DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

Negotiating Debt Agreements

Understand | Integrate | Collaborate | Mitigate | Manage

Jeff Wallace
Managing Director
Debt Compliance Services

Jim Simpson
Managing Director
Debt Compliance Services

www.debtcompliance.com
© 2019 Debt Compliance Services LLC

Presentation Topics

- Introduction
- Setting up the negotiations
- Understanding default risk
- Minimizing default risk
- Minimizing the consequences of default
- Summary of recommendations
- Post-closing negotiations
- Q&A
- About Debt Compliance Services

© 2019 Debt Compliance Services LLC

Introduction

- Too often, borrowers focus their negotiating on just maintaining the term sheet
- **However, default risk increases significantly by year 3,** when the glossed-over covenants can lead to covenant violations and:
  - Waiver fees
  - Higher spreads and rates
  - More onerous covenants
  - Lower stock price
- **Your primary negotiating objective must be to minimize the probability of a default over the life of the agreement**
  - Maintain lender confidence and goodwill by being upfront about your issues
  - **If** you do your homework, your lenders will help you
  - Debt compliance begins with the negotiations

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Minimizing Long-Term Default Risk

- Negotiating a realistic covenant package requires understanding
  - The impact of similar covenants in your other debt
  - Your operating risks by covenant
  - Your ability to comply
- You need to know the compliance realities for departments outside Treasury, such as Legal, Accounting, Operations, EH&S, HR, etc.
  - Particularly their willingness to **monitor, report and forecast** covenant occurrences in their areas of responsibility
- If they cannot adequately comply, then be upfront with your lenders
  - **Never agree to something you don't think you can do**

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Presentation Topics

- Introduction
- **Setting up the negotiations**
- Understanding default risk
- Minimizing default risk
- Minimizing the consequences of default
- Summary of recommendations
- Post-closing negotiations
- Q&A
- About Debt Compliance Services

© 2019 Debt Compliance Services LLC

Outside Resources

You negotiate debt agreements against professionals who have the best lawyers your money can buy, so even the odds by:

- Insisting that your outside counsel is a top 10 national law firm
- Getting a private rating if you are unrated so that you are dealing with facts about your credit rating
- Subscribing to Thompson/Reuters' LoanConnector*
  - See a demo to find out where your lenders go for market pricing by credit rating, financial covenants, sign up for deals, etc.

* https://www.loanpricing.com/products/loanconnectordealscan/

© 2019 Debt Compliance Services LLC

Structuring the Deal Team

- Assign negotiating responsibilities between Treasury and Legal
- Treasury's responsibilities should include:
  - Overall deal structure
  - Rates, fees and financial ratio realities
  - Restrictions on the business operations
  - Basket limits vis-à-vis business requirements
  - Timing of reporting, notices, and cure periods
- Treasury and Legal are both responsible if there is a Depositary Agreement
- Legal should be responsible for:
  - Overall agreement wording
  - Events of Default, Reps & Warranties, Conditions for Closing, Indemnities, and other ancillary transaction documents

© 2019 Debt Compliance Services LLC

Use a Deal Document

- The first thing your lender's lawyers will do is read your other existing agreements and highlight the critical covenants
- A deal document helps you maintain your priorities by
  - Tracking the progress of your negotiations
  - Showing how your new debt's conditions compare with existing debt
- An effective deal document has four major sections:
  - Changes from the accepted term sheet
  - Comparison of the new debt's major covenants, defined terms, knowledge, notice, thresholds, limits, etc. against comparable terms in your existing debt and, if applicable, the debt that is being refinanced
  - Listing of the closing conditions, closing reps and warranties, continuing reps and warranties, and post-closing covenants
  - Analysis of your financial ratios against scenarios and stress testing.
- It can be easily edited to explain the deal to your CFO, CEO, and Board
- Our DCS Deal Document Template.docx is included with this presentation

