

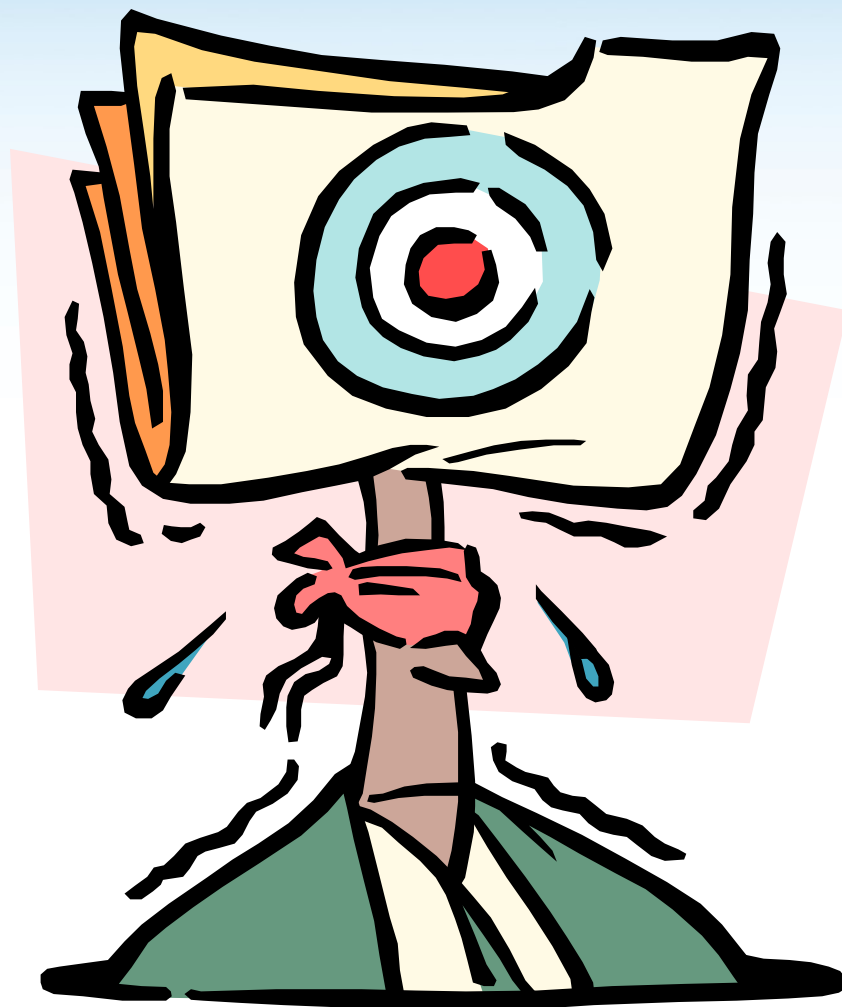
Debt Compliance: Understanding and Managing Debt Covenants

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Introduction



Agenda

- **Common provisions of debt agreements**
- **Less common provisions of debt agreements**
- **Implementing a Compliance Program**
- **Steps to take within Treasury**
- **Outreach to areas outside Treasury**

Why do we care about covenants?

- **Companies have legal obligation to manage operations within context of debt agreements**
- **Lenders expect borrowers to understand and comply with all covenants**
- **Covenant breach can trigger reclassification of debt on financial statements**
- **Covenant breach can also seriously impair price / ability of organization to raise debt in future**

Common Financial Tests

- **Debt / EBITDA**
 - indicates extent of leverage
- **EBITDA / Interest Expense**
 - indicates ability to service debt
- **Consolidated Net Worth**
 - indicator of 'wealth' of the company
- **Subsidiary Debt**
 - indicates other debt company must service
- **Definitions often 'layered'**

Financial Tests - Debt

- **Normally includes all amounts borrowed under credit facilities or debt agreements**
- **Can include other items**
 - e.g. obligations under capital leases, off balance sheet debt
- **Other items to consider**
 - should negotiate language so debt is net of cash
 - treatment of cross-currency swaps on foreign debt

Financial Tests - EBITDA

- **Standard definition on financial statements**
- **But not standard definition for covenants**
 - e.g. normally excludes transactions not typical of normal business activities
- **Other items to consider**
 - treatment of MTM on non-hedge derivatives
 - impact of dispositions of large business units (metrics are usually trailing four quarters)

