Understanding Debt Covenants
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Executive Summary

- The most misunderstood and seriously underestimated enterprise risk of speculative grade companies is debt default risk
  - S&P’s annual 30-year default study and DCS’ debt compliance survey with the AFP shows the 5 year risk for hard defaults is 2 to 5x higher than what speculative grade corporates estimate
- While Treasury is not responsible for poor operating results, Treasury is responsible for proactively managing compliance to minimize covenant surprises for senior management and the lenders and to maintain the company’s access to funding at the lowest possible cost
- Treasury can only do this if it has a strong, rigorous debt compliance process, a compliance process that not only efficiently manages the current quarter, but gathers information about existing and potential covenant issues so that they can be monitored, managed and mitigated in the succeeding quarters
- This process starts at understanding covenants and events of default
Presentation Outline

- The debt facts of life
- Understanding covenants
- Managing multiple agreements
- Best practices in debt compliance
- Conclusions and Q&A
- Appendix
  - Estimating technical default risk
  - The DCS Covenant Manager℠ Solution
  - About Debt Compliance Services
Companies have a legal obligation to manage their operations within the constraints imposed by all of their debt agreements.

Lenders expect the Borrowers to understand and comply with every lender protection in the debt agreements, no matter how insignificant.

US GAAP requires any debt with a covenant violation to be classified as short term because the violation gives the lenders the right to call the debt.

SOX requires public companies to have adequate internal controls to justify the CFO and CEO certifications that the financial statements are in accordance with GAAP and are not false or misleading.

The PCAOB has told the auditors they need to test, rather than accept, management’s assertions (e.g., we are in compliance with our debt).

Litigious shareholders will sue about misleading financial statements which have restated the LT debt as ST due to long outstanding covenant violations, especially when the auditors have issued a material SOX deficiency citation.
Inadequate Debt Compliance Practices

Yet, many companies have an inadequate debt compliance process that suffers grievously in comparison to their other compliance processes:

<table>
<thead>
<tr>
<th>Practice</th>
<th>Debt Compliance*</th>
<th>FCPA</th>
<th>SOX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Policy</td>
<td>50%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>A clear understanding of prohibited actions and requirements</td>
<td>47% do not have a comprehensive covenant checklist and 28% do not have a debt calendar</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>People with assigned responsibility for compliance</td>
<td>69%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Depth of coverage within the company</td>
<td>Generally confined within HQ Treasury, Legal and Accounting</td>
<td>All foreign units + HQ departments</td>
<td>All units + HQ departments</td>
</tr>
<tr>
<td>Documenting compliance by specific individuals</td>
<td>44%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Results regularly reported to the Audit Committee</td>
<td>28%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

*All percentages from the 2012 AFP Debt Compliance Survey of 401 corporate respondents
Treasury’s Limited View of Default Risk

- We find that Treasurers and CFOs generally ignore the SOX implications and justify weak practices because they assume that the default risk is small and their friendly lenders would be forgiving of any technical default.
- These assumptions could cost these Treasurers and CFOs their jobs.
  - S&P’s annual default study shows that actual hard default risk is 2 to 5x higher than speculative grade companies estimate.
  - With an inadequate compliance process, a technical default is likely to be long outstanding, rather than something that just happened.
  - A default involves much more than the lenders and at best is an unpleasant experience that no one ever, ever, wants to repeat.
- Will your CEO and Board will be forgiving of a technical default or will they perceive it as a costly Treasury mistake due to incompetence?
  - “It was the worse month of my life,” said a client Treasurer of a technical default, “Every day I thought I would be fired.”
Five Year S&P Transition Rates

Over 5 years, reflecting the likelihood of poor operating results and business stress, credit quality generally degrades:

Source: S&P’s 2013 Global Corporate Default Study and Rating Transitions, Table 21
Default Risk is Large and Underestimated

- Defaults can be one-time events or remain undiscovered for many quarters:
  - Hard defaults (HD) – missed payments, distressed debt exchanges, and bankruptcy filings (this is S&P’s and AFP’s definition of a hard default in the statistics below)
  - Technical defaults (TD) – any other kind of default

- The 5-year risks of hard and technical defaults are much higher than many speculative grade companies believe, who apparently think default can’t really happen to them

<table>
<thead>
<tr>
<th>5 Year Default Estimates</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC/C</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFP Survey HD Estimate (a)</td>
<td>2%</td>
<td>3%</td>
<td>5%</td>
<td>4%</td>
<td>15%</td>
</tr>
<tr>
<td>S&amp;P HD Default (b)</td>
<td>1%</td>
<td>2%</td>
<td>9%</td>
<td>21%</td>
<td>48%</td>
</tr>
<tr>
<td>DCS Technical Default (c)</td>
<td>4%</td>
<td>8%</td>
<td>18%</td>
<td>30%</td>
<td>55%</td>
</tr>
<tr>
<td>Net HD/TD Default Risk (c)</td>
<td>4%</td>
<td>8%</td>
<td>20%</td>
<td>34%</td>
<td>62%</td>
</tr>
</tbody>
</table>

