High-Yield: IFRS 16 impact on covenants

This article provides an analysis of the impact of IFRS 16 on high-yield covenants and an overview of the various approaches adopted by European high-yield issuers in the first quarter of 2019, including on some of the deals our team was involved in (Rexel, Faurecia).

The new International Financial Reporting Standard 16 *Leases* (**IFRS 16**) has taken effect, and the companies using IFRS shall adopt IFRS 16 for accounting periods beginning on or after **1 January 2019**. Under the prior IFRS accounting standard for leases (**IAS 17**), lessees accounted for their lease liabilities either as operating leases or finance leases. Operating leases were accounted for as off-balance sheet items, while finance leases were reflected on the balance sheet. A lease would be classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. All other leases would be classified as operating leases, with classification being made at the inception of the lease.

IFRS 16 removes the classification of leases as either operating or finance leases and instead requires all leases to be recognized on lessee's balance sheet.[1] Short-term leases (less than 12 months) and leases of low-value assets (for example, personal computers and small furniture items) are exempt from the requirements.

In practical terms, this change is expected to have the following general effects on the companies' financials:

Statement of Financial Position

- increase in **total assets**, as operating lease assets which previously were accounted for off-balance sheet are now recognized on balance sheet as right-of-use assets; and
- increase in **liabilities**, to reflect the obligation to make future lease payments relating to those leases;

Income Statement

- increase in **EBITDA**, as payments under operating leases (previously recorded as operating lease expenses and reflected in EBITDA) are now reclassified and split between (i) depreciation charges for lease assets and (ii) interest expenses on lease liabilities (both are excluded from EBITDA). While this new split would also increase **EBITA**, as interest expenses are not included in its calculation, this change is expected to be less substantial, as the majority of the typical operating lease expenses will be reflected in depreciation;

Statement of Cash Flows

- no expected change in total cash flow amount, however financing cash flows will increase proportionally to reduction in operating cash flows, driven by changes in operating leases.

The full scope of impact on the financial statements would depend on each individual company and the composition of its operating lease portfolio, including the size and durations of such leases. The changes are expected to be more significant for companies with a large number of operating leases, for example, those operating in retail, transport, logistics and wholesale sectors.

In the context of high-yield transactions, IFRS 16 will impact the companies' debt documentation in several key aspects:

- **Financial ratios and covenants**
  Financial ratios and covenants to meet those ratios in debt documentation may become problematic when the ratios are calculated under IFRS 16. For example, while varying somewhat across industries, the increase of liabilities under IFRS 16 is expected to be significantly greater than the increase in EBITDA. This may impact the Fixed Charge Coverage Ratio as well as any leverage ratio referenced in the covenant package and, depending on the drafting of the indenture, prevent companies from having the flexibility initially anticipated and lead to breach of respective financial covenants.

1 This publication focuses on lessee's IFRS 16 obligations. IFRS 16 did not significantly change IAS 17 requirements for lessors.

- **Financial and other definitions**
  Standard definitions in the high-yield context related to borrowings (such as "**Indebtedness**", "**Financial Indebtedness**", "**Finance Lease**" and "**Capital Lease Obligations**") have typically been structured to reflect the distinction between operating and finance leases, with operating leases generally not treated as borrowings. Under IFRS 16, with balance sheet recognition of all leases, depending on the structure of the applicable definition, the term "leases" or "finance leases" may be interpreted to include all leases accounted for on the balance sheet. This would result in significant change to the definitional scope and, in turn, may lead to breach of permitted borrowings baskets (upon, or even without certain additional incurrences, of debt or restricted payments) and impact other determinations, for example guarantor coverage and cross-default provisions.

Modelling on a case-by-case basis would be needed to fully assess the impact of reclassifying operating leases under IFRS 16. Furthermore, companies with currently outstanding or planned financing transactions should closely analyze the language in their debt documentation to ensure that the structure of definitions and ratios is appropriate in light of IFRS 16.

One common approach seen in the high-yield market has been the adoption of the so-called **"frozen" IFRS**, whereby the issuer preserves the IFRS position, allowing for ratios to be set and covenant compliance to be calculated, on the basis of accounting standards existing on a certain specified date prior to IFRS 16 adoption (for example, for some issuers it is the issue date of their latest issued and currently outstanding bonds). This approach is in contrast with a **"floating" IFRS**, which reflects the up-to-date accounting standards, including IFRS 16. Pursuant to the "frozen" IFRS approach, the companies and their respective auditors would effectively need to prepare parallel accounts for pre-IFRS 16 ratio assessment under their debt documentation and IFRS 16 assessment as part of their standard periodic reporting. While this approach may address the issue of financial ratios and covenant alignment, it is important to note that one must also

examine the structure of other definitions in the indenture and consider whether "frozen" IFRS also covers the definitions related to borrowings, and, if not, whether operating leases should be explicitly excluded from such definitions.

In another approach, while not "freezing" the definition of IFRS by reference to accounting standards prior to IFRS 16 adoption, some issuers have explicitly carved out operating leases from definitions related to borrowings, such as "Indebtedness" and "Capitalized Lease Obligations". This way, while all ratios and calculations will be reset based on the up-to-date IFRS, the issuers ensure the IFRS 16 will not impact their permitted borrowings baskets.

