

HANDOUT 2-1

LOAN COVENANTS: BASIC PRINCIPLES

- **Covenants do not repay loans.** In determining appropriate covenants, always remember that covenants, no matter how well crafted, **do not repay the bank's loan.**
- **Covenants are designed to protect the bank.** The purpose of a covenant is to be drawn sufficiently tightly so as to protect the bank, while at the same time to provide sufficient flexibility to the borrower to allow the business to be run effectively.
- **Covenants identify key risk points in the borrower's operating profile.** In establishing these guidelines, it is very important as a lender to identify the specific risks against which you need to be protected and to prevent certain actions by the borrower which could jeopardize the timely repayment of the loan.
- **Covenants required should be covenants which you, the lender, expect to enforce.** As a lender, the discipline of using only those covenants which will be enforced—those covenants which you need—is important. Including covenants which are not then enforced will give rise to confusion, negotiating lapses, and inconsistencies—particularly when you come to enforce other covenants in the loan agreement.
- **Covenants provide timely warning signs.** Covenants provide you, the lender, with a mechanism which raises warning flags in the event of deterioration in a borrower's financial performance, as well as provide guidelines within which a borrower's operating and financial performance must comply.
- **Covenants bring the borrower back to the table.** More important, covenants provide you with the means of bringing the borrower back to the negotiating table to restructure the loan in the event of breach of those established guidelines.

LOAN COVENANTS: PRINCIPAL OBJECTIVES

When setting loan covenants, a number of key objectives need to be remembered:

- **Full Disclosure of Information:** In supporting this objective, the following points should be covered in the discussion:
 - To make competent, ongoing, lending decisions, you must have an in-depth understanding of the borrower.

- This understanding only comes with full and timely disclosure.
 - Full disclosure also aids you in maintaining regular contact with the borrower, and close control over the lending relationship.
- **Protection of Net Worth:** In supporting this objective, the following points should be covered in the discussion:
 - Notwithstanding the significant importance of cash flow, much of a borrower's basic financial strength, intrinsic debt capacity, and the ability to absorb downturns, lies in the maintenance of its net worth.
 - Covenanting should always be targeted at assuring the growth and continued strength of net worth.
- **Protection of Cash Flow:** In supporting this objective, the following points should be covered in the discussion:
 - Cash flow is the primary source of repayment.
 - You should have every opportunity to monitor the level of cash flow as well as to preserve its quality.
- **Protection of Asset Quality:** In supporting this objective, the following points should be covered in the discussion:
 - A borrower's assets represent two major factors of importance to you: first, the underlying cash flow generating power of the company—the primary source of repayment.
 - Second, the preservation of the secondary source of repayment, namely, the liquidation value of the assets
- **Control Growth:** In supporting this objective, the following points should be covered in the discussion:
 - When companies grow, major drains upon cash flow are caused by the investment in both working investment as well as fixed assets, as well as, in the case of a public company, increased dividend payments.
 - With private companies, growth can be potentially damaging, and therefore an ability to monitor and, to some extent, control, the rate of growth, is important.

- **Maintenance of Key Management:** In supporting this objective, the following points should be covered in the discussion:
 - The character of a company's management team will often impact a company's ability to repay debt.
 - Continuing quality of corporate management is a critical objective.
- **Assurance of Legitimacy and the Company as a Going Concern:** In supporting this objective, the following point should be covered in the discussion:
 - Covenants should be devised to ensure that the company remain a viable entity—legally and economically—in order to effectively service and repay its debt.
- **Profitability for the Bank:** In supporting this objective, the following point should be covered in the discussion:
 - Covenants should be devised in order to maintain profitability—whether it is prepayment conditions in the event of fixed rate loans, or penalty default interest in the event of problem loans.

COVENANT OBJECTIVES: IMPLEMENTATION AND EXECUTION

How can you enforce such basic principles, and meet the above objectives, through the discipline of covenanting?

Set out below are the above objectives, and under each objective are examples of loan covenants which specifically address those objectives.

