Chapter 9

Bank Covenants—The Mystery Explained!

Julie felt that the covenant discussion with Mike would be best held in person. Her friend Stephen, a former banker, was advising his client Jessica, who was also trying to get a bank loan. She invited them both over for the discussion. Julie knew that Stephen, with almost two decades of banking experience, would add significant value to the discussion.

All four of them met in Julie's conference room. Introductions were made and then everyone got down to business.

Julie's conference room was nicely appointed but not too fancy. It had whiteboards on all but one side and a drop-down screen on one wall. A permanent projector hung from the ceiling. This room was clearly meant for brainstorming and serious work.

"Okay, are we all ready?" Stephen asked joyfully. "This is one of my favorite topics."

"Mike, Julie has already explained your situation and your goals. Jessica is also applying for a term loan with First Bank and wanted me to discuss bank covenants, so Julie and I thought we'd all discuss it together.

"Jessica," he continued, "Mike is also looking for a term loan, most likely an SBA loan, although he needs a smaller loan than you do. There are a lot of parallels between your situations, and both of your loans are sure to contain some covenants.

"Let's start from the beginning. I'll apologize in advance if we cover anything that you already know.

"You both know that every loan you take from a bank comes with strings attached. These 'strings' are more commonly known as *covenants*.

Covenants

Covenants—instructions and details on what you can and cannot do in your business

"Covenants come in several forms. To put it simply, they give you instructions and details on what you can and cannot do with your business as long as you owe money to the bank.

"You might ask why the bank should have any control at all over what you do or don't do as long as you are repaying them. After all, you've managed the business well enough to this point. Shouldn't they just trust that you will continue to do so?"

Stephen answered his own question. "One of my favorite sayings is 'Trust, but verify,' and in many cases, this is exactly what the bank is doing. They trusted you enough to lend you the money, but they have responsibilities to verify, at least at some level, that you are staying financially healthy enough to repay the loan.

"As you know, things change. Economies deteriorate, businesses lose key accounts, executives leave—any number of things could occur that might affect your business negatively. Loan covenants serve as an 'early warning system' that indicates (hopefully in advance) that your business' performance might be heading in the wrong direction.

Covenants Measure Trends and the Health of Your Business

"Think about it from the bank's perspective," Stephen continued. "If they can design the covenants to measure key metrics and trends that highlight the health of your business, then you need to track these metrics as well. They should, at least theoretically, keep your business safer. And if you can't meet the covenants, it might be a sign of a larger problem."

Jessica seemed to agree but had some concerns. "All that makes sense, but won't the covenants restrict me from doing some of the things that I might *need* to do for my business? What if I don't agree with what they are telling me to do?"

"Or worse yet," Mike quickly chimed in, "what if they *prevent* me from doing something, even if I really think it's necessary?"

"You both make excellent points," Julie said, "which is exactly why we are meeting today, before either of you sign any loan documents, so you can get a better understanding of the covenants. Forewarned is forearmed!" she said cheerfully.

Stephen added, "By understanding what covenants are and how they can affect you, you have an opportunity to review and analyze them up-front. In some cases, you may even be able to negotiate with the lender on which covenants to include or request modifications to the standard ones if you have sound rationale for the change.

"But before you get too concerned about the covenants, let's go into what they are and how they might be structured. We'll use a few examples."

Stephen turned to Mike and asked, "Mike, you have a teenage son, right? He works at a pizza shop, doesn't he?"

"Yes," Mike said, a bit surprised that Stephen knew that.

"Okay, let me give you an analogy. Suppose your son says he wants to borrow your car Friday and Saturday nights to deliver pizzas for his new job at the local Domingo's Pizzeria. He says he will pay for gas using the tips he makes each evening. You think about it, and then agree to let him use the car.

"But before you agree," he continued, "you set some conditions for borrowing your car.

"Here is what you tell him."

Stephen wrote each condition on one of the large whiteboards.

- Don't exceed the speed limit
- Don't take any passengers in the car
- Return the car by 11 PM each night
- Wash the car at the car wash on Sunday
- Fill the gas tank on Saturday night after work

"All of the above seems pretty reasonable, right?"

