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Coronavirus: Time for Private Equity to Have a Financing Check-up

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With confirmed cases of COVID-19 now in more than 50 countries and the death toll rising almost daily, experts are predicting that the situation will get significantly worse before it gets better. Concerns over the impact of the virus have caused significant volatility in the stock markets over the last week and the potential scale of the impact across a very wide range of industries is just beginning to be realized. Therefore for private equity sponsors now is the time to be checking their financing documents to fully understand how COVID-19 might have an impact on the operations and financial results of their portfolio companies and their ability to remain in compliance.

Key areas of focus for private equity sponsors include the following:

Financial Covenants/Equity Cure/Covenant Reset

In most markets in the Asia-Pacific region, leveraged facilities typically still have two or three maintenance financial covenants. Given the myriad of ways that a public health emergency like COVID-19 can affect businesses, and the scale of the impact, it seems inevitable that the virus will cause some companies to breach these financial covenants. The threshold questions then become which covenants will be breached, when will they be breached and what steps can sponsors take to address the problem.

It should be noted that Australia is an exception to the foregoing, with a significant number of unitranche financings that only contain a single leverage covenant and increasingly Term Loan B structures. Moreover, in the US and Europe Term Loan B structures with only a single springing leverage covenant for the benefit of the revolving lenders are commonplace. Sponsors should be aware, however, that even in Term Loan B structures, a precipitous fall in EBITDA could mean that some companies become more reliant on their revolving facilities, thereby pushing them above the springing test threshold.

Business Interruption Insurance

In determining whether a covenant breach is likely, it is worth first carefully considering whether there is business interruption insurance in place that will cover the losses incurred by a portfolio company. While proceeds of business interruption insurance can typically be added to EBITDA for purposes of calculating compliance with the maintenance covenants, whether a particular policy covers business interruption resulting from COVID-19 will be very much fact-specific and turn on its exact language. Many property insurance policies cover business interruption, but coverage for such loss often requires "direct physical loss or damage" which in many cases will not apply. Also, to the extent that business interruption insurance coverage is available, the EBITDA definition needs to be carefully reviewed to see whether amounts claimed can be included (more typical) or whether the insurance proceeds have to be actually received by the group in order to be included in EBITDA (which could create a timing issue).

Scrubbing the Definitions - Restructuring Initiatives/Other Add-backs

Upon initially concluding that a covenant breach is projected, the sponsor, the CFO of the portfolio company and their counsel should "scrub" the definitions to ensure that all available add-backs, synergies and initiatives, and the pro forma effect of each of them, have been properly included in the calculations. Thought should also be given to commencing certain planned initiatives and actions ahead of schedule to take advantage of the pro forma effect.

Prepayments to Avoid the Breach

In some circumstances, it may be possible to fix a potential covenant breach with a prepayment. For example, a well-timed voluntary prepayment of an amortizing facility made from cash on hand now, could, in addition to reducing leverage, potentially avoid a breach of the debt service cover ratio in the subsequent three quarters (often with a dollar-for-dollar reduction in debt service). Similarly, where sponsors have flexibility to apply mandatory prepayments first against amortizing debt, we have in the past seen sponsors use proceeds from disposals which have not yet been reinvested (or to specifically dispose of assets) in order to reduce both leverage and debt service.

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Additional Preemptive Equity

Typically sponsors always have the ability to inject additional capital into a portfolio company's business (by way of equity or subordinated debt), which would reduce net debt regardless of whether a prepayment is made. Nonetheless, this is not the typical approach for sponsors facing a prospective financial covenant breach unless the amount injected can be subsequently designated as a "cure amount" and there is additional benefit to injecting it earlier (for example, to fix a clean-down issue (as discussed below) or to avoid a mandatory prepayment if that is required under the equity cure).

Sponsors are then broadly faced with either (i) using the equity cure; (ii) asking for a waiver or (iii) negotiating a covenant reset/broader amendment or refinancing.

Equity Cure

Typically sponsors can "cure" financial covenant breaches within 15-20 business days of the date on which a compliance certificate is required to be delivered by the portfolio company to its lenders. Careful consideration needs to be given to the parameters of the equity cure provisions (which typically, but not always, apply to all of the covenants).

For example, can the cure be used preemptively and subsequently be designated as a cure amount? Some sponsors will opt to provide the equity cure at the same time they deliver the compliance certificate so that they are effectively never in breach. However, others will use the additional 15-20 business day grace period so that they are not making a call on their investors sooner than is necessary. For those who wait, the next question is whether a default continues during that cure period. If so, for most sponsors the issue that arises is whether or not their portfolio company needs to draw on any of the facilities during this time, as a continuing default would typically be a drawstop (except for rollover advances). Therefore careful planning around this approach is required.

