How to Effectively Negotiate Loan Covenants

Banks may be receptive to terms that further a well-conceived business plan.

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If you are responsible for raising capital, you are probably aware that many banks have become very strict in the arrangement of loan covenants since the collapse of the housing market. Breaching, or “tripping,” a covenant can have a devastating effect on any business. This article explains how to negotiate fair covenants with a banker and offers suggestions on what to do if a breach is imminent.

COVENANT NEGOTIATION

It is possible to effectively negotiate with your banker, and you should understand how to appeal to the banker’s best interests. Preparation is a key element in covenant negotiation. Some finance professionals first see covenants when asked to sign the loan documents, but they have had no preliminary discussions and believe that covenants are a one-sided dictation from the bank. In general, this is not true. Although certain covenants must be expected in a commercial loan, a knowledgeable CPA should effectively negotiate fair and reasonable covenants.

Before starting any negotiation with your banker, construct a conceptual framework of any covenant types that might be especially negative to your particular business. You must have a clear idea where your strengths lie and negotiate your covenants in that direction. For example, if your business has significantly deleveraged recently but your financial projections indicate potential losses for the next fiscal year, you would want to mitigate the effect of income-statement-based covenants by expressing your concerns and suggesting a realistic cushion in the required minimum or maximum limits. If your business plan requires expansion based on a mergers-and-acquisitions strategy, you would clearly need to include this as a key point in negotiations that might include restrictive covenants.

The bank will expect to include covenants that protect its interests. However, bear in mind that banks want your business to succeed. They prefer to help businesses grow so that their risks remain low and more loans are requested from the bank. If the CPA can present a well-conceived business plan and suggest covenants with appropriate limits that contribute to the success of the plan, most bankers will seriously consider the proposal. You can discuss any part of a proposed covenant in the give-and-take of a negotiation, but you must be prepared to offer well-considered and reasonable counterproposals to achieve a positive result.

Covenants should be reviewed collectively to achieve a logical result. Often, restrictive covenants are interspersed with boiler plate legalese in loan documents. These should be pulled out and listed together for review. Covenant language in multiple loans with the same bank should also be examined collectively to eliminate conflicts and unintended consequences. Take the following steps before entering into negotiations with a banker over covenants:

- Put yourself in the banker’s position based on your understanding of his or her internal and regulatory demands. Make a list of covenants that you would require if you were the banker.

- Develop a specific set of realistic covenants from your perspective. Ask yourself what kind of covenant structure
is reasonable based on your company’s financial position, then compare it to your business plan to ensure that your proposal does not restrict the company’s ability to execute effectively.

Begin a hypothetical discussion with your banker about the covenants that should be included in your next renewal. Stress that your conversation is hypothetical so that the conversation does not move too quickly into the realm of fact and negotiation. Use “what if” questions and gauge your banker's response. Ask a broad range of questions. From this, you can get a feel for what position the bank will take under certain scenarios.

It can be very difficult to adjust covenants once agreed to, so the key to effective covenant negotiation lies in preparation before the loan agreement is signed.

Measure proposed covenants against your most recent financials and your best projections. Look as far into the future as you can reliably project to determine if the covenant you agree to today will cause a problem in a couple of years based on future losses, equity issues and so on.

Covenants should also be compared to the near-term and long-term business plan for possible conflicts to determine if your plans for growth could be subject to restrictive covenants.

You should carefully gauge your relationship with your bank, and do everything possible to foster an open and communicative two-way association. Some banks have more Draconian credit policies than others. It never hurts to know, and talk frequently with, more than one banker. By developing these diversified relationships, you can better judge the fairness of proposed covenants.

If your business is in a strong enough financial position to be attractive to other financial institutions, you should consider additional sources of capital. Credit policy can change quickly at any bank due to acquisitions, regulatory issues or internal needs. Even if you don’t think your business is large enough to justify multiple banking relationships, get to know loan officers at other banks. Tell them about what you’re doing and see if they’ll make competitive offers.

**MONITOR YOUR COVENANTS**

One of the most critical aspects of effectively managing any loan relationship relates to constant monitoring of current covenant results through interim financial statements. In addition, all financial projections and prospective budgets should include a section on how loan covenants will be impacted.

Create a proactive system to monitor progress on all financial loan covenants. Recently, the Department of the Treasury and the Federal Reserve required many banks to pass a stress test to determine how the banks would perform under various circumstances. Create a stress-test system for your company by varying your latest financial results. For example, reduce revenues by 15%, increase your variable costs by 10%, then calculate how these changes affect your financial covenants. The result will constitute your covenant risk profile. You will gain a clear understanding of how certain events will affect the risk of a covenant breach.

Each interim financial statement and future projection should feature a covenant calculation measured against the results required by the loan documents. Track this data over time and adjust your covenant risk profile based on changes in your projections.

**HOW TO DISCUSS COVENANT BREACHES**

Possibly the most important aspect of the CPA’s involvement in covenant review is when and how to communicate with a banker on covenant performance. The life or death of a company can depend on how this step is handled.

What specific steps should you take in communicating with the banker on potential covenant breaches? Given enough time, many potential covenant breaches can be absorbed by the bank, allowing as much consideration as possible for a reasonable reaction. Waiting until the last minute to disclose a breach is almost universally a bad idea.