© 2019 Debt Compliance Services LLC

Rating Agency Considerations

- Since rating agencies will review your debt agreements, you need to consider how they will judge what you have negotiated
  - Said another way, your lenders make credit evaluations of your company and their evaluations are considered in the rating agencies' evaluations
  - As do your lenders, the rating agencies will evaluate all of your debt agreements together for your unique controlling covenants
- Agreements with these characteristics can negatively affect your rating:
  - An excessive number of covenants
  - Unwarranted concessions on key covenants, especially ratios
  - The frequency that your agreements are amended and the types of amendments made
- These rating agency considerations are another justification for a private rating if you don't have one, buying the Loan Connector, and using a deal document

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

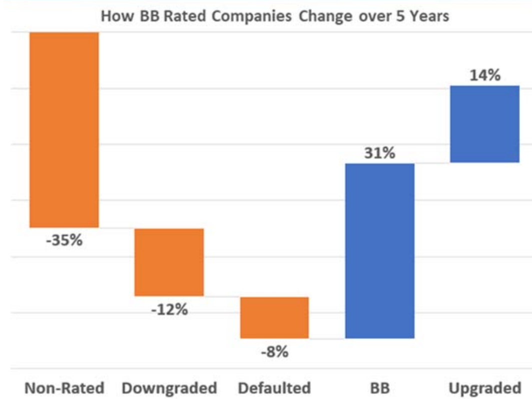
Presentation Topics

- Introduction
- Setting up the negotiations
- **Understanding default risk**
- Minimizing default risk
- Minimizing the consequences of default
- Summary of recommendations
- Post-closing negotiations
- Q&A
- About Debt Compliance Services

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

16% of BB-Rated Companies Default within 5 Years

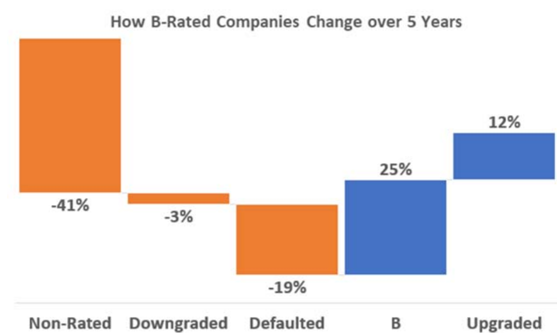


- Source: S&P's 2018 Transition Analysis
- (Hard) Default = missed payment, distressed debt exchange, or bankruptcy filing
- 35% of BBs become non-rated for many reasons, mostly bad

- 4x as many companies declined (55%) versus improved (14%)
- After 5 years, if 8% of BB's had a hard default, then at least another 8% must have had some kind of technical default, 16% in total

© 2019 Debt Compliance Services LLC

38% of B-Rated Companies Default within 5 Years

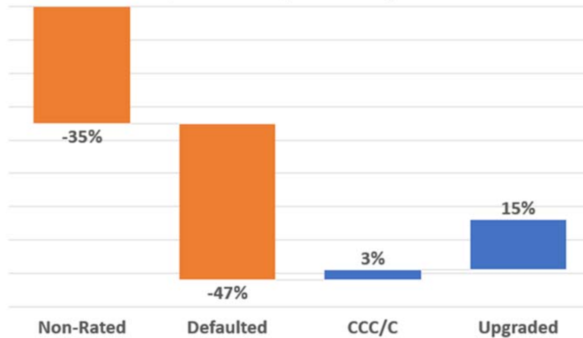


- Source: S&P's 2018 Transition Analysis
- (Hard) Default = missed payment, distressed debt exchange, or a bankruptcy filing
- Companies become non-rated for many reasons, mostly bad

- 5x as many companies declined (63%) versus improved (12%)
- After 5 years, if 19% of the Bs had a hard default, then it is likely that additional 19% must have had some kind of technical default, 38% in total

© 2019 Debt Compliance Services LLC

60% of CCC/C-Rated Companies Default within 5 Years



- Source: S&P's 2018 Transition Analysis
- Default = missed payment, distressed debt exchange, or a bankruptcy filing
- Companies become non-rated for many reasons, mostly bad

- 5.5x as many companies declined (82%) versus improved (15%)
- After 5 years, if 47% had a hard default, then it is likely that additional the total default rated must be over 60%

 © 2019 Debt Compliance Services LLC

Three Different Default Risks

- Cash flow and adverse event risks are best managed in your negotiations as they are inherently beyond treasury's ability to minimize after they are negotiated

