Client Alert | Banking

Synergising synergies

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Introduction

The definition of EBITDA has always been a fundamental negotiation point in the leveraged finance market; ultimately, a legal construct as opposed to one derived from any recognised accounting standard. In recent years, however, negotiation has increasingly focussed on the scope of EBITDA add-backs, particularly synergies and cost-savings, with sponsors demanding greater flexibility to increase EBITDA quantums. However, some market participants are concerned that the pendulum has swung too far and that such add-backs may simply conceal increased leverage. The following discussion seeks to shed light on such synergies and cost-savings, analysing how such discussions are no longer confined to the top-tier (or large-cap) arena, having slowly permeated the mid-market space and finally, touching on some of the key concepts in leveraged facilities agreements that are impacted as a result.

Background

Synergies/cost-savings (unless expressly stated below, we will refer to these terms interchangeably for the remainder of this article) are arguably the most hotly negotiated form of EBITDA add-back; the most common forms of these being the economies of scale and efficiencies that *can* be enjoyed from the shared use of personnel, facilities and infrastructure between similar businesses in the context of acquisition financing. Synergies are predominately in the spotlight as a result of their sometimes esoteric nature and potential to significantly increase EBITDA (and therefore impact on the calculation of any leverage ratio). The fact that terms such as "run-rate cost-savings" or "revenue synergies" are not defined further compound these concerns, and give parties extensive latitude when constructing the EBITDA definition.

However, importantly, loosening allowances for EBITDA add-backs are not simply reserved for top-tier deals, with these now also penetrating the mid-market. Despite such deals still often benefitting from financial maintenance covenants (uncommon in top-tier deals), add-backs may be restricting the usefulness of such performance testing measures. This can be particularly concerning for mid-market participants, given they generally do not benefit from the same liquidity in the secondary trading market as their counterparts operating in the top-tier realm.

Below, we touch on a few key discussion points on the synergies add-back, focussing on comparing the position between mid-market and top-tier transactions:

- **Scope**: the scope of events that trigger synergies was historically limited to the *completion* of an identifiable transaction (usually an acquisition or a disposal), offering a certain degree of certainty and quantifiability. However, in today's deals, this scope has considerably widened, often allowing synergies in

connection with any restructurings, reorganisations, operational improvements (for example, entry into new contracts) or similar initiatives (colloquially referred to as "group initiatives"). It has also become fairly commonplace in top-tier deals for "revenue synergies" to be added-back to EBITDA, these essentially being increases in revenue following an acquisition, contrasting to a cost-saving synergy, which goes towards stripping out duplicative costs and expenses following such an acquisition. Given the far more speculative nature of the former, these were often historically excluded from the scope of EBITDA adjustments, but are now a hallmark of such top-tier deals, with references to "synergies" alone in facilities agreements encompassing both permutations. In mid-market transactions, whilst we have seen a marked rise in the form of group initiatives included, there is continued resistance (with mixed success) to the inclusion of revenue synergies.

- **Time periods**: drafting often envisages a cut-off point by which any synergies must be realised (or, sometimes, for the measures which are anticipated to give rise to such synergies to be implemented or announced), following the expiry of which, such synergies will no longer be added-back to EBITDA. For top-tier deals, we are seeing 18-24 month periods become the standard (with the occasional deal having no time restriction at all), with mid-market transactions generally holding firm with 12-18 month realisation periods (although occasionally 18-24 month periods are accepted).

- **Caps**: to prevent overly optimistic projections, synergies are often capped to either an agreed specified amount or a percentage of EBITDA (prior to adjusting for the relevant add-back, although calculations of EBITDA after adjusting for the relevant add-back is sometimes seen in top-tier deals). Interestingly, there has been a steady decline in the number of uncapped deals in the top-tier market, although this has seemingly resulted in a trade-off for high-caps to be included instead, with caps of 25% fast becoming the norm in such deals. In the mid-market, we too have seen caps in recent years move away from the once standard 10-15% range, with 20% becoming increasingly common, and rarely, even 25% accepted.

- **Certification**: to provide additional comfort with respect to any projected synergies, certification by senior management or even third-party diligence or verification by auditors/consultants was often a prerequisite for the inclusion of the add-back. It was common to see such an obligation only where such synergies exceeded either an agreed specified amount or a percentage of EBITDA (being a threshold lower than the cap mentioned above). Whilst still an integral part of the mid-market space (in most but not all deals), we have seen a sharp departure from this approach in the large-cap market over the last few years, with the majority of such deals now not requiring any form of certification or verification; these only needing to be projected by borrowers 'in good faith'. Whilst this may initially appear to erode limits on synergies, in transactions where third-party diligence and verification still exists, it is debatable to what extent robust conclusions can be drawn from such deliverables, given the highly predictive nature of such exercise and the internal policies of third-party diligence providers on what they are prepared to confirm; drafting usually only requires such providers to confirm the projected synergies as "not being unreasonable" or "realisable", and reliance on such deliverables is often not provided.

