

# Negotiating Credit Agreements

Philla AFP Conference

May 8, 2018

**Understand**

**Integrate**

**Collaborate**

**Mitigate**

**Manage**

**Jim Simpson**

**Debt Compliance Services**

# Presentation Topics

- **Introduction**
- Setting up the negotiations
- Understanding & Minimizing Default Risk
- Negotiating Covenants
- Post-closing negotiations
- Summary of recommendations
- Q&A
- About Debt Compliance Services

# Core Financing Considerations

- How does the proposed financing fit within the company's capital structure plan?
- Has the company's credit rating changed?
  - Is there an opportunity to relax and remove covenants?
- Are current market conditions favorable?
- What is the relationship with the current bank group?
- What are the constraints imposed by any junior debt?
- What should the debt structure be?
  - Secured vs Unsecured
  - Amend & Extend vs New Credit Agreement
  - ABL vs Cash Flow
  - Term Loan vs High Yield

# General Negotiating Objectives



- *Your primary negotiating objective must be to minimize the probability of a default over the life of the agreement*
  - Realistic financial covenants
  - Securing an optimal non-financial covenant package
  - Achieving maximum operating flexibility
  - Maintaining a friendly and supportive bank group
- Maintain lender confidence and goodwill by being upfront about your issues
  - **If** you do your homework, your lenders will help you
  - Debt compliance begins with the negotiations

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# Outside Resources

You negotiate debt agreements against professionals who have the best lawyers your money can buy, so even the odds by:

- Insisting that your outside counsel is a top 10 national law firm
- If you are unrated, seriously consider getting a private rating
- Subscribing to Thompson/Reuters' LoanConnector\*
  - See a demo to find out where your lenders go for market pricing, financial covenants, sign up for deals, etc.

\* <https://www.loanpricing.com/products/loanconnectordealscan/>

# Structuring the Deal Team

- Assign negotiating responsibilities between Treasury and Legal
- Treasury's responsibilities should include:
  - Overall deal structure
  - Rates, fees and financial ratio realities
  - Restrictions on the business operations
  - Basket limits vis-à-vis business requirements
  - Timing of reporting, notices, and cure periods
- Legal should be responsible for:
  - Overall agreement wording
  - Events of Default, Reps & Warranties, Conditions for Closing, Indemnities, and other ancillary transaction documents
- Treasury and Legal are both responsible for a Depositary Agreement

# Use a Deal Document

- The first thing your lender's lawyers will do is read your other existing agreements and highlight the critical covenants
- A deal document helps you maintain your priorities by
  - Tracking the progress of your negotiations
  - Showing how your new debt's conditions compare with existing debt
- An effective deal document has four major sections:
  - Changes from the accepted term sheet
  - Comparison of the new debt's major covenants, defined terms, knowledge, notice, thresholds, limits, etc. against comparable terms in your existing debt and, if applicable, the debt that is being refinanced
  - Listing of the closing conditions, closing reps and warranties, continuing reps and warranties, and post-closing covenants
  - Analysis of your financial ratios against scenarios and stress testing.
- It can be easily edited to explain the deal to your CFO, CEO, and Board
- Our DCS Deal Document Template.docx is included with this presentation

# Rating Agency Considerations



- Since rating agencies will review your all of your debt agreements, you need to consider how they will judge what you have negotiated
  - Said another way, your lenders make credit evaluations of your company and their evaluations are considered in the rating agencies' evaluations
- Agreements with these characteristics can negatively affect your rating:
  - An excessive number of covenants
  - Unwarranted concessions on key, critical covenants, especially ratios
  - The frequency that agreements are amended and the types of amendments made
- These rating agency considerations are another justification for a private rating if you don't have one, subscribing to the Loan Connector, and using a deal document

