

High-Yield: IFRS 16 Impact on Covenants

This client briefing 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 some recent deals involving our team (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 was to be classified as a finance lease if it transferred substantially all the risks and rewards incident to ownership. All other leases were to 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 requires all leases to be recognized on a lessee's balance sheet¹. 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 a company's 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;

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

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, in many cases, is expected to be 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.

Financial and other definitions

Definitions related to borrowings (such as "Indebtedness" 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 (for example, prior to IFRS 16 adoption, which for some issuers could be the issue date of their latest issued and currently outstanding bonds). This approach is in contrast with a **"floating" IFRS**, which reflects accounting standards as may be amended from time to time, including IFRS 16. If the "frozen" IFRS approach is chosen to exclude the impact of IFRS 16, 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 assessed based on the up-to-date IFRS, the issuers ensure that IFRS 16 will not impact their permitted borrowings baskets.

Table 1 below presents a brief overview of some 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” IFRS 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 issuers’ ongoing reporting obligations, we note that, in precedents adopting the “frozen” IFRS approach, the issuers’ 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 the pre-IFRS 16 figures), effective investor monitoring of covenant compliance in such cases may be problematic.

- Finally, due to current variation of IFRS 16 adoption in high-yield debt documentation, the comparability of market precedents may be challenging and any peer analysis, even within the same industry, requires a careful approach.

In conclusion, currently the 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. Issuers 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 issuers’ 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.

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.

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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 (pre-IFRS 16) 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 (pre-IFRS 16) 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 (pre-IFRS 16) 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	“Frozen” IFRS (Issue Date) 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 March 2019 (Rule 144A/Reg S) Industry: Paper production	“Floating” IFRS, but “frozen” IFRS (pre-IFRS 16) specifically with respect to operating leases; operating leases are also excluded from definitions relating to borrowings (e.g. “Indebtedness”)
LeasePlan March 2019 (Rule 144A/Reg S) Industry: car leasing	“Floating” IFRS with operating leases excluded from definitions relating to borrowings (e.g. “Indebtedness”)

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