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The Bank Covenant Primer

Understanding the trigger points of financial covenants may head off future problems.

by Michael T. Newsome

Loan covenants are hardly a top of mind concern these days, when most businesses are reaping the rewards of a robust economic climate. It is easy to forget that the seeds of tomorrow's workouts are blithely being sown with the best intentions, as lenders and borrowers hustle to put capital to work. Times and markets change. There is value to be realized in negotiations with lenders by understanding the aims and mechanics of the financial tests that are a central part of most credit agreements.

Apart from the amount and terms of credit availability, the timing of its repayment, and its cost, there are a host of important, but generally boilerplate, provisions that are built into any credit agreement. The boilerplate includes representations regarding the condition of the borrower and the authority to enter into the agreement, as well as promises (covenants) to provide timely and accurate information, comply with relevant laws and regulations, and act in a manner consistent with the business's best interests. These terms are not particularly controversial and require little negotiation. But hidden amongst the boilerplate, there are generally a handful (two to six) of financial covenants that set the borrower's standard of performance and place limits on management's flexibility. They form the ultimate tipping point of power between the lender and the borrower over the life of the credit.

Financial tests are generally aimed at addressing reasonable lender concerns in a couple of areas:

- ***Performance***—generation of adequate earnings/cash flow to sustain the business and meet its obligations as they come due. Sufficient earnings must be produced over time to pay all of the costs of current operations, replace obsolete assets, fund growth, and pay agreed returns to lenders.
- ***Liquidity***—access to enough cash resources (liquidity) to meet the business's obligations as they come due. Lenders understand, as do most owners/managers, that there is only one asset that a business cannot survive without—cash. It's akin to oxygen; a business that doesn't have it, dies.

Earnings oriented financial tests are derived from a borrower's P&L statement for a period of time, such as the most recent fiscal year, trailing four quarters, or last 12 months on a rolling basis. Liquidity covenants are calculated from the business's balance sheet and reflect a single point in time. The lender's objective is to devise a set of financial tripwires that are triggered well before the borrower fails to generate the earnings to service its obligations or runs out of cash.

The fixed-charge coverage ratio is probably the most widely used financial test to measure a company's ability to generate enough after-tax "operating cash flow" (the numerator in the ratio) to cover debt service (interest and scheduled principal payments).

While bankers are not renowned for creativity, they can get inventive in devising variations on somewhat standard tests. In soliciting financing proposals from a number of banks, the norm is for each proposal to have a different twist on the calculation of financial tests. The syndicated loan market has brought standardization to the definition of financial covenants. So, the focus here is on the most common financial tests.

PERFORMANCE MEASURES

The fixed-charge coverage ratio is probably the most widely used financial test to measure a company's ability to generate enough after-tax "operating cash flow" (the numerator in the ratio) to cover debt service (interest and scheduled principal payments).

A ratio of 1.25:1, meaning a $1.25 of "operating cash flow" must be produced for each dollar of debt service, is a fairly standard benchmark. The appropriate coverage varies depending on the nature of the business, but in today's aggressive lending environment, a coverage covenant of 1:1 is possible. A test of 1.5:1 provides a huge cushion that would, in most cases, be overly conservative. The one cash flow variable that is invariably left out of fixed-charge coverage tests is a change in working capital. In a rapidly growing or poorly managed company (where receivables and inventory are expanding) a coverage ratio of 1:1 may not produce enough cash to actually meet all obligations.

LEVERAGE MEASURES

There are two approaches to measuring financial leverage:

- The most common is the ratio of outstanding interest-bearing senior (or total) debt to EBITDA, which serves to control the amount of debt relative to the most important yardstick of debt capacity, operating earnings prior to depreciation and amortization; or
- The old-school approach, which compares total liabilities to tangible net worth (accumulated paid-in capital and retained earnings, less total intangible assets), as a measure of the proportion of capital provided by third parties relative to the capital provided by business owners.

Today, the norm is to measure interest-bearing debt relative to cash flow. And, the permissible level can vary pretty widely, from two to more than five times EBITDA, depending on the size of the business and the perceived stability of its earnings.

Because tangible net worth is not particularly well correlated to either a business's ability to generate cash flow or the fair-market value of its equity, balance sheet leverage is a weak predictor of financial strength. In our view, this test rarely serves the borrower's or lender's interests well.

LIQUIDITY MEASURES

Theses covenants provide an early warning of a cash shortfall. The traditional tests have been minimum working capital (total current assets—total current liabilities) or current ratio (current assets divided by current liabilities). Both work fine, but they

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are clouded with a little extra noise as the result of the inclusion of the current portion of long-term debt. A trading ratio, which is calculated in the next column, can provide a little clearer view of liquidity.

The objective is ample equity in the business's trading assets, as evidenced by a trading ratio in excess of 1.0. Erosion of the trading ratio is a sign that trading assets are being liquidated to fund losses, acquire long-term assets, or distribute funds to shareholders. Trading ratio is always viewed in the context of undrawn credit-line availability, particularly at the peak of the firm's operating cycle. Excess credit availability and a strong cushion of trading ratio (> 1.5:1) are the hallmarks of adequate liquidity. A lower trading ratio may be warranted if receivables and inventory turn over quickly.

ADVICE TO BORROWERS

There are several considerations that borrowers should weigh when negotiating new credit arrangements.

1. Financial strength can be well protected with just two or three financial covenants (i.e. fixed charge coverage, financial leverage, and trading capital). Proposals that are larded with an extensive list of tests beyond these basics are likely an expression of the lender's lack of confidence or knowledge of the business.

2. Lenders tend to peg covenants 10 to 20 percent below either recent or projected performance. If business performance is strong, these levels may be well above what is required to assure adequate financial strength. Standards should be set relative to the firm's obligations, rather than its peak performance.

3. Proposed covenants should be sensitivity tested against a full economic or business cycle. They should trip when serious financial problems are encountered, but not by the normal ups and downs of an industry or operating cycle.

4. There should be little disparity between the levels of performance required to trip individual covenants. If the leverage covenant is breached at EBITDA of $3 million and fixed charge coverage is tripped at $4.5 million, covenants are misaligned.

5. Treat covenants and pricing as separate considerations. A lender may argue that attractive loan pricing warrants tighter financial covenants. While it's fair to tie credit spreads and fees to a performance measure, such as financial leverage, the performance benchmark that grants the lender the authority to declare an event of default and potentially accelerate the loan should be completely separate from pricing benchmarks.

The implications of financial covenants are easy to overlook when everything is going well and lenders are hungry to put money to work. But that is the very time when borrowers can negotiate the greatest flexibility with lenders. Markets, economies and risk appetites all change in time. Close attention to these details now may provide essential flexibility down the road, when the business outlook may not be quite as rosy. ❖

FIXED CHARGE COVERAGE RATIO

$$\frac{\text{EBITDA} - \text{Capex} - \text{Cash Taxes} - \text{Distributions}}{\text{Interest} + \text{Current Portion Long-Term Debt}} = \textbf{Fixed Charge Coverage}$$

FINANCIAL LEVERAGE RATIO

$$\frac{\text{Total Senior Debt}}{\text{Annual EBITDA}} = \textbf{Financial Leverage}$$

BALANCED SHEET LEVERAGE RATIO

$$\frac{\text{Total Liabilities}}{\text{Tangible Net Worth}} = \textbf{Balance Sheet Leverage}$$

TRADING RATIO

$$\frac{\text{Trade Receivables} + \text{Inventory}}{\text{Accounts Payable} + \text{Accrued Liabilities} + \text{Revolving Credit Line}} = \textbf{Trading Ratio}$$

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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