RESCUED FROM A SEA OF LOAN COVENANTS

by Steve Brown

While real estate can be comfortable and cozy, it is the loan covenant that is the life jacket of lending. If structured correctly, a good set of covenants can keep you floating when collateral volatility threatens to sink you and focus more on what matters - the cash flow that services the debt. This is why many bankers are paying close attention to testing the borrower's future ability to service a loan. It is important to make sure performance is on track periodically (preferably quarterly) through financial covenants. Doing so helps mitigate credit risk and allows the lender to take corrective action if required. In this manner, loans are less likely to default than loans without such covenants. Further, when loans do default, the expected loss is smaller for loans with well structured covenants than for loans without such safeguards.

Covenants come in many different forms. Operating activity covenants are most common and include preservation of a business, complying with laws and use of proceeds. Cash payout and distribution covenants restrict payment of dividends, stock repurchases, capital expenditures and acquisitions. Asset sale covenants prevent or restrict borrowers from selling assets or divesting businesses. Reporting covenants require that the borrower periodically and fairly report its assets, liabilities and contingent obligations. Preservation of collateral covenants require borrowers to preserve collateral; restrict future liens and guarantees; maintain proper security agreements and have insurance. The most hotly negotiated covenants (and in our opinion the most interesting for credit officers), are restrictive and proscriptive financial covenants.

Financial covenants attempt to control and test a borrower's financial performance. These covenants typically test four important aspects of the financial statements - debt leverage, cash flow generation, liquidity and balance sheet leverage: 1) Debt leverage is usually measured through a debt-to-EBITDA leverage; 2) Cash flow generation is measured through a number of tests that include debt service coverage, fixed charge coverage, minimum free cash flow from operations, minimum EBITDA, minimum EBITDA after capital expenditures and minimum EBITDA adjusted for working capital; 3) Liquidity is less commonly measured, except for early stage businesses or those with unproven managers. However, a lack of liquidity can quickly jeopardize a business. The liquidity ratios we typically see are current ratios, quick ratios and minimum cash or equivalents; 4) Balance sheet leverage is, in our opinion, the least important measure for lenders given the alternatives above. Balance sheet leverage is measured by maximum debt, debt-to-tangible net worth, debt-to-equity, minimum net worth or loan-to-value. Yes you read that right, loan-to-value is, considering the alternative measures, a lower value measure in all but real estate-secured loans. Even in certain real estate-secured loans, such as hospitality, loan-to-value measures lose much of their predictive and control value for lenders.

Despite the plethora of financial covenants, only two are widely used in large credits originated today (accounting for roughly 95% of all covenant occurrences). They are funded debt-to-EBITDA and fixed charge ratio. The importance of financial covenants is powerful as testing and reporting by the borrower gives the lender lead time to handle management issues and avert declining credit quality. In fact, the performance of loans with financial covenants has been maintained even through the recent recession.

In a future edition we will highlight the performance of certain loans and the importance of covenants during the recession in safeguarding credit quality of obligors. We also plan to host a webinar outlining our experience with syndicated C&I credits over the last five years and the importance of covenant safeguards in troubled loan resolutions. In the meantime, if your bank is regularly instituting covenants that we have not reference above, please let us know. We recently heard of a bank that is using debt-to-EBITAIR (debt to cash flow that is adjusted for pretended revenue increases).

BANK NEWS

2013 GDP

Even with an extension by Congress of expiring fiscal measures at the end of the year, JPMorgan still expects it to reduce GDP by 1.4% in 2013.

New CU Record

In March, the credit union industry reached $1T in total assets - a new record.

Getting Worse

Social Security trustees said the program is worse off than it was 1Y ago and won't have enough money to pay full benefits by 2033 (3Ys earlier than projected last year).

Less Leverage

Research by the Fed finds consumers have reduce credit card, mortgage and other debt from a record 123% of disposable income in 2007 to 105% as of 2011.

Working Longer

A Gallup poll finds Americans expect to work until age 67, up from 63 a decade ago and 60 in the 1990s.

Lehman

The Los Angeles Times is reporting that Lehman paid its top 50 employees $700mm less than 1Y before its collapse.

New Business

Wells Fargo will purchase Merlin Securities LLC, a $2B prime brokerage that serves hedge funds, as it seeks to establish a foothold in the sector. Prime brokerage services include lending, clearing trades and record-keeping for hedge fund managers.