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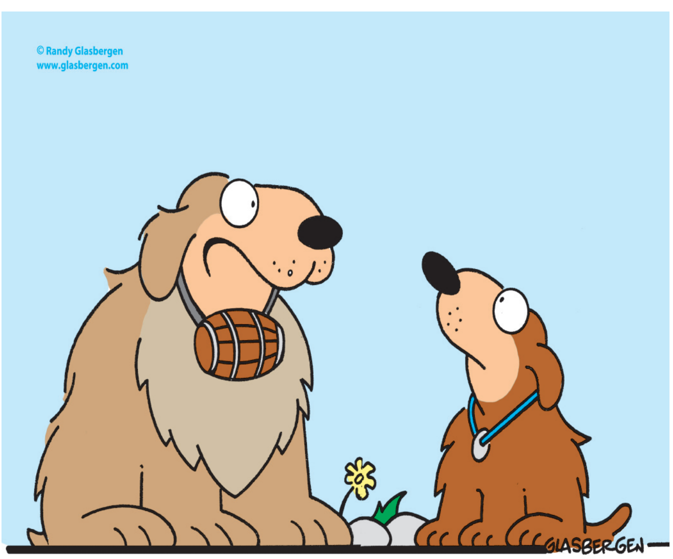
Loan Covenants *What do they mean?*

My last newsletter dealt with, in part, communicating with your banker. While communicating is not one of the 5-C's of credit, it provides key insights about at least one of them. As a quick refresher, the 5-C's of credit are: Character, Capacity, Capital, Collateral and Conditions. Every banker learns the 5-C's early on in their career, and that Character is the most important of all. And one of the best ways to get a measure of someone's character is by communicating with them. (It's so important, maybe we should be referring to the 6-C's of credit!)

Communications with your bank have formal and informal pieces. The informal part is fun. That is your banker getting to know you as a person (and you, them) over lunch, during a round of golf or an evening at the baseball game. While these times together can seem inconsequential your banker is learning very important information about you and how you conduct business.

Loan agreements are the formal part of bank communications. These agreements formalize the relationship, and cover in some detail what is expected of both you and them. They set out as much of the unspoken relationship as possible so both parties can live up to their end of the bargain.



"I once rescued a man who was buried under an avalanche of debt!"

Unfortunately many companies, particularly smaller ones, treat loan agreements as a one-way communication – the bank tells us what they want and that is that. But the agreements really are meant to be a two-way communication process. Your bank needs to hear from you whether certain parts of the agreement are possible or not. They do not want to write a loan that is destined to fail, so if you see something that is not workable you need to address it early-on, before any agreements are signed.

Corporate Value Partners, Inc.

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- Assisting with the acquisition or sale of a business, business unit or product line;
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- Preparing business valuations;
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- Assisting attorneys with the financial aspects of lawsuits.

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Restrictive and Financial Covenants

Nowhere is this truer than with loan covenants. There are two general types of loan covenants – restrictive and financial. Restrictive covenants require you (the borrower) to do certain things and not do other things. A common restrictive covenant is that the borrower cannot acquire or merge with another company without the bank's approval.

Financial covenants are different, and are based on your company's financial performance. They are, in essence, an early warning system for the bank and you. Your banker's goal is to design a financial covenant that lets her know when things are going much differently than planned so she has a chance to discuss your plans, see if they are realistic and possibly even help with some ideas. Set a covenant that is too tight (a minor change in operations violates it), and you'll be having discussions far too frequently. Set a covenant that is too loose (a major change in operations won't violate it), and the company's finances could deteriorate so much there isn't any chance to correct the situation.

Typical financial covenants are:

- Net worth maintenance
- Fixed charge coverage ratio
- Senior debt to EBITDA ratio
- Interest coverage ratio
- Positive cash flow from operations (more common recently)

Financial covenants generally come in groups. During the boom-time, it was not uncommon to hear of "covenant-lite" loans; meaning they didn't have many covenants, and those they did have were loose. Those days seem to be gone for many companies. Many businesses can expect their bank to require three or more financial covenants and they can be tight.

But that does not mean that you should simply accept whatever covenants your banker proposes. Because the loan agreement is part of the communication process, restrictive and financial covenants are meant to be discussed. Before discussing them, though, make sure to study the covenants and test how they match up to your business plan. How do they fit with your past financial results? How do they fit with your financial forecast? How much room do you have if your company doesn't meet the financial forecast?

If something doesn't seem to work, discuss it with your banker and show them why. Communications go both ways and the banker and borrower should be learning something about each other every step of the way. Both parties want a loan agreement that works, so they need to work together to get it right.

Please contact Ronald DiMattia at Corporate Value Partners at (440) 333-1910 or ron@corporatevaluepartners.com with any questions or to discover how CVP can help you get the most out of your assets.

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