# Presentation Topics

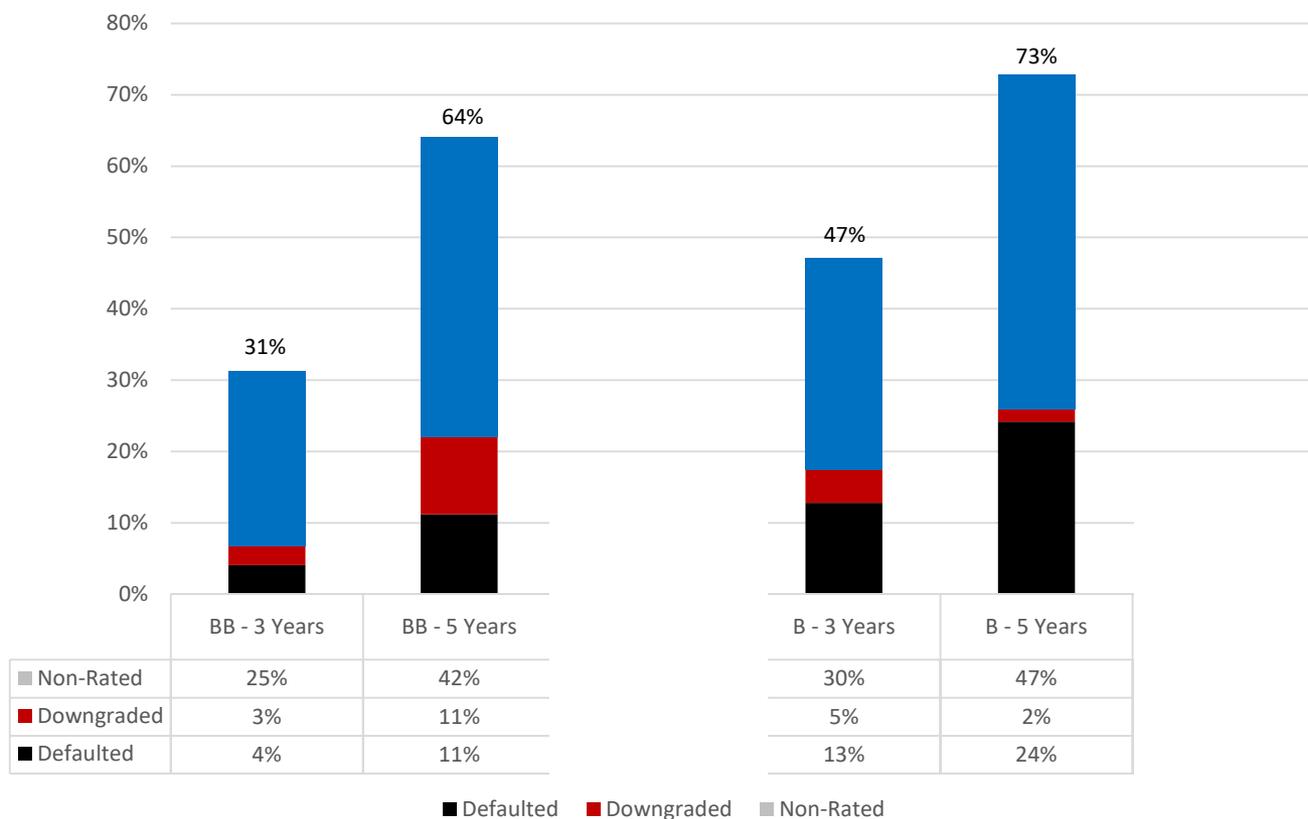
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# Minimizing Default Risk



- Negotiating a realistic covenant package requires understanding
  - The impact of similar covenants in your other debt
  - Your operating risks by covenant
  - Your ability to comply
- You need to know the compliance realities for departments outside Treasury, such as Legal, Accounting, Operations, EH&S, HR, etc.
  - Particularly their willingness to **monitor, report and forecast** covenant occurrences in their areas of responsibility
- If they cannot adequately comply, then be upfront with your lenders
  - **Never agree to something you don't think you can do**

# Default Risk is Large and Underestimated



- Sources: S&P's 2017 Default & Ratings Transition Study showing how ratings change after 3 and 5 years, and DCS's 2015 Benchmarking Study asking companies to estimate the 5 year default rate of companies with their rating

# Three Different Default Risks



- Cash flow and adverse event risks are best managed in your negotiations as they are inherently beyond treasury's ability to avoid after they are negotiated

## Cash Flow Defaults

- Broken ratios
- Missed payments

## Event Defaults

- Material Adverse Events

- Technical default are all other covenants. **Technical default risk is 100% controllable: there's no excuse for a technical default**

## Technical Defaults

- Failure to report an event
- Permitted baskets
- Cross default on the related ancillary documents
- Continuing reps and warranties

## Technical Defaults (cont'd)

- Invalidity of collateral, liens and other security documents
- Affirmative covenants
- Negative covenants
- Compliance reporting

