that "freeze" EBITDA at pre-determined levels for covenant purposes for a period of time. In the case of such amendments and waivers, investors could be in a position to negotiate the tightening of other terms in return for agreeing to these changes.

We recently published an Insights report titled "The Upside of the Downside: Tightening Terms at the Negotiating Table", which highlighted certain terms that investors might consider seeking to tighten should they be approached by a borrower with an amendment or waiver request.

However, such attempts to freeze EBITDA are not isolated to amendment and waiver requests. 9fin noted that in some new deals companies have "frozen" EBITDA for covenant purposes, setting out in the "Consolidated EBITDA" definition exactly what covenant EBITDA will be for the next several quarters (9fin report on one such deal available here). Unsurprisingly, the "deemed" EBITDA figures in 9fin's example can be traced back to pre-COVID EBITDA, as adjusted by further management add-backs. Such provisions could give the borrower another back-door to EBITDAC, and investors should be aware which deals contain such flexibility.

There is a serious risk that any "EBITDAC" measures will not accurately reflect the company's post-pandemic recurring revenue, making investors' risk assessments much more difficult. The ELFA believes that EBITDA should serve as a clear, comparable financial metric to determine the operating performance of a company and provide investors with a cash measure by which to determine a company's ability to service its debt. As we noted in our Insights report on EBITDAC, adding back revenue which was expected but never realised (and perhaps may never be, e.g., if the borrower's revenue generation profile has shifted due to the pandemic) is contrary to that principle.

"Pandemic-proofing" EBITDA – An emerging trend

According to Bloomberg, some U.S. credit agreements have gone one step further by including clauses in their documentation that explicitly permit EBITDA adjustments for the run rate effect of costs, expenses, revenue reductions and other negative impacts due to any pandemic or epidemic, including COVID-19.

9fin reports seeing this type of clause in more than half a dozen European or cross-border leveraged finance documents so far in 2021 (a summary of these examples is available upon request to 9fin). Each of the examples 9fin reviewed would permit the company to add-back not only pandemic-related costs and expenses, but also lost revenues.

Beyond the concerns discussed above regarding "EBITDAC" addbacks generally, the inclusion of these new clauses poses a serious risk of detrimental outcomes to investors for several reasons.

- These provisions undermine any argument that a COVID-related EBITDA adjustment should not have been made in reliance on a generically drafted clause (e.g., a clause for exceptional / non-recurring items). There is an argument that lost revenues fall outside the scope of such a clause and, depending on the nature of the adjustments, there may be arguments that other amounts cannot properly be characterised as "exceptional" or "non-recurring". A catch-all pandemic add-back would negate these arguments entirely.
- Such clauses would enable the company to add back COVID-related impacts not foreseen at the time of the original transaction (and therefore not grandfathered into the Base Case Model / opening EBITDA adjustments).
- These add-backs could permit the company to make corresponding adjustments for future pandemics or epidemics (arguably, a bad flu season that dampens demand for the company's products could qualify). To prevent such a use, investors should, at a minimum, request that these clauses reference the WHO definition of a pandemic. Unfortunately, the trend in the drafting of these clauses seems to take the opposite position. 9fin reports that the most recent examples of this type of clause have been even broader in scope than previous examples, permitting adjustments not only for future pandemics or epidemics, but also for any "outbreak, incident, disaster or similar such disruptions out of the Group's control".

Other documentary risks relating to EBITDAC clauses

These provisions present further risks in addition to those already described. For example, not all of the examples seen so far have been time-limited or subject to a cap, which increases the risk for investors and is a cause for concern across EBITDA addbacks more generally. Where caps have been included, these may only apply to a subset of the permitted adjustments, leaving other adjustments uncapped.

Further, according to 9fin, only some of the European pandemic add-back clauses limited the lost-revenue adjustments to those that are "temporary in nature and can be demonstrably reinstated" following the pandemic (though even these did not set any concrete timeframe for "temporary"). The others did not include such a limitation, which could facilitate open-ended adjustments in future years if EBITDA fails to recover post-pandemic.

Moreover, 9fin highlighted that none of the cost-side adjustments in these clauses have been limited to "temporary" or "one-off" costs – does this mean that ongoing costs for sanitisers, screens, floor markings, test kits and other COVID-related measures can be added back indefinitely?

How investors can respond to this trend

Investors should always voice their concerns to the syndicate about this type of provision, and can consider making orders conditional on its removal. Our New Deal Disclosure Questionnaire, which we send to the lead bookrunners soon after launch of new high yield deals, can serve as a useful tool to guide discussions with the company and its advisers.

If investors are unsuccessful in removing these clauses as they arise, then limiting their scope, adding caps and concrete time limits, and requesting an auditor's confirmation of EBITDA adjustments exceeding a stated threshold would go some way towards mitigating the concerns highlighted in this report.

Robust ongoing reporting and transparency with respect to COVID-related addbacks are also essential to investors' ability to assess the deviation between actual financial results and a borrower's idealised depiction of performance, particularly when the latter is the basis for covenant calculations. As such, investors should ensure that the reports covenant includes this requirement.

How the ELFA is addressing these issues

The ELFA remains committed to raising standards of disclosure on covenant terms and related capacity for the market as a whole through our Covenant Transparency Initiative. We also provide our members with Covenant Tearsheets produced by 9fin within hours of deal launch for both bonds and loans, offer educational resources like our ELFA Academy, and host webinars on covenant analysis and restructuring case studies, replays of which are available to members on our member portal.

Our aim is to ensure that credit investors can make informed investment decisions both at the new issue stage and on an ongoing basis, even as covenant complexity continues to evolve.

About the ELFA:

The ELFA is a professional trade association comprised of European leveraged finance investors from over 45 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The 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's website: www.elfainvestors.com.

About 9fin:

9fin is the faster, smarter way to find leveraged finance intelligence.

Through an AI-powered data & analytics platform 9fin centralises everything that's needed to analyse a credit or win a mandate in one place. Helping subscribers win business, outperform their peers and save time.

Product offerings include: News Alerts, Financials, Covenants, Comparables, Deal Predictions, ESG and Search.

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