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Debt Covenants

With rising inflation, staffing shortages, and a litany of regulatory burdens, many of us are seeking support from financial institutions to obtain business loans, lines of credit, support with capital asset purchases, etc. It can feel challenging to navigate these waters with your bank especially when the terminology is so different than what we see in healthcare. Let's get ahead of the challenge a bit by digging into Debt Covenants.

The term itself sounds a bit scary if you aren't familiar with it, but basically the lending process is a promise between your company and the bank. The Debt Covenants are a foundational part of that promise which are really intended to protect both sides.

- The bank promises not to lend you more money than is financially feasible for you to pay back
- You, in turn, agree to pay your debts and not do anything that would put your ability to do so in jeopardy.

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This promise digs in to outline the terms of that agreement to set requirements for lending in three categories: affirmative, restrictive, and financial. From the borrowing perspective, these break down into two main categories, what you must and must not do. For example, perhaps to borrow money you need to provide certain financial statements or pay down a certain amount of debt first. Perhaps it includes a statement that you cannot borrow any other debt or sell specific assets being used as collateral. The overall goal being, to make sure you can honor your promise of repayment.

- Affirmative Covenants (Positive) – these are the requirements the borrower must do
- Restrictive Covenants (Negative) – these are the actions the borrow must not take
- Financial Debt Covenants – these have to do with debt ratios and other specific financial metrics which may be included for oversight

So, what does that look like from the lender's perspective? It means, they will be looking at your financials including your debt to EBITDA ratio, balance statement, assets, etc. It is their responsibility to be transparent about debt covenants and yours to understand what they mean. If you agree to a debt covenant and violate that agreement, the lender has rights which may include, among others:

- Assigning penalty payments
- Increasing interest rate
- Demanding immediate full loan repayment

The process of implementing debt covenants helps businesses avoid going too far into debt. For this reason, they can be especially helpful to start-ups or organizations that want to ensure long-term viability regardless of short-term market volatility.

Financials, covenants, and reviews, they can all be unnecessarily convoluted. It's our job as community bankers to educate you as business owners and advocate for you. If you have questions on the lending process, debt covenants, or anything in between, give us a call.

References:

https://corporatefinanceinstitute.com/resources/knowledge/finance/debt-covenants/

https://www.wallstreetprep.com/knowledge/debt-covenants/

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