Loan agreements typically contain three types of covenants:

1. Negative loan covenants (borrower may not . . .)
2. Affirmative loan covenants (borrower promises to . . .)
3. Financial loan covenants (financial metrics tied to a borrower’s revenue, expenses, and debt)

Loan agreements usually provide that the occurrence of a breach of a covenant constitutes an event of default triggering a lender’s right to exercise remedies, increase interest rates, accelerate the due date of payments, and take other actions. Consequently, it is important for borrowers and their counsel to carefully review financial covenants contained in loan documents. Specific care should be taken at the outset of a loan to understand a borrower’s obligation to comply with the standard financial covenants set forth below and how they are defined and calculated.

**Debt Service Coverage Ratio**

The debt service coverage ratio (DSCR) is defined as a borrower’s net operating income divided by total debt service. A DSCR greater than one means there is sufficient cash flow to cover debt service. A DSCR below one indicates there is not enough cash flow to cover debt service. Generally, net operating income is calculated as the difference between a company’s revenue and its operating expenses (excluding interest and income tax). Some lenders use earnings before interest, taxes, depreciation and amortization (EBITDA) as the numerator in the calculation. Total debt service is the total annual payments that are
made on any debt a business has, including loan repayments on principal and interest and lease payments. If a business’s debt service coverage ratio is 1.5, this means a business’s cash flow can cover 150 percent of its yearly debt service payments. Similarly, if a business’s debt service coverage ratio is 0.85, this means that the business can only cover 85 percent of its yearly debt service payments.

**Interest Coverage Ratio**

The interest coverage ratio (ICR) is defined as a borrower’s earnings before interest and taxes (EBIT - total annual revenue less the cost of goods sold and other operating expenses, excluding interest and taxes) divided by a company’s interest expenses on outstanding debt. Some lenders use EBITDA instead of EBIT as the numerator. The ICR is used to determine how easily a company can pay its interest expenses on outstanding debt. The lower the ratio, the more a company is burdened by debt expense.

**Fixed Charge Coverage Ratio**

The fixed charge coverage ratio (FCCR) is defined as earnings before interest and taxes (total annual revenue less the cost of goods sold and other operating expenses, excluding interest and taxes) plus the fixed charge before tax divided by the fixed charge before tax plus interest. Some calculations use EBITDA or earnings before interest, taxes, depreciation, amortization, and rent (EBITDAR) as the numerator, as it provides a better measurement of a company’s cash flow. The FCCR shows how well a company’s revenue can cover its fixed charges—it measures a company’s cash flow. The fixed charge is calculated annually and includes regular business expenses that are paid regardless of business activity such as debt installment payments, lease payments, and insurance premiums. A FCCR equal to one means the company is just able to pay its fixed charges. A FCCR of less than one means that the company lacks enough money to cover its fixed charges.

**Debt to Tangible Net Worth Ratio**

The debt to tangible net worth ratio is a calculation of the net worth of a company, including cash, accounts receivable, inventory, equipment, buildings, real estate and investment, and excluding any value derived from intangible assets such as patents, trademarks, copyrights, and other intellectual property, divided by total liabilities of the company. One benefit of the tangible net worth calculation is that it is simpler to calculate than a total net worth calculation, as it is easier to place an accurate value on physical assets than it is to evaluate intangible assets such as customer goodwill or intellectual property. One drawback of the tangible net worth calculation is that it may fall substantially short as a representation of actual net worth in cases where a company has intangible assets of considerable value.

**Minimum EBITDA**

A minimum EBITDA covenant is typically measured quarterly on a trailing twelve month basis. It measures a company’s EBITDA against certain minimum requirements set forth by the lender.

**Conclusion**

Understanding the scope of financial covenants and how they are calculated and defined is essential to a company’s ability to comply with each of their specific requirements. A business must have a short-term and long-term understanding of its financial strengths and weaknesses. A borrower should take the time to assess its ability to comply with requested financial covenants at the outset of the loan negotiation process.