Bank covenants

Audit & Reporting Quality

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The Netherlands Authority for the Financial Markets (AFM)

The AFM is a strong proponent of fairness and transparency in the financial markets.

As the independent conduct supervisor, we contribute to sustainable financial prosperity in the Netherlands.

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1. Management summary

It is particularly important for users that companies provide transparent reporting of their bank covenants. The ratios agreed, the exact methodologies used for the calculation of these ratios by credit providers, the results at year-end and the potential sanctions if the covenants are breached by the companies all constitute very relevant information for investors. Given the recent financial problems at a number of companies, transparency with respect to bank covenants is an important and current theme. The information relating to bank covenants is crucial if the company is in a weak financial position. Based on risk-driven supervision, we have decided to focus our review on companies that are in a weak financial position and therefore exposed to the risk of breaching their covenants. In these cases, transparent disclosure regarding the covenants is essential information for investors. In this context, for companies in a strong financial position (for instance, with a net cash position) the disclosure with respect to covenants is less relevant to investors.

For our thematic review of bank covenants, on the basis of a risk analysis we selected eight companies from the AEX, AMX and ASCX indices with a weak financial position and a risk of breaching their bank covenants. Based on its review of the financial statements of these companies, the AFM notes the following:

- Greater transparency is needed on the calculation methodologies of these covenants.
- The results of the calculation for the covenants is stated, however the calculation is difficult to make for users.
- Disclosure of the consequences of breaching the covenants is lacking in the majority of cases.

Greater transparency is needed on the calculation methodologies of these covenants
The covenants are calculated on the basis of the definitions in the finance agreement with the banks. The majority of companies however do not report the exact method used to calculate these financial ratios. Companies often state that the reported figures are adjusted, for instance due to incidental items, certain items of financing expenses such as exchange rate differences or annualisation of the figures for businesses acquired. Based on the above, the AFM concludes that companies do not report on the calculation methodology used for covenants agreed with banks in sufficient detail. As a result, the AFM recommends that companies should be more transparent in their reporting with respect to the agreements made with banks regarding the calculation methodology of the covenants.

The results of the calculation for the covenants are stated, however the calculation is difficult to make for users
Half of the companies state the results of the calculation of the covenants in their financial statements. A table is often included showing the covenants, the agreed level and the actual figures. The other half do not state the actual ratios realised. They only report that the covenant requirements were met, or that they have a covenant holiday (a temporary exemption from covenants). It is only possible to calculate the covenant oneself in one single case. For the other companies, it is not clear which adjustments have to be applied to the reported IFRS figures in order to calculate the adjusted net debt figure or the figure for EBITDA for the covenants. It is

very important for users to have insight into the calculation methodology and the final adjustments to the figures. We therefore call on companies to be transparent regarding the calculation of the covenants and to show the arithmetical relationship between the reported IFRS figures and the figures as adjusted for the calculation of the covenants.

Disclosure of the consequences of breaching the covenants is lacking in the majority of cases

Only two companies state that if the bank covenants are breached their debts are in principle payable on demand. Not one company explains the measures that banks can demand, such as the sale of business divisions, cessation of dividend distribution or a one-off penalty. This information is however relevant for investors. The AFM recommends that companies should report transparently regarding the consequences of breaching their bank covenants.

2. Rationale, objective and scope

2.1 Rationale

The rationale for this review is that a limited number of companies in a weak financial position still do not report in sufficient detail on:

- the bank covenants agreed, the ratios and the actual figures realised,
- the calculation methodology for the covenants (the agreements made with the banks as to how the financial ratios are calculated),
- the potential consequences for the company if the bank covenants are not met.

This leads to a situation in which users do not in all cases have sufficient insight into the financial room available to companies and the risk that they will fail to meet their bank covenants. Potential and actual shareholders and users require more information on bank covenants in order to make an adequate risk analysis. The ratios agreed, the exact methodologies used for the calculation of these ratios by credit providers, the results at year-end and the potential sanctions if the covenants are breached by the companies should all be disclosed in the financial statements. The information relating to covenants is crucial if the company is in a weak financial position. Given the recent financial problems at a number of companies, transparency with respect to bank covenants is a very topical theme. Every year, a number of companies are in danger of failing to meet their covenants. Analysts and investors then make a number of calculations themselves to determine whether there is a risk that the bank covenants will not be met. Recently, investors have had to deal with the bankruptcy of Imtech and investors in Heijmans were also alarmed by the sharp rise in the company’s debt in the second quarter of 2015, whereby there was a risk that the company would not meet its agreed bank covenants.

2.2 Objective

The objective of the review is to assess the quality of the financial reporting with respect to the disclosure of bank covenants and identify potential areas of improvement. For companies in a weak financial position, the stakeholders want to know what the bank covenants consist of and what risk there is that they will not be met. The disclosure of bank covenants must meet the qualitative requirements of relevance, transparency and completeness.