Affirmative and Negative Covenants

Such covenants may be in one of two forms: first, **Affirmative Covenants** which provide you with a means of preserving minimum acceptable levels of operating and financial discipline and performance. Provided these covenants are consistently observed, they serve both a very important monitoring function as well as provide the right to step in should the borrower fail to comply with the required levels of behavior.

Second, **Negative Covenants**, which play an all-important role in preserving the cash flows and protecting the assets for the benefit of the lender by restricting certain activities of the borrower. Particular attention should be paid to:

I. Full Disclosure of Information

Examples of covenants which meet this objective include:

Affirmative Covenants

- **Timely Delivery of Financial Information:** Delivery of financial accounting statements (if audited, within 90 days of fiscal year end; if unaudited, within 5, 10, or 20 days of the period in question).
- **Timely Delivery of an Auditor's Letter:** Delivery of an auditor's letter stating that the borrower is in compliance with all of its loan agreement, and whether or not any event of default has occurred under any of the borrower's loan agreements.
 - **Consistent Preparation of Financial Statements:** There has been no change in the basis on which financial statements have been prepared, and in addition, that such financial statements have been prepared using accounting procedures which remain consistent and in accordance with GAAP.
 - **Location of the Company's Books and Records:** The company's books and records will be maintained in a specific location and will be available for your inspection.
 - **Maintenance of Rights of Inspection:** Representatives of the bank shall be permitted to inspect any or all records and property to verify the actual confirmed ownership of the property and other assets, the authenticity of the furnished statements evidencing ownership of such assets (which should also include, where appropriate, either a landlord's waiver or a mortgagee's waiver), as well as the actual condition of the assets.
 - **Timely Delivery of Information on Contingent Liabilities:** Delivery of any information of actual or probable litigation, or changes in contracts or the status quo which might affect the company's business.
 - **Maintenance of Operating Accounts with the Lender:** All principal operating accounts to be maintained, with the bank.

Negative Covenants

- **Restrictions on Change of Ownership and Management:** No change in the management or ownership of the company.

II. Protection of Net Worth

Examples of covenants which meet this objective include:

Affirmative

- **Maintenance of Minimum Tangible Net Worth:** The maintenance of a minimum tangible net worth ratio will ensure an adequate cushion for the senior debt provider, particularly when combined with carefully crafted working capital, current, and quick ratios.

Note: Such covenants should also include the formula for the calculation of minimum tangible net worth, and, most important, this formula or basis for calculation should always be communicated and explained to the customer.

With a seasonal loan, this covenant can still be reinforced provided the ability to receive regular and timely financial statements is reinforced.

- **Other Financial Ratios:** With seasonal and other permanent working capital loans, the maintenance of such ratios as:
 - sales to net worth,
 - net profit to net worth, and,
 - debt to depreciated capital assets
- **Maintenance of “Key Man Life” Insurance:** If you have identified that the continued success of the borrower is dependent on one or two key individuals, key man life insurance equal to the amount of the bank’s exposure, should be maintained, with the benefits assigned you.
- **Current Settlement of Tax Liabilities and Other Accrued Expense Obligations:** Tax payments should be made as they fall due, insurance premiums should be kept up to date, and restrictions on the cash payment of accrued officers’ salaries may also be appropriate.
- **Timely Delivery of Information on Contingent Liabilities:** Delivery of any information of actual or probable litigation, or changes in contracts or the status quo which might affect the company’s business.

Negative Covenants

- **Restrictions on Repurchase of Stock/Payment of Dividends:** Restrictions on dividend payments, the repurchase of stock, or “disguised reductions of equity such as higher officers/shareholders’ salaries, loans to officers/shareholders, or loans to affiliates and/or subsidiaries.

- **Restrictions on Mergers or other Changes in the Business:** Restrictions on activities which may indirectly negatively impact the capital base provided by shareholders including restrictions on mergers and acquisitions, a material change of business, and limited incremental borrowings from banks or other sources.
- **Restrictions on Additional Borrowings:** Even if the existing lender is secured, it is important that additional borrowings from other sources are curbed, so as to preserve the cash flows for the servicing of the existing lender's debt.

