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### Do Financial Covenants Have a Place in Equipment Finance?

*By James M. Johnson, PhD, and Barry S. Marks*

Financial covenants are promises by a borrower or lessee to achieve or maintain specific financial targets, often expressed as ratios, such as net worth or total debt levels, or cash flow debt coverage ratios. A survey of banks, independents, and middle-market companies examines whether, in the wake of the Great Recession, financial covenants have become commonplace in equipment finance documentation.

### A Cape Town Protocol for Marine Assets: What Can We Agree on Right Now?

*By Michael Kim*

The Cape Town Convention on International Interests in Mobile Equipment has served financiers of aircraft and their counsels very well. Such is not the case, however, with the ship finance industry. This article examines past attempts to develop a marine protocol, addresses whether cross border maritime issues are too difficult to fix, and proposes steps and guidelines for tailoring a workable protocol. Momentum may build once an initial set of principles is agreed upon.

### M&A Has Rapidly Changed the Canadian Commercial Equipment Finance Marketplace

*By Hugh Swandel*

Since the global crisis of 2008, consolidation and change have redefined the major players in the Canadian leasing industry. As with other types of financial services, the leasing industry was trying to understand a situation few had predicted and none could navigate with certainty. Banks and credit unions have gained market share at the expense of independent and foreign lessors. This article explains how those changes occurred and what they may portend.

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# Do Financial Covenants Have a Place in Equipment Finance?

By James M. Johnson, PhD, and Barry S. Marks

Financial covenants are promises by a borrower or lessee to achieve or maintain specific financial targets, often expressed as ratios, such as net worth or total debt levels, or cash flow debt coverage ratios. A survey of banks, independents, and middle-market companies examines whether, in the wake of the Great Recession, financial covenants have become commonplace in equipment finance documentation.

Financial covenants are promises by a borrower or lessee to achieve or maintain specific financial targets, often expressed as ratios such as net worth or total debt levels, or cash flow debt coverage ratios. In 2010, the authors published an article in this journal titled "Financial Covenants: Why They Are Coming Soon to a Lease Near You" (Vol. 28, No. 1, Winter 2010). The article indicated that the addition of financial covenants to equipment lease contracts seemed to be on the rise. One explanation was that credit officers were beginning to wonder why a borrower in a traditional loan arrangement was required to meet financial requirements while a lessee or borrower in an equipment finance transaction was not.

The information on the use of such covenants was anecdotal. The lead paragraph in that article stated:

> The recent economic downturn has shined a light on several weaknesses in equipment lease documentation. One of the most notable has been the lack of a lessor's ability to take action before an actual rent or other "monetary" default occurs. Many lessors have watched helplessly while lessees circle the economic drain, experiencing deteriorating financial conditions that will inevitably lead to bankruptcy.

Our inquiry was into whether financial covenants, which showed signs at least in anecdotal evidence of becoming more popular immediately after the 2008–2009 Great Recession, would become commonplace in equipment finance documentation in the years that followed.

The purpose of this article is to report the results of a survey to determine the extent to which financial covenants are used in equipment leasing contracts. Is their use on the rise? Are they commonplace now? Were they a passing fad? This survey is designed to shed light on their use or lack of use, and the reasons at play in either case.

## THE SURVEY

In summer 2016, a survey on the use of financial covenants was developed by the authors, and feedback was obtained from selected members of the leasing industry. To ensure a higher response rate, the survey was limited to 12 specific questions, plus one open-ended question at the end for respondents to add comments, if any.

With the assistance of the Equipment Leasing and Finance Association, approximately 350 survey links were sent to a cross section of ELFA members (bank lessors, independents, small ticket, and the like). A follow-up survey reminder was sent two weeks later. In addition, the authors sent the link to their leasing industry contacts. The result was a total of 87 responses. Table 1 shows the breakdown of respondents by type of organization.

Question 1 (as noted in Table 1) asked the respondent to check all boxes that apply. Thus, the numbers do not total 87 (the total number of responses), and the percentages do not total 100. For example, for bank lessors — 33 respondents in all — 4 also checked small ticket, 13 checked middle market, and 6 checked large ticket. The responses across all organization types are seen to be quite uneven.

