Lease Accounting Standards: effects on bank debt and covenants

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Overview of general bank covenants

Types of covenants

Lease Standards effect on Balance Sheet and Income Statements

Pitfalls and recommendations

Overview of general bank covenants

- Bank will gather financials statements and have an analyst do a spread over time with at least 30 ratios to be calculated.
- Leverage covenants come in three flavors. Cash flow leverage, Balance Sheet leverage, and Debt Leverage.
- Credit folks in banks will generally want to have one balance sheet covenant and one income statement covenant. This will vary depending on size of the bank, size and quality of borrower, and size of loan requests.
- Captive finance offerings are more likely to not have covenant requirements.
- Most debt documents have cross default language. So a default with one institution is default for all debt.

Cash flow Leverage

- Two primary and widely used covenants are Debt Service Coverage Ratio and Fixed Charge Coverage ratio. Difference is the use of Lease payments and possibility maintenance CAPEX in FCCR.
- DSCR formula is EBITDA divided by Prior Year CPLTD plus Interest (or P&I on all debt).
- FCCR includes rents/lease payments in both EBITDA and CPLTD.
- Maintenance CAPEX should be Unfinanced CAPEX or a percentage of Depreciation. This is tough calculation for Trucking companies because of velocity of revenue equipment turnover.
- This is a payment only focused covenant. It is very popular and widely used.

Balance Sheet Leverage

Primary covenant for Balance Sheet is Debt (Total Liabilities) to Net Worth or to Tangible Net Worth.

Very simply – Total Liabilities divided by Net worth or Tangible Net Worth.

Another popular balance sheet covenant is minimum net worth or tangible net worth.

Minimum working capital or current ratio can be used.

Debt Leverage

- Debt Leverage is predominately used for larger companies with multiple provider of debt.
- I prefer it because I can't control other lenders provide long amortizations thus improving the ratio or shorter amortization causing tighter cash flow calculation.
- Funded Debt is term debt only. It does not include the line. Senior Debt is all debt evidenced by a note and in a senior position. Total debt will include subordinated debt.
- Sr. Debt to EBITDA(R) most widely used.

General Standards – Pre-leasing standards

Cash flow: Not less than 1.2X for DSCR. Not less than 1.00 times for FCCR. The higher the better. Some banks will do math no post distribution basis.

Balance Sheet Leverage: Not more than 4X unless there is a compelling story. Many small business and trucking companies have trouble getting to 4X. The lower the better especially if there is substantial intangible to be netted out.

Debt Leverage: Not to exceed 4X. Again this is tough for trucking companies because of the velocity of the recycling of equipment.

New Leasing standards changes the yard sticks.

Lease Standards effect on Balance Sheet and Income Statements

TRUCKING COMPANY, LLC

BALANCE SHEETS

ASSETS

	BEFORE		AFTER	
Current assets:				
Cash and cash equivalents	$ 500,000		$ 500,000	
Accounts receivable - trade	1,000,000		1,000,000	
Prepaid expenses and other current assets	100,000		100,000	
Total current assets	1,600,000		1,600,000	
Property and equipment, net FINANCE LEASES	2,000,000		2,000,000	
Right-of-use assets OPERATING LEASES	-		407,017	
	$ 3,600,000		$ 4,007,017	
LIABILITIES AND STOCKHOLDER'S EQUITY				
Current liabilities:				
Accounts payable - trade	$ 750,000		$ 750,000	
Accrued expenses	200,000		200,000	
Current portion of long-term debt FINANCE LEASES	500,000		500,000	
Current portion of lease obligations OPERATING LEASES	-		67,836	
Total current liabilities	1,450,000		1,517,836	
Long-term debt FINANCE LEASES	1,500,000		1,500,000	
Lease obligations OPERATING LEASES	-		339,181	
Stockholder's equity:				
Common stock	10,000		10,000	
Retained earnings	650,000		650,000	
Total stockholder's equity	660,000	18.28%	660,000	16.43%
	$ 3,610,000		$ 4,017,017	
Debt to Net Worth	4.47		5.09	

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Cash flow leverage

TRUCKING COMPANY, LLC			
COMBINED STATEMENTS OF INCOME			
		FINANCE	OPERATING
Operating revenues		$ 5,000,000	$ 5,000,000
Operating expenses and costs:			
Salaries, wages and benefits		2,000,000	2,000,000
Operating supplies and expenses		1,400,000	1,400,000
Operating taxes and licenses		75,000	75,000
Insurance and claims		200,000	200,000
Communications and utilities		50,000	50,000
Depreciation and amortization	FINANCE LEASES	750,000	700,000
Rent and purchased transportation	OPERATING LEASES	250,000	305,000
		4,725,000	4,730,000
Operating income		275,000	270,000
Other income (expense):			
Interest expense	FINANCE LEASES	(75,000)	(70,000)
Interest income		4,000	4,000
Other, net		500	500
		(70,500)	(65,500)
Net income		$ 204,500	$ 204,500
EBITDA		$ 1,029,500	$ 974,500
	CPLTD	500,000	500,000
	CP Lease	-	67,836
	Interest Expense	75,000	70,000
	Total Debt Service	575,000	637,836
	DSCR	1.79	1.53

Debt Leverage

	Before	After
EBITDA	$ 1,029,500	$ 974,500
CPLTD	$ 500,000	$ 500,000
CP Lease	$ -	$ 67,836
LTD	$ 1,500,000	$ 1,500,000
LT Lease	$ -	$ 339,181
Sr. Debt	$ 2,000,000	$ 2,407,017
Sr Debt to EBITDA	1.94	2.47

Pitfalls

- New lease accounting standards has the effect of implying more leverage (all three) than previously.
- The tolerances for the covenant standards may or may not be understood early in the implementation by decision makers of the lenders.
- Analyst/lenders may decide that the Right-of-Use asset is a fuzzy asset and choose to net it out of net worth to yield Tangible Net Worth.
- New Standard makes comparisons to prior years financial difficult. Most accountants will restate the prior year. Bankers like to see multi-year trends. Multi-year means 3 to 7 years. The more the merrier.
- Some dealers provide full maintenance lease and how does that affect the valuation.
- Changes in long-term interest rates can affect discounted cash flow calculations. Value of the lease is different if rates go up 300 bps??? Similar to pension plans obligations???

Recommendations

- Make sure the banker/lender know and understand any differences.
- Re-state current year financials to the old method for a few years until you can show a trend. Or show them side by side (old and new) for a few years.
- If you have multiple lenders agree to one set of covenants with the same calculation for all. Everyone like what they like, but you need to be responsible for one set of calculations.
- Sr Debt to EBITDA(R) is both balance sheet and income statement oriented. Other lenders cannot affect outcome by going longer or shorter on amortizations. This is a far superior covenant for companies with high need for capital reinvestment like trucking. It is easy to calculate.
- Provide consolidating financials in back of financials with a complete set of footnotes.
- Meet and get to know the decision maker for the lender. This does make a difference.