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Adjusting EBITDA in the light of Covid-19; can losses be treated as an addback?

In light of the Covid-19 pandemic, one key metric in debt agreements particularly at stake is EBITDA, not only for the purpose of evaluating financial covenants compliance, but also, and especially in the cov-lite environment, for assessing ratio-based permissions, such as permitted acquisitions, payments, debt incurrence and other baskets.

In order to mitigate the decline of their EBITDA, one overarching issue for many companies is to thoroughly analyze the definition of EBITDA as contained in their facilities agreement in order to determine the add-backs they are entitled to, and whether costs and losses of revenues related to the pandemic may qualify as such.

The distinction between costs and losses is key here; costs are to an extent, relatively simple to identify (as cash out the door); losses, however, are potentially more tricky to quantify, because both revenues and costs need to be determined first. For some businesses, even though their revenues have taken a hit, if so do their costs, then the overall impact on losses will fade away. In any event, there is so much room for both subjectivity and debate here.

LMA based loan agreements will specifically have a concept of "exceptional, one off, non-recurring or extraordinary items", included as an add-back to EBITDA, that can provide flexibility to add-back items that otherwise do not fit into any other specific add-back in the definition of EBITDA, and leave room for interpretation, subject of course to the drafting of that provision in the specific loan agreement. Some borrowers may seek to argue that revenue shortfalls and other losses resulting from Covid-19 should altogether be treated as an exceptional item as the global pandemic is unusual, and, hopefully, non-recurring.

There might be another adjustment that borrowers may consider; in recent years, "shock" adjustment concept has been included in some loan agreements to offer one-off relief to borrowers in the testing of compliance with financial covenants. Historically these types of adjustments were included as a response to potential terrorism-related concerns for certain types of business, but consideration should be given to whether the drafting of such provisions may just be broad enough to cover a pandemic of this type and encompass related losses.

It is therefore of paramount importance to go carefully through each EBITDA definition, as the devil is often in the details of each individual definition, to determine how much leverage the borrowers may have to add-back losses to EBITDA in the actual circumstances; it's a safe bet to say that it will be a lively debate with pressure on the different lenders (banks, funds) to consider so, even if potentially at their disadvantage.

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