

# What's Market: 2020 Mid-Year Trends in Large Cap and Middle Market Loans

PRACTICAL LAW FINANCE

## AN EXPERT'S VIEW: VANESSA JACKSON, DAVIS POLK & WARDWELL LLP

*Vanessa discusses COVID-19 and its impact on EBITDA addbacks and the direct lending market.*

**Companies must adapt to an economy significantly impacted by the COVID-19 pandemic. In your practice, what have been some of the most important issues to borrowers and lenders since the outbreak? What do you anticipate for the second half of the year?**

The COVID-19 pandemic has had and continues to have a significant impact on the entire lending market as well as nearly every aspect of many companies' operations. Borrowers are therefore carefully analyzing their credit and other financing facilities to anticipate and proactively address the potential short, medium, and long term impacts of the pandemic, as current and expected revenue streams have dramatically decreased in many cases. It has become increasingly difficult for borrowers to predict with any certainty future cash flows and, as a result, EBITDA – a metric commonly used in credit facilities for determining borrowers' financial health. Lenders are, simultaneously, taking a harder look at their underwriting processes to carefully assess the proper circumstances under which they are willing to provide liquidity in light of the pandemic's impacts.

Since March, we have seen several distinct phases in borrowers' and lenders' responses to the COVID-19 pandemic, including:

- Unprecedented increases in borrowings under revolving credit facilities and incurrence of short-term "working capital" facilities.
- Adjustments to EBITDA to address the impact of the pandemic on borrowers' businesses.
- Temporary waivers to financial covenants.
- Amendments to "material adverse effect" representations, borrowing conditions, and events of default.

As the Federal Reserve and US Treasury have rolled out various bailout programs in an attempt to counteract the economic impact of the pandemic, borrowers have been assessing whether they qualify and, if so, the extent to which they can receive funding under these programs. To participate in these programs, many borrowers have been required to obtain amendments to their existing credit and other financing facilities, with approaches varying widely from broad-based permission to participate in any COVID-19 related governmental stimulus program without limit to more narrowly tailored permission to borrow under specified programs subject to agreed caps.

Other common amendments over the past few months include:

- Extensions of deadlines to satisfy collateral perfection requirements (that cannot be completed due to disruptions caused by the pandemic).
- Extensions of delivery periods for financial statements and, relatedly, carve-outs to the no "going concern" audit qualification requirement.
- Waivers of certain pandemic-related events of default.
- Temporary conversion to a "paid-in-kind" interest structure.

Given rapidly evolving market conditions, it is difficult to predict with any certainty what may unfold during the second half of the year. However, the fact, as noted above, that many borrowers have increased their overall liquidity position over the past few months and, in many cases, obtained waivers, consents, and amendments to financial and other covenants should provide them with additional runway to weather the challenges they are certainly likely to face as the global economy continues to reopen.

As borrowers continue to assess their liquidity needs, it will be interesting to see whether there is a continued uptick in loans provided by direct or private credit lenders, as opposed to traditional banks. Certain direct lenders are well positioned with substantial dry powder and there are likely to be many unique,

atypical, and opportunistic situations for direct lenders in the near term as the impact of the pandemic continues to unfold.

**Borrowers in many sectors of the economy can anticipate falling revenues amid great economic uncertainty as a result of the COVID-19 pandemic. For borrowers whose loan agreements include EBITDA addbacks, how has this started to play out in the way EBITDA addbacks are given effect? Also, in loan deals that have been negotiated since the outbreak of COVID-19, have there been changes in the way EBITDA addbacks are structured?**

Unsurprisingly, there have been many EBITDA-related amendments resulting from the COVID-19 pandemic, due to both actual and anticipated covenant breaches. Borrowers have been focused on the calculation of EBITDA under their credit facilities, which impacts both various incurrence tests as well as financial maintenance covenants. Customary EBITDA addbacks, including for goodwill impairment, business interruption insurance, nonrecurring, one-time or infrequent items, run rate cost savings in connection with operational changes, lost revenue addbacks, and other pro forma adjustments may all permit certain charges related to the COVID-19 pandemic to be included in EBITDA.

In addition to the above, borrowers have requested several amendments to EBITDA definitions to more specifically address pandemic-related items, including:

- Using pre-pandemic EBITDA from representative historical quarters.
- Permitting the “annualization” of one, two, and three-quarter post-pandemic EBITDA.
- Permitting lost revenue as a result of the pandemic to be added back (typically on a capped basis, applicable only to certain fiscal quarters and subject to other parameters), including by using an “Adjusted EBITDAC,” EBITDA adjusted for lost revenue that the borrower believes it could have realized but for the effects of COVID-19, metric.
- Permitting addbacks for charges regarding donations made to healthcare industry or for losses related to the pandemic.

Lenders, on the other hand, have sought, often as part of a covenant relief-related amendment, to explicitly exclude lost profits / revenue-related EBITDA addbacks due to COVID-19.

Borrowers have also sought, in combination with or in lieu of the EBITDA amendments above, financial covenant relief in the form of “holidays” (of often 3 to 4 testing periods post-pandemic) or wider testing levels, or both. As part of granting this relief, lenders have often sought to add a minimum liquidity covenant, anti-cash hoarding provisions, and other debt, lien, and restricted payments covenant tightening.

Minimum liquidity covenants are typically tested on the aggregate amount of unrestricted cash (and cash equivalents) and unused revolver commitments of borrowers, with the

frequency of testing and related reporting highly negotiated, but most often not less than quarterly. There are also several approaches to anti-cash hoarding provisions, but the most common require a mandatory prepayment if liquidity exceeds an agreed threshold at any time or an additional condition precedent to future revolver borrowings, or both. The negative covenant tightening in “cov-lite” TLB structures is often structured as a revolver-only default, which may be waived, amended, or acted on solely by the revolving lenders.

**Given the “buy and hold” nature of direct lending, has the impact of the COVID-19 pandemic affected borrowers whose capital structures include direct loans differently than borrowers whose loans are broadly syndicated?**

While there certainly has been a convergence of terms across the direct lending and syndicated loan markets over the past few years, direct lenders have remained focused on narrower covenant packages that are more tailored to the companies’ specific business profiles. As such, while borrowers may have additional flexibility in broadly syndicated loans to address pandemic-related impacts on their business, it is also likely that borrowers are better positioned to effectuate amendments on an ongoing basis with a small group of direct lenders than a broad lender syndicate.

A related factor to consider is the cost associated with obtaining these sorts of amendments. In particular, it will be interesting to see whether amendments to broadly syndicated loans become increasingly costly as compared to facilities held by a smaller group of direct lenders.

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