**Table 1.** "Please check the boxes that best describe the majority of your business."

| Organization | Number | Percent |
|---|---|---|
| Bank | 33 | 38 |
| Captive | 10 | 11 |
| Independent | 32 | 37 |
| Small ticket | 18 | 21 |
| Middle market | 24 | 28 |
| Large ticket | 7 | 8 |
| Law firm | 5 | 6 |
| Other service provider | 2 | 2 |

Banks are heavily involved in loan products, and it would seem more logical for them to be comfortable with similar covenants in their leasing contracts.

We question the interpretative value of categories where respondents are few in number. It is doubtful, for example, that the opinions expressed by five law firms speak for law firms involved in equipment leasing in general. Our cutoff is admittedly arbitrary, but we decided to report on only the three largest groups: bank lessors (33), independents (32), and middle market (24). However, in the interest of completeness, we report an "all" respondents category, which includes everyone who responded.

Not all respondents answered every question. In the interest of full disclosure, the percentage of banks, independents, middle market, and "all" respondents is show in the appendix. When reading through this article, note that the questions that were answered by the majority of respondents are more credible than questions eliciting fewer responses.

The questions eliciting the fewest percentage of responses are questions 3, 4, 5, and 9. All other questions had response rates over 90%. Thus, the interpretation of answers for these four questions is less representative than for the other eight questions. For ease of navigation, we put the percentage responding in parentheses under the firm type in each table.

## QUESTION 2: STATUS OF USING FINANCIAL COVENANTS

The difference in the use of financial covenants varies substantially among bank and independent lessors. Fully three-quarters of independents do not employ financial covenants, and only 16% have increased their use over the past few years. By contrast, only 38% of bank lessors do not use financial covenants, and 47% have increased their use. The results for middle market are about halfway between banks and independents. The reader is reminded that middle market is not a mutually exclusive category, as a number of banks and independents checked the middle-market category as well.

The heavier use of financial covenants by banks supports the anecdotal evidence the authors had observed six years ago. Banks are heavily involved in loan products, and it would seem more logical for them to be comfortable with similar covenants in their leasing contracts.

Almost 60% of all respondents indicated they do not use financial covenants. However, fully 30% indicate they have increased the use of financial covenants in recent years.

## QUESTION 3: WHY FINANCIAL COVENANTS ARE NOT USED

The most important reason checked by bank lessors for *not* using financial covenants is "adverse effect on sales." The banks also indicated their second most important reason was their having other mechanisms for achieving the same goal. Adverse effect on sales represented approximately a quarter of the responses for all three groups. However, the most significant reason for

**Table 2.** "Describe the use of financial covenants in your contracts." (percentages reported)

| Possible response | Bank (97) | Independent (100) | Middle Market (96) | All (93) |
|---|---|---|---|---|
| We do not have financial covenants in our contracts. | 38 | 75 | 52 | 58 |
| We have started using financial covenants recently. | 6 | 3 | 4 | 5 |
| We have increased the use of financial covenants over the past few years. | 47 | 16 | 26 | 30 |
| We are currently reviewing and considering adding financial covenants. | 9 | 6 | 17 | 7 |

independents is "never gave it much thought." For middle-market players, almost half either indicated "never gave it much thought" or "adverse effect on sales."

Surprising (to the authors) was the token response to enforcement. Conversations with individual lessors suggested this could be an enforcement or monitoring nightmare, but the survey evidence indicates it is not seen as a significant reason for not incorporating financial covenants.

The "all" respondents category indicated the more important reason for not using financial covenants is an expected adverse effect on sales. This was followed closely by the belief that they would be too cumbersome to enforce.

The "other" response category drew 18 responses. The most frequent responses given in this open-ended narrative form were as follows. Eight said they rarely used financial covenants but will on a case-by-case basis and usually based on credit and size of transaction. Five respondents indicated they did not use financial covenants either because it would not work for their kind of business or because they dealt with high-quality credits. The other five responses were scattered over several reasons.

## QUESTION 4: WHY FINANCIAL COVENANTS ARE USED

Why are financial covenants used? Question 4 asked, If you *do* employ financial covenants, what is the main reason? Here, wanting consistency between lease and loan contracts was either the most important reason for employing them or was tied for the most important reason. Tied for first among independents was the response that they are experimenting with them.