Financial Tests - Interest Expense

- **Standard definition on financial statements**
- **But covenants usually include other items**
 - e.g. interest component of capital lease payments
- **Other items to consider**
 - impact of dispositions of large business units (metrics are usually trailing four quarters)

Financial Tests – Impact of Disposition

- **Leverage Ratio:**

$$\frac{\text{Debt as at Q4 q/e}}{\text{EBITDA Q1} + \text{EBITDA Q2} + \text{EBITDA Q3} + \text{EBITDA Q4}}$$

- **Immediately prior to disposition:**

$$\frac{\$400\text{M}}{\$25\text{M} + \$25\text{M} + \$25\text{M} + \$25\text{M}}$$

= 4.0

- **Immediately after disposition:**

$$\frac{\$270\text{M}}{\$25\text{M} + \$25\text{M} + \$25\text{M} + \$15\text{M}}$$

= 3.0

- **Ratio will likely be adjusted for impact of disposition**

Financial Tests – Subsidiary Debt

- **Need to identify all debt across organization**
- **Debt may not be originated by Corporate Treasury**
- **Areas of Corporate Treasury involvement**

Other Negative Covenants

- **Mergers / Consolidations**
- **Sale of Assets**
- **Liens**
- **Trade and Terrorism Sanctions**
- **Dividend Restrictions**

Mergers / Consolidations

- **Successor entities must be solvent**
- **No defaults can exist immediately after transaction closes**
- **Often need to work with other areas to manage this metric**
- **Important: any businesses acquired immediately become enveloped by organization's debt agreements and covenants**

Sale of Assets

- **No defaults can exist immediately after transaction closes**
- **Disposition Value of assets disposed cannot exceed certain % of Consolidated Assets**
- **Often need to work with other areas to manage this metric**
- **Important: consider impact on Leverage Ratio and Interest Coverage Ratio of any large dispositions**

Trade and Terrorism Sanctions

- **No transactions with sanctioned countries, organizations or individuals**
- **Lists maintained by OSFI (Canada) and Treasury Dept (U.S.)**
- **'Transactions' defined more broadly – not just sales and purchases**
- **Evolving list of sanctioned countries as world events unfold**

Trade and Terrorism Sanctions

- **Can ‘look through’ immediate transaction**
- **Often hinges on reasonable awareness**
- **Relationships need to be scrutinized with more vigilance if outside Canada, U.S. or the EU**
- **Need to work with many other areas to manage this covenant**

Compliance Checklist

- **Ideally should gather representatives from key areas that could have an impact on debt covenants:**
 - Treasury
 - Tax
 - Corporate Secretary
 - Business Development
 - Controllers
 - Sales / Purchasing
- **Use checklist and review of quarterly activities to ensure compliance**
- **Should conduct on regular basis**
 - prior to q/e incase remedial action needed
 - after q/e before compliance certificate production

Reporting Requirements

- **Basic reporting requirements**
- **Requirements of compliance certificate**
- **Other items to consider**
 - 'operationalize' compliance certificate production
 - treated seriously by lenders
 - CFO often signs off

Events of Default

- **Most common - failure to pay principal or interest**
- **Many other events of default**
 - e.g. cross – default
 - critical to understand all events of default and operationalize process to ensure compliance
- **Other considerations**
 - reporting
 - cure period / remedy
 - timeline for debt becoming payable
 - level of debtholders required to trigger repayment

Managing Default / Potential Default

- **Accelerated repayment of principal**
 - may trigger repayment of other debt
 - interest and make-whole provisions
- **Rescission of accelerated repayment**
 - more complex if syndicated facility / multiple lender groups
 - specified percentages of lenders required for agreement
- **Amendment / waiver**
 - much better to be proactive – lenders do NOT like surprises
 - be prepared for high fees – banks have leverage at this point

Securitization

- **Another form of debt agreement**
 - many covenants similar to standard debt agreements
- **Some unique default provisions**
 - tied to business securitized (e.g. receivables)
 - Servicer Default vs. Termination
- **Need to watch out for cross-default**
 - can trigger default under other debt agreements

Questions?