This restriction should also extend to other forms of financing such as leases, affiliated company loans, or shareholder loans unless they are on terms which strengthen the existing lender's loan.

- **Financial Ratios:** Restrictions on leverage can be imposed as follows:

Maximum Leverage - Total liabilities to Tangible Net Worth

Maximum Leverage - Funded Bank Debt to Tangible Net Worth

- **Restrictions on Sales of Assets:** While more important in permanent working capital and term loans, fixed assets—in particular plant and machinery—may be a very important way out for the unsecured lender or the lender secured only by current assets should the latter be insufficient to liquidate the loan.

As a result, restrictions on sales of assets will be important, even in the case of a seasonal loan. Finally, since in nearly all cases these fixed assets will be essential for generating the future cash flows of the company, removal of the source of these cash flows should be prevented.

III. Protection of Cash flow

Examples of covenants to accomplish this objective include:

Affirmative

- **Maintenance of Working Capital and Liquidity:** This is an affirmative financial covenant requiring the maintenance of a minimum level of working capital.

Greater control may be exercised with this covenant by excluding certain elements of working capital (e.g., prepaid expenses) or allowing only a certain percentage of inventory to be included (e.g., 50%) regardless of whether or not the loan is secured.

Current Ratio: Working Capital can also be linked to a minimum current ratio. This, combined with the insistence on timely delivery of financial statements, particularly during the “season,” will ensure that the lender has the ability to move quickly in the event of a material decline in asset values.

Quick Ratio: Finally, use of a quick ratio can be an extremely powerful tool particularly as a warning sign against the artificial improvement in liquidity created by, say, a build-up in slow moving inventory.

Note: Such ratios may be very useful if applied over a full financial year or on a rolling four quarter basis. However, during the build-up of inventory of receivables, the company may be experiencing a negative cash flow, and negative interest coverage until the contraction of the current assets being financed has occurred.

This underscores the need in a seasonal or permanent working capital loan for covenants that are very closely linked to liquidity and adequacy of net worth. Such covenants would address minimum working capital, minimum current and/or quick ratios, and minimum tangible net worth combined with the right to obtain regular financial statements or conduct regular inspections.

- **Maintenance of Property and Casualty Insurance:** Whether or not the bank is secured, the maintenance of insurance should be equal to the market value of the assets based on a current valuation from an acceptable valuation expert.
- **Maintenance of Key Man Life Insurance:** As discussed previously.
- **Current Settlement of Tax Liabilities and Other Accrued Expense Obligations:** As discussed previously.
- **Maintenance of Minimum Levels of Cash Flow:** This will be achieved via financial covenants comprising:
 - Minimum interest coverage
 - Minimum fixed charge coverage (all debt service and lease payments)
 - Minimum cash flow to current maturities

Derivation of these covenants will comprise variations including:

- EBIT/Interest,
- EBITA/Interest,
- EBITDA/Interest,
- EBITDA-CAPX/Interest,
- EBITDA-CAPX-Change in WI/Interest +CMLTD,
- Net Income + Depreciation/CMLTD,

Note: EBITDA is the abbreviation for Earnings Before Interest, Taxes, Depreciation, and Amortization of non-cash charges; WI stands for Working Investment; CMLTD stands for

Current Maturities of Long-Term Debt; and CAPX stands for Capital Expenditures.

- **Timely Delivery of Information on Contingent Liabilities:** As discussed previously.

Negative Covenants

- **Restrictions on Borrowings:** As discussed previously.
- **Restrictions on Sales of Assets:** As discussed previously.
- **Restrictions on Capital Expenditures and Leases:** Limitations on investments in capital expenditures and lease expenditures will be limited to levels which ensure sufficient cash for servicing and repayment of bank debt.
- **Restrictions on Investments:** As for capital expenditures and leases as discussed previously.
- **Restrictions on Repurchase of Stock/Dividends:** As discussed previously.
- **Restrictions on Officers' Salaries:** As discussed previously.
- **Restrictions on Mergers/Change in Business:** As discussed previously.