(a) By publicly rated companies about the hard default risk of companies with their own credit risk, 2012 AFP Debt Compliance Survey

(b) S&P's 2013 Global Corporate Default Study and Rating Transitions, Table 21

(c) See DCS methodology using S&P’s 2013 rating transition rates in the Appendix
The Default Facts of Life

1. When known, defaults must be reported quickly to the lenders per the terms of the agreement, as not reporting would be fraudulent
   - Including reporting to other lenders due to cross-default clauses
2. Lenders will want to know the specifics of the default, when it started, and what steps the company has taken or proposes to take to remedy the default
   - The longer the default period, the more the 2% penalty interest is due on the outstanding debt and there’s more justification for higher waiver fees
3. The auditors will also need to be informed, and both the lenders and the auditors will insist on an intensive review to determine if there are any other covenant violations
4. Auditors will also want to know when the default started because a default occurring over several quarters will cause the financial statements to be restated
   - ASC 470-10-45-11 requires the defaulted debt(s) to be classified as short-term for any covenant violation, no matter how insignificant
5. If a public company, such a 10-Q/A restatement would incur a material SOX deficiency citation and possibly trigger an SEC investigation for a 1934 Exchange Act violation
The Default Facts of Life (cont’d)

6. If there is public disclosure, the stock price will be hit, which will be much more costly than the penalty interest, waiver, legal, audit, and advisory fees

7. Possible shareholder lawsuits for misleading financial statements

8. Business disruption can occur with vendors, customers and employees

9. What the lenders will accept in satisfaction is a complex calculation of factors that are beyond the company’s control:
   - The penalty interest accrued
   - The lenders’ downgraded evaluation of the company’s management
   - The company’s current credit risk, which may have worsen because the breached covenant may also be a symptom of poor operating results
   - The current economic conditions of the company’s industry
   - Current credit market conditions, especially if the pricing is now underwater

10. And, let’s not forget that the company may be unable to borrow on its credit lines until the default(s) are remedied
Presentation Outline

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Many companies assume that the affirmative and negative covenant sections contain all of the covenants that need to be followed. However, covenants are found in virtually every agreement section. These additional covenants account for another 20-30% more covenants.

A better way to identify and understand covenants is to look at the consequences of non-compliance. We define a covenant as every required action contained in a debt agreement that, if not adhered to, would constitute an Event of Default.

This section on understanding covenants covers:
- Common covenant fallacies and statistics
- Compliance certificate requirements
- What is a default
- How Events of Default are categorized
- The covenants typically included in each default category
Common Covenant Fallacies

**Fallacy**

Covenants are found only in the affirmative and negative sections of the agreements

20/80: The “real” covenants are limited to financial performance, permitted baskets, and quarterly reporting

The senior credit facility has all of the most restrictive covenants

“Covenant-lite” agreements have no covenants

**Fact**

Covenants usually number 80 for a typical senior credit facility and are found throughout the agreement

The non-financial covenants are where most mistakes are made

Other agreements often have covenants that are unique to that type of agreement or are more restrictive because the agreement was written earlier under different credit conditions

Covenant-lite agreements will have no maintenance (ratio) covenants, but they will have many, if not more, incurrence covenants and non-financial covenants
## Covenant Statistics

<table>
<thead>
<tr>
<th>Covenant Type</th>
<th>Revolving Credit</th>
<th>ABL</th>
<th>Senior Notes</th>
<th>Convertible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affirmative</td>
<td>25</td>
<td>45</td>
<td>20</td>
<td>15</td>
</tr>
<tr>
<td>Negative</td>
<td>15</td>
<td>15</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Reps &amp; Warranties</td>
<td>15</td>
<td>15</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Other</td>
<td>25</td>
<td>20</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td><strong>80</strong></td>
<td><strong>95</strong></td>
<td><strong>45</strong></td>
<td><strong>35</strong></td>
</tr>
<tr>
<td>Agreement in Pages</td>
<td>80-150</td>
<td>120-180</td>
<td>60-80</td>
<td>60-80</td>
</tr>
<tr>
<td>Defined Terms</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pages</td>
<td>25-35</td>
<td>40-50</td>
<td>15-25</td>
<td>15-25</td>
</tr>
<tr>
<td># of Terms</td>
<td>300 - 450</td>
<td>350 - 450</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Events of Default</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>#</td>
<td>12-15</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cure Period</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0-30 days</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Compliance Certificate Requirements