Mike and Jessica both nodded and said, "Yes."

"You just established covenants with your son! The covenants were the conditions that you set in place to borrow your car. Simple, huh?"

Julie went on to add, "A bank loan is very similar. Stephen, can you go into a bit more detail?"

"Of course. There are two major categories of covenants: *Restrictive Covenants* and *Financial Covenants*."

Restrictive Covenants and Financial Covenants

"I brought some diagrams I've prepared over the years to train some of my junior bankers. Hopefully these will help.

"The restrictive covenants are the ones that tell you what you can and can't do with your business. They come in two primary forms: *Affirmative Covenants* and *Negative Covenants*.

"Look at the first chart to see an example of some of the most common restrictive covenants," he said as he turned over a page to show the next infographic (on the following page).

Restrictive Covenant—A type of contract where one party agrees to do or not do something

Stephen walked through the examples of typical affirmative and negative covenants listed on the chart and how they identified things a company must do (called *protective covenants*) and things it can't do (known as *restrictive covenants*).

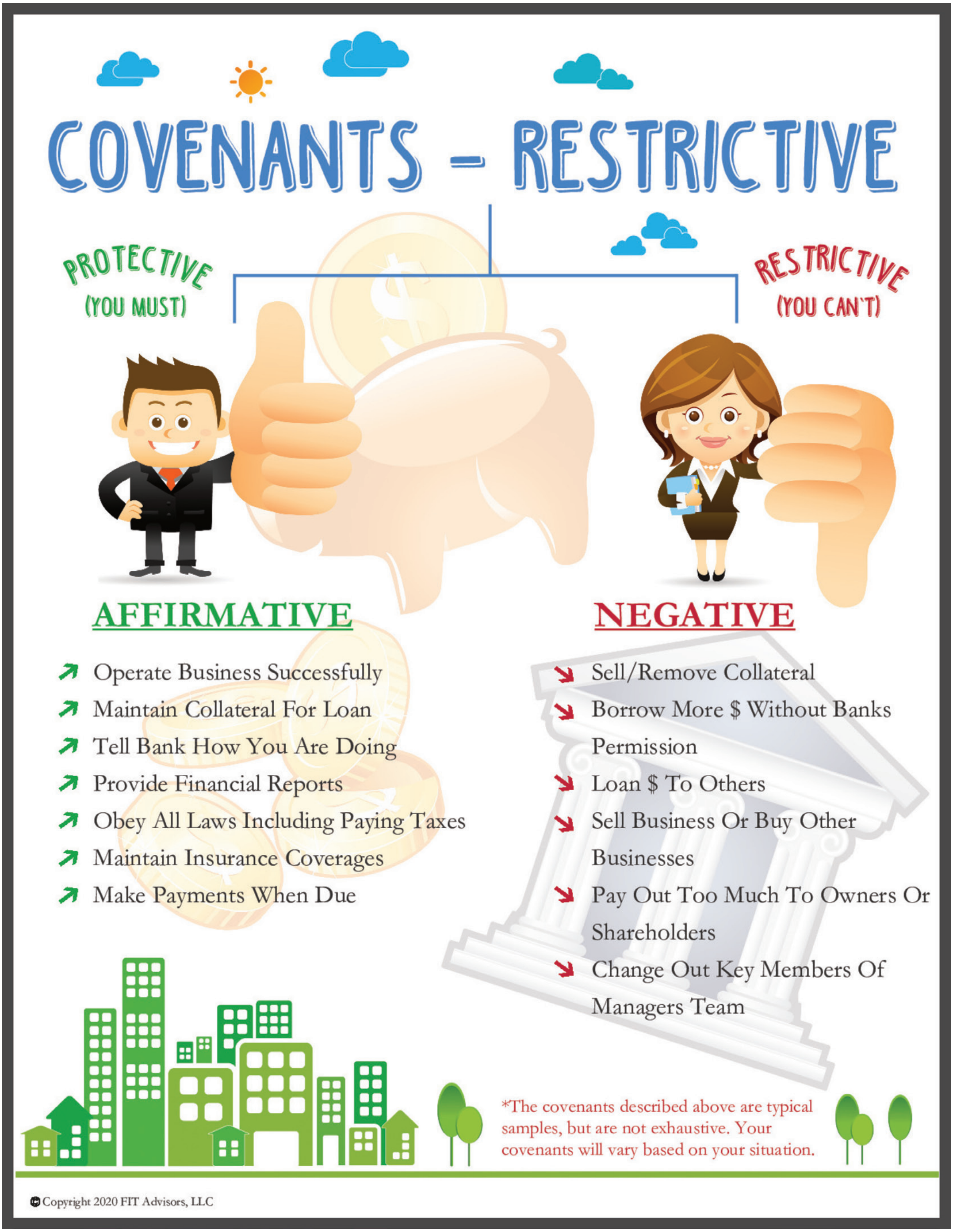
Financial Covenants—covenants that requires a company to meet certain financial goals; generally related to liquidity, profitability or leverage.

