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Credit Agreements: Amendments to Consider in Light of COVID-19

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Months after its emergence, the COVID-19 pandemic continues to adversely affect businesses worldwide, and the duration and scale of its damage is increasingly uncertain. Many borrowers are therefore seeking amendments to their existing credit facilities to allow them greater financial flexibility while the pandemic persists. Indeed, the LCD Daily Playbook (May 20, 2020) reports three times as many credit agreement amendments in the year to date compared with the same period of last year.

We outline below certain trends in credit agreement amendments entered into in the wake of the COVID-19 crisis by U.S.-based borrowers. In particular, we discuss financial covenant relief, modifications to EBITDA calculations and reporting requirements, certain liquidity enhancement strategies, and other amendments and considerations.

Financial Covenant Waiver and/or Reset

For borrowers, seeking relief from financial covenant compliance is an important logical step because calculation of the financial covenant is directly affected by COVID-19-related losses, and because doing so avoids an event of default under the credit agreement.

The most common approach in the amendments we have seen so far has been to waive financial covenant compliance from, and including, the first quarter of 2020 up to, and including, the fourth quarter of 2020. The exact period for the financial covenant waiver will vary depending on the circumstances of the borrower, so it may commence with the second fiscal quarter of 2020 and end only after the first fiscal quarter of 2021. The borrower is given the option to end the financial covenant waiver period early if it is in compliance with the financial covenant based on EBITDA calculated as provided by the relevant credit agreement (or after giving effect to the EBITDA adjustments applicable after the end of the financial covenant waiver period in more borrower-friendly amendments).

In some amendments, either in lieu of or in addition to granting a financial covenant waiver for a specified period of time, lenders agree to reset the financial covenant by increasing the financial covenant levels to account for the likely decreases in EBITDA during the COVID-19-affected fiscal quarters. The borrower then receives the benefit of a loosened financial covenant level for up to one to two years after the financial covenant waiver period ends.

Addition of Minimum Liquidity Covenant and Cashflow Reporting

In exchange for the financial covenant waiver and/or reset, most lenders are asking for a new covenant that requires the borrower to comply with a minimum liquidity level during each day of the financial covenant waiver period. For the lenders, monitoring a borrower’s liquidity ensures that the borrower is maintaining enough cash on hand to service the obligations under the existing credit agreement. Liquidity is defined as the sum of unrestricted cash plus undrawn commitments under revolving credit facilities.

In combination with the liquidity covenant, the following may also be requested by the lenders:

- The borrower certifies compliance with the liquidity covenant on a quarterly, monthly, or, if liquidity falls below a certain threshold, even weekly basis.

- The borrower is required to provide 13-week cashflow projections on a weekly, bi-weekly or monthly basis (sometimes the frequency being determined by liquidity levels) together with a comparison of the previous cashflow projection versus the actual cashflow for that cashflow reporting period.

Calculating EBITDA once the Financial Covenant Waiver Period Expires

Since EBITDA not only feeds into covenant compliance but is also widely used by investors to evaluate a company's financial performance, borrowers have been focused on ensuring that EBITDA under their credit agreements is reflective of their typical business performance notwithstanding the disruptions caused by COVID-19. In most of the amendments we have seen, after the end of the financial covenant waiver period, EBITDA calculation for purposes of the financial covenant (and in some instances for all purposes) is modified so as to exclude the effect of the COVID-19-impacted fiscal quarters. The various formulations we have seen include:

Historical EBITDA

Calculation of historical EBITDA entails substituting the COVID-19-impacted 2020 fiscal quarters (i.e., the period during which the financial covenant waiver applies) for corresponding 2019 fiscal quarters for purposes of calculating EBITDA for any four-quarter period that includes the impacted fiscal quarters.

Annualized EBITDA

This approach entails use of annualized EBITDA starting with the first fiscal quarter after the end of the financial covenant waiver period. This is usually calculated as:

- first fiscal quarter EBITDA post-waiver period multiplied by 4,

- first two fiscal quarter EBITDA post-waiver periods multiplied by 2, and

- first three fiscal quarter EBITDA post-waiver periods multiplied by 4/3.

Liquidity Enhancements

In the face of uncertainty and the disruption in cashflow brought about by COVID-19, borrowers have also taken steps to secure liquidity. In addition to making draws under existing revolving credit facilities and enacting operational cash conservation measures, some borrowers have entered into incremental term loan facilities or issued high yield bonds, and where possible, converted cash interest payments to payment-in-kind (or "PIK") interest and/or suspended quarterly amortization payments under their existing credit agreements.