When projections indicate that a financial covenant breach is possible, it is best to discuss the situation with your banker. Bankers hate surprises. Tell the banker that your early projections indicate a potential covenant problem and you want to discuss the possible effects. Although this discussion is not hypothetical, it is based on projections. This way, the banker is forewarned that a breach could occur, but he or she is not necessarily alarmed. The conversation can have a more relaxed tone than one occurring at the last minute based on a certain breach. The bank will monitor covenant progress more closely, and hopefully you can prevent the breach from
occurring.

If a breach does not occur, the banker will have gained greater insight into your business and more faith that you will not be the source of last-minute surprises. If a breach does occur, the bank will have had ample time to react appropriately.

**WHAT TO EXPECT FROM A BREACH**

Covenant breach penalties are almost completely within the control of the bank and can range from a simple caution letter added to your file (after you request a breach waiver) to the calling of all loans and the termination of a relationship. A covenant breach, no matter the severity, is a technical violation of the loan agreement and allows the financial institution to take any action legally available.

Midrange penalties could include a change in the interest rate paid or a onetime monetary penalty. This step can be controlled to some extent by taking timely steps appropriate to the circumstances.

Once a covenant breach is certain and the severity of the breach is clear, send a letter to your banker outlining the circumstances and requesting a waiver or reduction of penalty. You should have a reasonably clear idea of how the bank will react given your prior meetings on the subject.

Be prepared to negotiate if the penalty is unreasonably severe. A comparison of how other banks are reacting more favorably to the same circumstances could be useful. Diplomacy is a key skill at this point. Once a covenant is breached, a great deal of the power shifts to the discretion of the bank. Consider discussing how the severe penalty could impair the business and increase the ultimate risk to the bank.

**CONCLUSION**

It is critical to stay ahead of the curve on all covenant issues in today’s tight credit environment. Failure to do so can place your organization at a competitive disadvantage. Talk to your bankers so you understand the forces driving their credit decisions.

View your banking relationships holistically and with an intention to engage in healthy, profitable relationships. Negotiation is always possible if you take the time to gain useful knowledge, create strong relationships, and engage in well-timed discussions on covenant issues. Every negotiation is different, and it is not possible to provide advice to fit all circumstances. Enter any bank negotiation cautiously and fully prepared with a well-considered plan of action.

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**Why Banks Require Covenants**

To effectively negotiate with a banker, you must understand how a financial institution judges and mitigates risk. In general, your ability to negotiate will be a reflection of the overarching relationship with your bank. It is very important to foster a long-term positive and honest relationship with your banker.

Understand that your banker must deal with internal policies and external regulators in defending any part of your loan package. Depending on the size of the loan, your banker may be required to stand before a formal loan committee composed of credit officers responsible for ensuring that the bank does not accept undue risk. The credit committee will ask many in-depth questions, so providing your banker with as much supporting information as possible (your business plan, financial projections, etc.) is very beneficial. Your banker will be asked to justify to a skeptical committee why he or she wishes to structure the covenants and interest rate in a particular fashion.

The committee will usually review the overall profitability of the relationship, generally using a profitability model such as Risk Adjusted Return on Capital (RAROC). Once the loan is approved, an external regulator could review the entire package to determine if it agrees with the structure.
Common Covenants
In general, loan documents will contain both financial and restrictive covenants. Knowledge of how these covenants are constructed and why they might be included is very important in negotiating an effective loan agreement. When properly considered and effectively applied, covenants can provide sound benchmark metrics that are healthy for the organization. Poorly conceived covenants can devastate a business and wreck its capital base. It is the CPA's job to know the difference, negotiate effectively and protect businesses from capital disruption.

Financial Covenants
Financial covenants are usually derived from common ratios and other metrics based on the balance sheet (debt/equity), the income statement (operating profit, EBITDA), and the statement of cash flows (operating cash flow). EBITDA can be used as an approximation of positive cash flow.

Some covenants, such as debt service coverage ratios, reference several financial statements. See the most common financial covenants in Exhibit 1 and run those calculations through your most recent financial statements to determine which are the most beneficial and detrimental to your interests.

Many businesses have unique characteristics, and it is important to review your financial statements to determine if any presentation issue might alter the expected covenant calculation. For example, a business that holds high-cost, long-lived rental inventory might present that inventory as a depreciable asset rather than a current asset. The debt acquired in the purchase of the depreciable rental inventory will be presented as both long-term debt and the current portion of long-term debt. In this case, a current ratio may be less favorable since the assets supporting the current debt are not necessarily categorized as a current asset. At the least, some modification to the current ratio calculation should be negotiated into the covenant.

Restrictive Covenants
A restrictive covenant requires a company to act or not act in a certain way unless permission is expressly granted by the bank. For example, a bank may require a company to carry key-man insurance on principle executives, maintain property insurance or obtain permission before entering into a merger or acquisition.

Restrictive covenants tend to blend into the text of long loan documents, and you should be careful to identify any circumstances or actions for which the bank expects to grant permission. Poorly considered restrictive covenants can limit an organization’s growth. A full discussion of the company’s business plan with the bank and how restrictive covenants might negatively affect long term profitability should be considered.

EXECUTIVE SUMMARY
- Prepare to negotiate covenants by constructing a conceptual framework of any covenant types that might prove to be especially negative to your particular business. Have a clear idea where your strengths lie and negotiate your covenants in that direction.
- Create a proactive system to monitor progress on all financial loan covenants.
- Discuss potential covenant breaches with your banker as soon as possible. Waiting until the last minute to discuss a covenant breach is almost universally a bad idea.
- Once a covenant breach is certain and its severity is clear, send a letter to your banker outlining the circumstances and requesting a waiver of penalty. Be prepared to negotiate if the penalty is unreasonably severe.
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