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ALTERNATIVE INVESTMENTS PROGRAM

The Main Street Lending Program: Opportunities for American Businesses Part I: Leverage Limitations

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On April 9, 2020, the Federal Reserve announced a significant action intended to provide credit to small- and medium- sized businesses suffering due to the coronavirus pandemic: The Main Street Lending Program. The Federal Reserve's Main Street Lending Program consists of the Main Street New Loan Facility and Main Street Expanded Loan Facility. The term sheets for the program state that U.S. businesses are eligible for loans if they meet either of the following conditions: (1) the business has 10,000 employees or fewer; or (2) the business had 2019 revenues of $2.5 billion or less.

Loans under the new program would have a four year maturity, and principal and interest payments on the loans will be deferred for one year. The minimum loan size would be $1 million and the interest rate would be an adjustable rate of the short-term overnight financing rate plus 250-400 basis points. Eligible banks can originate new Main Street loans, or use the Main Street Lending Program to increase the size of existing loans to businesses. To ensure credit flows to small- and medium- sized businesses, the Federal Reserve will purchase up to $600 billion of the loans.

A key objective for both the Federal Reserve's Main Street New Loan Facility and the Main Street Expanded Loan Facility should be to reach as many viable small- and medium- sized businesses as possible. Supporting viable small- and medium- sized businesses will not only sustain jobs, but also promote the medium- and longer-term recovery of the U.S. economy. Therefore, restrictions in the Main Street New Loan Facility and Expanded Loan Facility should take into account the diverse business models of U.S. businesses.

In light of this objective, one significant issue in the Main Street Lending Program is the limitation on leverage. In the Main Street New Loan Facility, the maximum loan cannot exceed four times the eligible borrower's 2019 EBITDA, when added to existing outstanding and committed but undrawn debt. In other words, companies with debt in excess of four times EBITDA are not eligible to participate in the program. In the Main Street Expanded

Loan Facility, this leverage limitation is raised to six times EBITDA. Both of these leverage limitations could prove extremely problematic.

Excluding borrowers from the Main Street Lending Program with an EBITDA-based leverage test will inevitably leave out many viable companies. Some borrowers, such as early-stage growth companies, simply do not have positive EBITDA. In those cases, an EBITDA-based leverage metric is not generally used to measure creditworthiness. However, those early-stage growth companies are engaged in important growth and innovation that will be crucial to lifting the U.S. out of its pandemic-induced recession.

In addition to early-stage growth companies, the leverage restriction may also exclude research and development companies, publicly traded life sciences companies, and small- and medium- sized private equity-owned businesses. These companies also provide important goods and services, and offer jobs for many Americans. Unfortunately, many of those companies were already unable to receive loans under the Paycheck Protection Program, and therefore they could fall between the cracks — straight into insolvency.

Notably, for other borrowers, a standardized EBITDA-based leverage test could give a distorted view of true cash flow and therefore leverage. Importantly, debt agreements typically tailor the definition of EBITDA to eliminate non-cash and other items to establish a more accurate picture of cash flow available to service debt for the borrower's business. For example, banks often also use other metrics, such as market capitalization or internal valuations, to make lending decisions. Other potentially useful metrics include gross profit, and month-over-month gross revenue.

Instead of instituting a government-driven, bright-line, EBITDA-based leverage restriction, the lender and the borrower should agree on appropriate metrics consistent with the borrower's existing debt agreements and market conventions. Lenders should be permitted to extend loans to companies that exceed the four times or six times EBITDA thresholds if the lender, in its own judgment and expertise, feels comfortable extending credit. In fact, this is already U.S. regulators' position: In 2018, regulators indicated that strict restrictions on leverage do not necessarily make sense, and lenders were notified that they need not adhere to the Office of the Comptroller of the Currency's previous six times EBITDA limitation, so long as safety and soundness are not compromised.

While it is certainly clear that the Federal Reserve should not fund companies that are inevitably going out of business, it would be a mistake to let a generation of growth- and innovation- oriented companies fail because emergency lending programs did not take into account their unique business models. The jobs that those businesses provide are real, and their businesses will be critical to driving the recovery and expansion of the U.S. economy.