LOAN AND WORKING CAPITAL COVENANTS

2017

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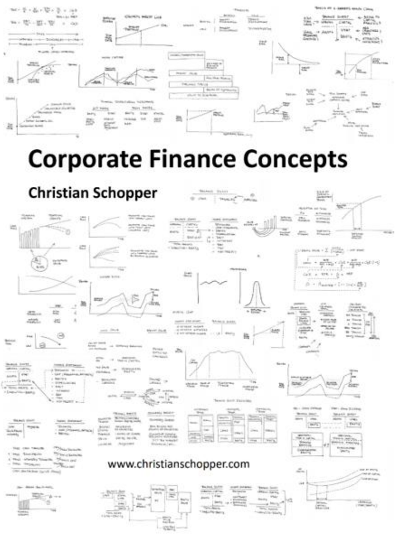

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Common Types of Ratios

Standard Ratios

- Liquidity
  - **Current Ratio**, measured as current assets divided by current liabilities
  - **Quick Ratio**, as current assets in the numerator less inventory, divided by current liabilities
- Leverage
  - Usually measured as **Total Debt-to-Total Assets** or **Total Debt-to-Total Equity**
- Profitability
  - Typically measured as **EBITDA**

“Back-up” Metrics

- Coverage Ratio
  - Times interest is covered by EBIT, measures a companys ability to service its debt
- Cash Flow Ratio
  - Cash Flow-to-Total Debt measures a companys ability to generate cash for debt service payments
- Debt Ratio
  - Total Debt-to-Total Assets; its complement is the net worth ratio as required in lending agreements

Common Types of Ratios (cont´d)

Additional possible covenants

- Dividend distributions
- Additional loan agreements
- Joint ventures
- Employee compensation changes
- Change in officers
- Creating or changing employee benefit plans
- Mergers or acquisitions
- Other Investments
- Debt retirement
- Changing any business agreements

Which Covenants are Used

Summary of Covenant Restrictions

The table presents a list of covenant restrictions found in loans to non-financial firms in the intersection of Dealscan and the merged CRSP-Compustat files during the period 1994-2005. *Packages* are collections of loans (i.e., tranches) entered into under one collective agreement. *Loan Amount* corresponds to the face value of the loans and are deflated by the all-urban CPI (year 2000).

Covenant	Number of Loans	Number of Packages	Loan Amount ($Bil) Average	Median	Total
Max. Debt to EBITDA	7,544	4,417	0.20	0.09	1,480.53
Min. (Tangible) Net Worth	7,196	4,931	0.13	0.03	926.67
Min. Fixed Charge Coverage	6,064	3,514	0.14	0.06	842.95
Min. Interest Coverage	5,856	3,486	0.22	0.10	1,299.70
Max. Leverage ratio	2,401	1,748	0.32	0.15	758.06
Max. Debt to Tangible Net Worth	2,331	1,677	0.06	0.01	137.90
Min. Current Ratio	2,098	1,455	0.06	0.02	126.45
Min. Debt Service Coverage	1,906	1,186	0.07	0.01	126.08
Max. Senior Debt to EBITDA	1,654	857	0.14	0.09	231.34
Min. EBITDA	1,556	886	0.09	0.04	135.32
Min. Quick Ratio	779	555	0.02	0.01	19.16
Min. Cash Interest Coverage	321	165	0.19	0.10	60.70
Max. Debt to Equity	169	119	0.17	0.04	27.95
Max. Senior Leverage	20	10	0.23	0.12	4.54
Max. Loan to Value	19	8	0.05	0.02	0.97

http://web.stanford.edu/group/SITE/archive/SITE_2007/segment_4/michael_roberts.pdf

Which Covenants are Used (cont´d)

Excursion: Fixed Charge Coverage

- Measures a firm's ability to satisfy fixed charges, such as interest expense and lease expense
  - Since leases are a fixed charge, the calculation for determining a company's ability to cover fixed charges includes EBIT, interest expense, lease expense and other fixed charges:

$$= \frac{\text{EBIT + Fixed Charge (before tax)}}{\text{Fixed Charge (before tax) + Interest}}$$

- Also referred to as the **solvency ratio**, the fixed-charge ratio is commonly used by lenders attempting to analyze the amount of cash flow a company has available for debt repayment

Which Covenants are Used (cont´d)

Covenant Frequency in Leveraged Loan Credit Agreements
(1994–1998)

Leverage	%
Maximum Total Debt/EBITDA	78
Maximum Senior Debt/EBITDA	11
Maximum Debt/Capitalization	7
Maximum Debt/Net Worth	5
Maximum Senior Debt/ Capitalization	1
Coverage	
Minimum Interest Coverage	70
Minimum Fixed-Charge Coverage	54
Minimum Senior Interest Coverage	4
Mandatory Prepayments	
Asset Sales Sweep	95
Debt Issuance Sweep	76
Excess Cash Flow Sweep	69
Equity Issuance Sweep	64

Potential Problems with Standard Ratios

Problems with Specific Ratios

- Total debt ratio or financial leverage
  - Total debt ÷ total assets
  - Including short-term?
- Total asset turnover
  - Sales ÷ total assets
  - Any distinction among specific asset categories?
- Inventory turnover
  - Cost of goods sold ÷ inventory
  - Inventory may be spoiled or incorrectly valued; among the most difficult of all assets to value

Problems with General Business Comparisons

- Companies seldom compare exactly
  - Different lines of business or markets, at different points in implementing technology …
- Accounting standards vary
- Different fiscal year-ends distort results
  - Particularly due to seasonality
- Unusual (non-recurring) events
  - Asset sales; windfall from legal settlement …

