Financial Ratios: Lost in Translation

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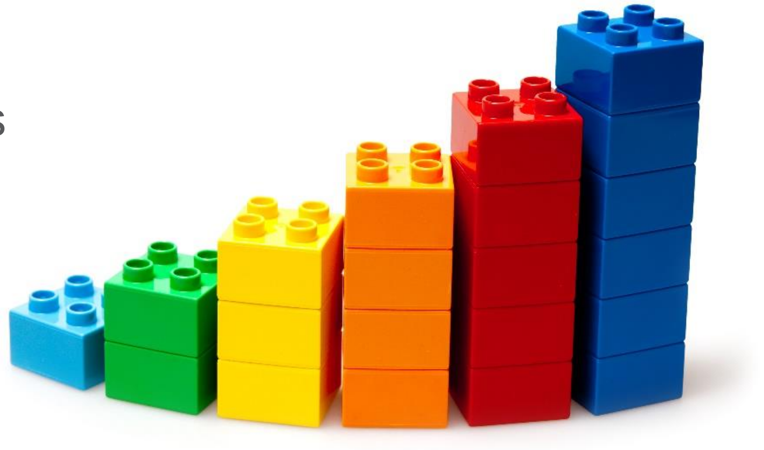
What we will cover

- Financial ratios - Why/How
- Typical ratios
- Basic concepts / when tested
- Accounting vs non-accounting concepts
- EBITDA basics
- Role of auditors
- Latest developments

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Financial Ratios: Why/How?

Why use them?

- Indicator of financial performance
- Monitoring device / trigger for consequences

How used?

- Conditions Precedent – Base Case to show minimum coverage
- Debt sizing – day 1 / accordion
- Margin ratchets – step-up/down
- Lockup – no distributions to equityholders permitted
- Cash sweep – mandatory prepayments required
- Guarantor Group test / Material Subsidiary - % of total assets or EBITDA
- Baskets/Buckets – eg disposals not to exceed % of total assets / total tangible assets

Financial Ratios: Why/How?

- **Undertakings** –
  - maintenance

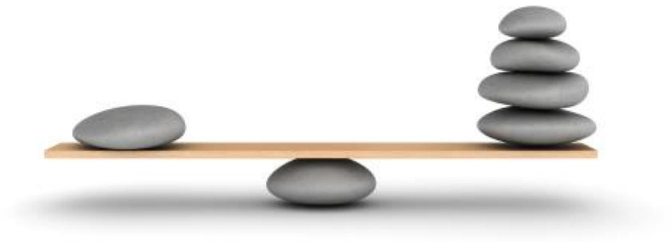
    vs
  - incurrence
- **Events of Default** – if ratios breach specified levels
- **Review Events** – a longer path towards an EOD?

Typical Ratios

Investment grade corporate	• Gearing/Leverage (Balance Sheet concepts more common eg Debt ÷ Debt + Equity) • Consolidated Net Worth • Interest Cover Ratio (**ICR**) + if relevant, Fixed Charge Cover Ratio (**FCCR**)
Leveraged	• Gearing/Leverage (Debt ÷ EBITDA) • Debt Service Cover Ratio (**DSCR**) • ICR + if relevant, FCCR • Restrictions on annual spend capital expenditure
Property	• Loan-to-Value Ratio (**LVR**) • FCCR / ICR
Project Finance	• Gearing/Leverage • DSCR • Loan Life Cover Ratio (**LLCR**) / Project Life Cover Ratio (**PLCR**)
Asset-Backed Loans	• Borrowing Base – Debt as % of eligible inventory / receivables

Basic Concepts

- Balance Sheet Ratios (point in time) – Gearing, Current Ratio
- Balance Sheet items – eg Consolidated Net Worth
- Minimum market capitalisation – lessons learned from GFC
- P&L / Cashflow ratios (over a period) – ICR, DSCR, FCCR
- Historical (look back) vs projected (look forward)
- Cash vs Accounting (accrual concepts)
- Actual vs Pro Forma



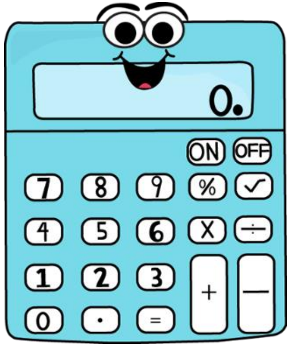
Basic Concepts

- Consolidated vs Standalone
- Excluded Subsidiaries
- Impact of FX / Other changes on certain terms
  - general buckets
    eg negative pledge = 5% total assets
  - what if after relevant grant of security
    - total assets number falls
    - total asset number changes due to fx changes?

