Coming to Terms with Financial Covenants

by Dev Strischek

Lenders have devised covenants and conditions—integral to the structuring of any loan agreement—to make sure cash is available for debt repayment. But do we need 100-page documents to define "as agreed" or to dazzle our borrowers with dozens of covenants and conditions? Which requirements are really critical and necessary? Which financial covenants act as triggers or early warning signals of threatened or deteriorating repayment sources? This article, which first appeared in the Journal *in January 1994, outlines how just a few financial covenants can improve the odds of repayment. The author proposes a simple balance-sheet formula that helps preserve and maintain sufficient repayment ability.*

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Why not manage the ends instead of the means?

Covenants are a crucial part of a loan agreement because they control future actions and events. Future control implies an obligation for the lender to employ a logical and integrated approach to covenant writing. Because the lender's goal is to be repaid on time and in full, "as agreed" should make sure all goes well—and ends well. Thus, sufficient cash flow derived from a profitable, growing enterprise with a balanced financial condition may be the perfect ending.

To achieve this happy ending, the lender needs to contemplate the kinds and probabilities of risks that might undermine the borrower's profitability. These risks are usually found lurking in undercapitalized firms with insufficient working capital and low earnings retention. Such firms are unlikely to generate enough cash flow to repay trade or bank debt.

Minimize Risk

Fortunately, the tools to minimize these kinds of risks are well known and easy to apply.

Affirmative financial covenants include such items as a minimum current ratio, minimum net working capital, and minimum net worth. Common negative financial covenants include a maximum debt/worth ratio, maximum total debt, maximum capital expenditures, and maximum dividends. What is less obvious is that just a few of these financial covenants are needed to stabilize the balance sheet's working capital and equity and ensure that enough cash flow is generated to repay the debt.

Manage the Ends, Not the Means

It is the infinite variety of covenants that can trip the lender. Bankers seem to carry excess intellectual baggage when they go cruising for covenants. Covenants are just a means to an end: They restrict undesirable behaviors, encourage desirable actions, and measure and monitor financial performance and condition.

If a few financial covenants can preserve and maintain repayment sources, why slather on extra ones? Although the negotiating environment sometimes requires some expendable items, lenders should guard the few good covenants and concede the expendable ones. It is important to determine which ones are really necessary to preserve and maintain repayment sources.

The key is to select financial covenants that stabilize the financial structure and protect the assets from losing value.

To discover how to stabilize the financial statement, let's look at the balance sheet from a different perspective.

The Balance Sheet Revisited

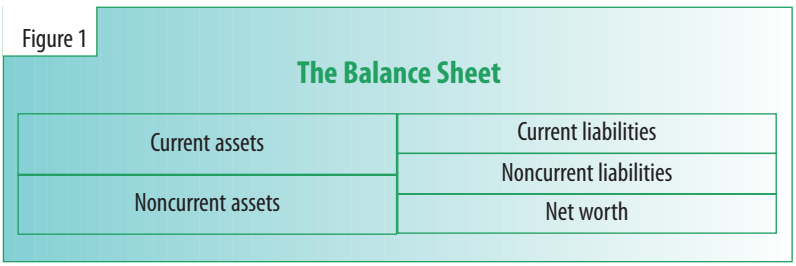
The balance sheet can be depicted as a box split vertically down the middle with assets on the left side and liabilities and equity on the right side, as shown in Figure 1.

Now let's see how a few financial covenants can contain or prevent some activities. Some of the most commonly proscribed activities are capital expenditures, owners' compensation, and dividends. If unrestrained, a borrower might use cash for these activities instead of using the cash to repay loans.

Moreover, many borrowers see the lender's specific restrictions on compensation, expenditures, and dividends as meddling in day-to-day operations. Again, why should the bank care how much the borrower spends or what the borrower buys as long as the borrower repays the loan on time and in full?

Why not manage the ends instead of the means? Why not mathematically lock in the maximum available for capital expenditures, owners' compensation, or dividends without appearing to micromanage the firm or discriminate against these hot-button items?

Figure 1



Horizontal Control

Current ratio. The lock-in of the balance sheet begins with a minimum current ratio, which is actually another way of restricting short-term borrowing. A minimum current ratio of 2.0 tells the borrower that current assets must always be twice the amount of current debt. Put another way, current debt should not exceed 50% of current assets.

