

## The Banking Perspective

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### Introduction

As you will have no doubt noticed, we are currently going through a periodic low point in the credit cycle with a number of high profile domestic collapses such as Pasminco, HIH, Harris Scarfe and offshore with Enron, Kirch Media and NTL etc.

This has, as many of you may have observed through your own practices, led to a general tightening in credit standards and covenant packages. As well there has been a notable increase in the number of Financial Ratio's that have been breached or restructured over the past 12 months reflecting the tighter business environment.

**Therefore, it is an opportune moment to give a bankers perspective on Financial Ratios and what I intend to do today is to give you a brief outline, from a banking perspectives, as to:**

1. Why we have financial ratio covenants;
2. The different types of Financial Ratios used in covenants;
3. Limitations of financial ratios; and
4. Current trends & issues with Financial Ratios.

### Why we have Financial Covenants

Financial institutions, rating agencies and equity analysts use ratios as a method of assessing and monitoring the financial health of an organisation.

By financial health I mean:

1. Ability to service obligations in a timely manner;
2. Ability to repay principal; and
3. Margin of safety to deal with unforeseen business/economic events.

Typically, ratios are seen in documentation in 4 contexts:

1. Default ratios – which enable a lender to demand repayment if breached;

2. Distribution restriction ratios – these restrict the ability of a Borrower to make distributions to subordinated creditors or equity holders;
3. Amortisation – ratios are commonly used as triggers for mandatory amortisation and/or cash sweep arrangements.
4. Further Indebtedness – ratios are also used to control company's undertaking additional borrowings.

In looking at ratios, it is important to remember that they are not there to “trap” borrowers. Rather, they are there to impose a certain level of borrower discipline (forcing the borrower to periodically examine the business or possibly reduce gearing) and as a safety measure to protect the lenders interest and enable them to act in a timely manner to ensure recover.

Financial Ratios are usually only part of a number of covenants, but the advantage is that they provide a clear, objective trigger mechanism, which provides minimal grounds for dispute. As a comparison, while many financings contain a broadly defined Material Adverse Change clause, this is generally seen as somewhat nebulous from a lenders perspective, while borrower's are concerned that it implies a lender can step in at whim. Financial ratios however, provide both the lender and the borrower with a greater degree of certainty over 'what happens and when'.

A simple example of this last point is 9/11. While a lender to a US airline would be able to argue a Material Adverse Change had occurred, this is a very loose concept to employ in a politically charged environment. A ratio breach however is a clear issue around which people can negotiate a solution, both as between borrower and lenders, but in this case also use as a clear lever for Government aid.

Ratios therefore provide a tool for both initially assessing a credit and for providing an ongoing early warning & management system that enables borrowers and lenders to hopefully act before an organisation reaches such a dire state that full recovery of principle is no longer possible.

## **Types of Ratios**

There are literally dozens of different types of ratios and countless hybrids in use. What I aim to do below is to discuss the key ratio groups and the form in which they are typically seen in domestic financings.

### **Asset Ratios**

The most common type of ratio in banking, which everyone should be familiar with from their own home loans, is the Loan to Value ratio (“LTV”).

This is simply the amount of the proposed loan divided by the assessed market value of the asset. While with a home loan, this is normally a once off calculation, with most commercial property loans and many other asset based financings, this will be calculated annually based on an updated valuation.

However, this type of ratio is only as good as the underlying valuations and I expect many of you here have been involved with cases involving disputed valuations.

As well, valuations can change significantly due to external factors. The recent 9/11 tragedy for instance significantly impacted aircraft values impacting many airline and aircraft financings.

In using asset ratios the level at which the ratio is set should reflect:

1. Volatility of underlying asset prices:
2. Income earning potential of asset (i.e. rent); and
3. Liquidity of the asset markets and hence time taken to dispose of assets.

Therefore, while a LTV of 80% is acceptable for a liquid asset such as Sydney residential real estate, an LTV of 50% might be seen as aggressive for certain types of rural assets which are more subject to cyclical markets with limited buyers.