Cash Flow Defaults
- Broken ratios
- Missed payments

Event Defaults
- Material Adverse Events

- Technical default are all other covenants. **Technical default risk is 100% controllable: there's no excuse for a technical default**

Technical Defaults
- Failure to report an event
- Permitted baskets
- Cross default on the related ancillary documents
- Continuing reps and warranties

Technical Defaults (cont'd)
- Invalidity of collateral, liens and other security documents
- Affirmative covenants
- Negative covenants
- Compliance reporting

 © 2019 Debt Compliance Services LLC

Presentation Topics

- Introduction
- Setting up the negotiations
- Understanding default risk
- **Minimizing default risk**
- Minimizing the consequences of default
- Summary of recommendations
- Post-closing negotiations
- Q&A
- About Debt Compliance Services

 © 2019 Debt Compliance Services LLC

Minimizing Cash Flow Default Risk

- Do not just haircut FP&A forecasts or the earnings guidance
- Instead, have FP&A develop 3 long-term P&L and cash flow scenarios assuming:
  - An industry downturn
  - A company downturn, and
  - A conservatively optimistic one
- Apply these scenarios against your ratios and:
  - Negotiate carve-outs to your EBITDA, Indebtedness, etc. ratio definitions to minimize breaking them
  - Stress-test them to see how much leeway you have
- If payments are a risk, apply these scenarios against **all** of your agreements' P&I payments

 © 2019 Debt Compliance Services LLC

Minimizing Event Default Risk

- Event risk comes in two flavors:
  - The event is a MAE that by definition is an Event of Default
  - Where the failure to report an event is an Event of Default
- Manage MAE risk by negotiating the tightest MAE definition you can, which is admittedly difficult
  - Always minimize the number of times the agreement has MAE language
- After "knowledge" of the event occurs, notice is required within a specified time period, so negotiate for:
  - The actual knowledge of a senior officer rather than the date the event actually happens
- Negotiate for "Notice" to be done "promptly" vs. 3-5 business days
- For an EoD event, the cure period clock starts after notice

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Minimizing Technical Default Risk

The specific language of any covenant must reflect the reality of the company's internal compliance capabilities and its financial situation.

1. If a company can not properly communicate its capabilities and financial situation, then the covenant is more likely to be violated
2. Share your internal compliance realities with your lenders so that they can be helpful in crafting easier compliance requirements
3. Defined terms, such as Cash, Indebtedness, Net Income, EBITDA, etc., must be carefully crafted to reflect the company's likely future reality
4. Similarly, thresholds and permitted basket limits need to provide the company sufficient flexibility but still provide lenders the comfort they need as the company changes its credit profile
5. Clarify covenants that are ambiguous or complex
6. **Covenant wording and requirements must always be compared to the other agreements**

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Critical Defined Terms

These defined terms are critical to managing your long-term compliance:

- **Permitted definitions:** Permitted Indebtedness, Liens, Investments, etc. provide a list of exceptions to prohibited activities
  - Negotiate enough exceptions to minimize needing consent for the likely volume of activity
- **Various Accounting Terms:** EBITDA, Indebtedness, Net Income, etc. often include negotiated carve-outs that may differ across agreements
  - Test definitions to make sure that you achieve the desired result
- **Restricted Payments:** This definition usually covers dividends, interco advances, fees and payments to subordinated indebtedness
- **Compare: Compare all similar definitions with other agreements**

© 2019 Debt Compliance Services LLC

Permitted Baskets

- Most negative covenants are accompanied by exceptions that can include lists of scheduled existing items, routine or required transactions, etc.
- Defined terms such as indebtedness, L/Cs, liens, investments, etc. will have exceptions with a dollar limit (a permitted basket)
- Unlike thresholds, a permitted basket limit is usually cumulative over the life of the agreement, can be very detailed, and can impact other baskets
- Negotiating these limits must reflect a compromise between the lender's need to have a say in future expanded activities and your ability to freely manage day-to-day business
- Can you setup the necessary processes to accurately monitor, manage and report on your basket and sub-basket items?