2.3 Scope

Based on risk-driven supervision, we have decided to focus our review on companies that are in a weak financial position and therefore exposed to the risk of breaching their covenants, since in these cases transparent disclosure of covenants is crucial information for investors. In this context, it is also the case that for companies in a strong financial position (for instance, with a net cash position) the disclosure with respect to covenants is less relevant to investors.

For our thematic review of bank covenants, on the basis of a risk analysis we selected eight companies from the AEX, AMX and ASCX indices with a weak financial position and a risk of breaching their bank covenants. For the eight selected companies, we carried out a desktop review of the disclosure of bank covenants in the financial reporting.

3. Review findings

The findings are listed below. Certain good practices[1] are also listed in this section. These are intended to serve as examples of a company-specific text for the disclosure of bank covenants. By citing these good practices, the AFM intends to inspire companies and help them to improve their disclosures.

The key results of our review are stated in the following overview.

Key review results

	Yes	No	Not applicable
Are covenants over a 3-year period stated	87.50%	12.50%	
Is the disclosure detailed, with statement of possible reasons (refinancing, increased financial difficulties)	62.50%	37.50%	
Is the calculation methodology (agreements with banks in finance agreements) fully disclosed	25%	75%	
Is the result or level achieved over the 3-year period stated	50%	25%	25%
Can the calculation be made independently	12.50%	62.50%	25%
Are the consequences of breach of the covenants stated	25%	75%	

[1]The good practices mentioned in this report are examples intended to increase the quality and relevance of the disclosures. The good practices should not be seen as a standard or as the only correct substance of existing or future disclosures. Other content may be used to comply with legislation and regulation. The quotation of good practices in this report does not imply any statement by the AFM regarding the financial statements in question as a whole.

As can be seen from the above overview, nearly all the companies provide a disclosure on their bank covenants. Most of the companies provide an overview of the most important bank covenants, such as net debt/EBITDA and EBITDA/interest. We also see that an absolute EBITDA floor plays an important part in new finance agreements. If we look over a 3-year period, we see that the disclosure is detailed in a number of cases. One possible reason for this is that a refinancing has occurred.

Moreover, information as to whether the bank covenants are of the 'incurrence' type or the stricter 'maintenance' type is often lacking.

In one case the company simply states that it is complying with its bank covenants without providing a description of the covenants themselves.

3.1 Greater transparency is needed on the calculation methodologies of covenants

The covenants are calculated according to the definitions of financial ratios in the financing agreements with the banks. Most companies however do not state the exact methodology used to calculate these financial ratios. Companies often state that the reported figures are adjusted, for instance due to incidental items, certain items of financing expenses such as exchange rate differences or annualisation of the figures for businesses acquired. Insight into the calculation methodology used for covenants is very important to users.

For instance, an adjusted EBITDA figure is an important input for many covenants, such as net debt/EBITDA and EBITDA/interest. Given this importance of the adjusted EBITDA figure in covenant calculations, it is important that companies are transparent with respect to the calculation methodology (whereby for example adjustment is made for non-recurring income and expense items). In our review however, we note that most companies do not state how the adjusted EBITDA figure is calculated. The calculation of other input variables such as net debt is also not stated in most cases.

Based on the above, the AFM concludes that companies provide limited reporting of the calculation methodology for the covenants agreed with the banks, even though this is relevant information for users. As a result of this, the AFM recommends that companies should be more transparent in their reporting of the agreements made with the banks with respect to the way in which covenants are calculated. This will enable investors to make a better assessment of liquidity risk.

The following is an example of good practice with respect to the calculation of bank covenants. The company in question (Fugro) expanded its disclosure on bank covenants after arranging a refinancing. The disclosure of the calculation methodology for EBITDA was greatly improved and clearly shows in qualitative terms that a large number of adjustments have been made. The disclosure could be further improved by the inclusion of quantitative substantiation (link between the figures according to IFRS and the adjusted figures for the covenant calculation).

Good practice 1: calculation methodology (Fugro annual report for 2014: page 154)

In addition, the covenant definitions have been amended in order to bring the calculations in line with common practice:

- Permanent exclusion of uncalled performance bank guarantees from net debt calculation, subject to a cap (EUR 100 million) which is in excess of the current outstanding guarantees. Refer to note 5.61.2. Amounts in excess of the cap will be counted in the net debt/ EBITDA covenant calculation.
- Until the end of 2015, certain exceptional one-off items (Exceptional Items) will be excluded from consolidated EBITDA up to certain agreed thresholds.

Adjusted consolidated EBITDA for purpose of the covenant calculations comprises the profit (or loss) from operations before interest expense, depreciation, amortisation and taxes, including any Exceptional Items incurred and adjusted by:

- Including pre-acquisition profit / (loss) from businesses acquired (note 5.27).
- Excluding profit / (loss) from businesses disposed of, for the period for which they formed part of the Group.
- Excluding profit / (loss) on disposal of property, plant and equipment (note 5.30 and 5.33).
- Provided that the aforementioned are not related to the Seabed business.

