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Contents WINTER 2019 / 2020

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Financial Definitions in **High-Yield Indentures**

The defined terms in any agreement are considered as the building blocks upon which the rest of the agreement is based, particularly when it comes to the negative covenants in a bond indenture.

THIS ARTICLE WILL INTRODUCE A FEW KEY FINANCIAL definitions found in high-yield indentures, with a particular focus on how they are derived from the income statement and used in the negative covenants. It will flag certain items within the financial definitions that company and underwriter's counsel often focus on as they review and negotiate the negative covenants in the typical high-yield indenture. Finally, it will discuss generally accepted accounting principles (GAAP) and the manner in which high-yield indentures typically regulate the issuer's accounting principles. This short introduction should not be considered a substitute for the careful review of proposed defined terms and their use in an indenture's covenants as these provisions are often extensively negotiated.

A typical high-yield bond indenture will include a suite of customary incurrence-based negative covenants. At a very high level, these negative covenants are intended to limit the ability of the issuer, the guarantors, and their restricted subsidiaries to engage in conduct that could potentially impair the issuer's ability to pay its interest and principal obligations in respect of the bonds. In order to provide the issuer with the flexibility to operate (and potentially grow) its business within the constraints of the negative covenants, the company and its counsel will negotiate with the underwriters and their counsel certain baskets and exceptions to each of the negative covenants. Given this article's focus on financial definitions, the discussion will be limited to how the financial definitions interact with the negative covenants governing the incurrence

of debt and liens, as well as those governing the making of dividends, other restricted payments, and investments.

Consolidated Net Income

The calculation of consolidated net income starts with GAAP net income (or loss) of a company and its subsidiaries whose actions are restricted by the indenture (the Restricted Group). Net income as set forth on the income statement is the difference between two primary figures: (1) revenue and (2) the combination of costs and expenses. Although GAAP net income is a useful metric for evaluating a company's performance, companies prefer to present, and investors find it useful to review, other metrics that are intended to more closely approximate the usual and ordinary ongoing performance of the business. One such metric is Consolidated Net Income (CNI).

CNI has two principal uses in a high-yield bond indenture. First, it is the primary component of the builder basket in the restricted payments covenant. Under this basket, the issuer accrues additional capacity to make dividends, restricted payments, and investments based on a percentage (almost uniformly 50%) of the issuer's CNI, as reported in its quarterly and annual financial statements. The second use of CNI in a bond indenture is as the starting point for the calculation of earnings before interest, taxes, depreciation, and amortization (EBITDA), which is used primarily in the covenants limiting the incurrence of debt and liens.

In order to calculate CNI, GAAP net income is adjusted to include or exclude certain items. Although the adjustments vary from deal-to-deal, adjustments to net income generally fit into one of three types: (1) control adjustments, (2) normalizing adjustments, or (3) deal-specific adjustments.

Control Adjustments

In making control adjustments to GAAP net income, the intent is to eliminate the net income (or loss) of persons other than the issuer and its subsidiaries that make up the Restricted Group. These adjustments are made to ensure that consolidated net income (or loss) is not impacted by the income (or loss) of unrestricted subsidiaries and non-subsidiaries that are not bound by the indenture covenants.

Additionally, control adjustments are made to exclude items to which the issuer and guarantors (the Credit Group) do not have ready access. Therefore, net income from entities in which any member of the Credit Group has a minority interest is excluded from CNI even if it would otherwise be included in a calculation of GAAP net income. Similarly, when calculating CNI for purposes of the builder basket in the restricted payments covenant, the net income of a restricted subsidiary of the issuer that is not a guarantor is excluded to the extent that the income of such subsidiary is unable to be distributed to an entity within the Credit Group, whether by contract, law, or otherwise. Notably, the net loss of any such subsidiary is typically not excluded from the calculation. The reasoning is that, even though the issuer is unable to access the net income of such subsidiary, the issuer should not be insulated from such subsidiary's losses given that under a typical high-yield indenture, an issuer retains substantial capacity to make investments in restricted subsidiaries that are not guarantors. Importantly, if a member of the Restricted Group actually receives cash dividends from an unrestricted subsidiary or a non-subsidiary, that amount is added back to CNI in order to fairly reflect the value of the Restricted Group.