Impact on Facilities Agreements

We have thus far sought to highlight the current trends with respect to synergies we are seeing across top-tier and mid-market transactions. In isolation, however, it is difficult to illustrate the effects that these negotiations can have. Given EBITDA forms the foundation of an assortment of provisions in leveraged facilities agreements, we now turn to analyse briefly the impact of such adjustments in both the top-tier and mid-market spaces.

The greatest impact of these add-backs will invariably be on financial covenant testing. Despite the disappearance of traditional maintenance covenants in favour of cov-lite deal structures in top-tier deals, we often still see the use of a springing leverage test, should a revolving credit facility be made available to a borrower alongside a term loan. In the mid-market, it is still common to see at least one maintenance covenant (usually, a leverage test). In each such case, the comfort provided by such leverage test is lowered by the inclusion of synergies to the EBITDA number resulting in such covenant being met with a greater degree of ease, with small adjustments to EBITDA having a multiplier effect. In practice, given generous headroom allowances and no step-down of the test ratios, such covenants may not provide as robust an early warning signal of risky leverage as has been traditionally expected.

Other significant provisions in leveraged facilities agreements, in which pro-forma EBITDA numbers are a key component include ability for additional debt incurrence, the making of restricted payments and/or the making of acquisitions subject to satisfaction of a leverage ratio test. This is a staple of most top-tier deals and

increasingly so in certain mid-market deals. As highlighted above, the ease with which these covenants are met grants significant capacity for debt incurrence and leakage via restricted payments. Nonetheless, some mid-market deals do not provide for incurrence-based testing, still often preserving the more generally lender-friendly LMA construct of ‘line items’ for “Permitted Financial Indebtedness” and “Permitted Payments”, usually with a grower basket construct (this being a general permission usually expressed as the greater of a hard cap amount and a percentage of EBITDA (or occasionally total assets)) for the general basket. In this scenario, although there is still an impact on incurrence of additional debt and the ability to make restricted payments, a higher EBITDA figure resulting from synergies has a lesser effect (given it looks at this one figure in isolation) compared to the ratio testing offered in top-tier (and certain mid-market) deals which involve the multiplier effect mentioned above.

One metric we can use as a like-for-like comparator is the guarantor coverage test (assuming testing is based on EBITDA). Again, with a test predicated on a metric subject to intense negotiation, lenders are potentially not achieving the desired security and guarantee package. When comparing top-tier and mid-market deals, this is even more pertinent, as the more aggressive terms seen in top-tier deals can result in (assuming the synergies negotiation is the only variable), a greater number of companies required to accede in the latter case than the former to achieve the same guarantor coverage threshold. Interestingly, in mid-market transactions, whilst an EBITDA-only guarantor coverage test has been seen, it is not uncommon to still see a test based on EBITDA *and* gross assets, somewhat mitigating the impact of synergies on ensuring adequate credit support has been provided on such transactions.

Lenders operating in the mid-market need to be particularly alert to the above discussed ‘synergising synergies’ (i.e. a convergence of the treatment of synergies across mid-market and top-tier deals), as ultimately, such lenders often do (and are expected to) ‘stick with the credit’, unlike their counterparts in the top-tier, where frequently participations will be traded-out (often very swiftly post-closing). Interestingly, often the documentary capacity for transferability across mid-market and top-tier leveraged facilities agreements is similar, highlighting a gap between theoretical and practical prospects of transferability, and therefore the potentially discriminatory impact overly ambitious synergies may have on lenders in mid-market deals.

However, are these concerns over adjustments over-hyped? Some market participants contend that the impact of synergies (and EBITDA add-backs generally), is not as pronounced as may be initially thought. Ultimately, the existence of these adjustments are well-known across the market and have been for quite some time. Investors often account for these (and their potential for distortion) when considering investment opportunities, essentially ‘re-adjusting’ the adjustments to discern an arguably more realistic cash-flow, with one portfolio manager claiming that “…*bankers and issuers can inflate their adjusted EBITDA numbers all they want, but we will do our own work on what we think the available cash is*”. This *can* lead to pricing being determined accordingly. Additionally, lenders may require borrowers to detail any synergies in compliance certificates delivered as part of the borrower’s reporting requirements, allowing scope for any overly zealous projections to be vetted. We have also seen an increasing trend, particularly over the last year, for the most flexible add-backs to be reconsidered (and potentially removed) following investor feedback during primary syndication.

Conclusion

It is clear that synergies are a point of laser focus for sponsors and lenders alike in the course of facilities agreement negotiations, with a spectrum of options available when negotiating these in both top-tier and mid-market transactions; sponsors expanding the range of pro-forma adjustments and lenders attempting to curtail add-backs that are difficult to monitor. However, what is imperative is that parties on both sides of the transaction (and particularly mid-market players) are alive to the issues, and as some market participants have suggested, the “problem” may not be a problem at all. Indeed, in these commercial negotiations, it is ultimately up to investors to look beyond the make-up on the face of EBITDA, draw their own conclusions on the credit and restrict terms where necessary or even walk away from deals where they consider terms to be too aggressive; an increasingly difficult endeavour in a very liquid market with a relatively limited supply of deals.

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