Exceptional Items consist of:

- Onerous contract charges (note 5.29).
- Impairments (note 5.32).
- Restructuring costs (note 5.33).
- Write-off receivables (note 5.33).
- Certain adviser and other costs (to the extent not capitalised as transaction costs on loans and borrowings (note 5.51.1 and 5.51.2)).
- Early termination costs of loans and borrowings (not applicable for 2014).

3.2 The results of the calculation for the covenants are stated, however the calculation is difficult to make for users

Half of the companies state the results of the calculation of the covenants. A table is often included showing the covenants, the agreed level and the actual figures. The other half do not state the actual ratios realised. Half of the companies only state that the covenants have been met. The other companies have a covenant holiday and probably for this reason do not state the realised ratios.

In only one case is it possible to make the calculation independently on the basis of combining figures from various points in the financial reporting. In all other cases, the adjustments that have to be made to the reported IFRS figures are not clearly stated, nor is there a clear statement of the amounts of these adjustments. One example of this is that the amounts of the adjustments that have to be made to the EBITDA figure are not clearly stated.
As stated earlier, it is of great importance to users to understand the calculation methodology used for covenants and the adjustments to the reported IFRS figures. It would also be useful to users if companies reported the size of the adjustments. We therefore call on companies to provide transparency with respect to the calculation of their covenants and to explain the numerical relationship between the reported figures and the adjusted figures for the covenant calculation. We cited an example of good practice with respect to the calculation methodology for bank covenants that enables calculation of the ratios in section 3.2. If this type of overview is supplemented with the amounts involved, the calculation will be transparently disclosed to investors.

The calculation and relationship are stated in other documents in some cases. See for instance the relationship and good practice cited below, regarding the adjusted net debt figure and its relationship to the IFRS figures from an investor road show presentation of the 2015 semi-annual figures for Heijmans (good practice 2). The company clearly states that its room with respect to its net debt/EBITDA covenant is limited. The calculation methodology is also explained, as is the relationship between the adjusted net debt figure and the IFRS figures. The AFM urges companies to include these relationships in their financial reporting.

Good practice 2: calculation/relationship of covenants (road show presentation Heijmans 1H2015 page 41)

Annex: Financial covenants

heijmans

Financial covenants *(in million €)*	Definition	Ratio	12 months rolling Actual 30-jun-14	Actual 31-12-2014	Actual 30-6-2015
Leverage Ratio	Consolidated Total Net Borrowings / Consolidated EBITDA	Max 3	1,6	-0,9	2,8
Interest Cover Ratio	Consolidated EBITDA / Consolidated Net Interest Payable	Min 3	8,0	3,4	5,1

Reported net debt (for accounting purposes)	99	31	108
adjustments for financial covenant purposes (from Reported Net Debt to Consolidated Total Net Borrowings)			
IFRS 11 adjustments*	85	78	71
Cumulative Preference shares	(66)	(66)	(66)
Non-recourse PFI debt	(53)	(53)	(61)
Other	(0)	(0)	1
Consolidated Total Net Borrowings (for financial covenant purposes)	**64**	**(11)**	**52**

Comments:

- Financial covenants were met in H1 2015 with limited headroom on Leverage Ratio. Only for calculating the financial covenants per 30/6/2015, the project loss of the Energiefabriek Tilburg (EUR 9.2 mln) was excluded from the Consolidated EBITDA (as per agreement with the Lender's syndicate)
- Effective 12-month Consolidated EBITDA (for covenant purposes as per 30/6/2015) was EUR 18 mln
- For calculating the financial covenants, a.o. the following adjustments of the accounting figures should be made of Total Net Borrowings, Consolidated EBITDA and Consolidated Net Interest Payable:
  - To add impact Joint Ventures that are not longer included under IFRS 11 as of 2014 (see asterisk above)
  - To subtract impact of ringfenced (non recourse) project financings in relation to PFI/PPP activities
  - To subtract impact of cumulative preference shares

3.3 Disclosure of the consequences of breaching the covenants is lacking in the majority of cases

If bank covenants are breached, debts become immediately due or banks can impose measures on companies such as cessation of dividend distribution, a share issue, a one-off penalty or the disposal of business divisions. For investors, it is important that companies are transparent with respect to these or other consequences. Only two companies state that if the bank covenants are breached their debts are in principle payable on demand. Not one of the companies reviewed explained the measures that could be imposed by the banks, such as the sale of business divisions or cessation of dividend distribution. This information is however relevant for investors. The AFM accordingly urges companies to provide transparent reporting on the consequences of failing to meet their bank covenants.

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