IN THE THICK OF THE ACTION

You need to get to the heart of exam questions to net the easy marks on offer, advises Doug Williamson

Exam questions can seem obscure if they don't at first glance appear to relate to your current job. So picture yourself at the very heart of the action described. From this perspective, the opportunities and risks immediately become more real and personal. It will often become totally clear what you would do in practice, and what you need to write in your exam answer.

Not my job?

In the April 2013 International Cash Management paper, question 1(f) was about (i) loan covenants generally, and (ii) why a group cash manager in particular should be aware of them. We will recruit ourselves as temporary group cash manager in the company. By doing so, we'll see how the second part of the question, about why the cash manager should be aware of the covenants, becomes very easy to answer.

But first, let's refresh our background knowledge about covenants, and their vital importance for companies.

What are covenants for?

Lenders have credit risk on their borrowers. If credit quality declines, lenders lose money. They may even go bust themselves. Lenders impose covenants to give them the earliest possible advance warning of any potential decline in the credit quality of a borrower. Preferably well before there is any significant risk of losses.

How do covenants work?

A typical borrowing covenant is to maintain a minimum ratio of operating profit to interest obligations. (This is known as an interest cover ratio.) Borrowers pay their interest obligations out of operating profits.

Loan covenant
An undertaking by a borrower, designed to protect the lender. Covenants usually include meeting specified financial targets or maintaining certain financial ratios.

Breach of covenant
If a borrower breaches a covenant, the lender can normally demand immediate repayment of the entire loan. This can cause a liquidity crisis.

Liquidity crisis
A company has a liquidity crisis when it doesn't have enough cash to pay its financial obligations. If the company doesn't resolve its liquidity crisis, by refinancing or otherwise, it will go bankrupt.

Need to know
In my role I need to understand and interact with all functions of treasury and the business, as they all impact the group's cash flows and debt.

Sarah Hogg, AMCT

So, lenders like borrowers with high cover ratios, protecting the safety of the lender's investment in the loan.

The interest cover covenant means that the borrower promises to maintain this important ratio above a specified minimum level, for example, three times. If the interest cover were to fall below the threshold level, this would be an early warning to the lender that the borrower's credit quality had weakened.

Don't crash the boat

A breach of covenant normally entitles the lender to demand immediate repayment of the entire loan. This is known as acceleration of the loan, and the threat compels the borrower to discuss the situation with the lender. Unfortunately for the borrower, this also puts the borrower in a very weak negotiating position.

Adverse consequences for borrowers can range from increased costs and more restrictive terms, to the total loss of the company's borrowing facilities. This can quickly lead to a liquidity crisis, and, ultimately, to the bankruptcy of the company.

It doesn't make any difference whether the manager who caused the breach of covenant was aware of it or not. Nor does it make any difference if the breach was inadvertent.