"Now let's go back to the example of your son borrowing your car. The covenants you laid out for him are very similar to the covenants that your bank will put in place with you. How so, you ask? Great question!" Stephen said, as he continued.

"Let's look at each one."

Condition 1 (Covenant 1): He must not exceed the speed limit.

"This would be a *negative covenant* because it restricts what he is allowed to do. While he is driving your car, he 'must not exceed the speed limit.'


COVENANTS – RESTRICTIVE
PROTECTIVE
(YOU MUST)
RESTRICTIVE
(YOU CAN'T)
AFFIRMATIVE
Operate Business Successfully
Maintain Collateral For Loan
Tell Bank How You Are Doing
Provide Financial Reports
Obey All Laws Including Paying Taxes
Maintain Insurance Coverages
Make Payments When Due
NEGATIVE
Sell/Remove Collateral
Borrow More $ Without Banks Permission
Loan $ To Others
Sell Business Or Buy Other Businesses
Pay Out Too Much To Owners Or Shareholders
Change Out Key Members Of Managers Team
*The covenants described above are typical samples, but are not exhaustive. Your covenants will vary based on your situation.
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Condition 2 (Covenant 2): He must not take any passengers with him.

"This would also be a *negative covenant*, as it prevents him from taking any of his friends or other passengers with him in the car."

Condition 3 (Covenant 3): He must have the car returned by 11 PM each night.

"This would be considered an *affirmative covenant* because it tells him that he *must* return the car at a certain time.

Condition 4 (Covenant 4): He must get the car washed at the local car wash on Sunday.

"This would be considered an *affirmative covenant,* because it tells him that he *must* get the car washed the next day."

Condition 5 (Covenant 5): He must return the car with a full tank.

Julie chimed in. "This would be considered an *affirmative covenant*, because it tells him what he must do."

Stephen added, "One of the things that confuses some borrowers is how covenants can actually fall into more than one category. Let me explain."

Stephen continued, "Let's say your son brings the car back Friday night, but it only has three quarters of a tank of gas. You ask him what happened. He says that he used his tips to put gas in the car but didn't make enough to fill the entire tank.

"Here we can make the parallel of a different kind of covenant. Not only is the requirement to fill the gas tank an affirmative covenant, but it might also be construed to be what's known as a *financial covenant*. One of the requirements you set out for him to use your car was that he return it with the same amount of gas that it had when he borrowed it. This would mean that he must make enough money in wages or tips to cover the fuel used. This didn't happen. Since he returned the car with three quarters of a tank of gas, he used, say, $10, or a quarter of a tank, more gas than he made in tips.

"Financial Covenants lay out specific financial requirements that your company must meet. Normally, these are related to *profitability*, *leverage*, and *liquidity*.

"Fortunately for your son, you said he had to return the car *Saturday* night with a full tank of gas. So he has another day to make up the shortfall in tips. Luckily for him, Saturday should be a busier night for pizza deliveries."

