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The Impact of COVID-19 on Adjusted EBITDA

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As COVID-19 sends shockwaves through the global economy, many experts are predicting one of the deepest recessions in U.S. history. The hospitality, employment services, transportation, travel, leisure, mining, and oil industries have been particularly hard hit, but borrowers in a myriad of industries have, or will, feel the fallout from this pandemic. Private credit lenders will be receiving first quarter financial reporting from borrowers in the coming weeks and the first effects of declining revenues will be apparent. Many borrowers will be looking for ways to counteract the effects of lost revenues in their financials, or will risk EBITDA-based financial covenant breaches and diminishing flexibility under their credit documents to take actions governed by EBITDA-based metrics. EBITDA addbacks will come into sharp focus. This article identifies certain addbacks that are susceptible to being exploited and provides tools for lenders to navigate their review of upcoming compliance certificates in this changing economic climate.

EBITDA in Credit Agreements

Adjusted EBITDA, the standard metric for evaluating a borrower's profitability in leveraged financing transactions, has significantly expanded in scope over the last five to ten years. The market has accepted increasingly aggressive methods of calculating adjusted EBITDA, which has the effect of producing lower leverage ratios. In addition, adjusted EBITDA has applications well beyond the traditional leverage maintenance covenant in modern credit agreements. For example, borrowers are frequently permitted to incur an unlimited amount of incremental debt (or incremental equivalent debt or ratio debt) subject to compliance with a leverage ratio test or, in some cases, an interest coverage ratio test; as well as to incur unlimited liens and to make unlimited amounts of investments, dividends and prepayments of junior debt facilities, all subject to compliance with a leverage test. A component of the calculation of these leverage and interest coverage tests is adjusted EBITDA.

Adjusted EBITDA is similarly present in leverage ratio-based usage conditions applicable to the “Available Amount” for the purpose of making dividends and prepayments of junior debt facilities, and in certain instances, investments. Many middle market credit agreements also contain grower baskets in the negative covenants, which automatically increase the capacity of dollar based baskets as adjusted EBITDA increases beyond the closing date level. Finally, a borrower’s obligation to prepay a lender’s loan with the proceeds of “excess cash flow” and certain asset sales may step down to a lower percentage (e.g., a prepayment with 50% of the proceeds becoming 25% of the proceeds) if certain leverage ratio levels are achieved, and many credit agreements have a floating margin concept that increases and decreases based on a borrower’s leverage ratio. Simply stated, adjusted EBITDA is ubiquitous in many credit agreements, and a higher adjusted EBITDA relative to a static level of debt allows a borrower to meet financial maintenance covenants and maintain the flexibility to take certain actions under their credit agreement.

Given that lost revenues associated with COVID-19 are expected to be significant for many businesses (and are likely to trump related costs and expenses by measures), borrowers will be searching for innovative ways to counteract revenue declines in their financials for the upcoming quarters in order to avoid covenant breaches and tightened restrictions under credit agreements. Lenders should expect to see addbacks related to COVID-19 in compliance certificates as early as March 31st (and certainly by June 30th), even if COVID-19 specific addbacks are not a component of the adjusted EBITDA definition.

Selected Addbacks to EBITDA

Lenders should be particularly careful of how borrowers are using negotiated addbacks to adjusted EBITDA in light of the current economic environment. We anticipate that the boundaries of the following addbacks will be tested in upcoming financial quarters.

Extraordinary, non-recurring and unusual costs, expenses and losses

Credit agreements typically permit an addback to adjusted EBITDA for extraordinary, non-recurring and unusual costs, expenses and losses. This addback is frequently uncapped in middle market and upper middle market transactions. These terms are not expressly defined in credit agreements, but should be interpreted in light of corresponding GAAP principles and the commonly understood accounting meanings of such terms.

