

Loan Covenants and their Impact on Credit Decisions

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Loan Covenants

- ◆ What is a Loan Covenant
- ◆ Why Do Banks Add Covenants to Loan Agreements
- ◆ Typical Covenants
- ◆ Typical Financial Ratios
- ◆ How this impacts the Customer and the Supplier

Loan Covenant Defined

- ◆ A covenant is a condition(s) that the borrower must comply with to be within the terms of the loan agreement.
 - Financial ratios
 - Restrictions on certain transactions
 - Providing information
- ◆ In most cases if the borrower is not within compliance the loan will be considered in default and the lender has the right to demand payment.
 - Curable vs. Non-curable
 - Affirmative vs. Negative

Why Banks Add Covenants to Loans

Ability to repay now and in the future
Pricing for the risk – pricing grids
Securing the debt with collateral
Monitoring through covenant tests and reporting
Restricting transactions that increase their risk

Ensure their position in repayment and claims on collateral are not undermined
Limitations on debt, liens, funds movements, expenditures
Reduction of security - Limit asset sales and insurance requirements
Restrict certain payments
Ratings triggers and/or springing liens

Ensure risk profile is neutral or increasing
Ensure adequate cash flow
Improving known capital structure weaknesses
Preserve equity
"Material Adverse Change" clause



Typical Loan Covenants

Affirmative covenants – things you are required to do

- Maintaining properties/Hazard Insurance
- Key-Man Life Insurance
- Payment of Taxes and Fees
- Compliance with the law
- Provide Financial statements and/or Projections
- Pledging assets
- Agreement to pay expenses of competing liens
- Retaining value
- Periodic certification of compliance
- Maintain books and records

Typical covenants

◆ Negative covenants-things you are prohibited from doing

- Distributions or Dividends or Intercompany transactions
- Change in Management
- Investments: Mergers, Acquisitions, JV's, Loans, Capex, expansions
- Divestitures
- Cross Corporate guarantees
- Incremental or Outstanding Debt
- Incremental liens
- Restrictions in other agreements

Typical Financial Ratios

- ◆ Interest Coverage Ratio
- ◆ Maximum Total Debt to EBITDA Ratio
- ◆ Minimum Quick Ratio, Current Ratio (liquidity)
- ◆ Minimum Return on Assets, Return on Equity (profitability)
- ◆ Minimum Equity, Minimum Working Capital, Maximum Debt to Net Worth (leverage)
- ◆ Borrowing Base Certificate

Impact to customer/supplier

- ◆ Payments due suppliers are junior in claim to employees and to secured lenders
 - Is the loan secured and by what collateral?
 - What remains unsecured for recovery?
 - What others may be in line ahead of you?
 - Are there any springing liens that can change your recovery position?
 - Are they able to move assets/funds between entities

Impact to customer/supplier

- ◆ What do their covenants tell
 - EBITDA
 - Non-cash income --changes in working capital
 - What are the add-backs
 - Are their covenants improving/declining & why
 - Are there triggers tied to the covenants
 - Do covenant level requirements change over time
 - It's all in the definitions (i.e. Indebtedness)

Impact to customer/supplier

- ◆ Actual liquidity of loan
 - Asset-based or cash flow
 - Covenants will vary with type
 - Asset-based for less credit-worthy
 - Liquidity may be constrained with changes in asset base
 - Are there LC's within the loan and how much is utilized
 - Are there any restrictions that reduce liquidity under certain circumstances

Impact to customer/supplier

- ◆ Are there surprises built into the agreements
 - Springing liens
 - Ratings triggers
 - Covenant changes
 - Amendments
 - Cross defaults
 - Materiality levels
 - Lack of cure periods
 - Footfaults

Questions????
