

## EBITDA: Loan Agreement Negotiating Considerations

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A Practice Note exploring common issues that parties should be mindful of when discussing EBITDA in the context of a loan agreement negotiation. This Note looks at specific considerations such as caps on EBITDA add-backs and examines the impact of EBITDA add-backs on the inter-relationship of certain loan agreement provisions.

EBITDA is an important concept in many loan agreements to measure the borrower's profitability (see [Practice Note, EBITDA: Introduction for Finance Lawyers](#)). The negotiation of EBITDA in a loan transaction is often complicated due to bespoke adjustments that the lender agrees to with the borrower (see [Practice Note, EBITDA Adjustments in Loan Negotiations](#)). However, although there are differences in the definition of EBITDA among loan agreements, there are common considerations to the negotiation of EBITDA that apply to most loans.

In the current market environment, EBITDA add-backs in corporate loan agreements remain generally borrower-favorable by historical standards. However, lenders have been more cautious in recent years, resisting those adjustments that are widely perceived as excessively liberal and diluting the usefulness of EBITDA as a measure of corporate profitability. Nevertheless, the market is accustomed to a variety of arguments from borrowers and sponsors for negotiated EBITDA add-backs in loan agreement negotiations, and many add-backs clear the syndications market. Private credit funds and alternative lenders have changed the lending environment more broadly, in some cases offering more flexibility than banks in the way they approach covenant negotiations, including those incorporating EBITDA. However, the growth in private credit has seemed to incentivize banks to accommodate borrowers' requests, particularly in heavily subscribed transactions with creditworthy borrowers and top-tier sponsors.

### Approaches to EBITDA

The dynamic surrounding EBITDA negotiations can vary significantly from deal to deal.

#### Detailed or Broad Add-Backs

In some transactions, the borrower may make specific requests for detailed adjustments to EBITDA, while in other deals adjustments may be referenced more generally or pushed to the future discretion of the parties. At the center of the debate is the lender's concern that the EBITDA numbers produced by the borrower during the term of the loan should appropriately reflect the borrower's financial performance. This ensures that the chosen performance metrics in the loan agreement give the lenders a reliable yardstick to gauge periodically the borrower's financial health and its ability to service its debt.

If the lender loses sight of this objective in its loan negotiations, it may agree to so many adjustments to the calculation of EBITDA that the resulting figures bear little relation to the borrower's actual financial position. Weak lender protections in a loan agreement undermine the credit quality of the deal, making the loan a less attractive and potentially riskier investment and inviting a chilled reception for the loan among potential buyers in the secondary market.

At tension with the lender's goal is the borrower's goal of avoiding a default under its financial covenants, obtaining as much flexibility as possible under its negative covenants, and receiving preferable pricing

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to the extent pricing is tied to an EBITDA-based financial metric.

Whether approved adjustments are broadly or narrowly worded can work in favor or against either party. Broad wording will work in favor of whichever party has more negotiating power in the future since the borrower will be able to push the lender harder to accept its interpretation of the broad language if it is in a strong position at the time it makes the request. Conversely, a lender will be able to more easily refuse a borrower's interpretation if the borrower is distressed.

### Understanding the Borrower's Business

The borrower's counsel can play a key role in guiding the borrower to develop its negotiation strategy for EBITDA adjustments. Even widely accepted add-backs may not be materially relevant to a particular borrower and an understanding of how the borrower operates its business is key to ensuring the successful negotiation of adjusted EBITDA in its loan agreement. For example, it is not a good use of negotiating leverage for the borrower's counsel to argue for an add-back for equity incentive programs if the borrower does not compensate its employees in that manner or have plans to do so in the future. However, it is critical that borrower's counsel negotiate to include add-backs that are relevant and consequential to the borrower's business.

### Sponsor Deals

Private equity sponsors with large portfolios of companies sometimes request that a specific list of EBITDA add-backs be included in the loan agreement to allow the sponsor to track the borrower's performance for loan agreement compliance purposes uniformly across its investment platform. This approach facilitates simplicity and accuracy in the sponsor's financial reporting across its businesses. Although particular add-backs may have greater or lesser relevance to individual borrowers, the sponsor's ability to track metrics uniformly across different companies and potential acquisition targets may have inherent and practical value for the sponsor.

### Multiple Creditor Classes

Loan agreements for borrowers with more complex capital structures that involve multiple and different types of creditors sometimes include EBITDA add-backs that are contemplated in the borrower's other financing agreements. Having alignment on EBITDA

add-backs across facilities will simplify reporting and compliance for the borrower. If it is relevant, this aspect of the negotiations is heavily deal-dependent and requires the parties to consider how closely intertwined the financial covenants are across the borrower's different facilities and how easing the borrower's burden weighs against the interests of the lenders.

For example, borrowers that raise financing in the capital markets, such as through notes offerings, may want their revolving lenders to incorporate add-backs that appear in the offering memorandum or other marketing documents related to the notes. Equally, in asset-based lending (ABL) where an asset-based revolver and a term loan may be provided by different groups of creditors, the lenders will want to consider whether more scrutiny of particular add-backs or performance metrics is appropriate for one group of creditors over another. This is especially the case where the separate groups of creditors have different priorities on different types of collateral, such as where the ABL lender has a first lien on the borrower's receivables and inventory and a second lien on its fixed assets, and the term loan lender has a first lien on the fixed assets and a second lien on the ABL lender's priority collateral.