Table 1 opposite presents a brief overview of high-yield offerings by European issuers from the first quarter of 2019 and illustrates the formulations used in connection with their IFRS 16 approaches. This includes some of the deals our team was involved in since the beginning of this year (Rexel, Faurecia). In light thereof, a few considerations should be highlighted:

- While some issuers have chosen a "frozen" IFRS approach, many have followed the "floating" IRFS with explicit carve-out of operating leases from the borrowing-related definitions. Regardless of the chosen approach, it is important to ensure consistency and, where suitable, eliminate redundancy to ensure clarity across all definitions, ratios and computations. For example, if a "frozen" IFRS approach is chosen, in the "IFRS" definition or another suitable section of the indenture, the lawyers drafting the relevant indenture may consider including some clarifying language that all ratios and computations based on IFRS contained in the indenture will be computed in conformity with IFRS as defined in the indenture. Furthermore, separate analysis of non-financial definitions should be undertaken to ensure their alignment with the "frozen" IFRS approach (for example, depending on the drafting, one may need to consider whether any carve-outs of operating leases from general covenants may be required).
- In terms of the companies' ongoing reporting obligations, we note that, in precedents adopting the "frozen" IFRS approach, the companies' reporting covenants require periodic reports to be based on the "floating" IFRS, including IFRS 16. Without a separate requirement to share some form of reconciliation statements (showing the ratio compliance based on pre-IFRS 16 figures), effective investor monitoring of covenant compliance in such cases may be problematic.
- Finally, due to current variation of IRFS 16 adoption in high-yield debt documentation, the comparability of market peer precedents may be challenging and any peer analysis, even within the same industry, requires a careful approach.

In conclusion, currently main solutions to the IFRS 16 adoption in the high-yield market appear to be split between the "frozen" IFRS approach and the "floating" IFRS with operating leases carved out from the borrowing-related definitions. The companies and their advisers have to assess on a case-by-case basis whether the "frozen" IFRS approach may be suitable in a particular scenario and, even if applied, care must be taken with respect to alignment of definitions, ratios and covenants. The companies' reporting obligations must also be analyzed for the level of deviation between financial ratios and metrics that are provided in the companies' periodic reports and related ratios and metrics set out for covenant purposes in the indenture or other debt documentation.

Table 1: IFRS 16 Approach in High-Yield Documentation

Issuer / Offering	Description of Notes – IFRS 16 Approach
Parts Europe January 2019 (Rule 144A/Reg S) Industry: Automotive, light vehicle and truck spare parts distribution and repair	Frozen "IFRS" with operating leases excluded from definitions relating to borrowings (e.g. "Capitalized Lease Obligations")
Smurfit Kappa January 2019 (Reg S only) Industry: Packaging manufacture	Floating "IFRS" with operating leases excluded from definitions relating to borrowings (e.g. "Indebtedness")
Stonegate Pub Company February 2019 (144A/Reg S) Industry: Food and drink, pub and bar operator	Floating "IFRS" with operating leases excluded from definitions relating to borrowings (e.g. "Indebtedness")
Digi Communications February 2019 (Rule 144A/Reg S) Industry: Telecommunication services	Frozen "IFRS" with operating leases excluded from definitions relating to borrowings (e.g. "Indebtedness")
Park Aerospace /Avolon Holdings February 2019 (Rule 144A/Reg S) Industry: aircraft leasing	Floating "IFRS" with operating leases excluded from definitions relating to borrowings (e.g. "Finance Lease", "Indebtedness")
Rexel March 2019 (Reg S only) Industry: Electrical products distribution	Frozen "IFRS" with operating leases excluded from definitions relating to borrowings
Digicel Holdings March 2019 (Rule 144A/Reg S) Industry: communications services provider	Floating "IFRS" with operating leases excluded from definitions relating to borrowings (e.g. "Capital Lease")
Cemex March 2019 (Rule 144A/Reg S) Industry: Cement production	Floating "IFRS" with operating leases excluded from definitions relating to borrowings (e.g. "Capital Lease")
Faurecia March 2019 (Reg S only) Industry: Automotive equipment supplier	Floating "IFRS" with operating leases excluded from definitions relating to borrowings and total assets (e.g. "Indebtedness", "Limitation on Indebtedness", "Consolidated Senior Net Indebtedness" and "Consolidated Total Assets")
Playtech March, 2019 (Reg S only) Industry: software development for the gambling and financial trading industries	Floating "IFRS" with operating leases excluded from definitions relating to borrowings (e.g. "Financial Indebtedness", "Capitalised Lease Obligation")
Sappi Papier Holding GmbH March 2019 (Rule 144a/Reg S) Industry: Paper production	Frozen "IFRS" specifically with respect to operating leases, operating leases are also excluded from definitions relating to borrowings (e.g. " Indebtedness")

We will continue to monitor developments in this area and welcome any queries you may have. For further information on any of the issues highlighted, we would encourage you to contact Sylvain Dhennin or your other usual Hogan Lovells adviser.

Contacts

Sylvain Dhennin
Partner, London
T +44 20 7296 5773
sylvain.dhennin@hoganlovells.com

Daria Latysheva
T +44 20 7296 5549
U.S. Securities Senior Associate, London
daria.latysheva@hoganlovells.com

Philip Schuster
T +44 20 7296 5885
U.S. Securities Associate, London
philip.schuster@hoganlovells.com

Jonathan Morris
T +44 20 7296 5886
Associate, London
jonathan.morris@hoganlovells.com