The authors had theorized that pressure from affiliates or concern over defaults would have been of paramount importance, but they were not. Between 11% (independents) and 27% (middle market) gave credit issues as a reason for including financial covenants. This is significant but not nearly as significant as many would have believed. The "other" category was checked by 18% (middle market) to 44% (independents).

The "all" respondents category indicated the two most important reasons for using financial covenants are consistency of requirements (between leases and loans) and concern over credit issues. These reasons appear mostly aligned with bank lessors.

The "other" category for this question generated 12 responses. Two-thirds of these respondents indicated the use of financial covenants was on a case-by-case basis and usually for high-risk or high-exposure deals. Three indicated the question was not applicable to their business.

**Table 3.** "If your company does *not* incorporate financial covenants into your contracts, which of the following best describes your position?"

| Possible response | Bank (55) | Independent (84) | Middle Market (71) | All (66) |
|---|---|---|---|---|
| Never gave it much thought | 11 | 30 | 24 | 18 |
| Not a priority for us | 11 | 22 | 12 | 19 |
| Adverse effect on sales | 22 | 22 | 24 | 26 |
| We considered it, but decided it would be too cumbersome to enforce | 6 | 15 | 18 | 24 |
| We have other mechanisms for achieving the same goal | 17 | 11 | 6 | 11 |
| Other | 39 | 26 | 41 | 32 |

**Table 4.** "If your company *does* employ financial covenants, which of the following best describes your position?"

| Possible response | Bank (67) | Independent (28) | Middle Market (46) | All (47) |
|---|---|---|---|---|
| We want consistency of requirements between our loan and lease contracts. | 27 | 22 | 45 | 24 |
| Our parent or affiliate insisted. | 18 | 11 | 18 | 12 |
| We became concerned with credit issues or had a bad result in a default in recent years. | 18 | 11 | 27 | 24 |
| We felt our lease contracts were not strong enough without them to protect our interests. | 9 | 11 | 0 | 10 |
| We are experimenting with them to see if it makes a difference. | 18 | 22 | 9 | 17 |
| Other | 23 | 44 | 18 | 29 |

Our survey results are consistent with Demerjian's findings, as cash flow and debt coverage ratios are generally more important than balance sheet ratios.

## QUESTION 5: TYPES OF FINANCIAL COVENANTS USED

Debt coverage ratios are by far the most important financial covenant to both banks and middle market. (Remember, we may be double-counting due to some companies checking both bank and middle market as their type of company.) Independents marked cash flow ratios as most important, but also half of them checked debt coverage ratios as well. Minimum net worth and debt ratios were significant, but both are static, representing what a company has or owes. It is significant that cash flow and debt coverage ratios were given high marks, and they may both be described as "ability to pay" variables.

This is consistent with a study of loan covenants by Demerjian (Peter R.W. Demerjian, "Financial Ratios and Credit Risk: The Selection of Financial Ratio Covenants in Debt Contracts," working paper, University of Michigan, Ann Arbor, January 2007). In his analysis of thousands of loan contracts, Demerjian found "ability to pay" ratios to be used most often in loan contracts, followed by three static balance sheet line items or ratios. One ability to pay ratio was "debt to cash flow," which uses one line item from the balance sheet and one line item from the income statement or statement of cash flows. Our survey results are consistent with Demerjian's findings, as cash flow and debt coverage ratios are generally more important than balance sheet ratios.

Eight answered "other." Three indicated the answer was none, or the question was not applicable to their business. The other five indicated they used one or more of the following: liquidity, net worth, debt coverage, fixed-charge coverage, and loan-to-value ratios. (Most of these ratios or levels are included in the survey question, but five respondents chose to provide their own answer anyway.)

## QUESTION 6: IMPRESSION OF THE USAGE OF FINANCIAL COVENANTS

This high-response-rate question indicated, overwhelmingly, that bank lessors, independents, and middle-market companies believe financial covenants are present in only a relatively small number of cases (50% to 70% of respondents). Only a relatively small number of respondents in each category felt these covenants are becoming more widespread (12% to 19%). This suggests that the respondents generally believe the level of use of financial covenants has plateaued and is relevant only in a "small number of cases."

The "all" respondents category chose, by far, the response that it is present in only a small number of cases. This is consistent with the other three groups presented in this study.