When tested

- What dates + when
  - testing on ratio dates *vs* at all times
  - when does it start? holidays?
- What period: rolling 12 month, quarterly, etc
- LTM = last 12 months
- Certifying directors / officers – personal liability

Accounting Concepts



Accounting-based financial ratios derived from financial reports

- GAAP = Generally Accepted Accounting Principles
- IFRS = International Financial Reporting Standards
- Accounting Standards http://www.aasb.gov.au/Home.aspx
- Frozen vs moving GAAP

  If solely as a result of a change in Accounting Principles after the date of this Agreement, the Borrower does not comply with the Financial Undertakings, or if the Borrower determines in good faith that those Financial Undertakings are no longer appropriate, the Borrower and the Agent will negotiate in good faith to make amendments to the affected clause or definition which take into account such change but to maintain the same headroom in respect of the Financial Undertakings that existed prior to such change. Prior to reaching agreement, the Financial Undertakings will be tested on the same basis as tested [before the change in Accounting Principles/underlying the financial statements as at financial close].

- IFRS 16 – from 1 Jan 2019, distinction between operating leases vs finance leases gone

Acct'g vs Non-Acct'g Concepts

What are the accounting terms used?

- Typical leverage ratio = Finance Debt ÷ EBITDA
- Finance Debt is usually defined by lawyers in the Facility Agreement, but some limbs may use accounting concepts (eg finance lease)
- Sometimes, ratio just lifts straight from Balance Sheet with no adjustment = eg Total Liabilities ÷ Total Assets

Acct'g vs Non-Acct'g Concepts – Finance Debt

Financial Indebtedness means any indebtedness for or in respect of:

(a) moneys borrowed and any debit balance at any financial institution;

(b) any amount raised under any acceptance credit, bill acceptance or bill endorsement facility or dematerialised equivalent;

(c) any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument;

(d) the amount of any liability in respect of any lease or hire purchase contract which would, in accordance with GAAP, be treated as a balance sheet liability [(other than any liability in respect of a lease or hire purchase contract which would, in accordance with GAAP in force [prior to 1 January 2019] / [prior to [ ]]/[ ], have been treated as an operating lease)];

(e) receivables sold or discounted (other than any receivables to the extent they are sold on a non-recourse basis);

(f) any redeemable shares where the holder has the right, or the right in certain conditions, to require redemption;

(g) any amount raised under any other transaction (including any forward sale or purchase agreement) of a type not referred to in any other paragraph of this definition having the commercial effect of a borrowing;

(h) consideration for the acquisition of assets or services payable more than [90-180] days after acquisition;

(i) any derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price (and, when calculating the value of any derivative transaction, only the marked to market value (or, if any actual amount is due as a result of the termination or close-out of that derivative transaction, that amount) shall be taken into account);

(j) any counter-indemnity obligation in respect of a guarantee, indemnity, bond, standby or documentary letter of credit or any other instrument issued by a bank or financial institution; and

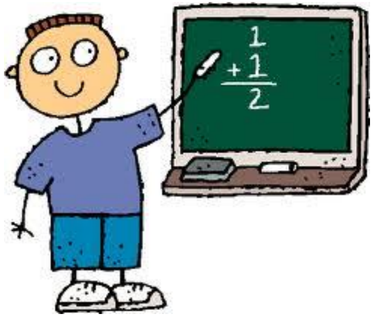
(k) the amount of any liability in respect of any guarantee or indemnity for any of the items referred to in paragraphs (a) to (j) above.