Other key questions to analyze in the context of an equity cure are:

- How is the cure actually implemented? Under many facilities in the Asia-Pacific region, sponsors are able to add cure amounts to EBITDA which obviously brings with it a multiplier effect, as opposed to being required to use such amount to make an actual prepayment to reduce debt (which is typically the case in Australia, outside of Term Loan Bs, for example). Similarly, where adding the cure amount to EBITDA is not permitted, under some facility agreements such cash is allowed to be retained by the portfolio company (thereby reducing net debt to the extent it remains in the company, rather than being required to be prepaid). Also, where a prepayment of the cure amount is required, the facility agreement may not obligate the company to use 100% of the cure amount for this purpose.
- What are the limits on the cure? For example, how many cures are permitted over the life of the facilities (typically 4-5)? Are over-cures permitted (often they are)? Are cures permitted in successive quarters? Where the cure amount is applied to EBITDA, does this carry over for the next three financial quarters (almost always it does)?
- Is there a mulligan? The true "mulligan" – taken from the golfing world – provides that an initial breach of the financial covenants is not a default unless the same test is breached on the subsequent test date. In the Asia-Pacific region, true mulligans are fairly rare. It is common, however, to see a deemed cure which provides that where there is an initial breach, it is deemed to have been remedied if the portfolio company is in compliance on the subsequent test date and the lenders have not accelerated the loans. In this scenario, where there is a projected single-quarter blip in performance, some sponsors might look to the lender syndicate to see if they have relationship lenders with blocking stakes (typically 33.34% or more in the Asia-Pacific region) who agree to prevent an acceleration event from occurring, but more often sponsors in this situation will seek a waiver or a covenant reset.

Covenant Waiver

For sponsors with a projected one-off financial covenant breach, they may seek a simple waiver of that breach. In the Asia-Pacific region, the waiver will typically require 66 2/3% of the lenders to consent to the waiver and a waiver fee would typically be paid.

Covenant Reset

Where a sponsor is projecting more than a one-off problem with the financial covenants, it is more typical that it would seek to reset the covenants to re-establish sufficient headroom. This approach is obviously a more protracted process than a one-time waiver as the lenders will need to get comfortable with an updated plan and financial model, and often involves a broader negotiation as some lenders may request changes to provisions such as amortization, excess cashflow sweep and pricing. They will also expect an amendment fee. Like a waiver, typically in the Asia-Pacific region 66 2/3% of the lenders would be required to reset the covenants. The sponsors may or may not negotiate the covenant reset in conjunction with an agreement to inject more equity into the portfolio company. Of course, they are more likely to agree to inject additional equity as part of the covenant reset if there is an underlying, fundamental issue with the company's performance rather than it simply being adversely affected by what are hopefully near-term situations such as COVID-19. In the latter case, sponsors may also proactively consider a broader "amend and extend" or refinancing of the facilities to fix the covenant issues and address any other issues such as impending maturities or a need for more flexibility in

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certain areas.

Clean-Down

Depending on the nature of the portfolio company's business, some facilities will have "clean-down" requirements on their revolving facilities (seen in a minority of sponsor deals). These provisions require cash drawings under the revolving and ancillary facilities to be reduced to an agreed amount (sometimes zero), either physically or net of cash and cash equivalents for a short period of time (typically 1-5 consecutive business days) in a year with a short period of time (say, 1 month) between clean-downs. Clean-downs are designed to demonstrate that the revolving facilities are not being used for permanent debt. Where there is an ability to utilize the revolving facility for permanent debt such as acquisitions, joint ventures or capital expenditures, the drawings of such amounts would necessarily need to be excluded from any clean-down.

COVID-19 is likely to mean that some companies are more reliant on their revolving facilities than usual and may struggle to meet their clean-down obligations. In this type of circumstance, in addition to waivers of the requirement, we have seen sponsors in the past preemptively inject equity into the company to fix the clean-down issue. In turn, the sponsors can subsequently designate the same proceeds as cure amounts to equity cure a covenant breach some quarters later.

Representations and Warranties

The representations and warranties in a facility agreement serve two primary purposes: (i) to flush out information regarding the portfolio company where the consequence of a breach is an Event of Default; and (ii) to serve as a drawstop on new utilizations of the facilities.

A number of typical representations and warranties should be given consideration in the context of COVID-19 (there may also be other deal-specific representations which need to be reviewed). First, the second limb of the "No Default" representation, which is a look-forward to defaults or termination events under other agreements (not the finance documents) and is typically subject to a "Material Adverse Effect" qualification. This representation could be relevant where a company's performance under a "material contract" is adversely affected by COVID-19 or a counterparty breaches such a contract. In addition, where a company has contracts which would reach this threshold of materiality, there is often an additional "Material Contracts" representation which should be reviewed.

