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Debt Compliance: Understanding Best Practices, Risks, and Costs in Today's Environment

Cindy Fryer

Senior Director – Treasury

Endo Health Solutions

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Presentation Topics

- **Underestimated debt compliance risks**
- **Best practices in debt compliance**
- **Endo Health Solutions case study**

Underestimated Debt Compliance Risks

- **Enterprise risk**
- **Covenant violation risk**
- **Balance sheet GAAP risk**
- **SOX control risk**
- **Bank call risk**
- **Stock price risk**
- **Career risk**

Enterprise Risk is Overlooked

- **The possibility of a default is the most overlooked enterprise risk, as it is rarely mentioned in any list of enterprise risks**
- **Yet, a default can:**
 - Shut the company down
 - Destroy its reputation overnight
 - Crater its market cap
 - Incur significant monetary penalties
 - Result in more restrictive debt agreements if not workout or Chapter 11

Covenant Violation Risk is Underestimated

US Corporates 1981-2011			
S&P Rating	Cumulative 5 Year S&P Default Rate	% with Higher Ratings Within 3 Years	% with Lower Ratings Within 3 Years*
A	2%	4%	28%
BBB	3%	9%	28%
BB	10%	12%	44%
B	22%	15%	48%

Source: S&P's 2011 US Corporate Default Study and Rating Transitions.
*Includes defaults and issuers becoming nonrated.

- **S&P Default Rate = Missed required payment or a distressed debt restructuring (a “hard” default)**
- **DCS estimates that the risk of any other kind of covenant violation is at least equal to the S&P Hard Default Rate**

Default Risk Increases Over Time

- **No treasurer borrows and no banker lends expecting a first year default**
- **The S&P data shows that bad things happen in years 2 and 3**
 - 44% of BBs will have lower credit ratings in three years, which is almost 4x the 12% of BBs who will have higher ratings
- **Yet many companies often judge the extent of necessary debt compliance controls by the first year risk**
- **It doesn't help that:**
 - Many treasury projects delayed during the debt negotiations often become a priority over developing compliance practices
 - In years 3 and 4, the company might well have new compliance staff who were not involved in the original negotiations and are never given the time to fully understand the covenant complexities

GAAP Risk is Often Unrecognized

- **ASC 470-10-45-11** requires that long-term debt be classified as current when there is a “violation of a provision” in the debt at the financial statement date that is either uncured or has not been waived by the lender
- **ASC 470-10-20** defines a violation as any objectively defined failure to comply with the terms of the debt agreement
- **ASC 470-10-45-12** states, “Drawing a distinction between significant violations of critical conditions and technical violations is not practicable. A violation that a debtor considers technical may be considered critical by the creditor. Furthermore, a creditor may chose to use a technical violation as a means to withdraw from its lending relationship with the debtor.”

SOX Risk is Often Not Considered

- **A SOX program evaluates the financial reporting risks and identifies the critical controls to mitigate these risks**
 - The likelihood of covenant violations is high for non-investment grade companies
- **When a critical control is missing or is not operationally effective, the internal control framework is weakened and this is a SOX deficiency**
- **If the financial statements are wrong because of the missing control – such as classifying debt as LT rather than ST – then the financial statements may have to be restated and reissued**
 - This may result in a SOX material weakness that would be reported in the next 10-Q or 10-K
 - The auditor may issue a qualified opinion that could trigger another debt covenant violation

Bank Call Risk is Greater Today

- **Banks now have greater profitability pressures**
- **Banks have new regulatory pressures to increase capital ratios, which they prefer to do by reducing total assets rather than capital increases**
 - Capital-stressed banks will welcome the opportunity to exit a credit at par
- **Bank loans are increasingly owned by mutual funds and hedge funds, who are 100% yield-focused and 0% relationship focused**

The Monetary Costs of Default

- **A default on just a \$50M three year facility can easily cost \$3M:**

Cost	BPs	Year 1	Years 2 & 3	Total
Amendment/Waiver Fees*	50	\$250	-	\$250
Default Interest Spread**	200	133		133
Increased Spread	200	800	1,200	2,000
Increased Commitment fees	50	50	100	150
Legal and Audit Fees		250		250
		<u>\$1,483</u>	<u>\$1,300</u>	<u>\$2,783</u>
*Assumes two months to renegotiate the facility				
**Standard default spread				
***Per CFO Magazine, June 2010, quoting an S&P Report				

Stock Price Risk

- As reported in the 8/31/12 Wall Street Journal, a recent study published by the Stanford Business School, *A Market-Based Study of the Cost of Default* by Davydenko et al., analyzed the costs of 175 publicly-held US corporate defaults between 1997-2010
- After adjusting for overall market gains and losses, they determined that the median stock price loss due to the default in the month of the default was 24.7%
- Defaults were defined as:
 - Bond payment omissions including those rectified within the grace period
 - Distressed bond exchanges
 - Bankruptcy filings