© 2019 Debt Compliance Services LLC

Thresholds

- Thresholds are used throughout the agreement, such as:
  - Notices
  - Judgments
  - Cross default
  - ERISA events
  - Environmental events
- Unlike permitted basket limits, thresholds are usually one-time events and are not aggregated
- Compare comparable thresholds in other agreements

© 2019 Debt Compliance Services LLC

Reps & Warranties

- Ensure that there is a clear distinction in the debt agreement between closing reps and warranties and continuing reps and warranties
- You will need to "re-rep" the continuing reps and warranties when you drawdown and rollover funds
- Negotiate minimizing the number of continuing reps and warranties
  - The more you have, the greater the risk that in times of economic or company distress, you cannot re-rep one of them – and suddenly you don't have liquidity under your revolver or CP
- Negotiate re-repping to only new drawdowns, not to rollovers

© 2019 Debt Compliance Services LLC

Presentation Topics

- Introduction
- Setting up the negotiations
- Understanding default risk
- Minimizing default risk
- **Minimizing the consequences of default**
- Summary of recommendations
- Post-closing negotiations
- Q&A
- About Debt Compliance Services

© 2019 Debt Compliance Services LLC

Events of Default

Understand how your covenants' cure periods are identified in the first six or so Events of Default sections:

Senior Credit Facility Event of Default Clauses	Cure Period
1. Principal payments, including Mandatory Prepayments	0-1 Days
2. Interest, fee and other required payments	0-3 Days
3. Reps & Warranties and incorrect reports, certificates, financial statements and other documents furnished	0 Days
4. Specifically identified covenants, such as maintenance, negative, reporting and notifications	0-5 Days
5. Invalidity of Credit or Security/Collateral Agreements	0 Days
6. All other covenants in a catch-all phrasing, which includes the affirmative covenants	30 – 60 Days

© 2019 Debt Compliance Services LLC

The Remaining EoDs are Covenants

They deal with specific events that do not appear elsewhere in the agreement and must be carefully negotiated:

Other Events of Default are:

- Cross default
- Cross acceleration
- Guarantors' default
- Voluntary/involuntary bankruptcy/insolvency
- Change of Control

Other Events of Defaults include:

- Judgments
- Cancellation of Material Contracts
- ERISA Events
- Governmental Actions
- Revocation of Licenses

Cure Periods

- Varies by specific default event, typically 0-5 or 10 **business** days

DEBT/COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Cure Periods

Cure Periods reflect the relative importance that the lender attaches to a particular covenant

- Clarify how "knowledge and notice" determines when an EoD actually begins
- If an EoD does not specify a cure period then it is zero days
- Negotiate increasing the Cure Period for each covenant
  - Try to increase zero day cure periods by at least one day
  - All short cure periods should be expressed as "Business Days"
- Compare the knowledge, notice, and cure periods against similar EoDs in your other agreements

DEBT/COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Amendments and Waivers

- Amendments and waivers are typically approved in three ways:
  1. The agent can unilaterally approve amendments reflecting corrections in wording and other minor issues
  2. A simple majority of the lenders, based on their dollar commitment, are required for amendments and waivers for breaches of covenants that are not considered critical
  3. A super majority (67%) is required for changes in the maintenance ratios, pricing and other serious covenant issues
- The company should attempt to negotiate as many of the covenants to either an agent acting unilaterally or to a simple majority
  - Your agent is your best friend, some of the other lenders, not so much

© 2019 Debt Compliance Services LLC

Presentation Topics

- Introduction
- Setting up the negotiations
- Understanding default risk
- Minimizing default risk
- Minimizing the default consequences
- **Summary of recommendations**
- Post-closing negotiations
- Q&A
- About Debt Compliance Services

© 2019 Debt Compliance Services LLC

For Investment Grade Companies

Investment grade companies should take advantage of their status by making the agreement easier to understand, easier to comply, and easier to manage:

1. Ensure that the hierarchy of the debt is reflected in the various covenants. In other words, make sure that the senior most agreement contains the strictest requirements so that similar covenants in the junior debt cannot trigger a default
2. Keep in mind that the junior debt may have some covenants unique to that type of agreement, so negotiate a long cure period for them
3. Reduce the number of covenants and allow for more flexibility
4. Negotiate basket limits that minimizes the frequency of have to go back to the lenders for consents
5. Increase the cure periods in the default section
6. Negotiate an amendment or waiver process that allows for more delegated power to the admin agent