Second, sponsors must check whether their facility agreement contains a particularly troublesome material adverse change representation which is included in the LMA's leveraged standard form. It provides that "*Since the date of the most recent financial statements delivered pursuant to Clause 25.1 (Financial statements) there has been no material adverse change in the assets, business or financial condition of the Parent or the [Restricted] Group [or the Group].*" This provision is a tripwire and should never be accepted by sponsors, although it is in a number of facility agreements in the market. This frequently misunderstood representation does not relate to the performance of the business since the closing of the loan facility, but rather since the date of the most recent financial statements and, equally importantly, is not the negotiated, defined "Material Adverse Effect" standard but is tied to the looser term "material adverse change." The tripwire here is that the portfolio company could be performing well above both its business plan and financial model but has a temporary but material dip in performance which can result in a performance breach despite the fact that it is in compliance with its covenants.

Third, the "No Proceedings" representations which relate to litigation and judgments should be reviewed. Invariably, some companies will be subject to litigation resulting from their failure to perform under their contracts, and it is likely that many parties will assert that COVID-19 is a force majeure event such that noncompliance with their contractual obligations was beyond their control and not actionable as a breach of contract. All of this could result in many businesses becoming tangled in complex and protracted litigation even when they intended to fulfill their obligations.

Finally, it is recommended to look at the "Insolvency" representation. This representation is linked to the insolvency-related events of default and discussed below.

Reporting Obligations

Reporting obligations to lenders vary from facility to facility but, in addition to financial information, typically include matters relating to litigation, judgements and, where relevant, material contracts as well as the catch all of whatever else is requested by a finance party. Sponsors are well-advised to discuss early and often with the management of their portfolio companies as to what, how and when information will be disclosed to lenders, particularly in light of the highly evolving nature of COVID-19 and its potential effect on businesses.

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Events of Default

Insolvency/Insolvency Proceedings/Creditors Process

These events of default speak for themselves and are unlikely to be the first breach of the facilities for a portfolio company that is seriously adversely affected by COVID-19. Nonetheless, they warrant consideration and attention because, among other things, the threshold for insolvency varies from jurisdiction to jurisdiction as do the duties of the directors.

Audit Qualification

Most traditional leveraged facilities in the Asia-Pacific region contain an event of default if the auditors qualify their report either on a going concern basis or a failure to disclose information. In the aftermath of the last financial crisis, there was much debate around whether a projected breach of a financial covenant which is noted in the auditors' report amounts to a qualification – thus causing an event of default ahead of any actual breach of covenant. In most cases, the conclusion was that for a simple projected financial covenant default, the auditors do not "qualify" their report but include an "emphasis of matter". The emphasis of matter is a paragraph which highlights a matter that in the auditor's opinion is of fundamental importance to a reader's understanding of the financial report but which falls short of the technical standard of an auditor qualification. However, although this has been the general conclusion in the case of projected breaches, it should be confirmed on a case-by-case basis with the relevant professionals in the local jurisdiction.

Litigation & Material Judgments

As discussed above, the impact of COVID-19 will inevitably be the cause of some contractual breaches which will result in litigation and judgments and need to be considered here.

Material Adverse Effect

Most traditional leveraged facilities in the Asia-Pacific region have a catch all Material Adverse Effect event of default. Sponsors in a reasonably strong negotiating position will negotiate the definition of "Material Adverse Effect" aggressively so that it is very limited and does not include the LMA formulation, which includes a look-forward on the ability to comply with financial covenants and/other obligations. Also, this event of default is typically negotiated to be an objective test – rather than the subjective "which the Majority Lenders reasonably believe…." construct of the LMA. Unfortunately, there are examples in the Asia-Pacific region that follow the LMA formulation. On the other hand, if this definition and event of default are correctly negotiated, while it may be scrutinized, in the absence of any other "black and white" events of default having occurred (such as a financial covenant breach), most lenders would be unlikely to rely solely on a Material Adverse Effect event of default in order to take any acceleration actions.

How We Can Help

Reviewing facility agreements and conducting an in-depth analysis of the current and future impact of COVID-19 on portfolio companies is necessarily a complex task, and there is no one-size-fits-all answer. Each case will need to be examined based on the particular facts and the specific drafting of the finance documents. Our global finance team is available to answer your questions and assist in evaluating your finance documents to identify any potential issues and work with you on the best strategy to address them.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Global Finance or Private Equity practice groups, or the author:

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