COVENANTS AND CONTROL

Loan covenants may oblige borrowers to maintain a certain credit quality over the life of a loan. Will Spinney explains

Covenants define the credit quality of a borrower that the borrower must maintain over the life of a loan. If loans are made on demand, there is no particular need for covenants since the lender could just ask for its money back on the slightest concern or whim. Loans made for a term require a mechanism to allow the lender to intervene if the borrower's credit quality falls below a certain level. Conceding covenants (and they do surrender some element of control to the lender) is the price that borrowers pay for enjoying term loans.

There are two types of covenants in conventional loan documents:

- Things the borrower *must not do*, such as:
  - Not subordinate the lender (meaning not to lower the lender in the queue for repayment following insolvency). This is called a 'negative pledge' and can come in several different forms;
  - Only make disposals, mergers, reorganisations, acquisitions, dividends or similar credit-changing events up to certain limits; and
  - Not change its business.
- Qualities that the borrower *must maintain*, mainly comprising:
  - Financial covenants.

Financial covenants can take several forms:

- Coverage covenants, such as interest cover or cash flow-to-debt service ratios;
- Leverage covenants, such as debt ceilings or debt/EBITDA or earnings ratios;
- Current ratios, such as around working capital, although these are relatively scarce and often limited to certain industry sectors;
- Net worth covenants, such as tangible or intangible net worth, which could be allied to a leverage covenant; and
- Capital expenditure limits.

Some particular debt structures will have their own covenants. For example, project finance and infrastructure arrangements (which are typically long term) use a loan life coverage ratio, which discounts future cash flows to the project.

There are many other possible provisions, but the above two types form the basis of covenants. Breach of a covenant will lead to a default event, which in turn allows a lender to ask for repayment of the loan.

Generally, the stronger the borrower, the less control is surrendered to lenders, and covenants are fewer and weaker. The investment-grade/sub-investment-grade boundary is often seen as a dividing line between low and significant surrender of control. Bank loans usually have more covenants than bonds, except in the case of bonds for sub-investment-grade borrowers, ie high-yield bonds.

The covenants described so far are examples of 'maintenance' covenants, meaning that the borrower must maintain or comply with the limits set by the covenants. An alternative approach is seen with 'incurrence' covenants, which work in a different way. Here, if a borrower wants to undertake a certain activity, such as make a dividend payment, sell some assets, merge or reorganise in some way, or take on further debt, it can do so *only* if it passes a certain test/s. One test might be a debt/EBITDA ratio, which allows more debt to be taken on if a ratio is passed (leading to the concept of ratio debt). These types of covenants are often referred to as 'cov-lite' and are associated with high-yield bonds.

While the usual focus of compliance, or the process of ensuring that covenant tests are passed, is around financial covenants, there are many instances of borrowers taking steps to refinance because of a breach in a negative pledge clause caused by some corporate activity. Compliance monitoring should therefore be around both financial and non-financial covenants.

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COVENANTS AND THE TREASURER

Treasurers must:

- Negotiate covenants so that they accurately reflect the business model and allow the borrower to operate. The borrower also needs flexibility to deviate slightly so that it can either take advantage of commercial opportunities or withstand some moderate weakening of performance;
- Direct the compliance process, ensuring that non-financial covenants are complied with across the group and that performance against financial covenants is properly forecast; and
- Lead the group if financial performance varies significantly from the defined covenants. If performance worsens, some re-negotiation might be required to avoid default. Equally, if performance improves, some pricing reduction or reduction of control might be possible.