Negotiating Fair Financial Covenants

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Loan covenants establish benchmark metrics that can ensure a company stays healthy. However, if the requirements are too stringent, too sensitive or too difficult to meet, they can put the same firm in a stranglehold.

Executives responsible for raising capital for their firms will need to negotiate covenants – conditions and constraints that require a company to operate within specified financial parameters, maintain certain ratios, disallow specific balance sheet items, or limit some actions.

Financial covenants are intended to help lenders mitigate risk and ensure that their loans are repaid. Many banks have become very strict about loan covenants since the implosion of the housing market. Under some agreements, a firm can automatically go into default if it breaches a covenant.

When negotiating financial covenants, the goal should be to negotiate covenants that provide enough flexibility to run the business prudently. Before entering into negotiations, clarity is required about any types of covenants that could potentially hobble or harm the business. Time should be taken to run various scenarios through the company's recent financial statements to determine which covenants would be the most beneficial and/or detrimental to its interests.

Generally, negotiating power is a reflection of the relationship with the lender. A long-term positive and open relationship with a banker is vital. It is advantageous to talk with more than one lender so there is access to additional sources of capital. Credit policies vary at different institutions and can change quickly due to regulatory issues or internal circumstances.

Understand the lender's perspective

Using the business and strategic plans, revenue projections, and other pertinent financial documents, draw up a list of covenants a lender would be expected to require. At the same time, develop a realistic set of covenants that reflect the company's perspective. Consider what kind of covenant structure is reasonable based on the company's business model, financial condition, and strategic objectives.

Pre-negotiation

Preparation is a key element in covenant negotiation. The bank will expect to include covenants that protect its interests. However, lenders genuinely want a client business to grow and succeed. Presenting a well conceived business plan and proposing realistic covenants with appropriate limits can gain bargaining leverage.

Early on, keep the talks on a hypothetical level so that the conversation does not get bogged down too quickly in specific details. Once into the realm of facts and figures, anticipate some healthy give and take, and be prepared to offer reasonable counterproposals to achieve a positive outcome.

Financial and restrictive covenants
Typically, loan documents contain both financial and restrictive covenants. Financial covenants are derived from common ratios and various other metrics found on financial reporting documents, including the balance sheet, income statement, and cash flow statement. An EBITDA calculation that includes all non-cash charges, including the write-down of intangibles, can be used as an approximation of positive cash flow. Another common covenant is the requirement to deliver financial statements prepared in accordance with generally accepted accounting principles (GAAP) by a certain date; however, if using a different basis of accounting - such as the cash or income tax method – be sure to notify the bank so that the standard language can be modified.

Affirmative financial covenants can include 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. It is worth pointing out that only a few of these financial covenants are actually needed to stabilize working capital and equity, and ensure enough cash flow to repay the debt.[1] Encourage the lender to use a broad definition of minimum net worth that includes key intangible assets, such as trademarks, patents or copyrights, when calculating the firm's minimum net worth. Test the sensitivity parameters of each covenant and be alert to any instance where a small movement in a given factor could trigger a violation.

Internal scrutiny, ongoing movement toward generally accepted accounting principles (GAAP), and progressive implementation of upcoming revised accounting standards may result in changes in asset and liability classifications. While there is no change in working capital or overall business health, the changes can alter covenant ratios and result in a company no longer being in compliance. In most cases, issues of this nature can be resolved by going to the bank as soon as the new covenant-related positions are recognized rather than waiting until statements are due. A comprehensive pro forma presentation to the bank provides a meaningful comparison of previous reporting positions to updated reporting positions and sets the stage for a request to modify the covenant appropriately.

Restrictive covenants require a company to take or refrain from taking certain actions. For example, a bank may require a company to maintain property insurance or carry insurance on principal executives; to insure and maintain loan collateral; or to obtain permission before entering into a joint venture or merger or even making an acquisition.

Restrictive covenants often get buried in the text of long loan documents, and it is important to consider carefully before agreeing to any covenant that calls for the bank to grant permission. Poorly considered restrictive covenants can limit an organization's ability to respond to market conditions or take advantage of opportunities that arise.

Some financial covenants have the effect of limiting or prohibiting specified activities as well. Commonly proscribed activities include owners' compensation and dividends. In negotiating such items, try to manage the ends rather than the means. For example, ask the lender to agree to lock in the maximum available for owners' compensation or dividends together rather than micromanaging each line item.

Avoid strict technical default clauses
Under very stringent technical default terms, a lender can force a firm to pay off a loan in full for violation of a financial covenant. Even unintentional or technical defaults may be considered default triggers. Ensure that the company will receive adequate notice and have an opportunity to address any problems before this occurs.

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For example, if a company anticipates potential losses in the upcoming fiscal year due to market conditions or expansion, it would want to mitigate the effect of income-statement-based covenants. Do this by suggesting a realistic cushion in the required minimum or maximum limits. If a business plan calls for expansion based on M&A, a company would definitely want to avoid any restrictive covenants that might hamper this type of growth plan.

Covenants should be reviewed collectively with the outcome in mind. Measure proposed covenants against the most recent financials and future projections, looking as far ahead as reasonably possible to determine if the covenants agreed to today might cause problems down the road based on sensitivity, reporting methods, future losses, equity issues or other factors.

Create a proactive system to monitor adherence to all financial loan covenants. Develop a stress-test mechanism by varying the latest financial results, and then calculate how any changes would affect compliance with financial covenants. The result will constitute a covenant risk profile and help see what events could potentially lead to a covenant breach.

It is important to stay ahead of the curve on all covenant issues in today's tight credit environment. Failure to do so can place an organization at significant risk. Communicate regularly with lenders so there is clear understanding of the factors driving their credit decisions. Reassure them that the company is on top of the terms of the loan and draw up a detailed course of action the business will take if it does violate any covenant obligations.

It is always possible to negotiate financial covenants if time is taken to understand lender needs, prepare thoroughly, and engage in constructive discussions on covenant issues.

As a result of 2011 joint Financial Accounting Standards Board/International Accounting Standards Board projects, there will be upcoming changes to accounting principles that will impact existing financial covenants. If a comprehensive review of current covenants or preparation for upcoming covenant negotiations exceeds the capacity of in-house resources, consider working with an outside professional to ensure covenants are fair, flexible, and correct in addressing company needs.

[1] Coming to Terms with Financial Covenants; Dev Strischek; The RMA Journal; June, 2007

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