# Minimizing Cash Flow Default Risk



- Do not just haircut FP&A forecasts or the earnings guidance
- Instead, have FP&A develop 3 long-term P&L and cash flow scenarios assuming
  - An industry downturn
  - A company downturn, and
  - A conservatively optimistic one
- Apply these scenarios against your ratios and:
  - Negotiate carve-outs to your EBITDA, Indebtedness, etc. ratio definitions to minimize breaking them
  - Stress-test them to see how much leeway you have
- If payments are a risk, apply these scenarios against **all** of your agreements' P&I payments

# Minimizing Event Default Risk



- Event risk comes in two flavors:
  - The event is a MAE that by definition is an Event of Default
  - Where the failure to report an event is an Event of Default
- Manage MAE risk by negotiating the tightest MAE definition you can
  - Minimize the number of times the agreement has MAE language
- After “knowledge” of the event occurs, notice is required within a specified time period, so negotiate for:
  - The actual knowledge of a senior officer rather than the date the event actually happens
- “Notice” to be done “promptly” vs. 3-5 business (not calendar) days
- For an EoD event, the cure period clock starts after notice
- Can your SME’s do the event monitoring, reporting and forecasting?

# Minimizing Technical Default Risk



The specific language of any covenant must reflect the reality of the company's capabilities and financial situation.

1. If a company can not properly communicate its capabilities and financial situation, then the covenant is more likely to be violated
2. Defined terms, such as Cash, Indebtedness, Net Income, EBITDA, etc., must be carefully crafted to reflect the company's likely future reality
3. Similarly, thresholds and permitted basket limits need to provide the company sufficient flexibility but still provide lenders the comfort they need as the company changes its credit profile
4. Clarify covenants that are ambiguous or complex
5. **Covenant wording and requirements must always be compared to the other agreements**

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# Covenant Statistics



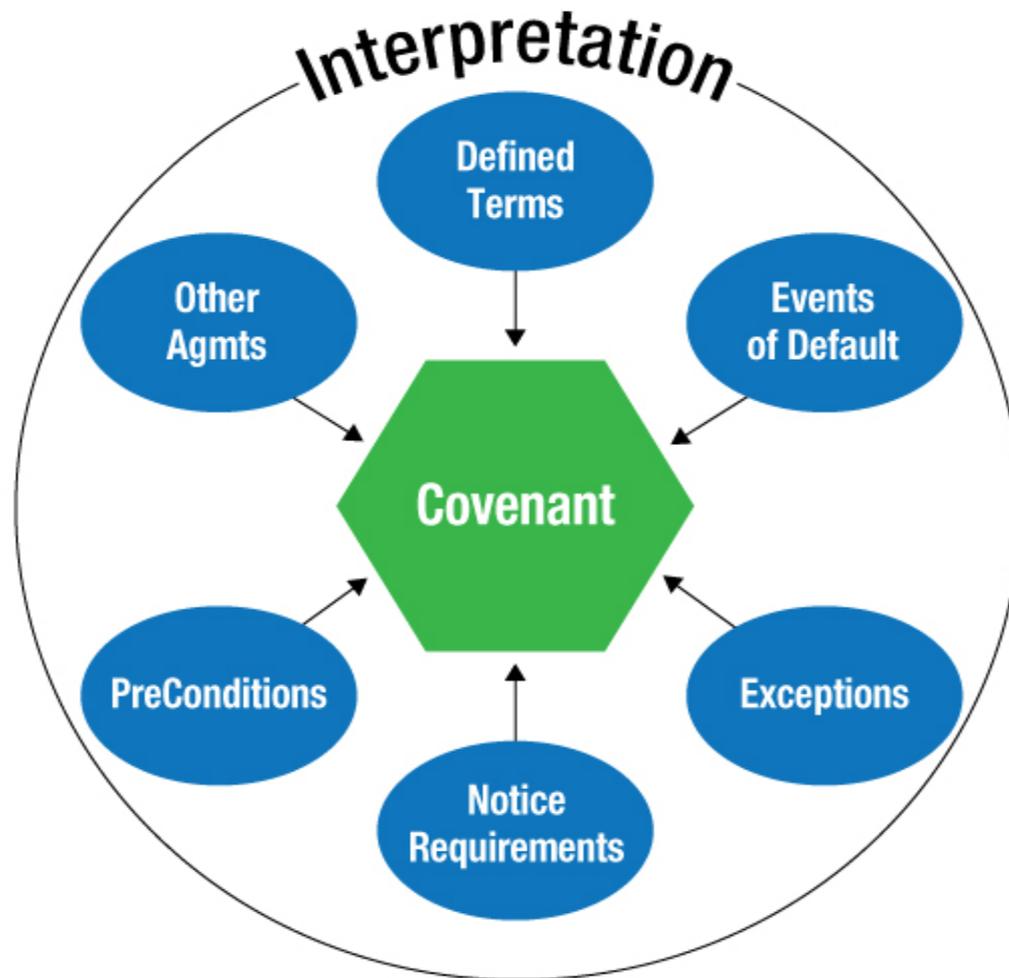
- There are more covenants than most companies realize
- The number of covenants depends on the type of agreement and the credit rating
- Not all covenants are the same from a risk viewpoint

