TRAVERS SMITH

Financial Covenant Re-sets

Relevant considerations when a covenant breach appears imminent

In the fifth of a series of briefings that looks at financial management in a downturn, this note considers the relevant considerations when re-setting financial covenants.

A significant number of companies are finding it increasingly difficult to meet their financial covenants in the current economic climate. If a company is at risk of breaching its financial covenants, then this may not only result in a default under its banking facilities but it will also distract management from the more important task of running the business efficiently. It may also cause alarm for shareholders who will be concerned about the value of their equity and their ability to maintain control of the company. It is therefore important to address the situation early on, before commencing a dialogue with the company's lenders. There are a number of important factors to consider when contemplating a financial covenant re-set.

"Sometimes the financial covenant definitions can offer 'hidden' financial covenant headroom"

Do you really need to re-set your financial covenants?

- Do the financial covenant calculations take into account all relevant items? For example, are there any additional exceptional or extraordinary items than can be taken into account?
- Consider whether there are any specific add-backs or deductions built into the financial covenant definitions in the banking documents. Sometimes these can offer 'hidden' financial covenant headroom. The requirement is typically to assess financial covenants by reference to these defined terms and the formal requirements of the documentation, rather than necessarily follow any past practice or custom.
- Is it possible to effect any other transactions to improve covenant performance? For example, a debt buyback could improve covenant performance over time. We will be distributing a note on debt buybacks shortly.
- Will it be possible to implement an equity cure without needing to approach the lenders? Please go to our legal briefings page on www.traverssmith.com to see a copy of our note on equity cures.

What conditions or fees will the banks impose?

Lenders typically require a combination of at least some of the following in consideration for re-setting financial covenants:

1. An amendment fee.
2. A margin correction to bring the facilities into line with current pricing.
3. An increase in commitment fees.
4. An increase in the percentage of excess cash to be swept each year.
5. An injection of new equity from shareholders and/or a prepayment of the facilities.
6. A revised base case model together with a plan for improving future performance.
7. The imposition of more onerous terms under the facility documentation (for example, a broader material adverse effect definition) to reflect what the lenders assert are current "market" terms.
8. Additional security from the group companies.

Will a financial covenant re-set require unanimous lender consent?

This depends upon the exact terms of the documentation, but in most cases it should be a majority lender decision.

If there is a mezzanine facility, as well as senior facilities, it may also be necessary to reset the mezzanine covenants, unless there would still be sufficient headroom on the existing mezzanine covenants (which will usually have been set with greater headroom at the outset, except as regards any cash cover covenant).

"It is important to ensure that any re-set affords the company sufficient headroom to operate its business comfortably going forward"

What should a company seek to achieve by a re-set?

The primary objective will of course be to avoid an imminent financial covenant breach. The secondary objective will then be to agree revised financial covenant ratios that provide sufficient headroom going forward to enable management to focus on the more important task of running their business. This will in turn provide shareholders with comfort that management are preserving or enhancing the value of their equity and preventing the lenders from taking control.

A re-set may also provide an opportunity to look again at the financial covenant definitions and consider whether any appropriate adjustments or add-backs are required (which may have the effect of generating additional headroom for the company). In many cases the definitions would have been agreed in haste at the time of the initial transaction or simply may no longer be appropriate, so it can be valuable to consider these again in detail.

Will a financial covenant re-set provide the required solution?

It is important to ensure that any re-set of financial covenants affords the company sufficient headroom to operate its business comfortably going forward, without any further fear of action by its creditors. If a financial covenant re-set is not going to achieve this and more fundamental action is required, it will almost always be better to consider this early on and take the initiative in achieving a solution. Potential more fundamental transactions could include:

- A revised repayment profile for any term debt.
- A new or increased facility to assist with working capital.
- An injection of equity funding to repay or buy back some of the facilities.
- A debt for equity swap, particularly if it is likely that the company will not be able to keep up with payments due to the lenders (please go to www.traverssmith.com to see a copy of our note on this topic).

How we can help

We would be happy to review your company's banking documents, consider how your financial covenants should be calculated and assist you in re-setting your financial covenant ratios.

If you would like to discuss any of the issues covered by this note, please contact any of the following members of our Banking Department:

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