The drafting of the actual asset ratio is normally relatively simple, with the issues arising in terms of:

1. The basis and standard of the valuation. While most professional valuation bodies have standards which can be used as the reference point for definitions, it should be noted that often the primary purpose of these standards is to protect the valuer by providing a clear framework for his valuation, rather than ensuring a realistic valuation; and
2. Dispute resolution. This includes issues such as who instructs the valuer & what rights the other party has to contest the basis of the valuation.
- 3.

### **Balance Sheet Ratios**

Balance Sheet ratios are calculated based on the accounts of a company. Usually they are calculated semi-annually based on unaudited half-year accounts and audited full year accounts.

There are many different types of balance sheet ratios and their use/ applicability depends on the type of company. As a generalisation, Balance Sheet ratios are more useful in asset intensive industries (i.e. BHP) than they are in less asset intensive business (e.g. an advertising agency).

Balance Sheet ratios typically take two forms:

1. Gearing Ratios such as "debt to debt plus equity", which are typically expressed as a percentage; and
2. Net Worth covenants which are typically expressed as a minimum dollar amount.

Often these covenants are used together, with the gearing covenant designed to ensure the company maintains a prudent funding mix between debt & equity while the net worth covenant ensures that it maintains a certain critical mass.

While the Balance Sheet is used as the basis of the calculation, you will typically note that the drafting provides for certain adjustments to the Balance Sheet prior to calculation. The most common of these is to exclude intangible assets.

Intangible assets as the name suggests are "soft assets" such as brand names, mastheads, intellectual property rights and goodwill. While these items do have a real dollar value, that value can deteriorate significantly in an insolvency situation (e.g. the Ansett brand). As well intangibles are notoriously hard to value and any valuation is extremely subjective, as there is rarely a liquid market for such asset. Therefore, to be prudent, banks will often exclude or limit their inclusions in ratios.

However, even excluding "soft assets" does not solve the problems with balance sheet ratios. Assets are normally valued on a "going concern basis" and usually reflect historical cost or directors' valuations. This is not normally reflective of market or liquidation values.

*An example of this would be a new piece of machinery such as computer aided die cutting machine. While the new machine might cost \$500,000 and be worth considerably more to the company due to the saving in labour etc. However if the company goes into liquidation a specialised piece of machinery like this may be worthless if there are no other potential users in the Australian market (which is a small market). Therefore while from an accounting point of view, the machine may be depreciated over 5 years, its liquidation value is virtually \$0, the day it is installed.*

Therefore in setting the levels of balance sheet ratios, the lenders are implicitly trying to determine the size "haircut" on assets values that is likely to occur in a distressed sale environment.

One recent issue that has been particularly relevant in the resources sector, is that balance sheet ratios rarely take into account the "mark to market" value of foreign exchange, interest rate and commodity hedging positions. The significant fall in the Australian dollar combined with weak commodity prices has resulted in many companies having significant out of the money positions which are effectively a "debt" which must be repaid on its scheduled maturity.

## **Profit & Loss Ratios**

Like balance sheet ratios, Profit & Loss ratios are derived from the information contained in a company's accounts.

Unlike Balance Sheet ratio's, which are primarily concerned with security value and historic value, P&L ratios are seen as a measure of a company's current financial health as shown by its ability to generate earnings (hopefully an indicator of its future ability to continue to do so).

The two terms that are principally used are:

1. **EBITDA** = **Earnings before interest, taxes, depreciation and amortisation**
2. **EBIT** = **Earnings before interest and taxes**

Why do lenders look at EBIT rather than NPAT (Net Profit After Tax)? The reason is that interest is a deductible expense and therefore in simplistic terms if you don't have enough earnings to pay your interest, then tax will be zero (sadly it is not always this easy due to differences in profit for accounting & tax purposes).

The next question is why do lenders sometimes use EBITDA rather than EBIT. The answer is that it depends upon the nature of the underlying business but as an example EBITDA would be appropriate in a business such as a Pipeline company. In a pipeline company (e.g. Envestra) you have considerable assets but little ongoing requirement to replace them due to their long life (typically 40+ years for a pipeline).

However, in a business where there is a constant need to reinvest capital then EBIT is a more appropriate measure, as the D&A part of EBITDA is not "free cash" but is required to fund the required reinvestment.