Normalizing Adjustments

The intent in adjusting GAAP net income for normalizing adjustments is to remove those financial statement items that are not considered to be reflective of the ongoing daily operations of the issuer. Normalizing adjustments may include:

- Adjustments for after-tax nonrecurring, unusual, or extraordinary gains, losses, income, expenses, or charges
- One-time gains or losses
- Noncash impairment charges
- Unrealized gains or losses from hedging activities
- Effects of purchase accounting adjustments or changes in accounting practices
- Infrequent or nonrecurring business expenses
- Transaction fees or expenses for financing or mergers and acquisition activities
- Income (or loss) from nonoperating assets (e.g., discontinued operations)
- Other similar (and often heavily negotiated) items

Negotiating normalizing adjustments to CNI often entails gaining a good understanding of the issuer's business, as the goal of including such adjustments (both positive and negative) is to reflect the performance of an issuer's ongoing ordinary-course business operations. Practitioners should be careful to understand specific items proposed to be considered nonrecurring, unusual, or extraordinary, particularly when an item (e.g., public company costs or human resources costs) has appeared in the financial statements on a regular basis in the past or is expected to appear on a regular basis in the future.

Frequently, gains from asset sales are excluded from the calculation of CNI, so that the disposition of an income-generating asset does not build the restricted payments basket and enable the issuer to pay dividends. Similarly, losses from asset sales may be excluded from CNI, although in some cases such losses are not excluded, given that the asset base of the issuer has been reduced.

Deal-Specific Adjustments

It is not uncommon for an issuer to seek adjustments and add-backs to the definition of CNI that are specific to that issuer. It is important to understand why an issuer would want a particular adjustment included in CNI and the implications of that adjustment. For example, an adjustment to CNI would affect the amount of restricted payments that the issuer could make through the builder basket. While the extent and range of additional adjustments will vary from deal to deal, issuers often seek adjustments for noncash compensation expenses and certain other cash items such as net pension or other post-employment benefit costs, the costs associated with becoming a public company or earn-out obligations, and purchase price adjustments.

Another important EBITDA adjustment typically included in a high-yield indenture will allow an issuer to include the EBITDA of an acquired business in the calculation of Consolidated EBITDA as if the acquisition of that business had been consummated as of the first day of the relevant financial reporting period.

Consolidated EBITDA

Another financial definition common in high-yield indentures is Consolidated EBITDA. Although EBITDA is not defined under GAAP, the interest, taxes, depreciation, and amortization components can be derived from an issuer's income statement without too much difficulty. Consolidated EBITDA is intended to measure the operating cash flow of a company's ordinary-course business in order to assess the issuer's ability to service debt on a run-rate or recurring basis. The starting point for calculating Consolidated EBITDA (sometimes referred to as consolidated cash flow) is CNI.

As mentioned above, the primary use for Consolidated EBITDA is in the calculation of the performance-based ratios that govern when an issuer can take certain restricted actions, such as incurring debt or liens, paying dividends, or making investments. These covenants rely on either meeting or exceeding a fixed charge coverage ratio or not exceeding a specified leverage ratio in order to take the desired action. Consolidated EBITDA is used in the numerator when calculating the fixed charge coverage ratio and the denominator when calculating the leverage ratio. The calculation of Consolidated EBITDA is therefore of central importance to the issuer and bondholders, as a greater Consolidated EBITDA will make it easier for the issuer to satisfy its fixed charge coverage and/or leverage ratios for purposes of those covenants. Additionally, certain exceptions to the covenants limiting the incurrence of debt, liens, restricted payments, and investments may also include a Consolidated EBITDA-based grower component, which gives the issuer the ability to benefit from any improvements in the performance of its business by increasing capacity under those baskets.

Complexity arises in the definition of Consolidated EBITDA, however, as adjustments, add-backs, and carve-outs to EBITDA are introduced. Issuers will seek to reverse many of the normalizing adjustments to CNI and to add back all other noncash items that reduce CNI. Another category of EBITDA adjustments is exceptional or one-time costs. Although the premise behind these add-backs is that adjusting for exceptional or one-time costs more accurately reflects the operating cash flow of the underlying business, these add-backs should be fully understood in order to ensure that they are not overly inclusive. Examples of add-backs of this nature include adjustments for restructuring charges or expenses, management, consulting and advisory fees, and expenses paid to sponsor private equity owners.