- **Extraordinary:** following the release of FASB ASU No. 2015-01, "extraordinary" is no longer defined under GAAP. However, under the historical GAAP definition, an underlying event or transaction had to be (i) of an unusual nature (defined below) and (ii) infrequent (i.e. of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates).
- **Non-recurring:** "non-recurring" is also a non-GAAP measure. The SEC's rules and regulations regarding the use of non-GAAP financial measures in public filings provides a window into the commonly understood meaning of this term, noting that items can only be described as non-recurring if they have not occurred within the most recent two years and are not expected to recur within the following two years.
- **Unusual:** under GAAP guidance, "unusual" describes an underlying event or transaction that possesses a high degree of abnormality and is of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.

A borrower may also employ a less technical, colloquial interpretation of these terms, which will blur the lines of what constitutes an acceptable use of this addback. Examples of COVID-19 related costs, expenses and losses that lenders may see in upcoming compliance certificates include the following:[1]

- Purchase of personal protective gear, including face masks and hand sanitizer
- Cleaning and disinfecting facilities more frequently or more thoroughly
- Costs of relocating employees or equipment to areas unaffected by stay at home orders
- Pandemic planning expenses
- Increased security and screening for visitors and guests
- Cancellation of events
- Production delays and missed deadlines due to supply chain interruption

- IT and training costs associated with transitioning to remote employees
- Temporarily paying a premium to compensate employees for performing their normal duties at increased personal risk (e.g., hazard pay)
- Terminating contracts or complying with contractual provisions invoked directly due to the events of the pandemic (e.g., contract termination fees or penalties)

The framework set forth in Item 10(e) of Regulation S-K and Regulation G, as well as the SEC staff's related guidance for the application of non-GAAP measures, suggests that COVID-19-specific costs and expenses that are not (1) incremental to and (2) separable from normal operations of a business are impermissible addbacks. Examples of impermissible addbacks might include:[2]

- Paying idled employees
- Rent and other recurring expenses (e.g., security, utilities, insurance, maintenance) related to temporarily idled facilities
- Excess capacity costs expensed in the period due to lower production
- Paying employees for increased hours required to perform their normal duties
- Paying more for routine inventory costs (e.g., shipping costs)

Key Takeaway: *Most companies will likely consider COVID-19 to be unusual or infrequent for purposes of GAAP, but this classification will depend on the business of the borrower and will be within the management's discretion to make. Borrowers are therefore likely to consider related costs, expenses and losses to be extraordinary, non-recurring or infrequent. Lenders should critically evaluate whether these items meet the above-mentioned classifications in light of the nature of a borrower's business. For example, the purchase of sanitation supplies and face masks may be ordinary in a food service business but unusual in a software business.*

Business Interruption Insurance

Credit agreements also generally contain an addback for insurance proceeds actually paid (without duplication of amounts already included in net income) or expected to be paid under third-party insurance policies, including for business interruption insurance covering a loss of income following a disaster or other covered event. Although the addback is not typically subject to a dollar cap, there are limitations on this addback in even the most borrower friendly formulations. There will generally be a requirement that, if not yet paid, the proceeds will be paid within a specified period of time (e.g. 180-360 days) and that the borrower has some “reasonable expectation” or believes in “good faith” that the proceeds will actually be paid in the required timeframe.

Business interruption insurance proceeds are considered to be a gain contingency under GAAP (subject to the guidance in ASC 450-30) and can only be included in net income if they have already been received or the amount and future payment has been confirmed by the insurer. In light of this, a borrower will typically need to rely on the “reasonable expectation” or “good faith belief” requirement of the addback for amounts not yet received. In the context of COVID-19, this requirement is likely to disqualify a borrower from using this addback.

Business interruption insurance coverage is generally related to losses stemming from property damage caused by a natural disaster, such as a hurricane, tornado or flood. After the 2003 outbreak of Severe Acute Respiratory Syndrome (SARS) and resulting losses in the hospitality industry, insurance providers began removing communicable disease coverage from policies. Coverage for lost revenues associated with COVID-19 and the economic shutdown are not anticipated to be universally (or even commonly, in many cases) covered by business interruption insurance. Lenders should ensure a borrower has evaluated any expected insurance proceeds in the context of the specific terms of their business interruption insurance policy.