The principal issues that Lenders have with P&L ratios are:

1. Equity accounted – off balance sheet vehicles (this applies to Balance Sheet ratios as well); and
2. Cash vs Earnings.

Equity Accounted – off balance sheet vehicles were the principal cause of Enron's downfall, when it became clear that its published accounts did not represent a fair view of its liabilities causing a crisis of confidence amongst shareholders and creditors.

Put simply if a company owns more than 50% of another company, it is required to consolidate that company and then back out the minority interest in its earnings. As an example:

*If Company A had \$100m of debt and Company B has \$50m, then if A owns more than 50% of B, A's consolidated Balance Sheet would show debt of \$150m.*

*The consolidated Profit & Loss would then include the full earnings of company A & B as well as the full interest cost on the \$150m. An adjustment would then be made for the minority interest in the earnings of company B.*

This can have both a positive and a negative effect for a lender depending on the relative financial strength of the subsidiary.

1. Where the subsidiary is highly geared, its exclusion from the consolidated accounts will improve the apparent financial health of the parent.

*In the case of Enron, it had entered into a number of limited liability partnerships, where it was deemed to own less than 50% through various accounting/legal devices. These vehicles were*

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*therefore off balance sheet. However, any layman looking at these structures would have struggled to work out why Enron had anything less than 100% effective ownership.*

*These limited liability partnerships were generally very highly geared and hence if they had been consolidated would have shown that Enron had a much higher gearing level than reported.*

*Off balance sheet vehicles are not completely off the balance sheet with:*

- 1. The value of the equity stake in the off balance sheet vehicle being recorded as an asset; and*
- 2. Any dividends paid by the vehicle being recorded as earnings.*
2. Conversely where a weak parent consolidates a strong partially owned subsidiary this can give a misleading view of the parents financial strength from a lending perspective as partially owned subsidiaries are often not parties to cross guarantee arrangements. Therefore, their cash flows/assets are not available to the lenders (except via sale of the equity stake).

Thankfully Australian accounting rules are tougher than the US rules and take a form and substance approach rather than a black letter approach. However, there are still avenues such as securitisations and sale and lease back transaction, which effectively achieve similar results. To address this you will often see ratios drafted to include the interest component of these types of transactions.

The other issue is one of the differences between P&L earnings and actual cash as a layman would understand it. This is a complex issue, better explained by an accountant than a banker, but in essence companies can report quite strong earnings but still go broke because of inadequate cashflow while particularly infrastructure investments such as toll roads, can record P&L losses, but generate very strong cashflows.

This leads me on to the subject of Cash flow Ratios

## **Cash flow Ratios**

Cashflow ratios are particularly prevalent in infrastructure and project financings where accounting earnings are not a true reflection of financial health. Increasingly, these ratios are also being used in leveraged and lower grade corporate financings as they better reflect on going viability.

Typically, in defining a cashflow ratio, we are seeking to mirror actual reality and therefore match actual cash in the bank.

The main area of discussion in defining cashflow is the differences between receipts and accruals both on the revenue and expenses side. Although a purist would say it is only revenue received less expenses paid, most definitions blur this concept and include some accruals either on the revenues and/or expenses side.

The purist approach in using cash flow is to define Net Operating Cash flow by reference to actual revenues received and expenses incurred. This can be quite different from the cash flow statement

contained in most annual reports and reconciling the two can be quite difficult. As a compromise you will often see an adjusted EBITDA, which would typically be

*EBITDA less capex less tax*

However being "earnings" rather than cash based it is less rigorous and more prone to distortion by non-cash items such as accruals. It should be noted that the favoured short-term method, for companies in trouble, is to improve their cash flow, by not paying creditors on time. While a short term boost to cash flow, this is not a long-term indicator of health, particularly when done over financial year end, this can significantly alter the apparent financial health of a company. While a purist cash flow definition would exclude this, the adjusted EBITDA would not.

This brings us to the next concept, the forward-looking ratios typically seen in project financing transactions.

The most typical is the Loan Life Cover Ratio (LLCR) which is:

*Present Value of the Cashflow available for debt service*

***Principal amount of Debt***

Present Value, is effectively the sum of all future cash flow available for debt service, but discounted by the cost of that debt (the interest rate). In simple terms as long as the above ratio produces a number greater than or equal to 1.0, then the project generates sufficient cash flow to repay the loan and all associated interest over its term.