The adjustment to Consolidated EBITDA that gets the most attention and requires the most skill in negotiating is the add-back for run-rate cost savings, business optimization expenses, or synergies. Broadly, this add-back allows an issuer to adjust EBITDA for the anticipated financial impact of certain specified planned actions or business changes. These savings could include those related to a reduction in the company's workforce, an operating improvement or business initiative, or perhaps the closure of a business unit. This add-back to Consolidated EBITDA is calculated on a pro forma basis, assuming the underlying action has already taken place even if it may not occur for quite some time. Accordingly, the issuer will be allowed to adjust for those actions that have either already been taken, or are expected to be taken or committed to be taken within a specified period of time (often 12 or 18 months, but sometimes longer) after the current financial reporting period. In addition, this EBITDA add-back may only permit adjustment for those cost savings or synergies that are actually realized during the relevant period of time or potentially for cost savings or synergies that are projected in good faith to be realized before a specific date. To mitigate the prospect of pure conjecture, the cost savings and synergies are required to be reasonably identifiable and factually supportable and, in many indentures, require a written certification regarding their accuracy from an officer of the issuer. The aggregate amount of adjustments pursuant to a cost-savings or synergies add-back is typically subject to an aggregate maximum amount, or cap, for the applicable reporting period, calculated based either on a dollar amount or on a percentage of Consolidated EBITDA (typically calculated prior to giving effect to the cost-savings adjustments).

Another important EBITDA adjustment typically included in a high-yield indenture will allow an issuer to include the EBITDA of an acquired business in the calculation of Consolidated EBITDA as if the acquisition of that business had

been consummated as of the first day of the relevant financial reporting period.

Consolidated Interest Expense and Consolidated Fixed Charges

Another income statement item that is important in high-yield indentures is consolidated interest expense, which is both a component of consolidated fixed charges (the denominator for the fixed charge coverage ratio) and an adjustment to Consolidated EBITDA. Interest expense is a nonoperating expense included on the income statement that represents interest payable on the issuer's debt instruments. Under GAAP, interest expense is the cost of the funds that have been loaned to a company. Interest expense on the income statement represents the accrued interest liability during the relevant financial reporting period.

Under the typical high-yield indenture, the calculation of consolidated interest expense starts with GAAP interest expense, which is then adjusted to include consolidated capitalized interest, the interest component of capitalized lease obligations, and certain other items, including amortization of original issue discount. Certain other items that are treated as interest expense under GAAP, such as administrative agency fees, noncash interest expense (e.g., paid-in-kind interest), and additional interest attributable to registration rights obligations are then excluded. In order to calculate consolidated fixed charges from interest expense, an issuer will also adjust for net payments and receipts pursuant to interest rate hedging obligations. This adjustment is common because issuers with variable rate debt (such as London Interbank Offered Rate- or Secured Overnight Financing Rate-based term loans or floating rate bonds) will customarily enter into hedge agreements or swaps in order to protect against a potential increase in interest rates (and the associated impact on their interest expense).

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For a discussion of the market trends and outlook for high-yield debt offerings, see

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For a general overview of debt securities, see

> CORPORATE DEBT SECURITIES IN U.S. CAPITAL MARKETS

RESEARCH PATH: *Capital Markets & Corporate Governance > Debt Securities Offerings > Rule 144A/ Regulation S Debt Offerings > Practice Notes*

Consolidated interest expense is also typically calculated net of any interest income earned during such period on the reasoning that if any cash interest was received it would be applied to reduce the company's interest expense burden.

Accounting Principles in Indentures

Given that there is so much reliance on the income statement for the financial definitions, the typical high-yield indenture will specify the accounting principles that apply when interpreting the indenture. U.S. issuers typically will prepare their financial statements in accordance with U.S. GAAP. Certain issuers that are either foreign or have substantial overseas operations will adopt the International Financial Reporting Standards (IFRS). The standard approach in high-yield indentures is to adopt the auditing and reporting standards in effect on the date the notes are issued, at least for purposes of the negative covenants. Although GAAP (or IFRS) is typically fixed at issuance for purposes of the negative covenants, many indentures will permit the company to prepare its financial statements in accordance with GAAP (or IFRS) as in effect from time to time, given that the accounting rules require financial statements to reflect the then-current GAAP.

There are two relatively recent exceptions to having a uniform set of accounting principles in an indenture. First, certain indentures provide issuers with the flexibility to switch the agreed-upon accounting principles in the indenture from GAAP to IFRS, assuming that they are also switching the accounting principles for their financial statements from GAAP to IFRS. The indenture will provide that once this switch has been made, it is irrevocable. Second, a handful of recent indentures permit issuers to convert, by written notice to the trustee, the accounting principles for purposes of the indenture from GAAP (or IFRS) as of the issue date to a version of GAAP (or IFRS) as of the date the notice is given. Some of these indentures will also permit issuers to exclude certain accounting changes that were adopted between the issue date and the date the issuer opted to switch to the current version of the accounting principles, so long as they clearly identify the changes to the accounting principles that are being excluded. As with a conversion from GAAP to IFRS, any switch to a more recent version of GAAP is also irrevocable. L

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