Lost Revenue

The largest “loss” associated with COVID-19 is expected to be lost revenue for most businesses. Adjusted EBITDA typically does not include a dedicated addback for lost revenues, although lenders should evaluate this on a deal-by-deal basis. To the extent a credit agreement does not contain a lost revenue addback, borrowers may attempt to classify lost revenue as a loss for purposes of the (i) extraordinary, non-recurring or unusual or (ii) discontinued operations addbacks. This should not be permitted.

Even in the most borrower friendly credit agreements, the basis of adjusted EBITDA is net income calculated in accordance with GAAP. The concept of "lost revenue" does not exist under GAAP as a component of net income. Revenues are either earned and recorded on the income statement or not earned and altogether outside of the realm of net income under GAAP. In light of FASB's reaction following the 9/11 terrorist attack in which it refused to treat the financial impact of the 9/11 attacks as an extraordinary and unusual event in FASB, we know that disasters, natural disasters, terrorist attacks or COVID-19 (however extraordinary these events might be) do not change this basic GAAP accounting rule. The Securities and Exchange Commission staff in the Division of Corporation Finance also recently released Disclosure Guidance: Topic No. 9, Coronavirus (COVID-19), which reinforces that estimates of lost revenue are a non-GAAP measure that should not be included to normalize the results of operations in SEC filings.

As a general rule, credit agreements only permit amounts to be added back in the calculation of adjusted EBITDA to the extent they were deducted in the calculation of net income under GAAP. Although there are certain express exclusions to this rule negotiated into the definition of adjusted EBITDA (e.g. cost savings and synergies), such an exclusion is not customary for the addbacks discussed above.

In addition, the nature of the term "loss" from an accounting standpoint is not commonly understood to mean lost revenues. Losses are the negative financial results that will be produced through a borrower's <u>non-primary</u> operations. Revenue, by contrast, is the positive financial result generated by the sale of goods or services related to a company's <u>primary</u> operations. Given the disparity in these concepts, "lost revenue" cannot reasonably be considered a "loss."

Key Takeaway*: Lost revenues generally will not be permitted to be added back in the calculation of adjusted EBITDA unless a credit agreement contains a dedicated addback for lost revenues. This is not common, other than in select upper market transactions, but lenders should evaluate this in the context of each transaction.*

<u>COVID-19 Addbacks to EBITDA</u>

Given the limitations of the addbacks discussed above, some borrowers have started to request the inclusion of COVID-19-specific addbacks in adjusted EBITDA. These requests are appearing in the context of new financings with documentation that is currently being negotiated and in amendments to existing credit agreements (now frequently occurring in the context of covenant and/or debt repayment relief).

This addback that expressly covers costs, expenses and losses attributable to or resulting from COVID-19 may be subject to a cap or uncapped, and may apply for the life of the facility or only for a specified number of fiscal quarters. Although some (or all) of these items may already fit within the extraordinary, non-recurring or unusual items addback, this approach provides a borrower with the benefit of avoiding any argument that COVID-19 is not an extraordinary, non-recurring or unusual event in the context of a borrower's particular business.

If the existing extraordinary, non-recurring or unusual items addback is subject to a negotiated cap, a lender should consider the cumulative effect of such addback and the new COVID-19-specific addback. If the addback for costs, expenses and losses attributable to or resulting from COVID-19 applies for the life of the facility, a lender should be mindful that COVID-19 may not always be a non-recurring event (some experts now predict annual or seasonal recurrence, much like the common influenza) and the addback could be applied in an unintended way. Finally, Lenders should also be cognizant that a COVID-19-specific addback may be used by a borrower to add back certain COVID-19-specific costs and expenses that would not be permissible pursuant to a traditional extraordinary, non-recurring or unusual items addback (given that there are no such requirements in this addback). See above for the discussion on impermissible addbacks.

