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## Could Virulent EBITDA Addbacks Inflate Capacity Under European Loans and Bonds As a Result of the Coronavirus Pandemic?

### The Bottom Line:™

- With coronavirus-driven liquidity pressures mounting, banks are seeing a surge in revolving credit facility drawdowns and heightened interest in bridge financing.
- Capacity for these drawdowns and new borrowings depends in part on a company's covenants under its existing bonds and loans.
- We recently summarized the potential for EBITDA addbacks related to COVID-19.
- In this report, we consider how European leveraged finance documents, which often use IFRS as the applicable accounting standards, could provide even broader scope for virus-related addbacks and increase capacity under existing agreements.

### Overview

With Europe now the [epicenter](#) of the COVID-19 pandemic, bond investors, asset managers, and CLO managers are increasingly concerned about the possible effects of a freefall in revenues for European companies, including those in the travel, hospitality, retail, and leisure industries as well as manufacturing, healthcare, and other sectors facing supply chain issues. As liquidity pressures mount, banks are [reportedly](#) seeing a surge in revolving credit facility drawdowns and heightened interest in short-term bridge financing, with companies seeking to maintain sufficient cash on hand to weather a potentially extended downturn.

For a company with existing term loan debt or bonds, the amount it can draw under its revolver, or borrow under new facilities, will depend in part on its debt capacity (and liens capacity, if the new borrowings are to be secured) under its credit agreement and/or bond indentures. As we regularly warn investors, under today's typical European loans and bonds, debt and liens capacity may be even higher than immediately apparent thanks to expansive EBITDA addbacks and other calculation flexibilities that can inflate basket capacity and/or make it easier to meet leverage or coverage ratios. In the context of the COVID-19 crisis, extra debt capacity may be a blessing in disguise for companies facing a short-term liquidity crisis, especially those whose fundamentals remain strong. However, it could also present a meaningful risk from an investor's standpoint if the negative effects of the virus have a positive effect on "grower" basket capacity and/or ratio test compliance by inflating EBITDA.

In our March 6, 2020 [Will EBITDA Become Infected by a Coronavirus Addback?](#) report, we addressed how companies might be permitted to use common addbacks for "extraordinary, unusual, or non-recurring charges" and losses covered by business interruption insurance in connection with COVID-19. In this report, we consider how European leveraged finance documents, which often use IFRS as the applicable accounting standards rather than US GAAP, could provide

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even broader scope for virus-related addbacks. We also review some of the more wide-ranging EBITDA provisions found in European loans and bonds, which companies might seek to use as justification for virus-related addbacks.

### ***“EBITDA”: The Devil Is In the Definition***

Like most terms in European high yield bonds and loans, the standard definition of “EBITDA” or “Consolidated EBITDA” has migrated from US bonds and loans. The term is typically defined as “Consolidated Net Income” as increased by certain addbacks and decreased by certain exclusions. “Consolidated Net Income,” in turn, is normally defined as net income (loss) determined on a consolidated basis in accordance with the applicable accounting standards under the document.<sup>1</sup> Additionally, like their US counterparts, most European bond indentures and leveraged loans include, as a general rule of construction, a provision specifying that accounting terms not otherwise defined in the document itself will have the meaning given to that term under the applicable accounting standards.

Herein lies the nuance for European credits. While some (albeit not all) of the terms used in common EBITDA definitions have clearly defined meanings under US GAAP, these terms may not be defined under IFRS. For example, most European loans and bonds include an EBITDA addback for extraordinary, non-recurring (and sometimes also “infrequently occurring”), exceptional, or unusual gains or losses—none of which, as we understand it, are defined terms under IFRS.<sup>2</sup> In the absence of an official definition, a company’s determination of what is encompassed by such an addback becomes a matter of judgment and discretion, resulting in uncertainty as to the potential scope for increases to EBITDA that could affect basket capacity and/or ratio test compliance.

In terms of COVID-19 addbacks, we noted in our March 6 [report](#) that we think companies can make a reasonable argument that pandemic-related costs and charges are unusual / non-recurring and, therefore, might appropriately be added back to EBITDA. With fewer constraints imposed by accounting standards definitions, some European companies may be able to go further than this when calculating COVID-19 EBITDA addbacks, potentially even taking a broad interpretation of the term “losses” to include lost earnings as well as realized charges and expenses.

Additionally, some sponsor covenant packages in European loans and bonds include non-standard, broadly-worded addbacks that could be implicated by COVID-19, such as:

- losses, costs, or cost inefficiencies relating to facility or property disruptions or shutdowns;
- losses associated with temporary decreases in work volume;
- expenses related to underutilized personnel; and
- facility closing costs.

Without a specific definition for these terms under IFRS, such widely-drafted provisions may well allow a company to add back COVID-19 losses, costs, and expenses.

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<sup>1</sup> Like EBITDA, Consolidated Net Income itself is typically increased by a litany of addbacks and decreased by certain specified exclusions.

<sup>2</sup> [IAS 1](#), the International Accounting Board’s standard on presentation of financial statements, prohibits companies from presenting extraordinary items in its financial statements or notes. Similarly, in 2015 the Financial Accounting Standards Board [eliminated](#) the concept of extraordinary items from US GAAP reporting.

Depending on the amount of EBITDA addbacks, it is possible that a company whose actual cash flows have been dramatically affected by COVID-19 could nonetheless maintain or even increase its capacity for incremental debt, dividends, investments, and junior debt prepayments under bonds and loans, as well as avoiding a breach of financial covenants (subject to meeting any applicable springing threshold) under its loans, if any. We will be watching with interest as European companies report EBITDA over the weeks and months to come.

— *Covenant Review*

**Disclosures**

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