TRAVERS SMITH

To cure or not to cure?

An analysis of equity cure provisions

In the fourth of a series of briefings that looks at financial management in a downturn, this note considers the many aspects of equity cures.

The current economic downturn has placed the spotlight on the ability of shareholders to cure a financial covenant breach by injecting further equity funding. Equity cure rights became increasingly prevalent in leveraged facilities from 2005 onwards, but they have only become subject to rigorous stress-testing more recently as the performance of some portfolio companies has suffered. At its best, an equity cure can provide shareholders with a cost-effective way of retaining control of their company and avoiding a default situation (and the consequent waiver fees). However a number of equity cure provisions may provide an ineffective remedy or a lack of certainty.

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What determines the effectiveness of an equity cure?

- Does the equity cure apply to all financial covenants? For example, many facilities will not allow an interest cover breach to be cured.
- Is an adjustment to interest cover fully retrospective? Because the interest cover test operates on a last 12 months basis, a cure will not be fully effective unless the prepayment is deemed to have been made at the beginning of the testing period.
- Is the adjustment to interest cover and leverage effected by way of a debt/interest reduction or instead will a more powerful EBITDA uplift be available?
- Will the equity cure require an actual prepayment of the facilities?
- Will the adjustments operate for one testing date only or will they continue to be taken into account for subsequent testing dates?
- Is there a maximum or minimum amount of new equity funding that can be applied by way of an equity cure?
- Can the equity cure be used pre-emptively or must it wait for an actual breach? If it is necessary to wait for a breach, will there be a default whilst it is being cured?
- Will a remedy of one type of financial covenant breach also create additional notional headroom for the other financial covenant tests which are not yet in breach?
- What are the time limits and other procedural steps which must be complied with in order to effect an equity cure?
- How quickly can new equity funding be injected and will a rights issue be required?

Conclusion

It will be an important part of any defensive portfolio management strategy to understand how effective any given equity cure provision may be and therefore whether it constitutes a viable option for a company and its shareholders. The value of an effective equity cure provision may extend beyond avoiding a forced restructuring, because in the current market lenders are requesting expensive waiver fees, margin corrections and voluntary prepayments for financial covenant breaches or resets. Equity cure provisions should therefore be examined very carefully in order to establish what is and what is not possible.

If an equity cure provision is insufficient for whatever reason, shareholders may want to consider alternative or additional options such as a debt buy back or an acquisition of goods or services produced or supplied by the company in order to generate additional covenant headroom. However such steps should be taken as early as possible in order to allow the full benefit to flow through to the covenants.

How we can help

We would be happy to review your company's banking documents, consider what effect an equity cure might have on the financial covenants and discuss with you appropriate defensive strategies.

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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