Career Risk

- **Whether a default is caused by ignorance, mismanagement, or just bad luck, it is always Treasury's fault**
- **As with any treasury mistake, hindsight is 20:20 about what Treasury should have done to proactively manage the covenant violation**
- **A treasurer speaking of a non-financial covenant violation, "It was the worst month of my life. Every day I thought I would be fired."**

Presentation Topics

- **Underestimated debt compliance risks**
- **Best practices in debt compliance**
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Survey Background

- As reported in the December 2011 AFP Exchange, “Default Lines: Best Practices in Debt Compliance” (AFP Exchange, December 2011), which is included in the conference CD, we had 192 companies participating in our 2011 survey, a fairly representative sample of the US corporate universe:

	How the 192 Companies Vary by Debt and Credit Rating					
	A or Better	BBB	BB to CCC	<CCC-	No Rating	Total
<\$100M Debt	10%	7%	15%	3%	0%	34%
\$100-375M Debt	4%	6%	9%	1%	1%	21%
\$375-1,000M Debt	2%	6%	13%	0%	1%	21%
>\$1,000M Debt	5%	8%	9%	0%	1%	22%
Debt N/A	0%	1%	2%	0%	0%	2%
Total	21%	27%	47%	3%	2%	100%

- The 192 companies rated their debt compliance process on a 1-5 scale, with 1 = Excellent and 5 = Very Poor, with an average of 2.32
- We will use these ratings to evaluate the assessment by these companies of the effective of the 9 compliance practice listed on the next slide

9 Compliance Practices Surveyed

1. Debt compliance policy
2. Written procedures (but no policy)
3. Comprehensive covenant checklist
4. A list of major covenants (but not comprehensive)
5. Marked-up debt agreements (no covenant list of any kind)
6. Questionnaires
7. Calendar of due dates
8. Quarterly analysis of possible/actual compliance exceptions for CFO review (“exception report”)
9. Board review of the debt compliance

Major Findings

Best is to have a policy, a comprehensive checklist and board review combined with supplemental practices such as a calendar, questionnaires, and exception reports:

Practice (% of 192 Companies)	Rating	Practice (% of 192 Companies)	Rating*	Difference
Uses 5-6 compliance practices* (9%)	1.69	Uses 0-2 compliance practices* (48%)	2.41	0.72**
Has a debt compliance policy (21%)	1.90	No compliance policy (79%)	2.43	0.53**
Board reviews debt compliance (66%)	2.13	No Board review (34%)	2.67	0.55**
Uses comprehensive covenant list (63%)	2.17	No comprehensive list (37%)	2.56	0.39**
4-6 Practices/Policy/Board Review (7%)	1.64	0-2 Practices/No Policy/No Board (19%)	2.74	1.10**

**Out of the 9 compliance practices listed in the last slide

**All differences are statistically significant at the 1% level with the > .55 differences at the 0.1% level

Debt Compliance Policy Recommendations

1. Policy objectives

- Accurately determine in a timely manner the Company's compliance with its debt agreements
- Maintain the Company's access to the capital on the best possible terms by anticipating potential covenant issues and proactively manage its lenders accordingly

2. Company-wide responsibility for compliance

- Use "Subject Matter Experts" (SMEs) to evaluate covenant compliance in areas outside of Treasury, Legal and Accounting
- This effectively trains SMEs who might be unaware of the potential impact of their otherwise appropriate business decisions on the company's covenants

Debt Compliance Policy Recommendations – 2

4. Define and assign responsibilities to Treasury, Accounting, Legal, Other HQ departments, and business units for:

- Managing the quarterly debt compliance process
- Proactive identification and reporting of potential covenant issues
- Providing notices, reports, fees, schedules, etc. to the lenders
- Providing numbers for calculating and forecasting covenant ratios and permitted baskets

5. Description of the compliance process and use of:

- Comprehensive covenant checklist, including the assignment of responsibility for each covenant to subject matter experts (SMEs) who are either knowledgeable about or can make decisions affecting that covenant
- Tailored quarterly questionnaires asking each SME with assigned covenants about the company's compliance with those covenants for both the current quarter and prospectively

Debt Compliance Policy Recommendations – 3

5. Description of the compliance process and use of (cont'd):

- Calendar of due dates for all deliverables and fees
- Exception analysis, a quarterly report for the CFO review's on all identified exceptions/issues to the covenants with recommendations on whether the exceptions require lender reporting
- Quarterly archiving process for saving compliance work papers and all written compliance communications to the lenders

6. SME responsibilities

- Requirement of accurate **and** timely response to the questionnaires
- Requirement to pro-actively involve Treasury/Legal as soon as they are aware of circumstances or decisions that could impact their assigned covenants

Debt Compliance Policy Recommendations – 4

6. Financial covenant procedures

- Regular forecasting of covenants on at least a rolling four quarter basis, forecasting that is based upon the company's current forecasting process (i.e., the forecasts are not made up by Treasury)
- Stress testing, determining how much leeway exists in each covenant before it is breached