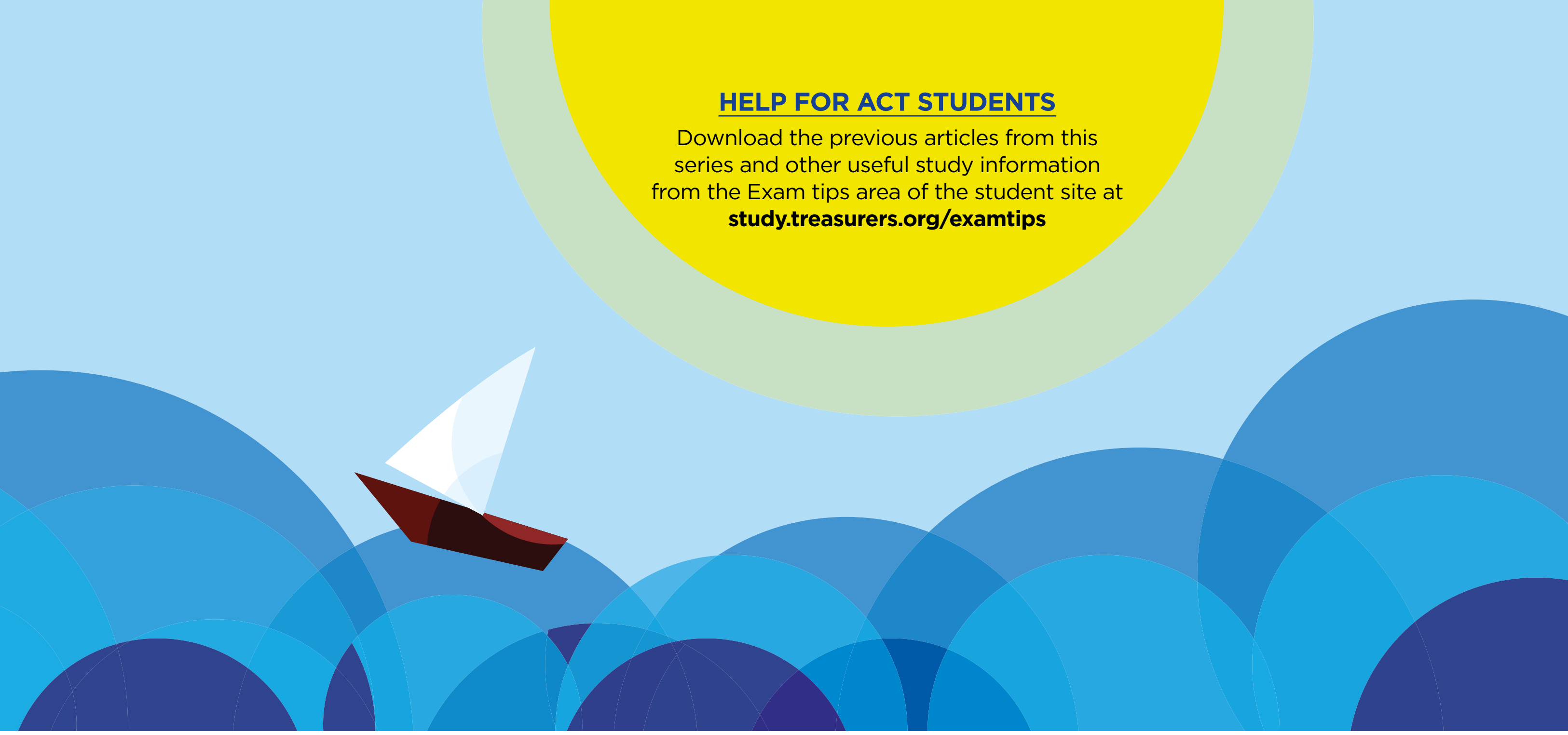
The full question

Let's now look at the full exam question.

> To Go Global plc (TGG) has long-term borrowings of £1,208m. Many of the loan agreements contain covenants. Explain what covenants are, highlighting the ones most commonly used. Why should the group cash manager of TGG be aware of them?
>
> **International Cash Management (CertICM) April 2013**

There are three important parts to this question:

(1) Explain what covenants are.
(2) Highlight the ones most commonly used.
(3) Explain why the cash manager should be aware of them.



To gain full marks, we need to answer all three parts. Sadly, most candidates didn't.

How candidates performed

> "Not many answered this question fully with regard to the typical covenants found or why they might be relevant to the cash manager. Some avoided this question altogether or did not say what a covenant is."
>
> **Examiner's Report, CertICM**

Reasons for incomplete answers

Why did some candidates not answer at all, or give incomplete answers?

Possible reasons include:

(1) It is not normally the cash manager's job to negotiate longer-term borrowings documentation.
(2) The topic was perceived as complex, technical or needing specialist legal knowledge.
(3) Candidates had not yet lived through a real-life liquidity crisis or refinancing and so had no relevant practical experience.
(4) Candidates hadn't revised this topic and hoped that it wouldn't come up in their exam.

Getting into the action

One antidote to these perceived difficulties is to imagine ourselves in the centre of the action, as the cash manager of TGG.

If our cash management activities were to lead to an inadvertent breach of covenant, our employer might have to repay borrowings of £1,208m immediately, and potentially be unable to refinance them. We'd have sunk our company. We'd be out of a job, along with our friends and colleagues. For this reason, it is clearly essential that we are aware of the covenants, and that the covenants are monitored.

The fact that covenant negotiations were not part of our former core job would be no excuse. Now it's clear how we should answer the exam question.

Outline answer

> **(1)** Covenants protect the position of lenders, being undertakings by borrowers such as TGG.
>
> **(2)** The most commonly used covenants include undertakings:
> - **(i)** To maintain a minimum interest cover ratio (operating profit ÷ interest).
> - **(ii)** To maintain a minimum net worth.
> - **(iii)** Not to exceed a ceiling gearing ratio (debt ÷ equity).
> - **(iv)** Not to exceed a ceiling ratio of net debt ÷ EBITDA*.
> - **(v)** To meet all payment dates for interest and principal.
>
> **(3)** It is **ESSENTIAL** for the cash manager to be familiar with the covenants and for covenants to be monitored, so that cash management activities do not cause any inadvertent breaches of covenant. For example, not to lock up invested funds for too long, leading to excess borrowing.
>
> **International Cash Management (CertICM) April 2013**

Now change sides

Looking at a deal from both sides gives essential insights for successful negotiation. Both sides to TGG's lending and borrowing are steering around different rocks to ensure their respective boats don't sink. The lender needs to minimise credit losses. The borrower needs operational flexibility.

Other ACT courses, for example, Corporate Finance and Funding, require explicit discussions about the different perspectives of lenders and borrowers in covenant negotiations, and how they might compromise.

Covenant negotiations are often contentious. Covenants restrict the flexibility of the borrower, and impose onerous monitoring and other obligations. From the lender's point of view, covenants are best set tightly to give early warnings of problems. But if the borrower is a strong credit, a good negotiator, or both, its covenants will be relatively few, and less restrictive.

Sail to success

So, use your imagination to get into the action, sail through your exam and apply your learning in practice. Complying with covenants will hugely improve your company's negotiating position with its lenders. Passing your exams and applying the learning will also hugely improve your personal negotiating position with your employer.

Doug Williamson FCT is an examiner, tutor and coach who enjoys helping you to pass your ACT exams

*EARNINGS BEFORE INTEREST, TAX, DEPRECIATION & AMORTISATION