**Table 5.** "What type of financial covenants do you include in your contracts generally?" (Check all that apply.)

| Possible response | Bank (73) | Independent (25) | Middle Market (50) | All (49) |
|---|---|---|---|---|
| Minimum net worth, total assets, or similar tests | 21 | 38 | 50 | 30 |
| Total debt, debt to equity, or similar tests | 42 | 38 | 33 | 40 |
| Cash flow ratios | 33 | 88 | 50 | 42 |
| Debt coverage ratios | 79 | 50 | 92 | 70 |
| Other | 21 | 13 | 8 | 19 |

**Table 6.** "What is your impression of the leasing industry's use of financial covenants in leasing contracts?"

| Possible response | Bank (100) | Independent (100) | Middle Market (100) | All (98) |
|---|---|---|---|---|
| No idea what the trend is | 15 | 31 | 21 | 27 |
| Believe it is becoming more widespread in leasing contracts | 12 | 19 | 17 | 14 |
| Believe it is present in only a relatively small number of cases | 70 | 50 | 54 | 56 |
| Believe it is a fad, and usage is declining as lessors remove financial covenants | 3 | 0 | 8 | 2 |

## QUESTION 7: TRAINING

The results of this high-response-rate question were quite interesting. Bank lessors indicate some training. Independents checked no training in 58% of responses. Similarly, middle-market companies indicated no training in 38% of responses. Some small amount of training was checked by 33% of middle-market companies. In no case is training widespread.

We must interpret these results with some caution. Arguably, training is not essential if personnel are already knowledgeable. And would be more important if it were a skill set most personnel lacked. Bank lessors indicated significant training or widespread training in 36% of respondents, while independents and middle-market companies checked those boxes in only 12% and 30% of all cases, respectively. To summarize, independents indicated no training 58% of the time. No training fell to only 38% and 24% of respondents in the case of middle-market and bank lessors, respectively. Training to a small degree was 39% for banks, and 29% to 33% for independents and middle market companies, respectively.

The "all" respondents category responses align most closely with middle-market responses. "No training" and "yes, but to a small degree" were the most common responses.

## QUESTION 8: SHOULD FINANCIAL COVENANTS BE REQUIRED?

The "no" response was virtually the same for all three categories at 12% to 13%. Independents marked "no, we should distinguish ourselves from lenders" in 17% of responses, while bank and middle-market companies thought this was essentially a nonissue. By far the prevalent response for all three categories was "sometimes, for weak credits or weak collateral only." This was the response in 43% to 67% of all respondents. The bottom line is that financial covenants should be required when credits or collateral are weak.

The "all" category most closely aligns with independents and middle-market companies. As with those two groups, the one major response was to use financial covenants sometimes, for weak credit or weak collateral deals.

Question 8 drew 11 "other" responses. The one response gathering the most comments was that it would be all right for larger exposure transactions but not for smaller ticket. Two-thirds responded along these lines. The other four responses were scattered.

## QUESTION 9: WHAT DRIVES USE OF FINANCIAL COVENANTS?

The response to "what is the driving force" behind the use of financial covenants is overwhelmingly attributable to mitigating risk. Other responses pale in comparison. Lawyers received a pass entirely for being the force behind the use of financial covenants. Pressure

> The response to "what is the driving force" behind the use of financial covenants is overwhelmingly attributable to mitigating risk. Other responses pale in comparison.

**Table 7.** "Do you train credit, operations, legal and/or others in your firm in the meaning and significance of financial covenants?"

| Possible response | Bank (100) | Independent (97) | Middle Market (100) | All (95) |
|---|---|---|---|---|
| No, no training | 24 | 58 | 38 | 40 |
| Yes, to a small degree | 39 | 29 | 33 | 37 |
| Yes, to a significant degree | 27 | 6 | 17 | 17 |
| Yes, training is widespread | 9 | 6 | 13 | 6 |

**Table 8.** "Should equipment lease contracts include financial covenants?"

| Possible response | Bank (100) | Independent (94) | Middle Market (100) | All (94) |
|---|---|---|---|---|
| No, it is not part of our industry. | 12 | 13 | 13 | 16 |
| No, we should distinguish ourselves from traditional lenders. | 3 | 17 | 8 | 7 |
| Sometimes, for weak credits or weak collateral only. | 67 | 43 | 67 | 54 |
| Yes, it provides a significant benefit. | 18 | 10 | 17 | 15 |
| Yes, we are no different from other lenders. | 3 | 3 | 0 | 2 |
| Other | 3 | 23 | 4 | 15 |

if covenants are not monitored for compliance on a regular basis, the lessor may have that right waived if litigation ensues.

from regulators was given as the driving force in only about 20% of responses from each category.

