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Will EBITDA Become Infected by a Coronavirus Addback?

The Bottom Line:™

- Global financial markets are reeling in the wake of the coronavirus outbreak.
- Although the travel industry is the hardest hit U.S. sector to date, the impact of the global coronavirus outbreak is expected to be widespread across many industries.
- In this report, we examine whether current documentation would allow issuers to make coronavirus-related adjustments to EBITDA.
- We also describe a novel addback that could be used for coronavirus-related adjustments.

Overview

Global financial markets are reeling in the wake of the COVID-19 coronavirus ("Coronavirus") outbreak.[1] Although the travel industry is the hardest hit U.S. sector to date, the impact of a global coronavirus outbreak is expected to be widespread across many industries. In this report, we examine whether issuers can make adjustments to EBITDA based on coronavirus-related losses. We also describe a novel addback for adjustments based on lost earnings from non-recurring events, potentially including the Coronavirus outbreak.

The impact of a global Coronavirus outbreak

A global Coronavirus outbreak will have widespread consequences. Fitch Ratings notes that "[s]ome U.S. corporate sectors are more vulnerable to disruptions caused by the global reach of the coronavirus (COVID-19) and the effects on U.S. leveraged loan issuers and subsequently CLOs depend on companies' exposure to these dynamics . . . US energy, metals and mining, airlines, travel services and gaming companies' cash flows are at greater risk relative to other sectors. Additionally, global supply chain disruptions could have lingering, rippling effects through a multitude of US corporate sectors, including industrials, homebuilding, retail, and technology."[2] Should the virus outbreak materially intensify in the U.S., additional sectors could be impacted to a greater degree than when the virus was predominately in APAC.[3]

How will a global Coronavirus outbreak affect high yield bonds and leveraged loans?

We are already seeing some near term effects of the global Coronavirus outbreak. Several companies with significant exposure have already announced a decrease in earnings since the onset of the outbreak in China. An earnings decrease has implications for leveraged finance issuers because EBITDA, the measure of earnings used in leveraged finance, is a building block of incurrence baskets for incremental secured debt, dividends, and prepayments of junior debt. Other uses

[1] See, e.g., Fed Slashes Interest Rates in Emergency Move as Coronavirus Fears Mount, New York Times, March 3, 2020.
[2] See, Fitch Ratings: Coronavirus Risk to US Leveraged Finance Issuers, CLOs.
[3] See Appendix A for additional commentary on the impact of the Coronavirus outbreak on travel-related companies. The content in Appendix A has been produced by our colleagues at Fitch Ratings.

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for EBITDA in leveraged loans include financial maintenance covenants (in the handful of broadly syndicated loans that have them) and step-downs in asset sale sweeps, excess cash flow sweeps, and pricing. Therefore, any ability to add back Coronavirus-related charges will benefit high yield issuers and leveraged loan borrowers with increased capacity for incremental secured debt, dividends, investments, and prepayments of junior debt. Meanwhile, depending on the size of the adjustments, leveraged loan borrowers will likely not be in default under their financial covenants and will possibly be able to retain more excess cash or asset sale proceeds, all at better pricing.

Two common EBITDA addbacks should be discussed. First the addback for "extraordinary, unusual, or non-recurring" charges and the like. Second, the addback for losses that will ultimately be compensated by business interruption insurance.

Let's look at each of these addbacks in turn:

The EBITDA addback for "extraordinary, unusual, or non-recurring charges"

Nearly every broadly syndicated institutional loan or high yield bond includes an addback for "extraordinary, unusual, or non-recurring" charges (or an addback with similar language).[4] This addback is typically uncapped in high yield bonds and broadly syndicated institutional loans, but sometimes capped in middle market and private lending deals. Here is an example of this provision:

> "Consolidated EBITDA" means, with respect to any Person for any period, the Consolidated Net Income of such Person for such period:
>
> (1) increased (without duplication) by:…
>
> (g) any extraordinary, unusual, infrequently occurring or nonrecurring loss, charge or expense . . .

We think issuers and borrowers can make a reasonable argument that charges related to a pandemic could be characterized as "extraordinary, unusual, or non-recurring" and that Coronavirus-related **charges** can be added back to EBITDA.[5] Examples of charges include refunds issued for cancelled travel bookings, costs incurred with respect to temporarily closed factories, and fines imposed by counterparties for missing deadlines.

Notably, the scope of the addback is typically limited to losses, charges, and expenses. We think it does not include lost earnings.[6] This is an important distinction.

The EBITDA addback for losses covered by business interruption insurance

Many (but not all) high yield bonds and leveraged loans allow adjustments for losses covered by business interruption insurance. Here is an example:

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[4] This item is sometimes included as an addback to consolidated net income. The effect on EBITDA is the same since EBITDA is typically defined as consolidated net income before interest, taxes or depreciation, plus the specified addbacks.

