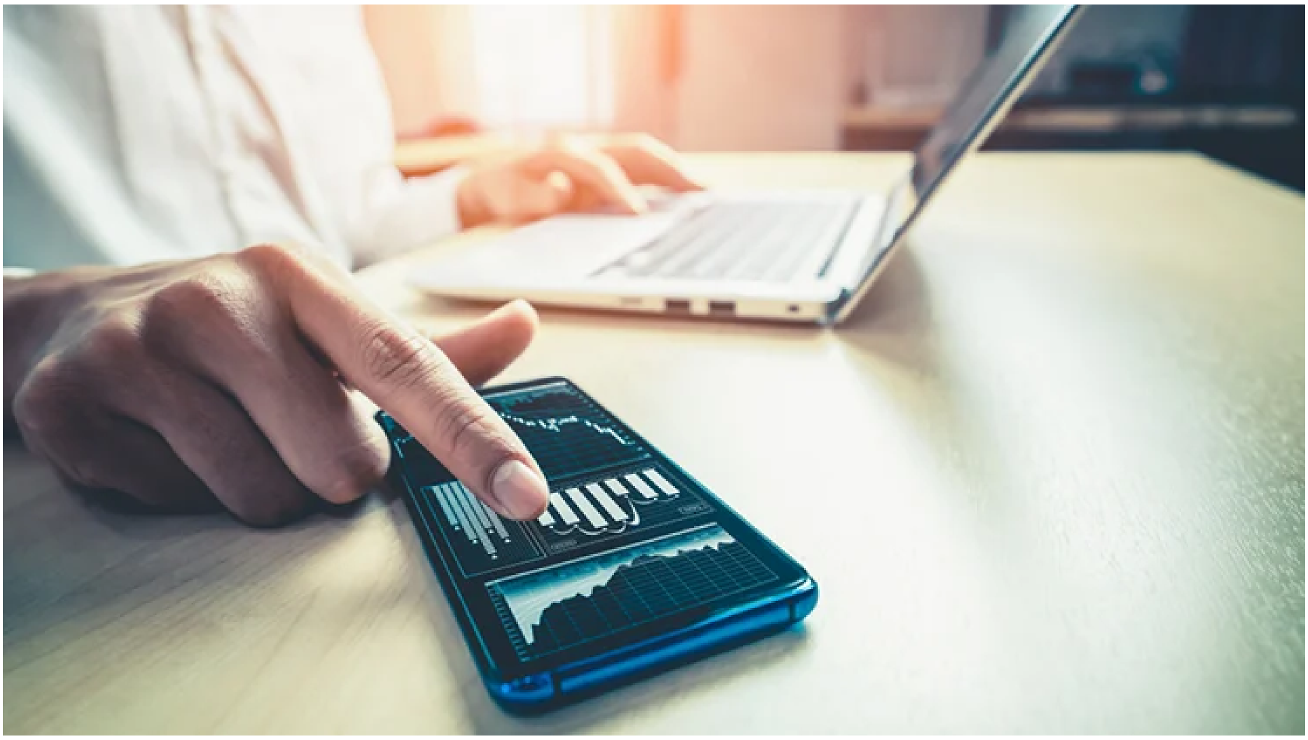
Watch your covenants!

By Fordham
19 February 2020



In the wake of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, many of our banking contacts have expressed the importance of Private Business Owners ensuring that they are bringing their banks along with them as they go on their Wealth Journey.

Misunderstandings around the way private businesses are reporting to their bank can lead to unnecessary enquiries from the bank, including reviews of facilities and bank exposure that could have been avoided if proactive communication and reporting was in place.

What is a Debt Covenant?