It is also logical that independents would select "pressure from funding sources" significantly more than banks or middle-market firms, since they are much more dependent upon outside financing. However, we must also note this is a relatively low response rate question, eliciting responses from 82% of the bank respondents, 67% from middle market, and a very low 31% of independents.

The "all" category appears most closely related to middle-market companies. By far the most important use of financial covenants for the "all" group is management's attempt to mitigate risk. This is very close to the middle-market group: middle-market companies gave this reason 81% compared to a close 76% for "all."

## QUESTION 10: SPRINGING COVENANTS

This question was answered by virtually all bank, independent, and middle-market respondents. For each of our questions that would not apply if the respondent does not use financial covenants, the respondent can select "we do not use financial covenants." Springing covenants are covenants that would be activated only if a base covenant is violated. A very small proportion of lessors in any of the three categories reported having springing covenants. Such "second-level" covenants are used by only 7% of responding independents and 16% to 17% of bank and middle-market lessors.

The "all" group gave responses similar to the other three groups. Only 14% have additional covenants that come into play if a base covenant is violated, which is virtually the same as bank and middle-market companies. We conclude that springing covenants are not an issue to most lessors.

## QUESTION 11: MONITORING

How are covenants monitored? That is the focus of question 11, summarized in responses in Table 11. A large percentage of lessors once again indicated they do not employ financial covenants. The second and third choices we offered lessors were (1) we monitor riskier credits and (2) we monitor all lessees.

Logically, one might think covenant monitoring would be more prevalent with riskier credits, but to an overwhelming extent the responses for bank and middle-market lessors rated all contract monitoring as the case. That independents did not rate "all contracts" monitoring as more prevalent may be simply due to not employing financial covenants much to begin with. However, if covenants are not monitored for compliance on a regular basis, the lessor may have that right waived if litigation ensues.

All respondents marked periodic monitoring for riskier lessees with the same frequency as virtually all three other categories. It is interesting to note that "all" was much less inclined to monitor financial covenants for all contracts — with only half the frequency of bank and middle-market lessors.

**Table 9.** "What is the driving force behind using financial covenants in your organization?" (Select all that apply.)

| Possible response | Bank (82) | Independent (31) | Middle Market (67) | All (53) |
|---|---|---|---|---|
| Pressure or requirements of regulators | 19 | 20 | 19 | 17 |
| Management being pressured by their lawyers | 0 | 0 | 0 | 2 |
| Management in an attempt to mitigate risk | 89 | 60 | 81 | 76 |
| Pressure from funding sources | 4 | 20 | 13 | 13 |

**Table 10.** "Do your contracts contain 'springing' covenants? (that is, covenants that are triggered only if a base contract covenant is tripped)"

| Possible response | Bank (97) | Independent (91) | Middle Market (96) | All (90) |
|---|---|---|---|---|
| No, we do not use financial covenants. | 34 | 79 | 52 | 55 |
| No, we use financial covenants but do not have a second layer that comes into play if a base covenant is violated. | 50 | 14 | 30 | 31 |
| Yes, we have additional covenants that come into play if a base covenant is violated. | 16 | 7 | 17 | 14 |

## QUESTION 12: COVENANT BREACHES

Banks have a case-by-case basis policy of curing breaches, more so than their other responses and much more so than independents and middle-market organizations. Independents are less likely to "work with their customer" (3%) than they are to inform the customer of a breach and indicate the time to cure. Banks and middle-market firms are more likely to work with a customer, and more likely to inform a customer of a breach than independents.

Handling breaches of financial covenants on a case-by-case basis was the most important to the "all" category, which mirrored the middle-market category most closely. The other two explanations were checked by "all," banks, and independents with similar frequency.

## QUESTION 13: SOLICITED OPEN-ENDED RESPONSES

"Please tell us, in your own words, anything additional you would like to add to this conversation on financial covenants."