## Caps and Limitations on EBITDA Adjustments

If a borrower takes an expansive view of EBITDA add-backs and argues that the loan agreement should include multiple adjustments, although the lender may concede that the adjustments are justifiable individually, it may nevertheless become concerned that the overall impact of the adjustments on the borrower's EBITDA figures renders them misleading. Weaker financial reporting standards make a loan inherently riskier from the lender's perspective. To manage their appetite for risk in their loan portfolios, lenders may impose in individual deals:

- Caps on individual add-backs.
- Aggregate caps on all applicable add-backs.
- Tighter financial ratio tests.

Individual and aggregate caps can be formulated as fixed dollar-amounts or variable limits based on a percentage of the borrower's most recently reported EBITDA. This is a point of negotiation, as is whether a cap based on a percentage of EBITDA

should be determined before or after giving effect to the cost savings. Tightening the covenant levels of the financial ratios that use EBITDA, such as the leverage ratio, is another way a lender can limit the effect of changes in the loan agreement's performance metrics that the lender views as overly permissive. Tighter ratio requirements may ultimately be more restrictive for the borrower than a few carefully negotiated borrower-specific requests. This underlines that the negotiation of EBITDA adjustments can involve a delicate balancing act and highlights the importance for borrowers in negotiating an outcome that ensures that the overall effect of the covenant package does not deprive the borrower of the intended benefit of addressing particular items of concern in individually negotiated adjustments.

### Accounting Considerations

Understanding relevant accounting considerations is especially important when negotiating EBITDA adjustments to ensure that there is no duplication in the treatment of individual items. If an expense item was not deducted from the borrower's revenues in the determination of its net income, then it is not appropriate to add that item back to the borrower's EBITDA. For example, an issue that sometimes arises in the negotiations concerns the accounting treatment of minority interests owned by the borrower. In some loan agreements, the borrower may adjust its EBITDA figure by adding back expenses relating to minority stakes that it holds in other businesses on the basis that these are not a part of the borrower's core business operations. However, the same result can be achieved by omitting all revenues and expenses relating to minority investments from the calculation of the borrower's net income. This removes the need for an add-back if the relevant expenses were not deducted in the first place. This example also highlights the principle that if expenses related to a part of the business are eliminated by an add-back, then associated revenue also needs to be deducted from EBITDA.

### Inter-Relationship of Loan Agreement Provisions

When parties are negotiating EBITDA adjustments, it is important to consider how different impacted loan agreement provisions work together.

### Equity Cure Rights

Many loan agreements to sponsored borrowers include equity cure provisions that allow the borrower's sponsor to inject curative equity into the business to remedy financial covenant defaults. This curative equity is treated for covenant compliance purposes as revenues in the calculation of the borrower's EBITDA, so that a large enough equity infusion can cure a default that would otherwise have arisen because of a shortfall in the borrower's earnings. The proceeds of an equity cure are usually disregarded for all purposes other than the narrow matter of avoiding a specific financial covenant breach. Under the loan agreement, increases in the borrower's earnings (other than from an equity infusion) may lower the interest rate margin on the loans and give the borrower greater ability to take particular corporate actions, such as making investments or paying dividends. However, lenders will not want the proceeds of equity cures to be used by the borrower as a substitute for revenue to obtain better pricing under their loans or more flexibility under the loan agreement's negative covenant exceptions.

### Covenants

In addition to the different types of caps that are commonly used in EBITDA adjustments, a loan agreement covenant package may also include other limiting factors or qualifications around permitted adjustments to EBITDA. It is common for time periods to be agreed for any pro forma adjustments that are intended to ramp-up or ramp-down earnings figures to reflect the impact of acquisitions or dispositions. For example, if a borrower sells a loss-making subsidiary, its loan agreement may permit the borrower to adjust its EBITDA figures during the fiscal year in which the disposition occurs to add-back losses that the borrower will no longer have once the subsidiary is sold. Other requirements may also apply, such as the need to obtain lender approval, or to act reasonably and in good faith when determining EBITDA. Grower baskets appear in many sponsor deals that increase covenant baskets alongside increases in EBITDA, thereby permitting the borrower to make more dividend payments, or investments in non-guarantor entities, or take other corporate action because the permission is based on EBITDA.

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### Prepayment Provisions

Borrowers that have significant cash and non-cash EBITDA adjustments should consider the impact of these adjustments on the relationship between EBITDA and their actual cash position. Extensive EBITDA adjustments may cause problems for some borrowers with loan agreements that include an excess cash flow (ECF) sweep.

If the ECF sweep requires the borrower to pay down its loans with cash that it has already spent, or cash

that it never received because its EBITDA number is significantly boosted by many adjustments to EBITDA, the ECF sweep could exceed the borrower's available cash. It is therefore a balancing exercise for borrowers to consider the greater flexibility that the borrower may obtain under its covenants on the one hand, with prepayment obligations under an ECF sweep on the other.

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