Debt covenants are promises that a Business Owner makes to their bank about various aspects of how they will conduct their business. These covenants can vary greatly depending on the size of the business, recent and historical profitability, assets that are available for security, the businesses history with the bank and so on. Some common debt covenants that we see include:

Interest Coverage Ratio	• Calculated asEBIT / Interest expense • Typically need to be 2 + times (can be as low as 1.5 times)
Current/Working Capital/Liquidity Ratio	• Calculated as current assets divided by current liabilities. • Typically need to be 1.5 - 2 times
Capital Adequacy Ratio	• Calculated as net tangible assets divided by total tangible assets • Typically needs to be greater than 30%
Stock Turnover Ratio	• Calculated as cost of good sold divided by average stock balances • Typically needs to be greater than 2.5 times per annum
Reporting Timeline	• Typically need to provide entity profit & loss, balance sheet and cash flow statements annually, quarterly or monthly. • Often also required to provide Tax Office reports showing all lodgements and payments are up to date.
Drawings	• Calculated as Drawings / NPAT • Typically need to be < 70%
Tangible net worth	• Calculated as: Total Tangible Assets – Total Liabilities • Generally want to see this improve each year through retained earnings.

Common Problems in Reporting

Some of the more commonly seen issues in covenant reporting are:

- Late provision of information – if your covenants say you need to report 28 days from the end of the quarter, then you need to get it done by then or it is a breach;
- Missing one of your covenant ratios or benchmarks
- Overdrawing on banking facilities like overdrafts, trade/debtor finance facilities
- Missing fixed loan payments
- Abnormal adjustments in your accounts at year end (e.g. management or other inter-entity charges booked only at the end of the year.

Any of these can all result in a breach of covenant being issued by the bank, which is something the banks are required to do. Sometimes, the breach of covenant will result in no action being taken at that time, however it will add to your account conduct history and may have a negative impact on your future banking arrangements.

What happens if you get it wrong?

Making sure that you both meet your covenants, and get your reporting right, is incredibly important in current economic conditions as getting them wrong can be very costly. Some of the common consequences that we see imposed on Private Businesses when they get their covenants wrong include:

- Banks not passing on interest rate cuts, or independently increasing your interest rate to a higher one due to an increased risk profile of your business
- Requirements to reduce the size of the debt over a period of time to reduce the overall risk of your business to the bank
- Being placed into the Credit Watch area of the bank – this usually involves you losing your regular business relationship manager that knows you and your business and being transferred to the specialist credit teams – you don't want to be here:
    - Once on credit watch the bank may request that you refinance to another bank, which if you are breaching your covenants anyways may prove to be difficult/costly/not possible for you to do.
    - Whilst not an ideal position, the Banks may also try and work with you to implement a plan to try and retain your business.
- Total withdrawal of support from the bank requiring you to refinance to another institution (if you can) on a deadline
- The bank appointing an Administrator or Liquidator to take control of your business so they can secure their debts

What should I be doing?

Despite what some people may try and tell you, banks aren't in the business of making the lives of Private Business Owners any harder than they have to be. So the best bet is to make sure that you are working with your bank in the spirit of the true partnership you have with them:

- **Have an Owner Plan** – banks like to see businesses with a plan that steps out where they are now, and where they want to be in the future. This lets them know
- **Report accurately and on time** – make sure that you meet your reporting timeframes, and make sure that what you say is accurate. The bank remembers what you told them last quarter, so you should not go changing things to suit this quarter.
- **Meet your Statutory Obligations** – we are increasingly seeing banks asking for evidence of statutory obligations being declared and paid on time. This can include income tax, GST, Pay as you go Withholding, Fringe Benefits Tax, and Superannuation
- **Get the right people on the bus** – business owners spend most of their time working in the business, and the last thing they want to do is put together monthly/quarterly covenant reporting for the bank. Get the right people in your finance team to help you do this and to get it right
- **Have a budget/forecast and track it** – How can a business owner or a bank know where a business is going without a budget? Many private businesses don't have a realistic or thought out budget that they

track against on a regular basis. Ideally, a forecast should consist of a profit and loss, balance sheet and cash flow forecast.

- **Communicate Early** – if there is going to be a problem in meeting your covenants, then communicate with your bank early. Don't stick your head in the sand and hope it will go away. Banks will generally try and work with you, but they can only do that if they understand the problem.

For further information contact your Fordham Partner.