Liquidity—a measure of the liquid, or readily available, assets of a company

Julie interjected, almost as if on cue, "This brings up another important point though. The bank will set up *periodic* measurements for your covenants, typically quarterly or annually. You only need to be in compliance with the covenant at the point in time that it is measured. This may only apply to the end of the measurement period. If the covenant is 'you must make a net profit of $50,000 each quarter,' that allows you some flexibility to operate your business within that period. Alternatively, it may be an ongoing requirement such as 'you must maintain a minimum tangible net worth of $250,000 at all times.'"

Measurement Period—A point in time or period of time over which a bovenant or period of performance is measured.

Stephen nodded in agreement and continued. "Exactly! Let's go back to the example of your son and his pizza delivery job.

"Thankfully for him, your condition (or covenant) was that he return the car on Saturday night with a full tank of gas. That means his pizza tips have time to increase enough for him to still meet his affirmative covenant with you to fill the tank.

"The measurement period in this case is the end of the two day pizza delivery cycle, not Friday night after only one evening of deliveries, so he hasn't violated anything yet. But he should be on high alert that things need to pick up or he risks violating one of the covenants you set in place for the use of your car."

"Does this all make sense to you two?" Julie asked.

Mike and Jessica indicated that it did.

"Mike, since you saw the gas gauge on Friday evening, you may have had some indication that your son was risking failure to meet his required conditions. This causes you some concern, so you discuss it with your son. He assures you that Saturday will be better and he'll be able to make his commitment.

"Ideally," Julie elaborated, "it would have been best if he had explained this in advance before you had to ask him about it, but then again, he's only 17. Still, had he come to you first, you would have felt better about him understanding his requirements."

"Now," Stephen interjected, "let's make an analogy to the bank.

"Let's assume you have a quarterly financial covenant to make $300,000 in profit each quarter. Your bank requires that you report your results each month, and you have sent in the results for the first two months of the quarter. Say you report a profit of $75,000 in the first month and $35,000 in the second. So far, you have a total of only $110,000 in profit for the quarter.

"In order to meet your 'profitability' covenant of $300,000 for the quarter, you need to make up a shortfall of $190,000 in the third month of the quarter, which is the *measurement period*.

"You haven't violated (or "tripped," in banker-speak) any covenant yet, because the measurement period allows you a full quarter to achieve the required profitability. But it isn't looking good so far.

"Your bank, having received your monthly financial reports, gives you a call and tells you they are concerned you might violate the quarterly profitability covenant. Sound familiar? It's just like the discussion you and your son had after the first night of borrowing the car.

"You assure them that the third month in the quarter will be an excellent one and that you will have no problem making the covenant."

Be Proactive!

Stephen continued. "You probably wished your son had come to you and explained that he wasn't doing so well after only one night but had a plan to make it up. The same thing would apply to your dealings with the bank. It would have been best had you been proactive in this situation and called the bank before they received the results of your second month of (sub-par) operations. During this call, you could have explained that the monthly results were nothing to worry about. You expected the third month in the quarter to be excellent, so the quarterly financial profitability covenant would be no problem to meet.

"How do you think your bank would have responded if you had done this rather than having them call you for an explanation?

"I'll tell you," he said as he answered his own question. "It would have instilled confidence that you understood your requirements and their needs. That would have reassured the bank that they could count on you to give them a 'heads-up' if there were ever a problem."

Julie added, "So, in this way, covenants can be beneficial as well. They can help you establish credibility with your bank, which is critical to a successful long-term relationship in which you maximize the value your bank can provide you and your business. The more they trust you and can count on you to keep them informed, the more you will be able to count on them to lend you money when you need it and work with you when you have a problem."

Stephen chimed in. "If you do have a problem, the lender normally has certain rights to modify the terms of your loan—although not always to your benefit. At a minimum, an open dialog gives the lender an opportunity to have a candid discussion with you about what happened and what your plans are to correct the situation.

"The covenants also keep a business focused on items like cash flow and profitability, areas where a lender sees the most risk. And like Julie said, this is a good thing because it will keep the borrower focused on essential operational parameters."