| Covenant Type      | Revolving Credit | ABL       | Senior Notes | Convertible |
|--------------------|------------------|-----------|--------------|-------------|
| Affirmative        | 25               | 45        | 20           | 15          |
| Negative           | 15               | 15        | 10           | 10          |
| Reps & Warranties  | 15               | 15        | 0            | 0           |
| Other              | 25               | 20        | 15           | 10          |
|                    | <b>80</b>        | <b>95</b> | <b>45</b>    | <b>35</b>   |
| Agreement in Pages | 80-150           | 120-180   | 60-80        | 60-80       |
| Defined Terms      |                  |           |              |             |
| Pages              | 25-35            | 40-50     | 15-25        | 15-25       |
| # of Terms         | 300 - 450        | 350 - 450 | 100          | 100         |
| Events of Default  |                  |           |              |             |
| #                  |                  |           | 12-15        |             |
| Cure Period        |                  |           | 0-30 days    |             |

# Covenant Basics

- Most all Debt Agreements contain similar Covenant Topics
- Each covenant is comprised of many of these elements:
  - Description of the prohibited or required action
  - Multiple Defined Terms
  - Section and Legal References
  - Notice requirements
  - Preconditions and exceptions
  - Corresponding Event of Default and Cure Period
  - Legal and/or practical interpretations
  - Subsequent amendments
- Therefore, Covenant Packages are best impacted by active negotiation of the component parts

# Covenant Basics



# Critical Defined Terms



These defined terms are critical to managing your long-term compliance:

- **Permitted definitions:** Permitted Indebtedness, Liens, Investments, etc. provide a list of exceptions to prohibited activities
  - Negotiate enough exceptions to minimize needing consent for the likely volume of activity
- **Various Accounting Terms:** EBITDA, Indebtedness, Net Income, etc. often include negotiated carve-outs that may differ across agreements
  - Test definitions to make sure that you achieve the desired result
- **Restricted Payments:** This definition usually covers dividends, interco advances, fees and payments to subordinated indebtedness
- **Compare: Compare all similar definitions with other agreements**

# Permitted Baskets

- Most negative covenants are accompanied by exceptions that can include lists of scheduled existing items, routine or required transactions, etc.
- Defined terms such as indebtedness, L/Cs, liens, investments, etc. will have exceptions with a dollar limit (a permitted basket)
- Unlike thresholds, a permitted basket limit is usually aggregated over the life of the agreement, can be very detailed, and can impact other baskets
- Negotiating these limits must reflect a compromise between the lender's need to have a say in future expanded activities and the borrower's ability to freely manage day-to-day business
- Can you setup the necessary processes to accurately monitor, manage and report on your basket and sub-basket items?

# Thresholds



- Thresholds are used throughout the agreement, such as:
  - Notices
  - Judgments
  - Cross default
  - ERISA events
  - Environmental events
- Unlike permitted basket limits, thresholds are usually one-time events and are not aggregated
- Compare comparable thresholds in other agreements

# Knowledge of Covenant Issues

- Critical to the management of any event that requires notice is when notice is required after the event occurs
  - It can be 3-5 business days after the actual event date, so a failure to do so when discovered later is a EoD
  - Or when there is “actual” knowledge of a Responsible Officer who must either promptly notify the lenders or must do so a predetermined number of days after knowledge occurs
- Best to negotiate for prompt notice after the knowledge of a Responsible Officer, which provides a built-in ambiguous “cure period”
- After notification, the real cure period clock starts ticking to avoid the lenders calling it an Event of Default

# Reps & Warranties

- Ensure that there is a clear distinction in the debt agreement between closing reps and warranties and continuing reps and warranties
- You will need to “re-rep” the continuing reps and warranties when you drawdown and rollover funds
- Negotiate re-repping to only new drawdowns, not to rollovers
- Negotiate minimizing the number of continuing reps and warranties
  - The more you have, the greater the risk that in times of economic distress or company distress, you cannot re-rep one of them
  - This is important not only for senior credit facilities, but even more so for Backup CP Lines, as a large number of continuing reps calls into question whether the backup will be always available.