- The quarterly/annual Compliance Certificate is the most important communication of the company with its lenders
- It attests that:
  - Continuing Reps & Warranties are still true
  - There has been no Event of Default or, in some cases, a potential default
  - The company is in compliance with all Maintenance Covenants with detailed calculations of the financial ratios
  - Any required schedules
    - AR aging, overdue A/P, material contracts list, etc.
- If there is an Event of Default
  - What happened, when it happened, and what actions have been taken or will be taken to remedy the default
What is a Default

- "Default" means any event, act or condition which, with notice or lapse of time, or both, would constitute an Event of Default.
- The Borrower is required to “promptly” notify the Agent/Trustee upon the knowledge of a Responsible Officer of such Default.
- In some cases, the agreement will assume knowledge by stating that notification of a specific default is upon “Knowledge” or at least X days from the event.
  - This means that borrowers can not use lack of reporting to the CFO as an excuse for not reporting the default.
- Some defaults – payments, reporting, insolvency – are obvious.
- Other defaults are related to actions not done after a specific event has occurred, which can be undiscovered for several quarters.
Specific Defaults

These specific defaults are listed in the first four to six Events of Default clauses and refer to specific covenants in the agreement

- Cure periods reflect the importance the lenders attach to each category

<table>
<thead>
<tr>
<th>Event of Default Category</th>
<th>Cure Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Principal payments, including Mandatory Prepayments</td>
<td>0-1 Days</td>
</tr>
<tr>
<td>2. Interest, fee and other required payments</td>
<td>0-3 Days</td>
</tr>
<tr>
<td>3. Reps &amp; Warranties and incorrect reports, certificates, financial statements and other documents furnished</td>
<td>0 Days</td>
</tr>
<tr>
<td>4. Specifically identified covenants, such as maintenance, negative, reporting and notifications</td>
<td>0-5 Days</td>
</tr>
<tr>
<td>5. Invalidity of Credit or Security/Collateral Agreements</td>
<td>0 Days</td>
</tr>
<tr>
<td>6. All other covenants in a catch-all phrasing, which includes the affirmative covenants</td>
<td>30 – 60 Days</td>
</tr>
</tbody>
</table>
Payment Covenants - Principal

Principal Payments

- Required Amortization
- Final payment
- Mandatory Prepayments
  - Excess Cash Flow
  - Net Proceeds from asset sales, insurance proceeds from casualty events, new debt, new equity
- Make-Whole Payments
- Voluntary Prepayments
- LC Reimbursement

Cure Periods

- 0-1 Business Days, very rarely longer
Interest, Fees, and Other Payments

- Interest
  - Additional Interest
  - Change in circumstances (new taxes, changes in lender costs, etc.)
- Commitment and Usage Fees
- LC Fees
- Agent/Trustee Fees
- Lender expense reimbursement
- Promptly pay taxes

Cure Periods

- 0-3 Business Days, sometimes up to 5
Representations & Warranties

Reps & Warranties

- Closing Date Reps & Warranties
- Post-Closing promises
  - Registering securities with SEC, banking arrangements, perfection
- Continuing Reps & Warranties
  - Required to be reaffirmed each time the borrower borrows
  - Continuing Reps & Warranties can include:
    - Material Adverse Change
    - Lawsuits
    - Strikes
    - Environmental
    - Solvency
    - No Default
    - Governmental Action
    - Margin Regulations
    - Intellectual Property
    - Full Disclosure

Cure Periods

- Usually 0 Days
Maintenance and Incurrence Covenants

Maintenance Covenants
Financial ratios tested quarterly or annually
- Leverage Ratios
- Fixed Charge Coverage Ratio
- Net Worth
- Interest Coverage
- Working capital
- Capital Expenditures

Incurrence Covenants
Financial ratios tested on a pro forma basis prior to a contemplated event such as incurring additional debt, paying dividends, cash dominion event, etc.
- Leverage Ratios
- Fixed Charge Coverage Ratio
- Net Worth

Cure Periods
- 0-5 Business Days
- PE Firms will often use an equity cure to remedy a leverage breach
Negative Covenants – Prohibited Actions

Prohibited Actions

- New Indebtedness
- Negative pledge
- Anti-layering (current debt is subordinated to new debt)
- Sale and leasebacks
- Lease obligations
- New Liens (negative pledged)
- New Investments
- Mergers and acquisitions
- Parent and sub guarantees
- Board changes

Other Prohibited Actions

- Sales of receivables
- Sale of assets
- Affiliate Transactions, especially with unrestricted upstream holdcos and downstream opcos
- Restricted Payments (dividends, advances to third parties, equity buybacks, debt repurchases, etc.)
- Restrictive agreements
- Restricted investments
- Changes in business activities
- Etc., etc.