[5] The SEC's Regulation G prohibits EBITDA adjustments when the "nature of the charge or gain is such that it is reasonably likely to recur within two years" or if there was a similar charge within the prior two years. See Regulation G, Conditions for Use of Non-GAAP Financial Measures.

[6] Almost every high yield indenture and leveraged loan agreement includes a provision stating that accounting terms are used with the meanings given under GAAP. The question of what constitutes a "loss" is therefore beyond the scope of this report.

> "Consolidated EBITDA" means, with respect to any Person for any period, the Consolidated Net Income of such Person for such period:
>
> (1) increased (without duplication) by:…
>
> (m) losses covered by or reasonably expected to be covered by business interruption insurance . . .

This addback has a high hurdle—the relevant issuer can take advantage of this only if the insurance policy has paid out or if there is a reasonable expectation that it will pay out. However, as noted by sister company Fitch Ratings, "most business interruption policy language requires some form of property damage for coverage to apply. Thus, an interruption of business activity, for example due to a factory shut down due to general government guidance for workers in a certain city to stay home, would likely not be covered."[7]

The Coronavirus EBITDA addback comes to market

Three things are inevitable in this world: death, taxes, and sponsor innovations in the leveraged finance market. So we were not surprised to see the following provision in a private middle market sponsored loan that closed at the beginning of this month.[8]

> (10) (i) pro forma "run-rate" cost savings, operating expense reductions, operating improvements and synergies (e.g., pricing increases, prospective RIFs, etc., whether or not yet implemented) (the "**Cost Savings**") that result from, or that are projected by Borrower in good faith and certified by a Responsible Officer of Borrower in writing to result from, the Related Transactions, Acquisitions, Dispositions, recapitalizations and other specified transactions, operating improvements or changes, restructurings, cost savings, operating expense reductions, operating improvements and synergies and similar initiatives, plans or other actions taken, committed to be taken or planned or expected to be taken within 18 months of the end of the measurement period, and
>
> (ii) **lost earnings** due to non-recurring events (e.g., lost EBITDA arising from lost revenue due to a hurricane, polar vortex, fire, other natural disaster, etc.);
>
> *provided* that a Responsible Officer of Borrower shall have provided a reasonably detailed statement or schedule of such Cost Savings **or lost earnings**, as applicable, and shall have certified to the Lenders by the chief financial officer (or other similar officer) that
>
> > (w) in respect of clause (ii) only, any amounts added back in respect of **lost earnings due to non-recurring events** (e.g., lost EBITDA arising from lost revenue due to a hurricane, polar vortex, fire, other natural disaster, etc.) shall not exceed an amount equal to 7.5% of EBITDA (calculated after giving effect to this clause (10)) in the aggregate for any LTM Period **less any income from business interruption insurance** received during the applicable measurement period,
> >
> > (x) in respect of clause (i) only, such Cost Savings are reasonably identifiable, factually supportable and reasonably attributable to the actions specified and reasonably anticipated to result from such actions,

[7] See Fitch Ratings: COVID-19 to Have Modest Impact on U.S. Property/Casualty Companies.
[8] We've broken the language into blocks for ease of reading.

> (y) in respect of clause (i) only, such actions have been taken and are ongoing (or have been committed to be taken or are expected to be taken) and the benefits resulting therefrom are anticipated by Borrower to be realized within 18 months of the end of such measurement period and
>
> (z) in respect of clauses (i) and (ii), the aggregate amount of Cost Savings and lost earnings added back pursuant to this clause (10), when taken together with the amount added back pursuant to clause (9) above and clauses (20) and (32) below, shall not exceed an amount equal to 25% of EBITDA (calculated after giving effect to such addbacks) in the aggregate for any LTM Period . . .[emphasis added]

This provision can be boiled down as follows: lost earnings due to a non-recurring event can be added back to EBITDA subject to a cap set at 7.5% of EBITDA and, together with pro forma synergies / "run rate" cost savings a joint cap set at 25% of EBITDA (in each case after giving effect to such adjustments), if set forth in a reasonably detailed statement and certified by a responsible officer of the borrower.

Thus, if the Coronavirus outbreak qualifies as a non-recurring event, and we think it very possibly would, then the borrower can add back Coronavirus-related lost earnings, subject to the caps. Notice that the addback does not specifically refer to the Coronavirus outbreak or even specifically refer to an epidemic. However, the absence of such specific references does not mean that Coronavirus-related adjustments cannot be made under the addback. That's because the specific items listed only provide examples of what fits within the addback. The list is only illustrative. It is not exhaustive.