# Amendments and Waivers

- Amendments and waivers are typically approved in three ways:
  1. The agent can unilaterally approve amendments reflecting corrections in wording and other minor issues
  2. A simple majority of the lenders, based on their dollar commitment, are required for amendments and waivers for breaches of covenants that are not considered critical
  3. A super majority (67%) is required for changes in the maintenance ratios, pricing and other serious covenant issues
- The company should attempt to negotiate as many of the covenants to either an agent acting unilaterally or to a simple majority
  - Your agent is your best friend, some of the other lenders, not so much

# Events of Default

Understand how your covenants' cure periods are identified in the first six or so Events of Default sections:

| Senior Credit Facility Event of Default Clauses  | Cure Period  |
|--|--------------|
| 1. Principal payments, including Mandatory Prepayments   | 0-1 Days     |
| 2. Interest, fee and other required payments   | 0-3 Days     |
| 3. Reps & Warranties and incorrect reports, certificates, financial statements and other documents furnished | 0 Days       |
| 4. Specifically identified covenants, such as maintenance, negative, reporting and notifications             | 0-5 Days     |
| 5. Invalidity of Credit or Security/Collateral Agreements  | 0 Days       |
| 6. All other covenants in a catch-all phrasing, which includes the affirmative covenants                     | 30 – 60 Days |

# The Remaining EoDs are Covenants



They deal with specific events that do not appear elsewhere in the agreement and must be carefully negotiated:

## Other Events of Default are:

- Cross default
- Cross acceleration
- Guarantors' default
- Voluntary/involuntary bankruptcy/insolvency
- Change of Control

## Other Events of Defaults include:

- Judgments
- Cancellation of Material Contracts
- ERISA Events
- Governmental Actions
- Revocation of Licenses

## Cure Periods

- Varies by specific default event, typically 0-5 or 10 **business** days

# Cure Periods

Cure Periods reflect the relative importance that the lender attaches to a particular covenant

- Clarify how “knowledge and notice” determines when an EoD actually begins
- If an EoD does not specify a cure period then it is zero days
- Negotiate increasing the Cure Period for each covenant
  - Try to increase zero day cure periods by at least one day
  - All short cure periods should be expressed as “Business Days”
- Compare the knowledge, notice, and cure periods against similar EoDs in your other agreements

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# Post-Closing Negotiations

- Negotiations do not stop with the closing because technical defaults can occur due to a misinterpretation of a covenant
- Interpretation issues arise from:
  - How exactly a covenant can be complied with
  - Poor, ambiguous or complicated wording
  - New situations not foreseen in the agreement
- When interpretations are agreed with your lenders, have them document the understanding with an email or letter
  - Saved and shared among Treasury and Legal
- Continue to maintain lender confidence and goodwill by being upfront about covenant issues
  - The objective always should be to not surprise your lenders
  - **And your CFO**

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# For Investment Grade Companies



Investment grade companies should take advantage of their status by making the agreement easier to understand, easier to comply, and easier to manage:

1. Ensure that the hierarchy of the debt is reflected in the various covenants. In other words, make sure that the senior most agreement contains the strictest requirements so that it would be difficult for the junior debt to trigger a default
2. Keep in mind that the junior debt may have some covenants unique to that type of agreement, so negotiate a long cure period for them
3. Reduce the number of covenants and allow for more flexibility
4. Negotiate basket limits that minimizes the frequency of have to go back to the lenders for consents
5. Increase the cure periods in the default section
6. Negotiate an amendment or waiver process that allows for more delegated power to the admin agent

# For Speculative Grade Companies



1. It may be worthwhile to get a private rating for your company, especially if you don't believe what your banks are saying about your credit
2. Sign up for Thomson/Reuters Loan Connector so that you really understand what the market terms are for your credit
3. Make sure your outside counsel is a top 10 national law firm with extensive experience negotiating speculative grade debt
4. Really work FP&A to come up with three realistic P&L/Cash Flow scenarios assuming an industry downturn, a downturn due to specific company risks, and a conservatively optimistic one, with likely carveout items detail
5. Have FP&A/Treasury work together on developing appropriate carveouts for the 2 or 3 financial ratios you are likely to have
6. Fully use a deal document to fully understand the covenants of your other debt and whether they are going to be controlling on your new debt
7. Really understand whether your subject matter experts will do – or can be persuaded to do – a very good job in monitoring and forecasting the covenant requirements in their areas of responsibility