Cure Periods

- 0-5 Business Days
Permitted Baskets

Many Prohibited Actions have numerous exceptions with a dollar limit

- Foreign debt
- Other debt
- Sale and leasebacks
- Other liens
- Acquisitions
- Sale of assets
- Restricted payments

Such limitations need to be tracked and reported on if and when such limits are breeched

Cure Periods

- 0-5 Business Days
Reporting

- Annual and Quarterly Financial Statements
- Auditor’s Report with Annual Statements
- Auditor’s statement of no knowledge of a default
- Compliance Certificate
- Annual Plan
- Excess Cash Flow Calculation

Other Reporting

- Excess Cash Flow Calculation
- All SEC filings, such as 8K
- SEC-like filings for 144A notes
- Update of certain schedules
  - Material contracts, AR aging, overdue A/P payments, etc.
- Collateral Report
- Weekly/monthly Borrowing Base Certificate for ABLs

Note that inaccurate reports are a covenant breach

Cure Periods

- Varies from 0-5 days to 30-60 days after month- or quarter-end
Notifications

- Default
- ERISA events
- Environmental claims, actions, incidents, real or pending
- Litigation
- Strikes

Other Notifications

- Prospective or actual Material Adverse Events
- Asset Sales
- Casualty Events
- Change in Collateral Location
- New subsidiaries

For weak credits, many of these items could be listed as negative covenants rather than as notification requirements

Cure Periods

- 0-5 Business Days
Invalid Security Documents

- If any of the Security or Collateral Documents cease to create a valid security interest in any material portion of the Collateral
- Or such security interest shall cease to be a perfected and first priority security interest subject only to Permitted Liens

Invalid Collateral

- Failure to provide security or collateral documents for new subsidiaries
- Invalid leasehold interests
- Good and marketable title to property

Cure Periods:

- 0 Business Days
All Other Affirmative Covenants

Affirmative Covenants

- Insurance
- Use of Proceeds
- Patriot Act/FCPA/FATCA
- Comply with laws
- Environmental
- Intellectual Property
- Interest Rate Hedging

Other Affirmative Covenants

- ERISA
- Maintenance of (Corporate) Existence
- Maintenance of Business
  - Property, IP, licenses, etc.
- Lenders can inspect of books and records and discuss with management (visitation)

Cure Periods

- Generally longer than the other Events of Default but usually do not exceed 30-60 Days
Other Events of Defaults

Typically deal with other areas of the Borrower and do not appear elsewhere in the agreement so they must be included in the comprehensive covenant list.

Other Events of Default are:
- Cross default
- Cross acceleration
- Guarantors’ default
- Voluntary/involuntary bankruptcy/insolvency
- Change of Control

Other Events of Defaults include:
- Judgments
- Cancellation of Material Contracts
- ERISA Events
- Governmental Actions
- Revocation of Licenses

Cure Periods
- Varies by specific default event, typically 0-10 days
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Managing Multiple Agreements

- Many companies assume that compliance with their senior most debt agreement is sufficient to cover any other agreements.
- However, the senior credit facility does not necessarily have all of the controlling covenants unless existing agreements are deliberately conformed to the new agreement.
- If not, some covenants in the older agreements may be controlling because they were written under different market and company credit conditions.
- And, different types of debt instruments will have unique covenants common to that type of financing.
  - Senior Notes, other indentures and convertible debt have different mandatory prepayment provisions, change of control, make whole, reporting deadlines and permitted basket limitations.
  - ABL’s have much more complex and frequent reporting requirements.
- The first step is developing a comprehensive covenant checklist for each unique agreement.
Developing a Covenant Checklist

- All covenants, regardless of their significance, need to be identified.
- Once identified, each covenant must contain the following additional information:
  - Section reference
  - A brief description of the covenant
  - Identification of the related Event of Default section
  - The length of the cure period
  - How frequently does each covenant need to be monitored or tested to determine any breach and when is notice required
  - Which department(s)/business unit(s) have the specific knowledge to determine at the earliest possible time if there is a breach of that covenant
- However, all interpretations about a possible covenant violation must be based upon a review of the agreement and consultation with Legal, not a review of the checklist.
Managing Multiple Debt Agreements – 2

- With a covenant checklist written for each unique agreement, review them to determine which covenants are controlling and unique.
- We recommend that a specific analysis is done of permitted baskets, which is a common place to find more restrictive limits over the senior credit agreement.
- Finally, a debt calendar of all fees, deliverables and notices needs to be done for each agreement, consolidated with the other debt, and assigned to specific individuals.
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## Debt Compliance Best Practices

<table>
<thead>
<tr>
<th>Objective</th>
<th>Best Practices</th>
</tr>
</thead>
</table>
| 1. Fully understand the debt agreements and their requirements.           | ▪ Comprehensive covenant checklist.  
▪ Permitted basket analysis.  
▪ Model covenant ratios with stress testing.  
▪ Due date calendar of deliverables and fees.                                  |
| 2. Integrate the covenants into the company’s operations and planning.    | ▪ Debt Compliance Policy.  
▪ Compliance Team, which generally includes staff from Treasury, Legal, and Controllers.  
▪ Assign Subject Matter Experts (SMEs) to the covenants that are in their areas of responsibility.  
▪ Train Compliance Team members and SMEs in their Policy responsibilities.  
▪ For significant permitted baskets risk, implement approval procedures for permitted basket items. |
# Debt Compliance Best Practices – 2