Acct'g vs Non-Acct'g Concepts – Finance Debt

Other aspects of Finance Debt to consider:

- Gross vs Net (= gross debt *minus* cash and cash equivalents)
- All Finance Debt or just the particular Facilities
- Subordinated Debt?
- Contingent exposures eg issued LCs/BGs
- Hedging – MTM/actual
- FX impact

From Consolidated Net Profit to
EBITDA



EBITDA = Consolidated Net Profit, *adjusted to exclude (ie. + or -):*

- interest (I)
- tax (T)
- depreciation of fixed assets, amortisation/impairment of any goodwill, intangible assets, acquisition costs etc (DA)
- what about extraordinary items?
  - “extraordinary”, “exceptional”, “abnormal” “significant” items all removed by Accounting Standards
  - avoid uncertainty by baking in specific examples – eg restructure costs, IPO/refi/acquisition costs
  - other descriptions include ‘one-off/non-recurring and exceptional’
- Non-cash accounting charges and adjustments

Role of Auditors

- Sometimes formal auditor review/signoff on compliance certificate

  "*… the auditors of the Company provide confirmation that the figures used in the calculations in the Compliance Certificate have been properly extracted from the relevant annual audited Financial Reports and that the arithmetic is correct, by reference to the audited Financial Reports <u>provided that auditors generally continue to be prepared to provide such confirmations</u>.*" (example leveraged deal, 2014)

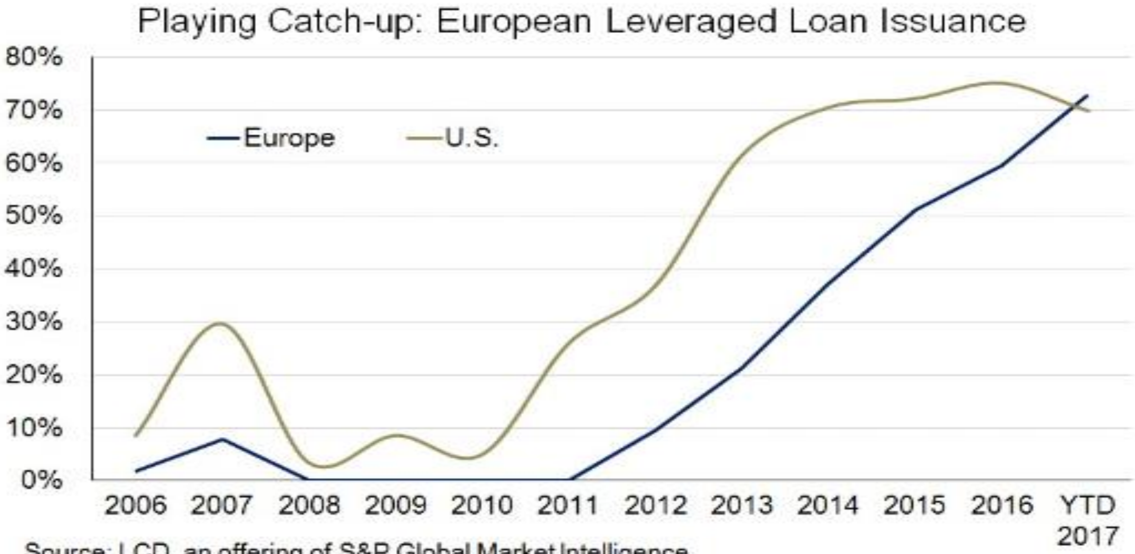
- Less common now
- Alternative = Borrower to ensure agreed-upon procedures to include review of financial covenant compliance
- Financial covenants war story
  - ideally not "lawyers *vs* auditors"
  - Q: what if contracting parties *inter se* clearly intend something different to Accounting Standards?

Covenant-Lite – A Late Arrival

May 11, 2017 at 11:39pm

European Leveraged Loan Market Warms to Covenant-lite Deals

Covenant-lite leveraged loan issuance in Europe has moved from a sideshow to the main event in just a few years, leaving the previously dominant covenanted sector as little more than a minor attraction.



Source: LCD, an offering of S&P Global Market Intelligence

Latest developments – Cov-Lite

- Covenant *lite* vs covenant *loose*
- Pressure from 2 ends of spectrum – to drop covenants
- Regulator (to protect SMEs) *vs* top-end of market
- Top end:
  - Aus Term Loan B
  - Australian institutional loans
- Stats on default rate on cov-lite *vs* covenanted loans – a mixed bag