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WORST, BETTER, BEST: EBITDA Adjustments - The Scope of Projected Synergies

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The Bottom Line:™

- Subscribers often ask for suggestions as to how a weak covenant provision could be improved.
- In our "Worst, Better, Best" series, we review provisions from recent European high yield bonds and leveraged loans, explaining the concerns raised by the "Worst" category, and the heightened protection provided by those in the "Better" and "Best" categories.
- Investors can refer to these examples when negotiating for improvements in covenant terms in primary deals.
- In this report, we consider the list of items, collectively referred to as "synergies", in respect of which EBITDA is allowed to be adjusted on a pro forma basis.

Overview

At Covenant Review, identifying weaknesses in bond and loan covenants is our bread and butter. Once we've pointed out risks in relation to a particular provision, subscribers often ask us for suggestions as to how it could be improved, ideally (given the power of precedent) supported by examples of better wording included in other deals.

In our "Worst, Better, Best" series, we provide actionable intelligence using examples of key covenant provisions from recent European high yield bonds and leveraged loans, explaining the drafting deficiencies of those in the "Worst" category and the heightened protection provided by samples in the "Better" and "Best" categories, which investors can refer to when negotiating for improvements in covenant terms in primary deals.

In this second instalment in our series on permitted EBITDA adjustments for projected *synergies*, we take a closer look at the scope and extent of items that fall within that collective term.

Great Expectations

As we discussed in our [previous report](#) (where we looked at the horizon periods that apply in the case of projected synergies), it is now commonplace in European leveraged financings that, when calculating EBITDA for any given period, the borrower will be allowed to take into account the "run-rate" effect of a number of items. In its original iteration, this provision was typically tied to an acquisition by the borrower of a complementary business. Rather than simply add the EBITDA of the acquired business (on a run-rate basis), the borrower could also factor in the projected cost savings and economies of scale that were expected to result from the combination of the original business plus the acquired business.

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This calculation necessarily involved some degree of subjectivity, and for that reason it was typically the case that where projected synergies accounted for more than a certain percentage of EBITDA (often 10-15%), then some form of independent verification would be required under the terms of broadly syndicated European leveraged loans.

That was then... in recent years, the scope of what may be taken into account under the broad heading of “synergies” has expanded greatly; arguably, well beyond the original purpose and logic of the provision.

There are a number of variables that one needs to examine when considering EBITDA adjustments for projected synergies in a credit agreement. These include (1) the extent to which those adjustments are capped, and (2) what, if any, horizon period will apply. Caps on projected synergies is a subject that we will examine in a future report, while horizon periods have been separately considered in our [previous report](#).

In this report, however, we will focus upon the scope of those projected items, in respect of which EBITDA may be adjusted.

Worst

“[...] when determining (or, as applicable, forecasting) Consolidated EBITDA for any Relevant Period [...], the Company may:

- [...] include an adjustment in respect of any [[Purchase]/[Disposition] and/or any steps taken or committed (conditionally or unconditionally) or expected to be taken in respect of such [Purchase]/[Disposition]] / [Specified Transaction]” up to the amount of the pro forma increase in Consolidated EBITDA projected by the Company (in good faith) after taking into account any add-backs and/or the full run-rate effect of all actual and/or anticipated synergies, savings, operating improvements, expenses, expense reductions (including operating expense reductions), restructuring charges and expenses, margin improvements, enhancements, revenue increases, price increases or other similar initiatives or other adjustments which the Company (in good faith) believes have been or can be achieved directly or indirectly as a result of that [Purchase]/[Disposition] / [Specified Transaction]” [...]; and/or*
- [...] include an adjustment in respect of each Group Initiative and/or any steps taken or committed or expected to be taken (in each case, unilaterally, conditionally or otherwise) in respect of such Group Initiative up to the amount of the pro forma increase in Consolidated EBITDA projected by the Company (in good faith) after taking into account any add-backs and/or the full run-rate effect of all actual and/or anticipated synergies, savings, operating improvements, expenses, expense reductions (including operating expense reductions), restructuring charges and expenses, margin improvements, enhancements, revenue increases, price increases or other similar initiatives or other adjustments (including in respect of new, extended, refurbished, renovated, redesigned or improved facilities, locations or projects and ramp ups) which the Company (in good faith) believes can be achieved directly or indirectly as a result of implementing or committing or expecting to implement such Group Initiative [...]” [Emphasis added]*