<table>
<thead>
<tr>
<th>Objective</th>
<th>Best Practices</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Determine efficiently and accurately the company’s quarterly compliance with its debt covenants.</td>
<td>▪ Review the comprehensive covenant checklist.</td>
</tr>
<tr>
<td></td>
<td>▪ Determine financial covenant ratios and permitted baskets amounts.</td>
</tr>
<tr>
<td></td>
<td>▪ SMEs complete (web) questionnaires on their covenants, with their responses reviewed by their managers.</td>
</tr>
<tr>
<td></td>
<td>▪ Exception Report analysis of all existing and potential covenant issues, no matter how small.</td>
</tr>
<tr>
<td></td>
<td>▪ Ensure that all deliverables and fees have been sent on time, including the quarterly Officer’s Certificate, per Debt Calendar</td>
</tr>
</tbody>
</table>
### Objective

4. Manage existing and potential covenant issues to mitigate the risk of future covenant violations.

5. Proactively manage senior management and lenders about significant possible covenant issues to minimize surprises and consequences.

### Best Practices

- Forecast and stress test financial covenant ratios.
- Forecast permitted basket items against limits, and where appropriate, establish approval procedures for new permitted basket items.
- Require by Policy that the SMEs report prospective covenant issues at all times, not just at quarter-end.
- Compliance Team monitors and manages existing and potential issues identified in the Exception Report.
- Treasurer discusses significant possible future covenant issues with senior management and lenders.
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Conclusions

- As with any treasury activity, developing an appropriate debt compliance process requires balancing risks versus costs.
- For speculative 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 and are compounded when there is new staff managing the debt compliance with less knowledge of the covenants and an inadequate process.
- The best practices listed are common sense that are consistent with how companies manage other compliance requirements like SOX.
- You have already received our best practices debt compliance policy, which is also available at our website, www.debtcompliance.com, in Presentations under Resources.
- For an automated, turnkey process, please see the description of our DCS Covenant Manager℠ solution in the Appendix.
Q&A

- Please ask your questions about the presentation and any questions about your own covenants in the webinar question box
- If you would like a private answer after the presentation is over, please indicate that in your questions
- All will receive a copy of this presentation
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Covenant Risk Increases over Time ...

How BB Credit Ratings Transition over 5 Years

Source: S&P’s 2013 Global Corporate Default Study and Rating Transitions, Table 21
Estimating BB 5 Year Technical Default Risk

- We believe that a lower bound for estimating BB technical default ("TD") risk is that it must be at least equal to the hard default rate
  - Which is what 93% of AFP Debt Compliance Survey said when asked to estimate hard and technical default risk
- We derive an upper bound by using S&P’s rating transition data for BB-rated companies shown in the next column, which was used to create the previous slide

| DCS TD Transition Analysis using S&P 2013 Transition Data |
|----------------------------------|----------|----------|----------|----------|
| From BB to: 1 Year 3 Years 5 Years | DCS 5Y TD Weighting | 5Y Technical Default Risk |
| AA 0.0% 0.1% 0.1% | 0.1% | |
| A 0.2% 0.6% 1.2% | 1.2% | |
| BBB 5.2% 11.4% 12.6% | 12.6% | |
| BB 76.3% 45.0% 29.1% | 29.1% | |
| B 7.1% 11.9% 11.3% | 50% 5.7% |
| CCC/C 0.7% 1.3% 1.4% | 1.4% 0.7% |
| Non-Rated 9.7% 25.1% 35.7% | 40% 14.3% |
| Defaulted 0.8% 4.6% 8.7% | 75% 6.5% |

Thus, the five year BB TD risk ranges between 8.7% and 27.1% and we will use the 17.9% midpoint as our estimate.
## Estimating A to CCC Upper Bound TD Rates