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

For Speculative Grade Companies

1. It may be worthwhile to get a private rating for your company, especially if you don't believe what your banks are saying about your credit
2. Sign up for Thomson/Reuters Loan Connector so that you really understand what the market terms are for your credit
3. Make sure your outside counsel is a top 10 national law firm with extensive experience negotiating speculative grade debt
4. Really work FP&A to come up with three realistic P&L/Cash Flow scenarios assuming an industry downturn, a downturn due to specific company risks, and a conservatively optimistic one, with likely carveout items detail
5. Have FP&A/Treasury work together on developing appropriate carveouts for the 2 or 3 financial ratios you are likely to have
6. Fully use a deal document to fully understand the covenants of your other debt and whether they are going to be controlling on your new debt
7. Really understand whether your subject matter experts will do – or can be persuaded to do – a good job in monitoring and forecasting the covenant requirements in their areas of responsibility

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Presentation Topics

- Introduction
- Setting up the negotiations
- Understanding default risk
- Minimizing default risk
- Minimizing the consequences of default
- Summary of recommendations
- **Post-closing negotiations**
- About Debt Compliance Services

DEBT/COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Post-Closing Negotiations

- Negotiations do not stop with the closing because technical defaults can occur due to a misinterpretation of a covenant
- Interpretation issues arise from:
  - How exactly a covenant can be complied with
  - Poor, ambiguous or complicated wording
  - New situations not foreseen in the agreement
- When interpretations are agreed with your lenders, have them document the understanding with an email or letter
  - Saved and shared among Treasury and Legal
- Continue to maintain lender confidence and goodwill by being upfront about covenant issues
  - The objective always should be to not surprise your lenders
  - **And your CFO**

DEBT/COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Presentation Topics

- Introduction
- Setting up the negotiations
- Understanding default risk
- Minimizing default risk
- Minimizing the default consequences
- Summary of recommendations
- Post-closing negotiations
- **Q&A**
- About Debt Compliance Services

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

Q&A

Understand | Integrate | Collaborate | Mitigate | Manage

© 2019 Debt Compliance Services LLC

Presentation Topics

- Introduction
- Setting up the negotiations
- Understanding default risk
- Minimizing default risk
- Minimizing the default consequences
- Summary of recommendations
- Post-closing negotiations
- Q&A
- **About Debt Compliance Services**

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Why You Should Consider Using DCS

- A default damages a company's reputation, hits its stock price, increases interest, incurs legal and audit fees, and has GAAP and SOX consequences
- In our 11th year, we provide an automated, risk-based debt compliance process in the cloud that minimizes default risk by:
  - Identifying the covenants that must be managed quarterly or annually or when triggered by events or not at all
  - Documenting compliance by SMEs with our concise web questionnaires, training them on their covenant risks
  - Researching covenant issues quickly with our multi-agreement contextual search engine on hyperlinked debt agreement webpages
  - Ensuring all scheduled requirements are delivered on time with our web calendar process
- ASC 350-40 requires capitalizing our implementation fees

