

BFSLA Annual Conference

Financial Ratios : Lost in Translation



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What we will cover

- Demystifying the Jargon
- Purpose of Financial Ratios
- Drafting Considerations
- Comparative Ratios
- Key Takeaways



Demystifying the Jargon

- A lot of acronyms and jargon but concepts are simple:
 - Is the borrower in good financial shape?
 - Can the borrower afford to pay its interest?
 - Can the borrower afford to service its loan?
 - If the borrower goes bust, will the proceeds of enforcement pay the bank back?

Purpose of Financial Ratios

- Focus in ensuring capacity to service debt and/or maintaining collateral
- Measure:
 - Risk
 - Profitability
 - Cash flow
 - Liquidity

Key Considerations for drafting covenants

- Test that covenants (or their component parts) are appropriate to the business or transaction
- Ensure all components of the ratios are derived from the financial model
- Ensure that all components which are derived from the financial statements are stated as they appear in those financial statements
- Ensure the borrower can derive the component parts (within the time required)
- Ensure that CFO of Borrower is satisfied with her or his task of calculating compliance

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Comparison of Typical Financial Ratios

	Investment Grade Lending	Leveraged Finance	Real Estate Finance	Project Finance	Borrowing Base Financing
Loan to Value Ratio (LVR)			Debt : Value of Property at most recent valuation		
Gearing Ratio	Debt : Debt & Equity			Debt : Debt & Equity	
Leverage Ratio (or Debt Cover Ratio)	Debt : EBITDA	Debt : EBITDA			
Interest Cover Ratio (ICR)	EBITDA : Finance Charges	EBITDA : Finance Charges	Net Rental Income : Finance Charges		
Debt Service Cover Ratio (DSCR)	Cash Flow : Debt Service	Cash Flow : Debt Service		CFADS : Senior Debt Service	
Fixed Charge Cover Ratio	EBITDA + Rent : Finance Charges + Rent	EBITDA + Rent : Finance Charges + Rent			
Weighted Average Lease Term (WALT)/Weighted Average Lease Expiry (WALE)			Average of all lease terms weighted to proportion of lease income		
Loan to Total Costs			Loan : Total Costs (Development Facilities)		
Loan Life Cover Ratio				$\frac{\text{NPV Projected CFADS}}{\text{OPA}}$	
Debt as % of Eligible Receivables / Inventory					LTV of the basis of a specified % of each type of eligible collateral
Special Features		<ul style="list-style-type: none"> Cash Sweep Dividend Lockup Equity Cure Mulligans 	<ul style="list-style-type: none"> Equity Cure Additional Capital 	<ul style="list-style-type: none"> Debt sizing Cash Sweep Dividend Lockup Debt service reserve trigger Equity Cure (Aus) 	<ul style="list-style-type: none"> Additional Collateral

Cash Flow Lending : Investment Grade to Leveraged Finance

- Gearing/Leverage Ratio: Debt : Debt & Equity/Debt : EBITDA
- Interest Cover Ratio (ICR) : EBITDA : Finance Charges
- Debt Service Cover Ratio : Cash Flow : Debt Service (sometimes)
- Fixed Charge Cover Ratio : EBITDA & Rent : Finance Charge & Rent

Cash Flow Lending : Investment Grade to Leveraged Finance

- Distinctions between investment grade and leveraged transactions
 - Investment grade borrowers are likely to have less restrictions, e.g. leverage ratio will be only constraint on incurring further debt
 - Investment grade borrowers are likely to report less often and on the basis of publicly available financial information
 - Leveraged borrowers are likely to have second chances, e.g. equity cures, mulligans and deemed cure

Real Estate Finance

- Typical Covenants
 - Loan to Value Ratio (LVR)
 - Testing debt against value of property
 - Cure rights, e.g. equity cure or additional collateral
 - ICR
 - Net Rental Income : Finance Charges
 - Both forward and projected

Real Estate Finance

- Weighted Average Lease Term (WALT) Covenant
- Development Facilities : Loan to Total Costs Ratio
 - Total Costs = lesser of purchase price or current value of property plus cost spent on development

Project Finance

- Typical Covenants

- Gearing Ratio: Debt: Debt + Equity
- DSCR : Cash Flow Available for Debt Service (CFADS): Senior Debt Service
 - CFADS is essentially Gross Revenue – Operating Expenses
 - Typically very low
 - Typically dividend lock-up and cash sweep at a level before Event of Default
- Loan Life Cover Ratio / Project Life Cover Ratios $\frac{\text{NPV CFADS}}{\text{OPA}}$
 - OPA is outstanding principal amount

Asset-Backed Financing

- Typical Covenant
 - Debt as % of Eligible receivables/inventory
 - Testing debt against value of collateral
 - Different “Advance rates” attributable to different eligible assets

Asset-Backed Financing

- Exclusions from Eligibility – need to be fact specific
 - Reservation of title arrangements
 - Proceeds PMSIs
 - Past due receivables
 - Obsolete inventory
- Consider impact of preferential claims

Key Takeaways

- Don't get bamboozled by the jargon
- Covenants should be tailored to the specific business – precedents should be treated with caution
- Drafting should be reconciled to the financial model and financial statements
- Borrowers should ensure they can evidence compliance from available data
- Take accountants on the journey



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