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## Q&A

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# About Debt Compliance Services

- Now in its 9<sup>th</sup> year, DCS is a joint venture between Greenwich Treasury Advisors and Corporate Finance Solutions
- Jim Simpson founded Corporate Finance Solutions in 2002
  - A 35-year career leading over \$4 bn in convertibles, high yield bonds, revolvers, term loans, and ABLs
  - CFO of Moore Medical (public, \$300M sales) and CS Brooks (private, \$200M sales), and Treasurer of Sandoz USA (now Novartis)
- Jeff Wallace founded Greenwich Treasury Advisors in 1992
  - Recognized expert in risk management and international treasury
  - VP-International Treasury at American Express, AT at both Seagram and D&B, and a CPA at Price Waterhouse

# DCS' Value Proposition



- With its reputation, funding, GAAP, and SOX risks, minimizing default risk is an enterprise risk that requires a rigorous compliance process
- We provide a comprehensive, best-in-class, risk-based, automated debt compliance process in the cloud that minimizes default risk by:
  - Identifying the at-risk covenants that must be managed quarterly or annually or when triggered by events from the low and no risk covenants.
  - Training and documenting compliance by SMEs outside of treasury on their truly-at risk covenants in their areas responsibilities with our integrated, risk-based web questionnaires
  - Researching covenant issues quickly, accurately and consistently with our multi-agreement contextual search engine on hyperlinked debt agreement webpages with commenting and file uploading
  - Ensuring all scheduled requirements are delivered on time with our web calendar process with assigned tasks and email notification
- No corporate has the resources to duplicate services
- Our SaaS implementation fees can be capitalized and amortized per the Big 4

# DCS Clients

We have over 30 clients, ranging from large public to private middle market companies:

- A power generator with \$25B in debt and over 40 project financings
- A utility with \$21B in debt with 8 project financings
- RES Americas, a renewable energy company with 3 project financings
- A midWest utility with \$8.5B in debt with three separate holding companies debt
- Municipal Authority of Georgia, with \$6B in debt
- Two water company utilities with holding company and sub company debt
- A \$6B pharmaceutical with \$10B in debt
- Henry Schein, an \$8B global multinational
- PolyOne, a \$4B industrial manufacturer
- Church & Dwight, a \$3.3 billion consumer products company
- Hyster-Yale, a \$2B industrial
- A Big 4 audit firm

# Client Testimonials



*“You have a best-in-class debt compliance process,” reported the lead manager of a Big 4 audit of the company’s debt compliance to the treasurer of a client that is one of the five largest US utilities.*

*“Actavis is one of the world’s leading generic pharmaceutical companies, operating in 50 countries across the globe. We chose Debt Compliance Services to assist us in designing a comprehensive debt compliance process to meet the reporting requirements of our complex external financing arrangements. We are impressed with the sophistication of their debt compliance services and the professionalism and responsiveness of their ongoing support. DCS’ unique global web questionnaire system has enabled our key business stakeholders to better understand our ongoing obligations and resulted in an efficient way to manage the substantial information flow generated by our large and complex business. We now have a clear overview of what is going on in the Group without having to spend too much time and resources in the attempt. We highly recommend DCS’ professionalism and services.”*

**—Gudjon Gustafsson, Group Treasurer, Actavis Group**

*“Debt Compliance Services’ tools reduce my risk, save me and my team time and effort, and have made our compliance reporting easy. Gone are the days when we would have to pull out our old, worn loan documents to review all of the various covenants and restrictions before making critical strategic business decisions. With DCS, reviewing our agreements is literally done with a few clicks of the mouse.”*

**—Christine Sacco, Chief Financial Officer & Treasurer, Smart Balance, Inc.**

# DCS Publications

1. “Cutting the Clutter: Developing a risk-based covenant checklist”, *AFP Exchange*, August/September 2015
2. “No Doubt, FASB’s new rules forces firms to disclose going concern doubts”, *AFP Exchange*, October 2014
3. “Coming Due, Treasurers must be wary of today’s easy covenants”, *AFP Exchange*, September 2014
4. “Truth or Consequences: Understanding Default Risk and its Ramifications”, *AFP Exchange*, September 2013
5. “Pure Speculation: Treasurers of Non-Investment Grade Companies Must Reduce Covenant Risk”, *AFP Exchange*, June 2013
6. In collaboration with the AFP, the *AFP Debt Compliance Survey*, January 2013

# Contact Information

- For more information, please contact:

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