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Adjustments for a Pandemic: How High Yield Issuers Are Dealing With Extraordinary Adjustments in Covenants and Disclosure

By: Peter Schwartz & Ed Holmes

While the effects of the Coronavirus Pandemic have been unprecedented on the world's economy and have had drastic impact on the financial results of high yield issuers, the market for new issuance has remained open including to issuers that have seen material reduction in revenue and EBITDA since the COVID-19 pandemic began. Many of these issuers have disclosed the impact of the pandemic on their businesses and adjusted their performance accordingly. A smaller number of issuers have taken more aggressive measures, including post-COVID-19 forecasts and the introduction of new addbacks to EBITDA to exclude the impact of COVID-19.

Adjusted EBITDA Addbacks to Covenants

Adjusted EBITDA is an important component of high-yield documentation in determining an issuer's ability to incur additional debt, make restricted payments, such as dividends and investments, and in understanding the trend in issuer's financials. Over the last five to ten years, the market has significantly expanded the scope of adjusted EBITDA definitions and accepted aggressive methods of calculating adjusted EBITDA, which have the effect of permitting excessive leverage ratios, such as including in adjusted EBITDA forecasted synergies from M&A and cost savings from current and even future reorganization initiatives.

The boundaries of the adjusted EBITDA definition and addbacks have once more been tested in the current COVID-19 impacted economic environment. Indentures typically permit an addback to adjusted EBITDA for extraordinary, non-recurring and unusual costs, expenses, and losses. Such terms are typically not expressly defined in the indentures, but should be interpreted in light of corresponding GAAP principles and accounting meaning of such terms. Furthermore, the requirements set forth in Item 10(e) of Regulation S-K, Regulation G, and the SEC staff's related guidance apply to adjusted EBITDA as a non-GAAP measure. Such requirements suggest that COVID-19-related costs and expenses can be permitted as addbacks if they are incremental to, and separable from, normal operations of the issuer. The examples of such costs and expenses include pandemic planning expenses, costs of relocating employees or equipment, purchase of personal protective gear, IT, and planning costs associated with transitioning to remote employees.

Of course, for many companies, the biggest COVID-19-related loss is due to lost revenue. However, lost revenue is unlikely to be permissible under the extraordinary event addback, as such concept does not exist in GAAP, and a number of authorities do not accept lost revenue as a permissible, non-recurring addback. Revenues are either earned and recorded on the income statement or not earned and altogether outside of the realm of net income under GAAP. Such stance is aligned with the SEC's Disclosure Guidance Topic No. 9, Coronavirus (COVID-19) from March 25, 2020, which reminded issuers that it is not appropriate to present non-GAAP financial measures for the sole purpose of presenting a more favourable view of financial performance. Such guidance is consistent with the Financial Accounting Standards Board's decision after the September 11, 2001 terrorist attacks that the attacks cannot be used as a basis for adding-back lost revenue and that companies are supposed to include the impact of the event as part of their continuing reporting obligations. The take-away point from such guidance is that natural disasters, terrorist attacks, or pandemics do not bend basic accounting rules. Hence, lost revenues will not generally be permitted to be added back in the calculation of adjusted EBITDA, unless an indenture contains a dedicated addback for lost revenues. It is worth noting that the foregoing is also applicable to consolidated net income (itself a component of adjusted EBITDA which is typically used for restricted payments' builder basket calculation) as extraordinary, non-recurring and unusual costs, expenses and losses are often included in the definition of consolidated net income.

For example, Selecta Group's first and second lien notes issued as part of their restructuring explicitly allowed COVID-19-related addbacks to EBITDA for any extraordinary costs and expenses incurred as a result of the COVID-19 impact. However, the indenture specifically disallowed the adding back of lost revenues.

The first bond deal with EBITDA addback specifically referring to COVID-19 was launched in May 2020 when AZEK Company, a residential and commercial building products manufacturer, marketed $320 million of Senior Notes due 2025. The EBITDA definition included a provision that allows the issuer to add back to EBITDA earnings lost due to COVID-19, capped at 25% of EBITDA (after giving effect to the addback), provided that such lost earnings are reasonably identifiable and factually supportable. While AZEK Company has not reportedly exercised the specific COVID-19-related addback, it remains unclear what earnings will be considered reasonably identifiable and factually supportable and how will the threshold be set. Furthermore, it is worth noting that the market has not been receptive of AZEK Company's aggressive 25% of EBITDA addback and that it has not become standard in COVID-19-era issuances.

