Damage limitation

As the recession deepens, the issue of covenants in debt facilities (and the potential for them to be breached) has occupied the headlines. Companies in sectors that have borne the brunt of the recession – principally retail, construction and property – are particularly at risk, with Woolworths and Zavvi among the recent high-profile casualties.

The three basic forms of covenant are:

- **financial:** the borrower agrees to meet specific financial performance measures such as net worth, interest cover, and debt to EBITDA ratio, or for property loans, loan to value (LTV) ratios;
- **information:** the company agrees to regularly provide the lender with financial and other business information; and
- **non-financial:** such as an obligation to maintain property and other assets.

LTV covenants compare the outstanding principal with the market value at the time the covenant is tested. In the recession of the early 1990s, a property market slump caused several companies to breach their LTV covenants (indeed, Canary Wharf's current owner Songbird Estates has warned that it is close to a breach, reviving memories of 1992 when the site's original developer, Olympia & York, went bust). Property loan documentation typically includes a covenant that the borrower will not permit the LTV ratio to exceed a specified percentage, which can be anything up to 85%.

In a bleak economic environment, financial covenants risk being breached, and covenants relating to leveraged deals are particularly vulnerable. Many leveraged companies have quarterly covenants linked to the past 12 months' trading on a rolling basis. Trading conditions deteriorated sharply last summer and with the downturn persisting, and in some cases worsening, in the opening months of 2009, earnings have decreased and the pressure on covenants intensified. According to The Financial Times, "a flood" of covenant breaches is likely over the next few months.

The response of banks to covenant breaches has been mixed. Ideally, they should prove supportive when companies are at risk, not from any altruism, but because a relaxation or renegotiation of terms means they face much smaller losses than they would in the event of a default. But in February the ACT reported that some banks have been taking a hardline stance by using technical covenant breaches to "create substantial levers in their favour" such as punitive new terms.

Executive summary

- Traditionally, covenants define the terms on which a company can borrow money. Structured as agreements between a company and its creditors, they set limits the company has to operate within, provide safeguards to lenders – principally banks and other financial institutions – and act as an early warning system should the company's fortunes take a sudden turn for the worse.

A SIGN OF POOR HEALTH To guard against a company adjusting its accounting practices to meet covenant requirements should its financials deteriorate, the numbers the company is expected to meet and the manner in which those numbers are calculated are specified in the covenant. A prospective or actual covenant breach therefore indicates a company is in poor financial health and its problems are likely to intensify if action is not taken.

A breach usually allows the company's creditors to demand immediate repayment, although this right is typically not enforced as it is in the lender's interests to maintain the business as a going concern. Should the company be unable to make immediate repayment, a more likely scenario is that the covenant will be restructured and the debt renegotiated, but on less favourable terms than before as the price for delaying the repayment. For example, a covenant on gearing may oblige the company to dispose of assets.

The conditions of a covenant vary. In some cases, the company will agree to limit its other borrowing or maintain a certain level of gearing, interest cover, working capital or cashflow. But the system should allow the lender to step in before insolvency or default occurs and impose some form of control over the running of the company.

A variety of banking covenants can be included within a loan facility agreement; the following are the most commonly used:

- **Interest cover**: A test of the company's ability to make enough

AS THE PROSPECTS GROW OF A DEEP AND LENGTHY RECESSION, **GRAHAM BUCK** EXPLAINS HOW COMPANIES SHOULD RESPOND IF THEY ARE FACED WITH THE POSSIBILITY THAT THEY MAY BREACH THEIR COVENANTS.

operating profit to pay interest costs as they fall due. Banks generally base it on EBITDA rather than EBIT (which excludes depreciation and amortisation).

- **Leverage**: A test measuring the company's debt levels versus its operating income or net worth.
- **Capital expenditure**: A capex covenant gives lenders some control over the amount borrowed and basically caps the amount that may be spent as budgeted capex over any given period. It limits cash leaving the company and any manipulation of cashflows.
- **Debt service cover ratio (DSCR)**: This measure sets net revenue before payment of interest or principal against the costs of that payment. A backward-looking DSCR measures the cashflow available to service the debt during the previous 12 months against the actual cost of financing the debt during that same period. A forward-looking DSCR shows how much principal a borrower has to pay on a set date.

TAKING ACTION Companies are taking a range of actions to prevent a breach of covenant, with many opting for rights issues. In March, for example, Premier Foods renegotiated its banking terms, extending loan maturities and resetting its covenants, which paved the way for a £404m equity issue and bank refinancing to reduce its £1.77bn debt. Acknowledging investor concerns that Premier would be swamped by its debt – and in the current climate unable to dispose of its assets except at a knock-down price – chief executive Robert Schofield said the group now had "enough headroom to dispel any talk of covenant breaches".

If a covenant needs to be renegotiated, the key to success is getting in early, says Bob Williams, group treasurer for housebuilder Barratt Developments. Many companies are experiencing pressure on their covenants as the downturn intensifies and are looking to renegotiate and reset them.

Williams says: "If a company possesses both the foresight and ability to keep the banks regularly updated on how the business is faring, it will greatly assist when it comes to renegotiating covenants and refinancing. There is nothing worse than a bank manager discovering that a client has problems only when he reads about in the business pages. Keep your bank in the dark and it's likely you'll end up working with its workout team, which will focus principally on getting the money back, rather than the business relationship team. Be warned: it's not a pleasant experience."

The options available to treasurers are fairly limited, but José Leo, chief financial officer of airports operator BAA agrees that maintaining a dialogue with financial institutions over a period of time is essential. He also suggests spreading the net fairly wide: "For the first time in many years, treasurers are denied the luxury of choosing which banks they prefer to work with. Instead, it's a case of having to work with those still standing. So you need to keep the dialogue open, and work on building up mutual confidence."

BAA was fortunate in being able to complete an ambitious refinancing last August, only weeks before the demise of Lehman Brothers and AIG's near-collapse made already difficult conditions even tougher. The transactions included the creation of an investment-grade rated debt programme, the migration of £4.5bn of existing bonds into a ringfence by a liability management exercise and a seven-year bank facility to finance several airports.

Leo says that putting together a similar package today would prove much more difficult: "It's not just that a deal of similar size would be difficult; it's also a case of the complexity, as it involved the migration of existing bonds into newer structures and a bank funding package. Something smaller and simpler is still feasible, but also more expensive as banks are imposing less favourable terms."

However, he concedes that BAA is relatively fortunate in being protected against the full impact of the downturn. Traffic at Heathrow might have dipped, but sectors such as retail and construction have felt the impact far harder and are most vulnerable to the more conservative banking attitude to covenant breaches.

EARLY AND FAST At Barratt, Williams says the company helped its cause by taking action at a relatively early stage: "It was clear to us last April that there was a definite step down in the market and we realised that it could result in our covenants coming under pressure. So we went in to reset them and took the decision to complete the process as quickly as possible."

The company turned the process around in no more than six weeks, thereby reassuring its note holders. Williams adds that, one year on, it would probably take longer in today's tougher conditions. "The period taken depends very much on the strength of the company's relationship with its banks," he says.

Barratt was keen to complete the deal promptly ahead of its trading update in July so it could use the update to announce the resetting of the covenant.

Williams' advice to treasurers and finance directors faced with a potential breach of covenant is to grasp the nettle early and be realistic about expectations.

"The ability to negotiate with the banks is certainly rather tougher than it was a year ago and pricing has increased over the period. Corporations may also find they are unable to secure as much as they require in funding lines and that the period is shorter – as many others have recently observed, 'Three years is the new five years.'"

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