Nonetheless, we think that if the intention behind this novel provision was indeed to allow for Coronavirus-related adjustments, then a forthright draftsman would have included specific references either to the Corona outbreak or to epidemics in general. If the aim was instead to hide the ball, then using a non-exhaustive list, and leaving those specific references out, was a good way to do that.

We think this addback is problematic for several reasons.

First, and most importantly, if the addback is meant to relate to the Coronavirus, it is not closely tailored to achieve that end. Rather, it can be used in the case of any non-recurring event whatsoever. Second, there is no requirement that the lost earnings be "reasonably identifiable, factually supportable or reasonably attributable" to the non-recurring event. That standard only applies to the addback for pro forma synergies / "run-rate" cost savings. Third, lost earnings are inherently difficult to quantify, leaving room for borrower manipulation. Fourth, although capped at a relatively conservative level, the cap is calculated after giving effect to the adjustments.[9]

On top of the problems with this particular provision, the concept of an addback for lost earnings due to a non-recurring event is inherently problematic. This addback could allow the borrower to incur incremental secured debt and make dividends, investments, and prepayments of junior debt using leverage or coverage ratio incurrence tests with EBITDA as the denominator or numerator, respectively. This potential dilution of existing creditors and leakage from the credit could happen when the issuer or borrower is in financial distress due to the Coronavirus outbreak (or some other non-recurring event), thereby facilitating coercive restructurings.

[9] See our report The Algebra of EBITDA Adjustment Caps for more details on why this calculation is problematic.

We urge our subscribers to resist this latest sponsor innovation as it will only get worse. Moreover, if a global Coronavirus outbreak causes a financial downturn, deals with this type of EBITDA addback might leave investors without protections at the most critical point in time.

— *Covenant Review*

Appendix A

Disruptions Are Nature of Operations for Travel-Oriented Companies

Operational disruption caused by idiosyncratic risks, such as disease, terrorism, and weather are perennial risks that travel-related companies face. Publicly-traded companies in the cruise, online travel, and global distribution system (GDS) industries generally do not report extraordinary/unusual/non-recurring charges from these events in statements, nor add them back in reconciliation tables of GAAP to Non-GAAP metrics. However, some will provide guidance on impacts to certain metrics in earnings releases or earnings calls for investors to use at their discretion when comparing performance over time. Many also do not have defined EBITDA add backs for travel disruptions in debt documents, while others have covenants that are not tied to a cash flow definition (ex. lien basket based off percentage of total assets or debt carve-out for an defined dollar amount).

Sabre GLBL, a global GDS company, has a provision in its credit agreement for financial maintenance covenant suspension should travel disruption occur. If "Material Travel Event Disruption" occur, defined as a decrease in 10% or more in the number of domestic revenue passenger enplanements (based of Air Traffic Statistics), then the total net leverage financial covenant gets suspended. In addition, should the disruption trigger occur and Sabre not be in compliance with the leverage covenant (had it not been suspended), limitations are placed on RPs, acquisitions, and investments. Incorporating travel disruptions into documentation via temporary covenant suspension limits the potential for inflated EBITDA or other financial metrics from disruption expense add-backs.

Most cruise operators have investment grade covenants, but Norwegian Cruise Line Holdings has a more traditional high yield capital structure and its credit agreement includes the potential for expense add backs, versus Sabre's covenant suspension approach. There are no disruption/event triggers, but 'Consolidated Net Income' can exclude any net after tax extraordinary, nonrecurring, or unusual expense or charge (the EBITDA definition is built off of CNI). While GAAP accounting does not permit the add back of revenue that was never sold, there is potential for travel companies to try and add back certain costs associated with coronavirus, though historically this has not been common practice from idiosyncratic events. Norwegian's 2019 EBITDA reconciliation table in its 10-K includes an addback to Adjusted EBITDA for the redeployment of Norwegian Joy, a ship that was moved from China to Alaska for commercial reason, not travel disruption.

Sample of Travel Company Disruption Impact Disclosures

Company	Sector	Event	Time Period	Metric	Estimated Impact	Source
Expedia Group, Inc.	OTA	Paris Terrorist Attacks	Fourth-quarter 2015	EBITDA	$10 million - $15 million	Press Release
Sabre GLBL	GDS	Coronavirus	First-quarter 2020	EBITDA	$80 million - $100 million	Press Release
Royal Caribbean Cruises Ltd.	Cruise	Weather, Cuba cancellations & drydock incident	Full-year 2019	EPS	$0.80	10-K
		Coronavirus	First-quarter 2020	EPS	$0.65	Press Release

Source: Fitch Ratings, company filings.

OTA - online travel agency. GDS - Global distribution system

For any questions on the above travel company related topics, please contact Colin Mansfield, CFA – Director of Corporate Ratings at Fitch Ratings (1-212-908-0899, colin.mansfield@fitchratings.com).

Disclosures

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