7. Permitted basket covenant procedures

- Regular forecasting of permitted baskets on at least a rolling four quarter basis to determine the extent of excess capacity
- HQ Treasury approval required before an item is added to a permitted basket

Debt Compliance Policy Recommendations – 5

- 8. Non-Financial Covenants (affirmative, negative and occurrence-based covenants) procedures**
 - Questionnaire based upon a comprehensive covenant list tailored to SME responsibilities
- 9. CFO review procedure before signing the certification letter**
 - A resolution report analyzing possible/actual compliance exceptions
 - Financial covenant analysis and permitted baskets schedules, both actuals and forecasts
- 10. At least annual presentations on debt compliance to the Audit Committee of the Board of Directors**

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About Endo Health Solutions

- **\$3B diversified healthcare solutions company**
- **Strategic acquisition growth strategy from 2009 through 2011 with several large transactions**
- **\$2.9B cash acquisition in mid-2011 more than tripled debt to approximately \$4.0B**
- **5 major debt agreements: Revolver, Term Loans A and B, three Senior Notes, and a Convertible**
- **Rated BB and Ba2**
- **Maintaining Endo's access to capital by properly and proactively managing its debt compliance is a critical treasury responsibility for supporting the growth strategy**

Debt Compliance Implementation – 1

- **Engaged Debt Compliance Services (“DCS”) and their automated, web-based services**
- **DCS identified over 300 covenants in the five agreements that were carefully vetted by Treasury and Legal**
- **With DCS, we wrote over 600 questions about compliance with those questions**
 - Yes/No format with required explanations
 - Pop-up boxes provided definitions of the agreement’s defined terms used in the questions to be legally precise
 - Questions asked about current quarter compliance **and** prospective compliance

Debt Compliance Implementation – 2

- We then identified over 30 respondents in treasury, legal, controller's, divisional operations, procurement, intellectual property, and human resources
- DCS then developed web questionnaires for these 30+ respondents, asking more than 900 questions, as it was sometimes necessary to ask the same question of multiple respondents
- DCS also developed a calendar of all regularly required deliverables for all five agreements

Quarterly Review Process

- **Utilizing DCS**
 - Review respondents for personnel changes
 - Open questionnaires with five days to respond; allow an additional five days for reviewers to review responses
 - Using DCS' reporting tools, validate all responses and analyze exceptions in an Exception Report used in quarterly meeting with Treasurer, CFO and CLO
- **Outside of DCS**
 - Calculate and stress test covenant ratios
 - Calculate permitted baskets
 - Review with CFO, who signs the certification

Benefits

- **Provides a clear corporate overview with minimal effort that far exceeds the understanding of any individual or team**
- **Endo's key business stakeholders now understand Endo's debt obligations, substantially minimizing the risk of business decisions inadvertently breaching a covenant**
- **Permanent, repeatable process that can be easily and accurately transferred to new staff for debt going out to 2022**
- **Can proactively manage Endo's lenders and avoid surprising them by identifying and managing future covenant issues**
- **Endo Treasury is fulfilling its responsibilities to fund Endo's growth strategy at the lowest possible cost**

Conclusions

Conclusions

- **As with any treasury activity, developing an appropriate debt compliance process requires balancing risks versus costs**
- **For less than investment grade companies, we have shown that these risks are too great to leave to an incomplete, manual process**
- **These risks are relatively small in the first year, but increase over time which can be further increased if there is new staff managing compliance with less knowledge of the covenants and their often complex nuances**
- **The best practices listed are common sense requirements**
- **The cost is spending the time to set up the process**
- **Once complete, the process runs smoothly and efficiently**
- **The benefits of these practices are not only completing this quarter efficiently but managing proactively the debt compliance risks of the future quarters**

Appendix

Jeff Wallace

- **Managing Director, Debt Compliance Services, which he co-founded in 2009**
- **Managing Partner, Greenwich Treasury Advisors, which he founded in 1992**
- **Publications**
 - *Default Lines: Best Practices in Debt Compliance* (AFP Exchange, December 2011) with Jim Simpson
 - *The Group of 31 Report: Core Principles for Managing MNC FX Risk* (AFP, 1999)
 - FAS 133 chapter of *The Handbook of International Finance & Accounting* (John Wiley, 2004)
- **VP-International Treasury at American Express, AT at Seagram and at Dun & Bradstreet; CPA at Price Waterhouse**
- **303-442-4433 and jeff.wallace@debtcompliance.com**

Cindy Fryer

- **Senior Director – Treasury, Endo Health Solutions Inc.**
- **Director – Corporate Finance, Treasury, Campbell Soup**
- **Various accounting and finance positions at JPMorgan Chase, SJ Gas Company and PricewaterhouseCoopers**
- **MBA from Drexel University**
- **CPA and CTP**