### 5 Year Time Horizon

<table>
<thead>
<tr>
<th>From Initial Rating To:</th>
<th>A-Rated Transition Rates*</th>
<th>DCS Weighing</th>
<th>Technical Default Risk</th>
<th>BBB-Rated Transition Rates*</th>
<th>DCS Weighing</th>
<th>Technical Default Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>AA or AAA</td>
<td>5.5%</td>
<td></td>
<td>0.6%</td>
<td></td>
<td></td>
<td>0.0%</td>
</tr>
<tr>
<td>A</td>
<td>53.8%</td>
<td></td>
<td>10.3%</td>
<td></td>
<td></td>
<td>0.0%</td>
</tr>
<tr>
<td>BBB</td>
<td>15.3%</td>
<td>10%</td>
<td>1.5%</td>
<td>49.4%</td>
<td></td>
<td>0.0%</td>
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<tr>
<td>BB</td>
<td>2.3%</td>
<td>40%</td>
<td>0.9%</td>
<td>7.8%</td>
<td>25%</td>
<td>2.0%</td>
</tr>
<tr>
<td>B</td>
<td>0.8%</td>
<td>50%</td>
<td>0.4%</td>
<td>2.6%</td>
<td>50%</td>
<td>1.3%</td>
</tr>
<tr>
<td>CCC/C</td>
<td>0.2%</td>
<td>60%</td>
<td>0.1%</td>
<td>0.4%</td>
<td>75%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Non-Rated</td>
<td>21.6%</td>
<td>20%</td>
<td>4.3%</td>
<td>26.7%</td>
<td>30%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Hard Defaults</td>
<td>0.7%</td>
<td>65%</td>
<td>0.4%</td>
<td>2.3%</td>
<td>70%</td>
<td>1.6%</td>
</tr>
<tr>
<td></td>
<td>100.0%</td>
<td></td>
<td>7.7%</td>
<td>100.0%</td>
<td>13.1%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>From Initial Rating To:</th>
<th>BB-Rated Transition Rates*</th>
<th>DCS Weighing</th>
<th>Technical Default Risk</th>
<th>B-Rated Transition Rates*</th>
<th>DCS Weighing</th>
<th>Technical Default Risk</th>
<th>CCC/C-Rated Transition Rates*</th>
<th>DCS Weighing</th>
<th>Technical Default Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>AA or AAA</td>
<td>0.1%</td>
<td></td>
<td>0.0%</td>
<td>0.0%</td>
<td></td>
<td>0.0%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>1.2%</td>
<td></td>
<td>0.3%</td>
<td>0.2%</td>
<td></td>
<td>0.2%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BBB</td>
<td>12.6%</td>
<td></td>
<td>1.7%</td>
<td>0.8%</td>
<td></td>
<td>0.8%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BB</td>
<td>29.1%</td>
<td></td>
<td>10.3%</td>
<td>2.8%</td>
<td></td>
<td>2.8%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>11.3%</td>
<td>50%</td>
<td>5.7%</td>
<td>23.8%</td>
<td></td>
<td>11.6%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CCC/C</td>
<td>1.4%</td>
<td>50%</td>
<td>0.7%</td>
<td>2.9%</td>
<td>70%</td>
<td>2.0%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Rated</td>
<td>35.7%</td>
<td>40%</td>
<td>14.3%</td>
<td>39.6%</td>
<td>50%</td>
<td>19.8%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hard Defaults</td>
<td>8.7%</td>
<td>75%</td>
<td>6.5%</td>
<td>21.3%</td>
<td>80%</td>
<td>17.1%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>100.0%</td>
<td></td>
<td>27.1%</td>
<td>100.0%</td>
<td>38.9%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Per S&P’s 2013 Global Corporate Default Study and Rating Transitions, Table 21*
Estimating Hard & Technical Default Rates

Using the upper bound estimates from the previous slide, we calculate:

- The mid-point as a conservative estimate of the technical default rate
- An estimate of total net hard and technical defaults, adjusting for defaults that are both hard and technical

### Calculation of DCS Technical Default (TD) Estimate

<table>
<thead>
<tr>
<th>Source</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC/C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower Bound</td>
<td>S&amp;P Hard Default Rate</td>
<td>0.7%</td>
<td>2.3%</td>
<td>8.7%</td>
<td>21.3%</td>
</tr>
<tr>
<td>Upper Bound</td>
<td>DCS Transition Analysis</td>
<td>7.7%</td>
<td>13.1%</td>
<td>27.1%</td>
<td>38.9%</td>
</tr>
<tr>
<td>DCS TD Estimate</td>
<td>Midpoint between Upper and Lower Bounds</td>
<td>4.2%</td>
<td>7.7%</td>
<td>17.9%</td>
<td>30.1%</td>
</tr>
</tbody>
</table>

### Calculation of Total Net Default Risk

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC/C</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P Hard Default Rate</td>
<td>0.7%</td>
<td>2.3%</td>
<td>8.7%</td>
<td>21.3%</td>
<td>48.3%</td>
</tr>
<tr>
<td>DCS Technical Default Estimate</td>
<td>4.2%</td>
<td>7.7%</td>
<td>17.9%</td>
<td>30.1%</td>
<td>54.8%</td>
</tr>
<tr>
<td>Less: TD's that are also Hard Defaults</td>
<td>-0.4%</td>
<td>-1.6%</td>
<td>-6.5%</td>
<td>-17.1%</td>
<td>-41.1%</td>
</tr>
<tr>
<td>Total Net Default Rate</td>
<td>4.4%</td>
<td>8.4%</td>
<td>20.1%</td>
<td>34.4%</td>
<td>62.0%</td>
</tr>
</tbody>
</table>
Estimating 5 Year TD Expected Loss