This was the only completely open-ended question asked in this survey. Twenty-four responded, but two had nothing to add. The following commentary attempts to develop a composite of the 22 usable comments. Those that use covenants (10) do so for large-ticket and significant credit-risk customers. Covenants were not deemed useful or too burdensome for small to middle-market deals. The six that do not use financial covenants said they have other tools such as scorecards or risk predictive tools.

A general belief is that financial covenants are for banks or larger ticket deals, or to use when credit risk is a concern.

**Table 11.** "How do you monitor financial covenants?"

| Possible response | Bank (97) | Independent (97) | Middle Market (96) | All (92) |
|---|---|---|---|---|
| We do not use financial covenants. | 28 | 81 | 43 | 55 |
| We periodically monitor financial covenant compliance for our riskier lessees. | 16 | 13 | 13 | 18 |
| We periodically monitor financial covenant compliance for all our contracts. | 56 | 6 | 44 | 28 |

**Table 12.** "How do you handle the breach of a financial covenant?"

| Possible response | Bank (97) | Independent (94) | Middle Market (96) | All (92) |
|---|---|---|---|---|
| We do not use financial covenants. | 25 | 80 | 43 | 50 |
| We bring a breach to the attention of our customer and try to work them back into compliance. | 16 | 3 | 17 | 10 |
| We inform a client they have breached a financial covenant and indicate they have a specified period to cure the breach. | 19 | 10 | 21 | 14 |
| We handle breaches on a case-by-case basis — no set procedure. | 41 | 7 | 17 | 26 |

## SUMMARY AND CONCLUSIONS

Based on the survey, a few general observations appear justified:

1. Independents, by far, use financial covenants the least. (75% do not.)
2. There is no single, commonly cited reason for not using financial covenants in lease contracts. The most common reasons given by bank lessors were adverse effect on sales and having other mechanisms for achieving the same goal. Independents and middle-market companies indicated adverse effect on sales and "never gave it much thought."
3. When financial covenants are employed, banks, independents, and middle-market companies all indicated consistency between lease and loan products as the main reason for employing them.
4. Specific financial covenants used most often are debt coverage, cash flow, and debt ratios. While cash flow ratios are much more important to independents, debt coverage is more important to banks and middle-market companies.
5. The overwhelming response by all three company types is that financial covenants are not frequently utilized and included in lease contracts.
6. Training in the use of financial covenants is not widespread, but it is higher for banks than independents.
7. As to whether leasing contracts should include financial covenants, the largest response was that they should be used sometimes, and for weak credits or deals with weak collateral.
8. Most frequently, financial covenants are used "in an attempt to mitigate risk."

9. Very few respondents used "springing covenants," which are covenants activated by breaching a base level covenant.
10. Banks and middle-market leasing companies are much more likely to monitor covenant compliance than independents. Covenant breaches are handled on a case-by-case basis in the case of banks, and informing the customer they have breached in the case of independents and middle-market companies.

Where does this leave us? The consensus is that — contrary to the anecdotal evidence shortly after the 2008–2009 market turmoil — lessors have not embraced the use of financial covenants. As may be expected, these loan-type provisions are more likely to be used by banks than independents, in larger transactions and for weaker credits and weak collateral deals.

It appears that, after a brief flurry of activity, equipment finance has returned to the old rubric that equipment finance focuses on the equipment collateral, rather than on the credit criteria employed by traditional lenders.

**APPENDIX.** Percentage of Respondents Answering Each Question

| Question | Bank | Independent | Middle Market | All |
|---|---|---|---|---|
| 1 | 100% | 100% | 100% | 100% |
| 2 | 97 | 100 | 96 | 93 |
| 3 | 55 | 84 | 71 | 66 |
| 4 | 67 | 28 | 46 | 47 |
| 5 | 73 | 25 | 50 | 49 |
| 6 | 100 | 100 | 100 | 98 |
| 7 | 100 | 97 | 100 | 95 |
| 8 | 100 | 94 | 100 | 94 |
| 9 | 82 | 31 | 67 | 53 |
| 10 | 97 | 91 | 96 | 90 |
| 11 | 97 | 97 | 96 | 92 |
| 12 | 97 | 94 | 96 | 92 |

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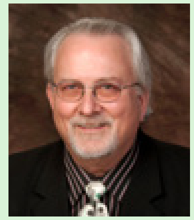

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