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“Group Initiative” means any action or step (including any restructuring, integration, reorganisation, cost savings, price increase, roll-out or other initiatives) in each case, implemented, undertaken, or committed (whether conditionally or unconditionally) to be undertaken by the Group.”

“Specified Transaction means any acquisition (including signed letters of intent), any investment, any disposition or divestiture, any discontinued operations, any capital expenditure, any designation of an Unrestricted Subsidiary (or redesignation of an Unrestricted Subsidiary as a Restricted Subsidiary), any incurrence, payment or debt reduction, any new, amended, revised or terminated contracts, products, product lines, start-ups, businesses, disposals, investments (including capital expenditure), business lines, ventures or services, any new, extended, refurbished, renovated, redeveloped, redesigned or improved locations, projects, sites, brands, portfolios, operations, facilities, any ramp ups, any outsourcing (including offshoring or nearshoring), any efficiencies, capacity enhancements or improvements, operational changes, group initiatives, the implementation of any new or amended pricing model, any shut-downs, closure of facilities or stores or termination of contracts, any projects, any build-out or renovations, any systems, processes, technologies, plant, assets, development, any research and development, any restructuring, reorganisation, redundancy programs, integration, or any similar transaction, any transactions to facilitate any carve-out step, any employee utilisation ramp-up adjustment (whether as a result of or in connection with other items in this definition or otherwise), any implementation of an operating improvement initiative or efficiency initiative or any other initiatives or transaction, in each case, which have been implemented, undertaken, or committed (whether conditionally or unconditionally) to be undertaken by the Group.”

As noted in our introduction, recent years have seen a pattern of ever more expansive synergies drafting in top tier sponsor financings. The example above is at the most aggressive end of the spectrum, even by those standards.

Before we consider what will constitute a “synergy” for the purposes of EBITDA adjustment, we need to look firstly at those *actions* in respect of which synergies will be allowable (which we will refer to as “Relevant Actions” in this report).

In short, Relevant Actions in the above example – which includes everything that comes within one or more of “Purchase”, “Disposition”, “Group Initiative”, or “Specified Transaction” definitions – encompasses any conceivable transaction, step, or other action that may be undertaken by the borrower group. Not only are “Purchase” and “Disposition” broadly defined, but they both include any *commitment* therefor. Not only that, but the combined effect of the “Group Initiative” and “Specified Transaction” definitions (which include matters that are either implemented, undertaken or committed (including on a conditional basis)) is that more-or-less anything can constitute a Relevant Action.

The concept of synergies, in respect of which EBITDA is allowed to be adjusted, is intended to capture the upside to the business that is projected to result from the Relevant Actions. As is evident from the example above, however, we have since moved well beyond a consideration of projected cost savings and economies of scale expected to result from the combination of businesses. In addition to cost savings and operating expense reductions, “synergies” will include a number of items that, although still

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within the remit of projected upside, are at the more speculative – and certainly, most aggressive - end of the scale; in particular “[...] *margin improvements, enhancements, revenue increases, price increases or other similar initiatives or other adjustments* [...]”

Possibly the most permissive is projected *revenue increases*, while *margin improvements* and *enhancements* are undefined. These are then followed up with the catch-all wording of “[...] *similar initiatives other adjustments* [...]”, with all such items being estimates.

Not only that, but in the case of any Group Initiatives, EBITDA may be adjusted for synergies projected to result not only from Group Initiatives that are implemented or committed to be implemented, but also from those *expected to be implemented*.

Finally, it is worth noting the absence of any third-party verification requirement. Although this reflects the current market position, it nevertheless results in projections being at the discretion of the borrower (subject to compliance with stipulated accounting principles).