Minimum net working capital. The lock-in clicks up a second notch through the setting of a minimum net working capital (NWC) position. In addition to a minimum 2.0 current ratio, a requirement of, for example, at least $100,000 of NWC keeps an absolute portion of the owners' equity invested in trading assets. The third notch of the lock-in is a required minimum NWC of some set amount each period. If that amount is equal to the earnings projected by the borrower, the step-up provision forces the borrower not only to retain projected earnings but also to invest the profits in assets that are more liquid and more readily productive than fixed assets and other noncurrent assets.

The minimum current ratio and a minimum NWC amount with a periodic step-up provision relatively and absolutely lock in the current boxes of the balance sheet. Vertical lock-in comes next.

Vertical Restrictions

Debt/worth ratio. Probably the most common negative financial covenant is a debt/worth ratio, and relatively speaking, it is a very powerful covenant. A maximum 3.0 debt/worth ratio warns the borrower that he or she can borrow no more than $3 for every $1 of equity. Since a growing firm typically acquires 50 cents of new assets to support every $1 of new sales (the sales/total asset ratio for many lines of business is around 2.0), this 50 cents of additional resources is a lot easier to fund with borrowed money now than with the unfulfilled promise of retained earnings later.

The entrepreneur sees the alternatives this way: "One dollar of equity allows me to borrow $3, and with the $4 sum, I can buy $4 of assets that will generate $8 of sales." A 2.0 maximum debt/worth ratio limits the sales generation to $6; a 4.0 maximum debt/worth ratio raises the sales expansion to $10; a 5.0 maximum debt/worth ratio raises the sale expansion to $12; and so on. Guess which debt/worth ratio an entrepreneur with $2 to invest and a $10 sales goal is going to select?

Minimum net worth. A minimum net worth covenant with a step-up provision is analogous to the minimum NWC covenant with a step-up provision. Just as the minimum NWC covenant with its step-up restriction keeps owners' equity invested in the current assets, the minimum net worth with its step-up keeps owners' equity in the total assets.

The debt/worth covenant can be made attractive to small business borrowers too. Since many closely held borrowers have elected S corporation tax status, modifying the debt/worth ratio to treat subordinated debt as equity rewards the borrower for putting the lender first. The modified ratio would be a senior debt/capital funds ratio in which capital funds are defined as net worth plus subordinated debt.

However, the lender should be sure that the debt is really subordinated. He or she should review the note to be satisfied that both principal and interest are subordinated until bank debt is repaid in full. Some bankers think they have subordinated their borrowers' insider loans to find that these notes are only subordinated on default.

Meanwhile, interest and principal dollars have been paid to outsiders right along or maybe just ahead of the bank loans. Finally, the note should be held physically by the bank.

Borrower's Choice

Once these types of covenants are in place, whether borrowers choose to pay dividends, purchase capital assets, or compensate themselves is still their choice. All the borrowers have to do is meet the relative and absolute tests of these ratios. The prudence of conservative debt/worth ratios and the need for equity are philosophically more acceptable than arbitrary and specific restrictions on discretionary management choices.

Is it necessary to prohibit dividends as long as the borrower injects additional funds to meet the minimum net worth requirement? Is an earnings recapture covenant really necessary if the borrower has stepped up net worth and paid down the debt as originally scheduled and agreed to by the lender?

In fact, the combination of the current ratio, net working capital, debt/worth ratio, and net

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worth covenants is sufficient for preserving and maintaining the borrower's balance sheet. How does it work?

The Math

Assume that the lender wishes to preserve the borrower's present balance sheet proportions and discourage excessive fixed-asset purchases, owners' compensation, and dividends. If the goal is to restrict noncurrent assets—the asset catchall for fixed assets, intangibles, and other not-so-desirable assets—it is possible to quantify these objectives by mathematically linking them as shown in Figure 2.

An Example

The following example illustrates how the formula works. It shows how a few financial covenants determine noncurrent assets and, by extension, limit fixed assets.

Jurassic Jagger Corporation (JJC) distributes major artists' compact discs to retail outlets and has in place several large distribution warehouses with excess capacity. JJC has been growing rapidly because the economic rebound has generated more personal disposable income for people to buy recorded music.

The account officer proposes to curtail any further fixed-asset expansion by relying on a few financial covenants that will stabilize the balance sheet and encourage earnings retention.

