CURRENT ASPECTS OF UNSECURED LENDING
FINANCIAL RATIOS IN THEIR LEGAL CONTEXT

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Don Argus has outlined the principal categories and presented a banker's viewpoint as to the value of these ratios in the course of analysis of a borrower's ongoing performance.

I have selected two cover ratios for analysis:

(a) an interest or fixed charge cover ratio applicable to a high cash flow style of business; and

(b) a cover ratio as might be found in an oilfield project financing.

By way of general comment - financial ratios of any category do not appear in isolation. They are to be found amongst a range of measures or "financial covenants" usually including negative pledge, subordination, requirements as to the maintenance of certain levels of net worth, limitations on payments etc.

Financial covenants of this nature have as their objective the maintenance of an acceptable financial position in the borrower.

To the extent that management decision may be involved in preserving or meeting their required financial condition, financial covenants serve a positive function of disciplining and directing financial policies, for example by restricting drains on a company's cash resources.

They have been referred to as "contractual policy controls".

Fixed Charge Cover Ratio

The recent financings arranged for the Bond Brewing Group offer an example of an interest or fixed charge cover ratio.

The borrower was the immediate holding company for the Bond Brewing Group of Companies, owners of the Castlemaine, Tooheys and Swan breweries.

Borrowings were unsecured and without recourse to other companies in the Bond Corporation Holdings Group.

In short, the banks and purchasers of certain public securities could look only to the Brewery Group for repayment out of operating cash flow plus certain investment assets, added to the Group for the purposes of the borrowings in order to increase its net worth to an acceptable level.

Central to the financial covenants employed were interest coverage ratios designed to test the borrower's ability to pay interest on its overall borrowings out of its net operating revenues.

Such interest cover limitations were applied both as maintenance ratios i.e. the borrower had to maintain a stipulated interest cover ratio at all times during the currency of the borrowings AND as test ratios - to be applied at certain times, namely, on occasions that the borrower wished to make a payment which fell into a proscribed or restricted category (referred to as "Restricted Payments") an example being payment of a dividend upstream.

Interest Coverage was defined as the ratio of Operating Cash Flow (calculated for the four preceding quarters) to Interest Charges accruing in the fiscal quarter in which the calculation occurred and the three next ensuing fiscal quarters i.e. it involved a projection forward to pick up the immediate forward cost of future interest payout, rather than comparative historical cost in terms of interest paid over the period covered by the Operating Cash Flow calculation.

Some of the debt is at a floating rate; accordingly this calculation will involve assumptions to be arrived at between lenders and borrower in good faith.

The Interest Coverage test was set at a progressively higher ratio for each of the first three years and is thereafter required to be maintained at a plateau level.

At the same time the borrower was required to increase its net worth progressively over the same period to a final plateau level.

The policy objective in imposing increasingly higher ratios and increasingly higher net worth values in those first three years was to ensure a cash build up in the borrower group by the time principal repayments were required in terms of the borrowing schedule.

The test to be applied in each case the borrower seeks to make a Restricted Payment was set in the alternative - a certain Fixed Charge Coverage <u>OR</u> a given level of net worth.

In essence, the borrower was precluded from making a Restricted Payment unless and at the time of such Restricted Payment no event of default or potential event of default had occurred and -

(i) immediately prior to the time of such Restricted Payment and after giving effect thereto either the tangible net worth of the borrower was not less than a given dollar value or the Fixed Charge Coverage was greater than a stipulated ratio; and

(ii) upon giving effect to such Restricted Payment the aggregate amount of Restricted Payments made subsequent to initial drawdown of the facilities would not exceed the net aggregate build up of what was defined as "net net cash flow" over the relevant period.

Slightly abbreviated versions of the principal defined terms employed for the purposes of calculating these ratios are attached.

Reserve Life Cover Ratio

A very different form of cover ratio is one designed to test the ability of the borrower to meet its total borrowing commitments out of the estimated net operating case flow derived from a particular source such as a mine or an oilfield.

Such a ratio in say an oilfield financing may be referred to as the "Reserve Life Cover Ratio", being the ratio of:

(a) the aggregate present value of projected net revenue (at the time in question) in respect of the period from the date on which the calculation is made to the date estimated (on the basis of the planned recovery rate when applied to the reserves figures) as the date at which net revenues will either be nil or negative (i.e. at the point operating costs will be equal to or greater than operating revenues) ("economic end date"); to

(b) the amount of the loan outstanding at the calculation date.

This is an exercise which usually involves first a technical appreciation of the proven reserves or, in the case of an oilfield, of the number of economically recoverable barrels of oil in place, second a prognosis as to product prices over the relevant period and third a calculation of the net present value of the recoverable resources e.g. oil.

Central to this calculation is a concept of net revenue i.e. gross receipts less operating costs.

Such ratios are usually tested at "milestone" dates such as drawdown and/or as a trigger event signalling default.

Definition of Terms for Calculating Ratios

"Fixed Charge Coverage" means with respect to any person the ration of:

(1) The aggregate amount of Operating Cash Flow, less capital expenditures, on a consolidated basis, for the four fiscal quarters for which financial information in respect thereof is available immediately prior to the date of the transaction giving rise to the need to calculate the Fixed Charge Coverage ("the Transaction Date"); to

(2) The aggregate of Fixed Charges, plus dividends on redeemable preference shares on a consolidated basis that such person and its subsidiaries will accrue during the fiscal quarter in which the transaction date occurs and the three fiscal quarters immediately subsequent to such fiscal quarter, assuming the consolidated Fixed Charges accruing on the Transaction Date and those reasonably anticipated to be accrued by such person in good faith during such period.

"Fixed Charges" means for any period and with respect to any person the sum of:

(1) The aggregate amount of interest in respect of Indebtedness (including amortisation of original issue discount on any Indebtedness and the interest portion of any deferred payment obligation, calculated in accordance with the effective interest method of accounting, all commissions, discounts and other fees and charges with respect to letters of credit and bankers acceptance financing); and

(2) All but the principal component of rentals in respect of Capitalised Lease Obligations, paid, accrued or scheduled to be paid or accrued by such person and its subsidiaries during such period, determined on a consolidated basis in accordance with current accounting practice.

[with an exclusion for interest accrued in respect of non-recourse indebtedness].

"Net Income" means, for any period, the aggregate of income (or loss) before extraordinary items from continuing operations, on a consolidated basis for such period taken as a single accounting period determined in conformity with current accounting practice [with certain specific exclusions].

"Operating Cash Flow" means for any period and with respect to any person, the sum of:

(1) Net Income;

(2) Fixed Charges;

(3) Provisions for taxes based on income;

(4) Depreciation expense;

(5) Amortisation expense;

(6) Other non-cash items reducing net income, minus non-cash items increasing Net Income, all as determined on a consolidated basis in conformity with current accounting practice [with exclusions for cash flow directly attributable to assets sold in the period which had contributed to cash flow and also excluding the amount of operating cash flow attributable to non-recourse indebtedness].