Better

“Consolidated EBITDA” means, with respect to any Person for any period, the Consolidated Net Income of such Person for such period [...] increased (without duplication) by [...] the “run rate” cost savings, operating expense reductions and synergies that are expected (in good faith) to be realized as a result of actions relating to any acquisition [...], disposition, divestiture, restructuring, cost savings initiative, operating improvement, procurement rationalization, information and technology system establishment, modernization or modification, modification or renegotiation of contracts or any other similar initiative (calculated on a pro forma basis as though such cost savings, operating expense reductions and synergies had been realized from the first day of such period and during the entirety of such period), net of the amount of actual benefits realized during such period from such transaction or initiative [...], if such actions have been taken or are expected to be taken (in the good faith determination of the Parent) within [...] months of the determination date or substantial steps with respect to such actions have been taken or are expected to be taken within [...] months of the determination date and which the Parent believes are reasonably likely to be achievable within [...] Months after the end of the period for which Consolidated EBITDA is being calculated;

From an investor perspective, this provision is an improvement on our “Worst” example. While the Relevant Actions remain broad in their scope (note, for example, the inclusion of “*or other similar group initiatives*”), they are somewhat more tightly defined.

Unlike with our “Worst” example, the projected or anticipated items in respect of which EBITDA may be adjusted are limited to cost savings, operating expense reductions and synergies. The more speculative items, such as revenue enhancements, have not been specifically included in the list of what is allowable.

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Best

“[...] for purposes of calculating the Consolidated EBITDA for such period [...] acquisitions [...], including through mergers or consolidations, [...] and including all related financing transactions and including increases in ownership of Subsidiaries which are Restricted Subsidiaries, and (ii) cost saving or reduction measures, restructuring or reorganisation measures, operating expense reductions, operating improvements, capacity improvements, redundancy measures or other similar group initiatives, made or implemented, in each case during the four-quarter reference period or subsequent to such reference period and on or prior to the relevant Calculation Date, or that, in each case, are to be made or are to be implemented by the relevant Calculation Date, will be given pro forma effect (as determined in good faith by a responsible accounting or financial officer of the Borrower and may include anticipated synergies and expense and cost reductions provided that such synergies and expense and cost reductions have occurred or are reasonably expected to occur within the next [...] months following the date of such calculation as a result of actions of the Parent or any Restricted Subsidiary and substantive steps have been taken to realize such synergies and expense and cost reductions) as if they had occurred on the first day of the four-quarter reference period and provided further that if the amount of any pro forma synergy, expense or cost reduction taken into account is greater than 7.5% of the Consolidated EBITDA of the Parent, such synergy, expense or cost reduction shall be commented on as not being unreasonable by a reputable accountancy firm or industry specialist, such firm or specialist to be determined in good faith by the Borrower (which commentary may be provided in any accompanying accountants or industry specialist due diligence report); [...]; [Emphasis added.]”

In the current market, against the backdrop over ever loosening sponsor-friendly covenant packages, this example is better again. The Relevant Actions are largely limited to (1) acquisitions, and (2) actions that are designed to reduce costs or generally increase efficiencies. While there are a small number of examples in the current market where Relevant Actions are limited to a permitted acquisition or disposal, these will tend to be legacy financings where the credit agreement was originally executed prior to 2020.

As with our “Better” example, the projected benefits for which EBITDA may be adjusted, are limited to synergies, expense and cost reductions.

Finally, there is a relatively conservative threshold above which some form of third-party verification of synergies shall be required. To be noted, such independent verification requirements are increasingly rare in modern vintage European leveraged loan agreements.

Conclusion

As we continually point out at Covenant Review, when assessing EBITDA adjustments it is vital that investors look behind the caps and horizon periods, as marketed. As this report highlights, what a borrower may classify as anticipated “synergies” will vary greatly, deal by deal.

We hope the specific examples and explanations in our “Worst, Better, Best” series help investors analyse provisions in new deals and push for more protective versions whenever possible.

— *Covenant Review*

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