In certain more conservative financings lenders have started to request exclusions (rather than addbacks) for costs, expenses and losses attributable to or resulting from COVID-19. As a result of the modern trend towards increasingly aggressive addback inclusions, current formulations of adjusted EBITDA do not always produce a meaningful picture of a borrower's operations or leverage calculations that are reflective of the current risk profile of a business. Lenders are looking for more transparent reporting in these uncertain times. Given that this has the potential to exasperate a borrower's ability to meet its financial covenants, this approach is most likely to be applied for borrowers with revenues that are generally unaffected by or are benefiting from COVID-19 (e.g. certain shipping companies) but we do not expect that this approach will be widely adopted by the market.

Key Takeaway*: Lenders should critically evaluate any requests for COVID-19-specific addbacks to ensure they are appropriate in size, scope of application and duration, and that they don't provide unintended flexibility when taken together with other existing addbacks to adjusted EBITDA. Lenders should also establish controls around the calculation of "lost earnings" or "lost profits," given the amorphous nature of these concepts, to the extent these concepts are agreeable.*

What can Lenders do?

Lenders are encouraged to review the calculations included in compliance certificates for upcoming quarter ends with a critical eye. To the extent that a compliance certificate includes insufficient information for a lender to gain comfort with the calculation of adjusted EBITDA, a lender should seek to understand the scope of the information rights provisions under its credit agreement and use them to obtain additional information from the borrower. Lenders can then start a dialog about any aspects of adjusted EBITDA that seem inappropriate in the context of the particular business or the negotiated definition.

1. Check for Itemization of Addbacks of Adjusted EBITDA

- **Certain forms of compliance certificate will break down adjusted EBITDA on a line-by-line basis for each addback**. This allows a lender to better understand which addbacks are significant in any particular reporting period or otherwise seem unusually high in comparison to a lender's expectation or in comparison to a number provided in a prior compliance certificate.

- **If a compliance certificate does not break down adjusted EBITDA on a line-by-line basis, ask the borrower for an itemized list of addback amounts.** Even if adjusted EBITDA is typically represented to lenders as a single line item with no visibility into the specific components of the calculation, a borrower should have this information available.

2. Understand and Utilize Information Rights Provisions

- A credit agreement will typically have an affirmative covenant that requires the borrower and the guarantors to produce information in response to the requests of the administrative agent and/or the lenders. The scope of information that may be requested pursuant to this provision can be broad (i.e. anything reasonably requested by the administrative agent or the lenders, as applicable) or narrow (i.e. reasonable requests related to the operations and business affairs of the borrower and the guarantors).
- Under most constructions of this provision, lenders should be able to request, directly or through the administrative agent, additional backup related to the calculation of adjusted EBITDA. This information can give a lender a more nuanced understanding of the effects of COVID-19 on a borrower and enhanced visibility into the health of its business. A lender will also be in a better position to engage in informed discussions about controversial addbacks with a borrower if necessary.

3. Engage in Discussions with the Borrower

- COVID-19 accounting (and the classification of related costs, expenses and losses for purposes of adjusted EBITDA addbacks) is uncharted territory and will depend on the discretion of management in the context of the particular business of the borrower. Lenders should engage in discussions with their borrowers regarding the addbacks if unexpected, unusual or significant items are present.

Proskauer’s Private Credit Group is focused on supporting and addressing client concerns as lenders navigate the upcoming quarterly financial results provided by borrowers in connection with private credit transactions. We continue to monitor emerging market trends related to the treatment of COVID-19 related losses. Clients are encouraged to reach out to their Private Credit Group deal teams for assistance with interpreting the parameters of adjusted EBITDA in their existing deals and in connection with requests for the inclusion of new COVID-19-specific addbacks.

[1] *See e.g.*, Ernst & Young LLP., *How to appropriately use non-GAAP measures to discuss the effects of COVID-19*, Technical Line (April 14, 2020), https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/topics/assurance/accountinglink/ey-tl08892-201us-04-14-2020.pdf?download.

[2]*See e.g.*, Ernst & Young LLP, *supra* note 1.

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