The Advisor – Spring 2015

Financial Covenants in the Lending Agreement

"A bank is a place that will lend you money if you can prove that you don't need it." - Bob Hope

Truer words have never been spoken.

We often hear similar comments from prospective clients about the behaviour of lending institutions i.e. "banks don't understand our business"; or "banks are never there when you need them".

The bottom line is that lenders (whether they are a transitional lender, a leasing company or a traditional bank) are not in the business of financing operating losses.

Their mandate is to finance entities that are profitable or have the prospect of profitability in the short term. In addition to securing their loans with collateral, they also look to the profits or future cash flows of the company to repay the loans that are made to their clients.

A key method lenders use to protect their interests is to include financial covenants in lending agreements they enter into with borrowers. These covenants are the minimum financial commitments borrowers are required to meet in order to ensure a lender will continue to lend to them. Violating one or more covenants is usually grounds for termination of the lending agreement and allows the lender to call the loan or seek other remedies from the borrower.

Some of the more common financial covenants lenders use include:

1. **Minimum Working Capital.** This is calculated by taking the borrower's current assets and dividing them by its current liabilities. The main purpose of this ratio is to assess the borrower's ability to meet its current obligations as they come due. A ratio of less than 1 to 1 signals a significant liquidity issue that should be rectified immediately. Senior lenders usually require a minimum ratio of 1.10 to 1 to provide a working capital cushion in order to meet current obligations.

2. **Minimum Tangible Net Worth.** Tangible net worth ("TNW") is calculated by taking the borrower's equity and adding to this amount any shareholder or related party loans made to the borrower that are not allowed to be paid back without the lender's permission. Deductions from TNW include any intangible assets or loans made by the borrower to shareholders or other related parties.

© Aries Advisory Group Ltd. 2015

By establishing a minimum TNW, the lender ensures that the borrower is not: (a) losing money; or (b) moving cash out of the company to other related parties since both of these actions will reduce TNW and violate the covenant.

3. **Maximum Debt to TNW.** This covenant is calculated by dividing all of the borrower's liabilities (both current and long-term) by its TNW. The purpose of this covenant is to ensure that the borrower's balance sheet is not overly burdened with debt. Lenders usually include a covenant that allows for a maximum of 2.5 to 3.5 times debt to a borrower's TNW. Any more would signal a leverage issue to a lender.

4. **Minimum Debt Service.** This covenant is calculated by taking the operating cash flow the borrower generates in a fiscal year (usually defined as net income plus depreciation and interest expense) and dividing it by all of the scheduled principal and interest payments to service the borrower's debt. The purpose of this covenant is to ensure adequate cash flow is being generated from operations in order to meet the payment obligations of all loans advanced to the borrower. Lenders usually require a minimum ratio of anywhere from 1.1 to 1.25 in operating cash flow to scheduled debt payments in their lending agreements.

Lenders establish covenants by reviewing a company's historical financial statements and assessing what ratios it can meet. They will also review financial forecasts for the next 12 to 24 months to determine if management expects results to improve. It is not uncommon for a new lender to set introductory covenants and then increase thresholds to a more acceptable level in the second and third year of the relationship.

When entering into a new lending agreement (or renewing an existing one), it is prudent to have an outside advisor assist the company in negotiating these agreements. They can lend knowledge and credibility to the negotiating process to ensure the lender will "sharpen its pencil" and not specify overly restrictive covenants. An advisor can also use their experience to perform sensitivity analyses on the borrower's forecasts to ensure the negotiated covenants will be met under various scenarios.

Aries Advisory Group can assist you with your lending agreement negotiations. We have over 25 years' experience in negotiating lending agreements and establishing acceptable financial covenants for our clients. We will ensure that you have the best lending agreement given your specific circumstances. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.

© Aries Advisory Group Ltd. 2015