Adjustments to Financial Disclosure

In assessing the evolving impact of COVID-19, issuers need to disclose the risks and effects the pandemic has on their businesses, including how issuers and their management are responding to them. While the disclosure needs to be tailored to the issuer's specific situation, it should include the expectation of COVID-19's impact to the future operating results and near- and long-term financial condition, the impact on capital and financial resources, the anticipation of material impairments, any challenges in implementing the business continuity plans, and the effect on demand for issuers' products and services. Such disclosure would involve forward looking information that may be based on assumptions and expectations regarding future events and should be undertaken to avail companies of the safe harbors in Section 27A of the Securities Act and Section 21E of the Exchange Act.

For example, the bond issuance of Boparan, a U.K. food manufacturer, in November 2020 makes detailed disclosure of COVID-19's impact on business operations and provides an estimate of Adjusted Like-for-Like EBITDA year-on-year growth between 20% and 30% for the first quarter of fiscal year 2021. Other recent bond issuances disclose financial reliance on various governmental support programs. Stonegate, a pub company, in its bond issuance from July 2020, disclosed its reliance on the U.K. government's furlough scheme and estimate of additional cash flow from future furlough schemes. Adevinta, an online classifieds company, in its bond issuance from October 2020, disclosed that its gross operating profit decrease was offset by government support measures related to employees. Cinemark, a cinema company, in its bond issuance from July 2020, evaluated the impact of the CARES Act relief and made an estimate of future cash tax refund and deferred social security payroll tax it can rely on. Akumin, diagnostic imaging services company, in its bond issuance from October 2020, disclosed the government payments it received under the CARES Act and an estimate that additional grants may be available to the company under the CARES Act in future.

Some companies, eager to assuage investors of the impact of COVID-19, have taken a more ambitious approach to disclosure since the pandemic began. For example, the financial statements attached to Merlin Entertainment's offering memorandum issued in April 2020 forecast that the issuer's revenue would recover to over 90% of normal levels after two months post lockdown.

Disclosure has also mirrored the adjusted EBITDA add-backs we discussed in the previous "Adjusted EBITDA Addbacks to Covenants" section. Greif, an industrial packaging manufacturer, included incremental COVID-19 costs in the Adjusted EBITDA reconciliation, and CVC-owned Douglas, a retailer of beauty and personal care products, made similar adjustments to EBITDA. Despite the reluctance of the market to accept COVID-19-related add-backs for lost revenue in negative covenants, recent quarterly earnings season displayed COVID-19-related EBITDA adjustments in companies' financial reports. For example, Blackstone-owned Schenck Process, a measuring instruments developer and manufacturer, and Cirsa, a gaming company, adjusted EBITDA upwards for pandemic-related losses. Schenck adjusted for missed contribution margin and Cirsa for unprecedented year-over-year volume declines. The COVID-19 adjustments trend is obvious and it is yet to be fully unfolded how issuers' managements will utilise COVID-19-related addbacks to offset the effects of COVID-19 in their financial performance and/or increase their capacity under covenants.

Other COVID related trends

Some recent COVID-19-era deals introduced the "automatic reset" formulation in EBITDA-based growers. Instead of basket capacity increasing when EBITDA increases and decreasing when EBITDA decreases, the automatic reset feature allows the basket to continually increase to match the highest level of EBITDA recorded since issuance. An example of such construct is in a bond offering by Thyssenkrupp Elevator in June 2020:

> "If any Applicable Metric is determined by reference to the greater of a fixed amount (the "numerical permission") and a percentage of LTM EBITDA (the "grower permission") and the grower permission of the Applicable Metric exceeds the applicable numerical permission at any time as a result of an acquisition or Investment that is permitted under the Indenture, the numerical permission shall be deemed to be increased to the highest amount of the grower permission reached from time to time as a result of any such acquisitions and/or investments and shall not subsequently be reduced as a result of any decrease in the grower permission."

The automatic reset formulation benefits issuers, as it allows them to mitigate the negative impact COVID-19 has on its revenue/EBITDA by permitting them to set their basket capacity to the highest recorded EBITDA.

Furthermore, a new trend has appeared in recent bond offerings (such as Cleveland-Cliffs, AMC Entertainment, and Adient) with the inclusion of a specific redemption provision for a "Regulatory Debt Facility" incurred under COVID-19-related government loan programs. The Regulatory Debt Facility language allows for equity-claw like redemption, i.e., it allows the issuer to repurchase up to 35% of the issued notes with the net cash proceeds of any Regulatory Debt Facility loan, provided that at least 65% of the originally issued bonds remain outstanding.