IV. Protection of Asset Quality

Examples of covenants to accomplish this objective include:

Affirmative

- **Maintenance of Property and Casualty Insurance:** As discussed previously.
- **Maintenance of Key Man Life Insurance:** As discussed previously.
- **Current Settlement of Tax Liabilities and Other Accrued Expenses:** As discussed previously.
- **Maintenance of Minimum Levels of Working Capital and Liquidity Ratios:** As discussed previously.
- **Maintenance of Property, Plant, and Equipment in Good Repair:** Not only should a level of good repair be maintained, but the lender should retain rights of access to inspect the property, plant, and equipment at the lender's convenience.
- **Maintenance of Rights of Inspection:** As discussed above.
- **Maintenance of Information on Contingent Liabilities:** As discussed previously.

Negative Covenants

- **Restrictions on Sales of Assets:** As discussed previously.
- **Restrictions on Capital Expenditures:** As discussed previously.
- **Restrictions on Leases:** As discussed previously.
- **Restrictions on Loans to Officers:** As discussed previously.
- **Restrictions on Mergers or a Change in the Company's Business:** As discussed previously.

V. Control Growth

Examples of covenants to accomplish this objective include:

Affirmative Covenants

- **Maintenance of Minimum Tangible Net Worth:** As discussed previously.

Negative Covenants

Permanent working capital loans arise as a result of both successful and unsuccessful, planned and unplanned growth patterns within companies.

To interfere with the evolution of a company's growth profile can, in certain circumstances, create lender liability problems for the bank.

There are, however, a number of ways in which growth can be controlled without interfering with the day to day management of the company.

These include restrictions on line availability, both in terms of absolute dollar amounts, as well as through the judicious and conservative use of a borrowing base.

Covenants, while a less direct tool, can nevertheless serve a useful function particularly when focused on the following areas:

- **Restrictions on, or maximum level of, Working Investment/Sales:** As discussed previously.
- **Restrictions on Borrowings, and Growth in Leverage:** As discussed previously.
- **Restrictions on Capital Expenditures:** As discussed previously.
- **Restrictions on Leases:** As discussed previously.
- **Restrictions on Mergers or a Change in the Business:** As discussed previously.

VI. Control of Key Management

Examples of covenants to accomplish this objective include:

Affirmative Covenants

- **Maintenance of Key Man Life Insurance:** As discussed previously.
- **Timely Delivery of Financial Statements:** As discussed previously.
- **Maintenance of Consistent Accounting Procedures:** As discussed previously.
- **Maintenance of Rights of Inspection:** As discussed previously.
- **Maintenance of Employment Contracts**

Negative Covenants

- **Restrictions on Mergers or a Change in Business:** As discussed previously.
- **Restrictions on a Change in Management:** As discussed previously.
- **Restrictions on Officers' Salaries:** As discussed previously.

VII. Assurance of Legitimacy and the Company as a Going Concern

Examples of covenants to accomplish this objective include:

Affirmative Covenants

- **Maintenance of Key Man Life Insurance:** As discussed previously.
- **Maintenance of Corporate Existence:** Preservation of the corporate entity is extremely important in order to ensure the continued identity of the borrower and the legal obligation of that entity to repay its bank loans.
- **Maintenance of Information on Contingent Liabilities:** As discussed previously.

Negative Covenants

- **Restrictions on Asset Sales:** As discussed previously.
- **Restrictions on Mergers or a Change in the Business:** As discussed previously.
- **Restrictions on Change in Management or Ownership:** As discussed previously.

VIII. Profitability for the Bank

Examples of covenants to accomplish this objective include:

Affirmative Covenants

- Maintenance of Banking Services, in particular Checking Accounts, with the Lender.
- Default pricing in Loan Agreements.
- 'Step up' or 'Step down' pricing related to declines or improvements respectively in operating performance.