

COVID-19: MANAGING FINANCIAL COVENANTS IN A DOWNTURN

INTRODUCTION

Given that financial covenants are measured on a rolling LTM (last twelve months) basis, there is a time lag from a negative earnings development until an actual breach. For some of the industries affected, the COVID-19 earnings decline came overnight and with unprecedented force leading to potential defaults starting in Q3.

Leveraged borrowers and their owners, including private equity sponsors, should prepare covenant management now. Options include waivers, new base case, covenant reset and cure.

It is not all bad. We expect Danish bank lenders to be relatively flexible. One of the reasons is the interpretation issued by the Danish FSA on 19 March 2020, implying that banks granting temporary relief from covenant breaches are not required to make loan loss provisions.

Financial covenants come in two shapes and forms: "Maintenance covenants" implies that a breach is an event of default triggering immediate repayment of the debt. "Incurrence covenants" implies that the borrower is restricted from taking up new debt, if by doing so the borrower would breach a covenant.

PROVISIONS

Maintenance Covenants

Credit facilities made available by banks typically include a number of financial maintenance covenants that requires a borrower to maintain certain financial ratios or metrics. Such provisions set minimum requirements for the financial results or the financial position, which will be tested by the lenders at the end of each accounting quarter based on the borrowers' financial performance on a rolling LTM basis.

The COVID-19 outbreak could therefore have an effect on the upcoming reporting period ending 31 March 2020 and potentially on the subsequent test periods to an even greater extent as the relative significance of the pre-COVID-19 period diminishes. On top of this, the financial covenants usually tighten over time, i.e. the ratios or metrics drop (as the case may be for net leverage ratio) or increase (as the case may be for interest cover ratio). This creates a potential for the occurrence of an event of default leading to acceleration of the debt and immediate repayment.

Most prevalent as financial covenant is the net leverage ratio, testing the borrowing group's net debt to consolidated EBITDA (earnings before interest, tax, depreciation and amortization, which is then often further adjusted for negotiated terms) at the end of the relevant test period. Adverse impacts on a net leverage ratio covenant would either be triggered by (i) reduced revenue, (ii) higher costs or (iii) both, and in all cases, affecting both EBITDA and net debt (the latter due to less cash to net).

Many loan agreements also contain an interest cover ratio, testing the group's EBITDA to net financial payables.

Facility agreements may leave contractual cure rights (as further described below) such as equity injection or being able to raise subordinated group debt to apply in partial prepayment or, if not, a need to obtain a waiver or reset covenants with lender support will occur.

Incurrence Covenants

High yield bond instruments often include incurrence based financial covenants, meaning that the test only applies when certain fundamental corporate actions are taken such as incurring debt, distributing cash to shareholders and/or selling assets. Only when such actions are to be taken will the covenants be tested and, if pro forma breached, the corporate action will be impermissible. The existing debt will, however, remain.

The above-mentioned covenants' net leverage ratio and interest cover ratio could be incurrence based as well. For instance, if incurrence based covenants are included, these must be met prior to issuing subsequent bonds under a bond frame.

Equity Cure Rights

Typically, borrowers have the right to cure a breach of financial covenants within a certain period of, customarily, 10-30 banking days within the date on which a compliance certificate (being a standardized form set out in the loan agreement specifying the financial covenants, including financial specifications) is required to be delivered to the lenders. These provisions are of great importance and will require cautious considerations to the parameters of such provisions, including, inter alia, analyzing the time limits and how the cure is implemented. It is also worth noting that limits often apply on how often cures can be made, e.g. equity cures can often not be made in two consecutive financial quarters.

In European leveraged facilities agreements, the equity injection will often be deemed to reduce net debt on the net leverage ratio and the net financial payables on the interest cover ratio, with the effect that a greater equity injection is needed to sufficiently impact the financial covenant in breach. It may be a requirement that a certain percentage of the equity cure is applied towards prepayment of the facilities.

COVENANT WAIVER OR COVENANT OR BASE CASE RESET

If a single breach of financial covenants is predicted, borrowers may seek a simple waiver of that breach. Typically, this will require the consent from 66 2/3% of the lenders (based on the lenders' commitments) and may prompt a waiver fee. However, before seeking a waiver, the borrower should scrutinize the definitions of the financial covenants and assess whether any add-backs could be applied to limit financial covenant impact.

When predicting more than a single breach, it would be advisable to seek covenant reset to re-establish sufficient headroom. This will require lender support and flexibility, as this approach calls for a need to prepare an updated financial model and plan as well as negotiations among the lenders. Some will request changes to the set-up such as amortization, excess cash flow sweep and pricing, an increase of the margin to reflect new terms, and normally an amendment fee would apply.

If a covenant reset is pursued, the parties may consider this as an opportunity to revise the base case model and the definitions of the financial covenants.

BANK-SIDE CONSIDERATIONS

The Danish Government has called upon Danish banks to support retail and businesses affected by the crisis and the Danish Central Bank has taken extraordinary measures to extent cheap liquidity to banks by an extraordinary three-month lending facility. 19 March 2020, the Danish FSA backed this initiative by favorable interpretations for calculating banks' Liquidity Coverage Ratio.

Equally important, on 19 March 2020 the Danish FSA issued a policy statement stipulating that a temporary breach of financial covenants as a result of COVID-19 should not "automatically" be deemed a material deterioration of creditworthiness and lead to loss provisioning.

23 March 2020, the banking sector responded that it would act responsibly and would increase corporate lending facilities, increase revolving facilities and increase maturity and waive instalments.

GOVERNMENT MEASURES

The government has presented a financial bail-out plan for large companies, which have experienced a loss in revenue of 30% or more due to the COVID-19 outbreak. The bail-out plan offers such companies in need of financing with a guarantee from Vækstfonden on 70% of the amount. This bailout plan will be particularly helpful to borrowers blocked by failure to meet the incurrence based covenants and not being able to raise further financing this way. The details on bail-out plan can be read [here](#) (in Danish).

RECOMMENDATIONS

The COVID-19 outbreak is likely not a force majeure implying an excuse for a covenant breach.

We recommend that borrowers:

- analyze existing financing arrangements to determine head-room in all scenarios, potential events of default/covenant breaches, in particular maintenance covenants and cure rights. Note that in the Nordic region even some bonds may have maintenance based covenants
- take measures to protect availability of committed, undrawn facilities
- consider relief programs available
- consider financing options (debt/hybrid/equity) if additional cash injections are required and
- engage early with the agent and the banking group to facilitate covenant waivers or a reset of covenants or base case

Our finance team is available to assist you and answer specific questions and address the best strategy going forward.

IF YOU WOULD LIKE MORE INFORMATION, PLEASE CONTACT:



Henning Aasmul-Olsen

PARTNER

Tel. +45 33 77 90 50

Mob. +45 30 37 96 50

HAO@mwblaw.dk



Andreas Selzer

JUNIOR ASSOCIATE

Tel. +45 33 77 90 59

Mob. +45 30 37 96 59

ASE@mwblaw.dk



Joakim Holdt

JUNIOR ASSOCIATE

Tel. +45 33 77 90 21

Mob. +45 30 37 96 21

JHT@mwblaw.dk

The above does not constitute legal counselling and Moalem Weitemeyer Bendtsen does not warrant the accuracy of the information.

With the above text, Moalem Weitemeyer Bendtsen has not assumed responsibility of any kind as a consequence of any reader's use of the above as a basis for decision or considerations.