What's a Banking Covenant?

Executive Summary: What are banking covenants? Banking covenants are conditions put upon a borrower by the bank. Although they can be general in nature, they often are quantitative. Some typical covenants are listed here.

What sort of loan? In the construction industry, there's all sorts of loans: line of credit, equipment loan, construction loan, et cetera. These particular loans are given cap amounts. For example, you may have a $500,000 line of credit and a $1,000,000 equipment line of credit. Both of these sorts of loans are given an upper threshold and as you need this money it is peeled away from the core, like an onion, on a case-by-case basis.

This cap amount is, in essence, your loan amount. You may not be drawing upon the entire amount at once, but you have the ability to draw up to this cap amount.

Maintaining the loan. In order to (a) continue to draw upon the loan and to (b) maintain the cap amount of your loan, you as the borrower must continue to satisfy the bank.

Herein lies the purpose of banking covenants. Banking covenants, at least the quantitative covenants, allow a loan officer to quickly determine whether or not you are achieving the minimum financial standards. If you do not meet your covenants and you are not satisfying the bank, they can "call the loan". Calling the loan in whole or in part means paying the loan back.

Sample covenants. There are all sorts of numbers bankers derive from your balance sheet. Three sample covenants follow:

Current Ratio – this is the ratio of current assets to current liabilities. Your current ratio covenant may be, say 1.15. You must maintain a current ratio above 1.15.

Current Assets / Current Liabilities > 1.15 **<< OK!**

Debt to Tangible Net Worth – this is another ratio comparing your total liabilities (debt) to your equity (tangible net worth). Banks vary on what numbers from your balance sheet are included in your debt and tangible net worth, but here in my example it is a simple calculation from your balance sheet and its value could be, say, 2.25:

Total Liabilities / Equity < 2.25 **<< OK!**

In this case, your Debt to Tangible Net Worth cannot exceed 2.25.

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Tangible Net Worth – Lastly, a final covenant may simply be minimum equity. Equity is equal to total assets less total liabilities and for smaller contractors, this could be $1,000,000:

Tangible Net Worth > $1,000,000 **<< OK!**

My story. The covenants above are real. During the course of my business, these were the covenants required of my bank at one time. During the good times in the economy, I was able to meet or exceed these values. It was much harder during the tough times, especially for a fledgling company requiring large capital expenditures such as dozers, excavators, and trucks to execute the work.

The math is simple on covenants, the debt amount must rise in order to execute the work and each time more debt is taken on, the debt to tangible net worth ratio goes the wrong way!

Bonus tip. A good exercise for you is to go to http://finance.yahoo.com/lookup and choose a contractor. Look at one of the United States' most successful contractors: Granite Construction (Symbol: GVA). They're easily in compliance with these covenants!

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