In documenting this type of ratio there are a number of issues in addition to those raised above which apply to all cash flow ratios:

**Discount Factor** – typically the cashflow available for debt service is discounted at the debt rate (Base + Margin) to achieve its present value. Where an interest rate swap has been entered into for the full term of the loan, this is relatively simple. Increasingly, however, lenders and borrowers are preferring to enter into shorter term swap profiles, which roll forward on an annual basis, leaving a floating rate portion of interest rate exposure– conceptually easy, but much harder to document as you have no certainty as to future interest rates.

**Whose Forecast** – to calculate these numbers you need a financial model to calculate long term cashflows (typically 20+ years) the question is then whose, model is this and whose assumptions are used (Borrowers vs. Lenders).

In the good old days, it was always the lender model and the lenders assumptions. Now it is often the Borrowers model and assumptions, but if they are lucky the Lenders have a right to dispute the assumptions, (which then gives rise to your usual dispute resolution issues).

## Limitations of Financial Ratios

Financial ratios do not protect lenders from fraud. Ultimately lenders are dependent of the good faith of the Borrower in providing the base financial data to ensure compliance.

While relying on audited financial information and audited compliance certificates does provide a degree of comfort, it needs to be remembered that the auditors in turn are relying on the company to provide data to them. As the recent examples of Harris Scarfe & K&S Freighters show, if the CFO really wants to disguise the true numbers it can be very difficult to detect.

## Trends and Issues

I have already highlighted most of the key issues with individual ratios so I will finish off by giving a brief history of where ratios have come from and where they are going.

None of the ratios I have mentioned are new. A colleague gave me a copy of the 1950 edition of *"Balance Sheets and the Lending Banker"*<sup>1</sup> which pretty much covers all the issues I have raised. The more recent forward looking ratios have been around at least since the early 70's resource boom in Australia and the North Sea oil financings of the same period.

What many of you will have noticed, however, is an increase in the way in which these ratios are used and how some concepts have migrated from project financings to corporate financings.

## A Brief History

In the 1980's, the Corporate lending market was relatively unsophisticated in its approach having traditionally relied on bricks and mortar security – which was represented by a reliance on gearing covenants and priority in liquidation.

However, the corporate cowboys of the '80's quickly showed the banks how you could drive a fleet of trucks through these covenants. Then the property crash of the late 80's means that even if bankers managed to get their hands on the assets they were worth much less than expected.

This has lead to a fundamental reassessment by lenders of their business practices and a renewed focus. Therefore, in the corporate lending market you will find that the general philosophy of lenders is that while asset values are a comfort you really want to ensure the viability of the business (earnings and cashflow) so that you never have to test the asset values.

This is a trend, which is reinforced by the increasing influence of the rating agencies (Standard & Poors, Moodys and Fitch/BCA) in the Australian market. The approach of the rating agencies is driven by the use of benchmark financial ratios, which have been developed for various industries

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depending on their historical performance. While the rating agencies use a wide variety of ratios, their primary focus tends to be on cash flow.

In Australia, this was combined with the boom in infrastructure lending, which forms a disproportionately large share of our loan market compared to Europe or the USA. Infrastructure lending was generally carried out by Project Finance Teams with the result that Australia has a large pool of Project Finance trained bankers who have brought this approach into the corporate market, particularly for the higher risk credits.

The late 90's also saw the emergence of LBO's in Australia and these drew on US and European precedents to bring their own sets of ratios into common use. Debt/EBITDA is the most obvious example of this, which is increasingly used instead of balance sheet gearing covenants.

As mentioned above, the increasing role of the rating agencies (Standard & Poors as well as Moody's) has led to some of their primarily American precedent ratios appearing in Australian documentation. FFO or Funds From Operations is an S&P definition of cash flow that is increasingly seen in Australian documentation.

In terms of where we are going, the latest round of corporate collapse will, in my opinion, increase the reliance upon cashflow rather than accounting based ratios. In addition, the increasing globalisation of the loan market and the push for greater secondary trading in loans will lead to increasing standardisation of covenants to match European and American norms, particularly the benchmark ratios used by the rating agencies.