- This analysis is for BB’s with $750M in facility debt
- Click the schedule and you can estimate your company’s expected TD loss using your own estimates of your company’s TD risk and debt

<table>
<thead>
<tr>
<th>Technical Default Scenario Description</th>
<th>Minor</th>
<th>Medium</th>
<th>Significant</th>
<th>Major</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported before financials were issued</td>
<td>1</td>
<td>4</td>
<td>17</td>
<td>30</td>
</tr>
<tr>
<td>Reported after one quarter of financials were issued</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reported after two quarters of financials were issued</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reported after three quarters of financials were issued</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Debt in Default ($000)
- Total Debt + Undrawn Committed Credit
- O/S Debt subject to 2% default interest
- Facility waiver fee (bp)

Non-Monetary Consequences
- Financial restatement of LT debt as ST
- Sox Deficiency/Material Weakness Citation
- Cascading cross-defaults
- Public disclosure of default

Monetary Consequences ($000)
- 2% Default Interest
- Facility Waiver Fee
- Legal fees
- Audit fees
- Advisory fees

Total

Impact on stock price

| Impact on stock price | 0% | 5% (?) | 10% (?) | 15% (?) |
Presentation Outline

- The debt facts of life
- Understanding covenants
- Managing multiple agreements
- Best practices in debt compliance
- Conclusions and Q&A
- Appendix
  - Estimating technical default risk
  - The DCS Covenant Manager℠ Solution
  - About Debt Compliance Services
The DCS Covenant Manager℠ Solution

- The DCS Covenant Manager℠ is a cloud service in which all clients access the same system with automatic updates
  - User-friendly and thoroughly debugged after four years of development and client feedback
  - A rigorous, automated turnkey best practice compliance process in which DCS does the heavy lifting, minimizing scarce staff time
- It consists of three integrated, but separately available, applications
  - The DCS Debt Manager℠
  - The DCS Compliance Manager℠
  - The DCS Calendar Manager℠
- Some individual services of each Manager are separately available
The DCS Debt Manager℠

- Debt agreements become easy-to-navigate webpages linking defined terms and section references
- Embedded, linked covenant checklist
- Multi-agreement contextual searching
- Comments capability shares hard-earned covenant understandings, reducing training time
- Amendments conformed easily and quickly
- Linked annual calendar and permitted baskets analysis
Covenant Synopsis Questionnaires: Using the covenant checklist’s synopsis, DCS will upload it into our web questionnaire process
- The uploaded synopsis description and/or a pdf of the actual covenant text will be used for the respondents to interpret and then state whether they believe the company is or is not in compliance with that covenant
- We recommend this as a cost-effective approach for companies that will have a few respondents who are highly knowledgeable of both the company’s activities and the debt agreements

Covenant Question Questionnaires: For each covenant, DCS writes questions in a Yes/No format about whether the required covenant action did or did not occur, which avoids respondent interpretation errors and inconsistent interpretations
- We recommend this as a sounder methodology and is especially appropriate for complex agreements which require many respondents who cannot be expected to correctly and reliably interpret their assigned covenants

Both Questionnaire types require explanations of negative answers
- Error messages identify incomplete or otherwise erroneous answers
Extensive Reporting Capabilities

- Module Completion Report shows status of questionnaire completion, allowing easy follow-up of respondents and reviewers who need reminders, as well as real-time identification of negative responses indicating possible covenant issues.
- The General Report and the Report on Questions with Different Answers allows the Compliance Manager to quickly clean-up incomplete answers and validate the responses as accurate.
- The Resolution Report is where the Compliance Manager evaluates the significance of all negative responses and their explanations with recommendations regarding their materiality and course of action: manage, monitor, mitigate or report to senior management and/or lenders.
- The Comparison Two Quarter Resolution Report ensures that nothing slips between the cracks: it identifies last quarter’s covenant-question issues and how those covenant-questions were answered this quarter – and vice versa.