Incremental Term Facilities and High Yield Bonds

Over the last few months, in both the U.S. and Europe, the high yield bond market has generally been more accessible than the syndicated term loan market. However, in the last month, we have also witnessed a reopening of the term loan markets in the U.S.

For a borrower experiencing financial challenges (COVID-19-induced or otherwise), pricing for an incremental term loan is usually significantly wider than for the existing term loan tranches. This arises out of the need to compensate for the discount at which the existing term loans may be trading. Depending on the impact of COVID-19 on the underlying business and trading level, we have seen incremental term loan yields set on average at about 250-300 basis points higher than pricing for the existing term loan facility.

If the new incremental term loan pricing is wider than the existing term loan pricing, the borrower may also be required to increase the pricing on the existing term loans if any "most-favored-nation" ("MFN") clause is in effect, which will further increase the overall debt costs.

While issuing high yield bonds in lieu of entering into an incremental term loan would avoid this issue, as most MFN clauses are not triggered by bond issuances, borrowers would have to keep in mind that high yield bonds often come with call protection provisions that make it expensive to refinance or redeem such bonds in the near future, especially when compared to the ease of a repricing amendment if one expects normalized market conditions to return in the short-medium term.

Interestingly, we have seen one recent amendment include bond-style make-whole provisions in incremental facilities applicable for the first two years (and also, likely due to the difficult financial condition of the borrower, in the event that the borrower becomes the subject of a bankruptcy proceeding or the obligations under the credit agreement are accelerated).

Converting Cash Interest to PIK Interest and/or Suspending Quarterly Amortization Payments

Delaying or avoiding cash interest and amortization payments is a convenient way to save cash, but may be difficult to achieve. Under most credit agreements, converting cash interest into PIK interest and suspending or delaying scheduled amortization payments triggers an affected lender vote. Incentives to convince lenders to agree to PIK interest and/or to suspend amortization payments often include a step-up in the applicable margin for any loans that accrue PIK interest (often in the range of 100-150 basis points) and/or fees (sometimes structured as PIK or exit fees). For broadly syndicated loans, however, the composition of the lender group may further impact to what extent interest payments can be converted into PIK. This is because certain non-bank lenders may have restrictions under their formation documents that prevent them from accepting PIK interest.

Where available, a borrower may also use certain structural options to pressure lenders into accepting a PIK debt tranche. These include modifying payment priority under the waterfall provisions (where amendments to the pro rata provisions are not based on an all-lender vote), entering into a priming tranche and/or exit consents.

Other Amendments and Considerations

Changes to Material Adverse Effect Clauses. Certain of the amendments we have seen include carve-outs to the definition "Material Adverse Effect" for the impacts of COVID-19 on the business of the borrower. With respect to draws under revolving credit facilities, some amendments specify that the impact of COVID-19 will be disregarded in ascertaining the accuracy of the bring-down of the representations.

Temporary Suspension of Discretionary Baskets. Most financial covenant waivers have been accompanied by temporary suspensions of certain EBITDA- and ratio-based restricted payments, debt and lien baskets and/or reduction of fixed baskets during the financial covenant waiver period. Where only the revolving facility consent is being sought, and the revolving lenders do not constitute the required lenders entitled to amend the entire credit agreement, breach of these restrictions will end the financial covenant waiver period, rather than result in an event of default.

Government Debt. Given the availability of government-backed financing, we have seen the inclusion of a number of provisions which would facilitate the incurrence of government-backed financing, such as more lenient debt incurrence ratios, carve outs from any maturity/weighted average life to maturity restrictions and/or disapplication of any MFN triggers.

Additional Leverage Tests. In some of the amendments, additional financial covenant tests, such as the interest coverage ratio test, were added after the financial covenant waiver period.

Consent Fees and Margin Increases. Not surprisingly, borrowers have had to pay for the newly found breathing room under their credit agreements in the way of amendment consent fees and increased interest rate margins. We have seen in recent amendments one-time consent fees (typically in the range of 0.25% to 0.40%) and/or increases in interest rate floors, applicable margins and unused commitment fees (including the disapplication of any leverage-based step-downs) for the duration of the financial covenant waiver period.

Key Takeaways

The economic damage caused by COVID-19 is proving to be more severe and promising to linger a lot longer than initially expected. This leads us to believe that over the coming months, more borrowers will seek accommodations under their existing credit agreements, particularly in relation to financial maintenance covenants and liquidity enhancements. It is likely that the trends identified in the loan market so far will continue and evolve based on the length and severity of the COVID-19 crisis, continued availability of government-backed financing and recovery in the syndicated term loan markets.