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

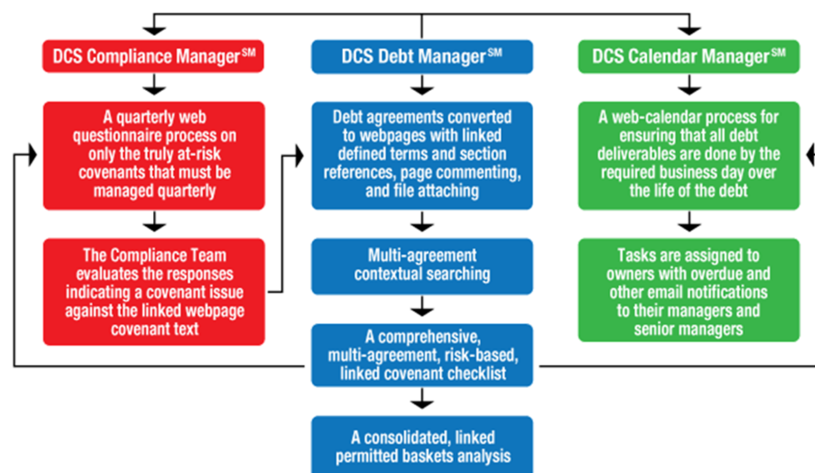
© 2019 Debt Compliance Services LLC

The Human Side of Debt Compliance

- With few tools and little corporate-wide support, debt compliance is the worst job in treasury
- It's demoralizing to have the responsibility for mistakes that can have grave consequences to the company and your career that you can do little to prevent or manage
- Our complete, automated, risk-based process makes the quarterly compliance simpler and easier
  - Transition risk to a new manager is low
  - It becomes a desirable rotating position because it teaches covenant risk, a critical skill for negotiating successful debt agreements

© 2019 Debt Compliance Services LLC

The DCS Covenant Manager℠ Solution



© 2019 Debt Compliance Services LLC

DCS Clients

Founded in 2009, we have over 30 clients, ranging from large public to private middle market companies, including:

- A power generator with $10B in debt and 7 projects
- Over 55 project financings of a PE firm's renewable energy portfolio
- A utility with $35B in debt with 8 project financings
- A midWest utility with $8.5B in debt with three separate holding companies
- Municipal Authority of Georgia, with $6B in debt
- A NY Power Authority with its power and servicing authorities
- RES Americas, a renewable energy company with 3 project financings
- A California O&G company with $2.5B in debt
- A $6B pharmaceutical with $10B in debt
- Henry Schein, an $8B global multinational
- PolyOne, a $4B industrial manufacturer

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

Client Testimonials

"You have a best-in-class debt compliance process," reported the lead manager of a Big 4 audit of the company's debt compliance to the treasurer of a client that is one of the five largest US utilities.

"Actavis is one of the world's leading generic pharmaceutical companies, operating in 50 countries across the globe. We chose Debt Compliance Services to assist us in designing a comprehensive debt compliance process to meet the reporting requirements of our complex external financing arrangements. We are impressed with the sophistication of their debt compliance services and the professionalism and responsiveness of their ongoing support. DCS' unique global web questionnaire system has enabled our key business stakeholders to better understand our ongoing obligations and resulted in an efficient way to manage the substantial information flow generated by our large and complex business. We now have a clear overview of what is going on in the Group without having to spend too much time and resources in the attempt. We highly recommend DCS' professionalism and services."
—Gudjon Gustafsson, Group Treasurer, Actavis Group

"Debt Compliance Services' tools reduce my risk, save me and my team time and effort, and have made our compliance reporting easy. Gone are the days when we would have to pull out our old, worn loan documents to review all of the various covenants and restrictions before making critical strategic business decisions. With DCS, reviewing our agreements is literally done with a few clicks of the mouse."
—Christine Sacco, Chief Financial Officer & Treasurer, Smart Balance, Inc.

DEBT COMPLIANCE SERVICES Risk-Based Cloud Covenant Management

© 2019 Debt Compliance Services LLC

About Debt Compliance Services

- Now in its 10th year, DCS is a joint venture between Greenwich Treasury Advisors and Corporate Finance Solutions
- Jim Simpson founded Corporate Finance Solutions in 2002
  - A 35-year career leading over $4 bn in convertibles, high yield bonds, revolvers, term loans, and ABLs
  - CFO of Moore Medical (public, $300M sales) and CS Brooks (private, $200M sales), and Treasurer of Sandoz USA (now Novartis)
- Jeff Wallace founded Greenwich Treasury Advisors in 1992
  - Recognized expert in risk management and international treasury
  - VP-International Treasury at American Express, AT at both Seagram and D&B, and a CPA at Price Waterhouse

© 2019 Debt Compliance Services LLC

Contact Information

- For more information, please contact:

Jim Simpson	(203) 329-7491	jim.simpson@debtcompliance.com
Jeff Wallace	(303) 442-4433	jeff.wallace@debtcompliance.com

- Visit our website at www.debtcompliance.com

© 2019 Debt Compliance Services LLC