Quarterly Compliance Process Management

- The website provides all the tools necessary to update any changes need for a quarter’s questionnaire compliance process.
The DCS Calendar Manager℠

- All regular deliverables and payments scheduled out to each debt’s maturity to the actual business day based upon the business day convention and country holidays
  - Each task is assigned an owner and a manager with email reminders and warnings
  - Overdue tasks are escalated with email warnings to senior manager
  - Estimated due dates and commenting functionality
- Substantial reporting capabilities:
  - Upcoming tasks with estimated and hard due dates
  - Completion date vs. hard due date
  - Filtering options include by agreement, task owner, manager, and task type
- Can be easily expanded to include other regularly occurring departmental tasks
DCS Covenant Manager℠ Benefits

1. Provides a clear overview with minimal effort that far exceeds the understanding of any individual or team

2. Identifies potential covenant issues so that they can be monitored or mitigated, minimizing surprises for senior management and lenders

3. Questions about the covenant implications of strategic initiatives and operational changes can be quickly, accurately and consistently answered

4. The company’s key business stakeholders now understand the restrictions imposed by debt obligations in their areas of responsibility, minimizing actions inadvertently breaching a covenant

5. The cost can be capitalized with the debt issuance costs

6. As a cloud service, there's no implementation or maintenance by IT

7. Permanent, repeatable process that can be easily and accurately transferred to new staff

8. Saves valuable treasury staff time for other department priorities
“Actavis is one of the world’s leading generic pharmaceutical companies, operating in 50 countries across the globe. We chose Debt Compliance Services to assist us in designing a comprehensive debt compliance process to meet the reporting requirements of our complex external financing arrangements. We are impressed with the sophistication of their debt compliance services and the professionalism and responsiveness of their ongoing support. DCS’ unique global web questionnaire system has enabled our key business stakeholders to better understand our ongoing obligations and resulted in an efficient way to manage the substantial information flow generated by our large and complex business. We now have a clear overview of what is going on in the Group without having to spend too much time and resources in the attempt. We highly recommend DCS’ professionalism and services.”
—Gudjon Gustafsson, Group Treasurer, Actavis Group

“Debt Compliance Services’ tools reduce my risk, save me and my team time and effort, and have made our compliance reporting easy. Gone are the days when we would have to pull out our old, worn loan documents to review all of the various covenants and restrictions before making critical strategic business decisions. With DCS, reviewing our agreements is literally done with a few clicks of the mouse.”
—Christine Sacco, Chief Financial Officer & Treasurer, Smart Balance, Inc.

“Grupo Cementos de Chihuahua is a Mexican-based cement and ready-mix concrete company with extensive operations in the U.S. The 2008 peso devaluation and the construction industry downturn led us to refinance our credit facilities with a tightly-coupled syndicated loan and note purchase agreement. We chose Debt Compliance Services because of their ability to integrate the compliance of these two agreements. As one of DCS's first customers, we are pleased with service they have provided and how their service capabilities have expanded over the last two years at no cost to us. We have also found that the hyperlinked credit agreements allow us to quickly and accurately respond to questions that arise internally. We highly recommend their services.”
—Luis Carlos Arias Laso, Director, Corporate Treasury, Grupo Cementos de Chihuahua
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About Debt Compliance Services

- Now in its 6th year, DCS is a joint venture between Greenwich Treasury Advisors and Corporate Finance Solutions
- Jim Simpson founded Corporate Finance Solutions in 2002
  - A 35-year career leading over $4 bn in convertibles, high yield bonds, revolvers, term loans, and ABLs
  - CFO of Moore Medical (public, $300M sales) and CS Brooks (private, $200M sales), and Treasurer of Sandoz USA (now Novartis)
- Jeff Wallace founded Greenwich Treasury Advisors in 1992
  - Recognized expert in risk management and international treasury
  - VP-International Treasury at Amex, AT at both Seagram and D&B, and a CPA at Price Waterhouse
We have over 20 clients, ranging from large and middle market public and private companies:

- Actavis, an private multi-billion € Icelandic pharmaceutical company
- Church & Dwight, a $2.6 billion consumer products company
- Smart Balance, a $300 million food manufacturer
- RailAmerica, a $500 million owner of leading short line and regional railroads providing rail service to customers across North America
- Grupo Cementos de Chihuahua, a multi-billion $ Mexican cement company with extensive US operations
- Waters Corp., a $1.6 billion manufacturer with leading positions in complementary analytical technologies
- A privately held, multi-billion $ security firm
- A well-known luxury goods company
- A major international audit firm
2. “Pure Speculation: Treasurers of Non-Investment Grade Companies Must Reduce Covenant Risk”, AFP Exchange, June 2013
3. In collaboration with the AFP, the AFP Debt Compliance Survey, January 2013
6. “Safeguarding Your Liquidity”, CFO.com, September 1, 2012
7. “…Debt Compliance Services …[is an example of]… Treasury 3.0.” Treasury and Risk Magazine, September 2010
Contact Information

- For more information, please contact:

<table>
<thead>
<tr>
<th>Jim Simpson</th>
<th>(203) 329-7491</th>
<th><a href="mailto:jim.simpson@debtcompliance.com">jim.simpson@debtcompliance.com</a></th>
</tr>
</thead>
<tbody>
<tr>
<td>Jeff Wallace</td>
<td>(303) 442-4433</td>
<td><a href="mailto:jeff.wallace@debtcompliance.com">jeff.wallace@debtcompliance.com</a></td>
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- Visit our website at www.debtcompliance.com