Jessica interrupted. "Your last graphic showed us typical restrictive covenants. Can you also give us a few examples of what types of financial covenants we might see?"

"Absolutely," Stephen said. "The major categories are profitability, leverage, and liquidity. The infographic [on the following page] shows some possible financial covenants associated with a small business loan."

Stephen went on to explain, "We've grouped the financial covenants into primary categories so they're easier to understand. Although there are variations, they generally come in three major categories that, when measured periodically as we've discussed, will alert the lender that the business is or may soon be experiencing problems. Here are the primary categories and some sample measurements or ratios that they will use."

- Profitability Covenants
  - ◊ Net Income
  - ◊ Pre-Tax Profit
- Leverage (Or Debt Coverage) Covenants
  - ◊ Debt/Tangible Net Worth
  - ◊ Fixed Charge Coverage
  - ◊ Interest Coverage
  - ◊ Debt/EBITDA
  - ◊ EBITDA/(P&I of Debt Payments)
- Liquidity (Working Capital) Covenants
  - ◊ Current Ratio
  - ◊ Net Working Capital

Profitability Covenants measure financial success of your business

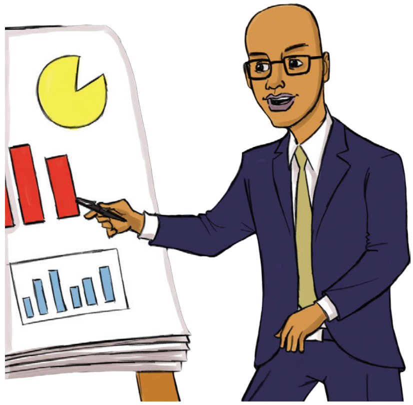
Leverage Covenants ensure you aren't taking on too much debt

Liquidity Covenants ensure you have enough liquid assets for operations

Mike studied the infographic for a second and asked a logical question. "Will a bank use all of these for every loan?"

"No, not at all," Julie explained. "They will probably pick one from each. Maybe two related to leverage. And some of them, like fixed charge coverage and Debt/EBITDA, are generally used for larger businesses with larger loans. The bankers will try to select the measures and ratios that

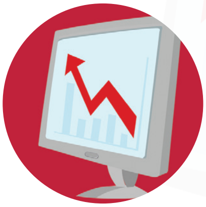
COVENANTS – FINANCIAL



Used to alert lender that the business is or may experience problem

Measures ratios and trends of profitability, cash flow and debt

3 MAIN TYPES



Profitability

- Net Income
- Pre-tax Profit

Leverage (Debt Coverage)

- Debt/Net Worth
- Fixed Charge Coverage
- Interest Coverage
- Debt/EBITDA

*EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization

Liquidity (Working capital)

- Current Ratio
- Net Working Capital

*The covenants described above are typical samples, but are not exhaustive. Your situation may vary make the most sense for your business but also give the bank adequate protection."

Stephen reinforced Julie's point. "Julie's correct. Bankers typically refer to this as *belt and suspenders* protection. The 'belt' normally holds up your pants, but just to make sure your pants don't fall down, the 'suspenders' act as a second means of protection. In the recent past, banks would have multiple (and often redundant) forms of covenant protection. It was not uncommon to see five or more primary covenants. There is a current trend to move away from this. Unless the business has had problems in the past, most banks will try to reduce the number of financial covenants to as little as two or three. This makes the loans easier to manage and track and still provides the bank with adequate protection."

Stephen summarized, "Honestly guys, that's all there really is to covenants. If you like, we can go over some specific examples of covenants and their calculations. Keep in mind that in addition to the covenants, a particular bank may also require you to have your primary banking relationship with them. That may also include offsetting deposit requirements and an obligation to cancel or discontinue deposit or credit relationships that you may have with other financial institutions."[3]

Everyone agreed that the discussion was worthwhile. They all left the meeting having a better understanding of bank covenants. Each was poised to review them thoroughly in their respective loan documents before signing anything.

3 Sample covenants and calculations can be found in Appendix A.