



KREDED



HELPING BUSINESSES
KEEP THEIR LIGHTS ON

LET'S TALK ABOUT FINANCIAL COVENANTS

A beginner's guide to Financial
Covenants.

What they are and how to understand them

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INTRODUCTION

A loan agreement is a legal contract between a lender and borrower that allows the borrower to borrow money or property. The agreement will establish the terms and conditions of the loan, including the length of time it will be outstanding, the interest rate charged, collateral requirements, and financial covenants.

These covenants are performance measures that must be satisfied to receive funding from a lender. If they are unhappy, the lender can take specific actions to mitigate the risk associated with the loan.

While financial covenants may seem like an additional burden on the borrower's accounting department, they help prevent lenders from taking on too much risk.

In a loan agreement, there are two types of financial covenants: affirmative and negative. Affirmative covenants are those provisions in a loan agreement that obligate a borrower to adhere to certain conditions and standards of conduct as outlined by the lender.

Negative covenants limit activities that may affect the borrower's ability to repay the loan. For example, negative covenants may restrict the borrower from incurring additional debt or using assets as collateral for other loans.

DEFINING FINANCIAL COVENANTS AND THEIR PURPOSE

Financial covenants are typically divided into two classes: affirmative and negative. Affirmative covenants are mandatory requirements to ensure compliance with certain financial ratios or other standards of financial performance, while negative covenants are restrictions on future actions that the borrower must refrain from engaging in.

There are three categories of Financial covenants: maintenance covenants, negative pledges, and affirmative or positive covenants.

Maintenance covenants are also referred to as financial maintenance covenants because they require the borrower to maintain a certain level of financial performance. These include provisions such as minimum asset values, minimum profitability, and minimum net worth.

Negative pledges and affirmative or positive covenants are particular types of financial covenants that focus on how borrowers can use their assets. A negative pledge requires shareholders of the company to refrain from taking on additional debt without permission.

An affirmative or positive covenant is when the borrower must take on other debt to facilitate business growth.

DEFINING FINANCIAL COVENANTS AND THEIR PURPOSE

A financial covenant specifies the actions that a lender expects from its borrowers, such as maintaining a certain working capital ratio, achieving a minimum gross profit margin, or keeping net worth above a certain level.

Affirmative Financial covenants are generally tests for coverage or balance sheet driven. Coverage tests measure the company's financial performance over a specific period – this could be a quarter or a full fiscal year.

These covenants are guided by the income statement and statement of cash flow. The coverage test measures the cash flow available for debt service (repayment of the loan) over a period of time.

Balance sheet tests measure the company's net worth and leverage and are based on the company's financial position as of one specific date, as the balance sheet is a snapshot of the company's financial condition at a specific date.

WHY LENDERS IMPOSE FINANCIAL COVENANTS

Lenders use financial covenants because they provide them with a level of comfort that they will recover the money they loaned out and allow the lender to monitor the borrower's financial performance.

When the borrower breaches specific metrics during an accounting period (usually a quarter), it signals that the business could soon become insolvent; if the lender does not take steps to protect itself at this point, it may find itself in a position where it will not receive any money back from the borrower.

The lender can then ask for its money back early, refuse to renew the borrower's line of credit, or take over ownership of collateral securing the loan and sell it. All options could put the borrower out of business entirely.

An excellent way to test if your business is at risk of defaulting on the covenants is to monitor these requirements internally, as the loan agreement will define how the lender intends to measure each covenant. If you identify any risk is best to contact your lender and begin working together to improve the outcome for both parties.

MOST COMMON FINANCIAL COVENANTS

1

Current Ratio Test

Measure short-term financial strength.
Are current assets sufficient to pay
current liabilities?

2

Cash Flow Test

Measure the cash flow generated after
paying for capital expenditures for debt
service. The higher the better.

3

Fixed Charge Coverage Test

Measure how many times some fixed
charges are covered by operating profit
available to repay them.

4

Net Worth Test

Measure the minimum levels of
shareholders' equity.

MOST COMMON FINANCIAL COVENANTS

5

Leverage Ratio Test

Measure the level of debt (Liabilities) in relation to shareholders' equity

6

Minimum Working Capital Test

Measure the company's capability to convert assets into cash to support operations. Can be measured in dollar or ratio.

7

Capital Expenditure Test

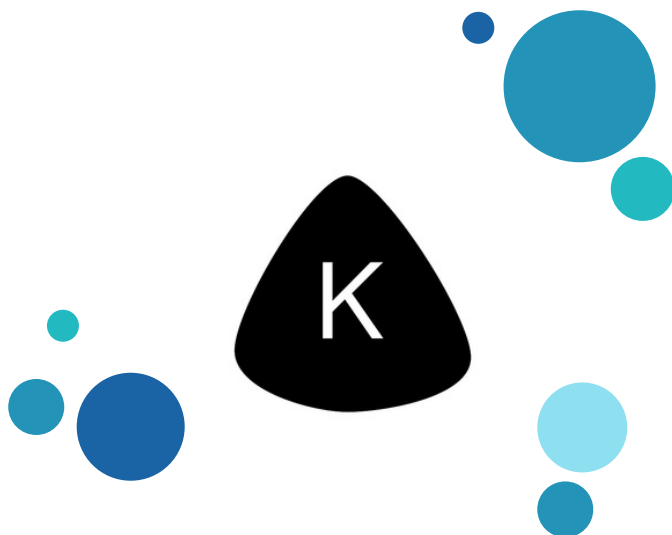
Measure how much the company has spent on fixed assets. Typically limits the company spending. (negative covenant.)

8

Negative Covenants

Limits on future indebtedness

ABOUT KREDED



KREDED

KREDED is an innovating commercial loan marketplace, servicing middle market companies. Our mission is to help business keep their lights on by giving decision makers more time to focus on operating their businesses; while providing convenience and a streamlined funding process.

You can email KREDED at capital@kreded.com