JJC is an S corporation, so its owner typically has loaned back the firm's profits as loans from stockholders subordinated to the bank. JJC's balance sheet and the account officer's suggested financial covenants are summarized in Figure 3, which includes the mutual agreement that 1994's projected $50,000 profit will be retained and that NWC and net worth will be stepped up by $50,000.

Using the formula, it can be seen that noncurrent assets would be kept at $300,000 based on the constraints set by the four financial covenants. Of course, the formula can be used to solve for the other variables. All things being equal, the account officer might want to solve for one of the balance sheet components, one of the covenant ratios, and so on.

Conclusion

A few financial covenants can improve the odds for repayment by preserving and maintaining a borrower's resources. Here is a simple formula to calculate the impact of these covenants on areas of the balance sheet typically earmarked for control and monitoring.

Let the covenants monitor the borrower's progress and guide him or her along the road to repayment, but let the borrower drive the process. Aim for results, and leave the means to the borrower. Finally, keep it simple. As Aesop said in his fable of the fox and the cat, "Better one safe way than a hundred on which you cannot reckon." ❐

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Figure 2

The Formula

$$\text{Noncurrent assets} = \left[\text{Net worth}\left(\frac{\text{Total liabilities}}{\text{Net worth}} + 1\right)\right] + \left[\left(\text{Net working capital - current assets}\right) \times \left(\frac{\text{Current assets}}{\text{Current liabilities}}\right)\right]$$

Total assets = Current assets + noncurrent assets

Total liabilities = Current liabilities + noncurrent liabilities

Net worth = Total assets - total liabilities

Net working capital = Current assets - current liabilities

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Debt/worth ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Figure 3

JJC's Balance Sheet

Jurassic Jagger Corporation
(in $000s)

	12/31/93	Projected 12/31/94		12/31/93	Projected 12/31/94
Current assets	200	250	Current Liabilities	100	100
Noncurrent assets	300	300	Noncurrent liabilities	200	200
			Net worth	200	250
Total assets	500	550	Total liabilities + net worth	500	550

Proposed financial covenants for fiscal year 1994

Current ratio ≥ 2.0
(Projected value from balance sheet is 2.5)

Net working capital ≥ 150
100 + 50 step-up = 150

Debt/worth ≥ 1.5
(Projected value from balance sheet is 1.2)

Net worth ≥ 250
200 + 50 step-up = 250

Applying the formula:

Noncurrent assets =

$$\left[\text{Net worth}\left(\frac{\text{Total liabilities}}{\text{Net worth}}+1\right)\right] + \left[\left(\text{Net working capital - current assets}\right) \text{X} \left(\frac{\text{Current assets}}{\text{Current liabilities}}\right)\right]$$

$$= \left[250\left(\frac{300}{250}+1\right)\right] + \left[\left(150-250\right) \text{X} \left(\frac{250}{100}\right)\right]$$

$$= 550 - 250$$

$$= 300$$

2007 Author Update

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Thirteen years ago, most of us were recovering from one of the worst recessions, and we learned the hard way that the best loans were those with simple structures. After all, if a banker had to truss up a borrower with dozens of covenants and conditions, maybe the banker should have thought a little more about whether the front-end fuss was worth the back-end muss.

The good news is that less is still better than more in the world of covenants. Many banks are examining the administrative tails of their loan structures to bob them as much as possible. Just as relevant today is the article's point that a few covenants can protect the banker as well or better than many constraints—and more cheaply. Enforcing covenants means that the banker must ensure compliance, and if there is a covenant default, the banker must respond promptly. Too many covenants take too long to monitor and raise too high the risk of slow or no response, which ultimately weakens them as protection for the bank's position.

The rules still hold that a ratio covenant must be anchored to some dollar limit in order to prevent financial drift. There is more use of debt/EBITDA covenants, and the resurgence of off-balance-sheet financing means that lenders must capitalize the rents and leases to get a true picture of the total debt landscape and employ EBITDA to capture the expense associated with the rents and leases. The greater incidence of debt layers calls for limits on junior debt as well as total debt.

A last suggestion is to be sure to require a periodic—at least quarterly—covenant compliance certificate from the borrower. A certificate with a few covenants will not be burdensome, and every so often the borrower is reminded that the banker is interested in the borrower's financial condition and performance. As Ben Franklin noted 250 years ago, creditors have better memories than debtors.

—Dev Strischek
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