Potential Problems with Standard Ratios (cont´d)

Problems with Assets Presented using Misleading Values

- Certain assets are never included in balance sheets
  - People; market value of intellectual property; potential value of strategic initiatives (e.g. joint ventures; new products)
- Certain assets are included at artificial values, misrepresenting actual value
  - Land (at cost); buildings (after depreciation); natural resources (after depletion); intellectual property (valued after the cost has been amortized)

Problems with Obligations that are not Recognized in Financial Statements

- Obligations addressed in footnotes cannot be evaluated using traditional ratio analysis
  - Lines of credit
  - Leases
  - Ongoing or threatened legal proceedings
  - Value of certain derivative transactions
  - Actual foreign exchange values
  - Rights to product marketing following an acquisition
  - Plans to restructure such as the exiting of certain businesses
  - Employee stock options that may be exercised in the future

Appendix – Working Capital Covenants & Collateral

Example 1

Borrower:	Motoparts Manufacturing Co., Inc. Carsville, USA
Business:	Manufacturer of specialized components for the automobile industry.
Facility Description:	$5MM RC with a decreasing term sub-limit on machinery, equipment, and real estate. Originated four years ago at $4MM. Increased to current amount two years ago. Matures in three months. Interest is current.
Pricing:	Prime + 150 basis points. RC is interest only.
Repayment:	Term portion amortizes monthly over seven years. Reductions in term loan add to availability back to the RC.
Repayment Sources:	RC through conversion of current assets to cash. Term portion through operating CF and conversion of current assets to cash.
Collateral:	Eligible accounts receivable and inventory, at 87.5% and 65% advance rates respectively. $4.3MM outstanding under RC, leaving $200M available under borrowing base formula. M & E valued at $2.7MM and RE at $120M. Term outstanding is $500M.

Example 2

Borrower: Tschockies International, Inc.
Tackytown, USA

Business: Home decoration and crafts distribution.

Facility Description: $3.5MM one-year revolver with annual renewal. Line originated three years ago and has never achieved off-season payout, as projected at inception. Currently fully advanced. Line is governed by borrowing base of accounts receivable and inventory. Reporting includes monthly borrowing base certificates and accounts receivable aging. Terms also provide for periodic field audits. The last audit was performed 21 months ago. Loan has been governed by forbearance agreement for five months; bank is implementing an exit strategy and has increased pricing.

Pricing: Bank floating base + 200 basis points.

Repayment Sources: Primary: Conversion of current assets to cash.
Secondary: Refinance of debt or sale of business.

Guaranty: None.

Covenants: Covenants are measured and enforced annually at quarter-end:

Covenant	Required Level	Actual	Interim 5 mos.
Minimum EBIT/Interest	1.4x	0.98x	0.94x
Maximum Debt/NW	8.0x	8.70x	8.74x
Minimum Fixed Charge Coverage[1]	1.0x	0.91x	0.89x

[1] Defined as EBITDA-CAPEX ÷ Debt service.

Collateral: Borrowing base totals $3.5MM. It consists of eligible ARs of $1.4MM, with an 80% advance rate, providing $1.1MM in availability and eligible inventory of $3.4MM, with a 70% advance rate, providing $2.4MM availability. Only ineligible ARs are those greater than 90 days past due.

Example 3

Borrower: Jack's Sprouts, Inc.
Beantown, USA

Business: Seed processing and distribution.

Facility Description: $3.3 MM three-year revolver. Line originated 6-01 at $3MM amended to $3.3MM from 4-02 to 6-02, and matures 6-03. Inventory sublimit of $2.1MM. Current outstandings are $3.1MM. Line is fully followed with weekly borrowing base certificates and accounts receivable agings. Terms also provide for periodic field audits.

Pricing: LIBOR + 300 basis points

Repayment Sources: Primary: Conversion of current assets to cash. Secondary: Refinance or sale of company. Tertiary: Liquidation of assets.

Guaranty: Owner guarantees, but financial statement indicates only nominal support from that source.

Covenants: Covenants are measured quarterly.

Covenant	Required Level	FYE-01	Interim (9 mo.) 3Q'02
Minimum EBIT/Interest	1.10x	1.12x	1.15x
Maximum Debt/TNW	4.0x	1.45x	3.40x
Minimum Fixed Charge Coverage[1]	1.05x	1.10x	.99x

[1] Defined as EBITDA-CAPEX ÷ Debt service

Collateral: Eligible accounts receivable of $1,940M, based on an 80% advance rate. Eligible inventory of $2,520M, based on a 50% advance rate. Only ARs considered ineligible are those more than 90 days past due.

Working Capital Finance Instruments

Finance Instrument	*Description*	*Key Terms*
Line of Credit	Maximum loan limit established. Firm draws on loan as needed up to limit.	Can be unsecured or secured. Annual repayment. Compensating balance may be required.
Accounts Receivable (AR) Loan	Loan secured by accounts receivable.	Loan amount based on a percentage of accounts receivable. Accounts receivable assigned to lender as sales occur. Loan balance paid down with AR collection.
Factoring	Sale of accounts receivable to a third party collector (factor). Factor bears collection risk.	Company paid based on average collection period less a collection fee. Collection amount can be advanced with an interest charge.
Inventory Loan	Loan secured by inventory.	Loan amount based on a percentage of inventory value. Lender receives security interest in inventory and may take physical control. Release of inventory with loan repayment.
Term Loan	Medium-term loan. Principal repaid over several years based on a fixed schedule.	Loan amount tied to collateral value. Can be fully amortized or a balloon loan. Typical term is three to seven years.

Contact

Christian Schopper

Private: christian.schopper@aon.at
Business: christian.schopper@corpfince.com

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