The Hidden Loan Covenants of a “No-Covenant” Deal

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Introduction

Successful venture-backed technology businesses face trade-offs in deciding how to finance their continued growth. Equity capital is highly flexible but may dilute current owners. Bank credit facilities are non-dilutive but typically contain loan covenants to help lenders keep track of a borrower's financial solvency. This paper will explore nuances among covenants and explain why some "no-covenant" deals are more complicated than their initial term sheets appear.

It is important to distinguish between the different types of covenants. Flexible covenants serve as a way to promote financial discipline within a portfolio company. By contrast, restrictive covenants require rigorous oversight and can severely limit a company's freedom to invest in growth initiatives.

Banks that cater to software and technology companies have become more competitive by pitching "no-covenant" credit facilities, but borrowers must beware. Although "no-covenant" deals may sound appealing, these loans may often include terms in their credit agreements that can be just as restrictive as financial covenants. We think of them as "hidden covenants" because they rarely appear on the initial term sheet. Below we discuss three types of "hidden covenants" we believe software companies should look out for: liquidity requirements, repayment terms and technical defaults.

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Liquidity Requirements

In our experience, bank credit agreements typically contain covenants that require the borrower to maintain a specified level of cash and/or other liquid assets. The first two examples, below, are commonly found in term sheets, but the third is often only found in the final credit agreement:

- **Minimum Cash.**
  This simple, straightforward covenant requires the borrower to maintain at least a specific amount of cash on hand at all times.

- **Current Asset Ratio.**
  This covenant requires the borrower to maintain current assets at least equal to a stated multiple of the company's debt; in our experience, typically 1.00x to 1.25x. For example, if a borrower had $10MM of debt outstanding, it would typically need to maintain $10MM to $12.5MM of current assets (e.g., cash, qualified accounts receivable).

- **No Going-Concern Opinion.**
  This covenant requires the borrower to obtain an annual audit without a going-concern opinion.[1] Generally, an auditor may be inclined to issue a going-concern opinion if the company does not have at least a year's worth of liquidity available. We view this as a "back door" liquidity covenant.

A growing technology business may find that the liquidity requirements in its credit agreement limit its flexibility in using loan proceeds to make growth investments. In other words, a company could end up having to retain borrowed funds on its balance sheet to satisfy covenant requirements, effectively "borrowing your own cash."

1. A going-concern opinion is an audit opinion letter in which the auditor expresses substantial doubt about the company's ability to operate as a going concern. (i.e., satisfy its financial obligations as they become due) for a reasonable period of time (typically at least 12 months from the date of the financial statements).

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Repayment Terms

The repayment terms of a bank credit facility can be restrictive, even in a "no-covenant" deal. We view certain structural features of a credit agreement as similar to financial covenants in that they give the lender a mechanism to constrain borrower behavior. Examples include:

- **Maturity.**
  In our experience, for growth stage companies, the term for a Monthly Recurring Revenue ("MRR") revolver is typically 12-24 months—shorter than the three-year to five-year terms we typically see on traditional commercial revolvers. The shorter tenor can make it more difficult for the borrower to use MRR proceeds to achieve their business goals. We think of it like an asset-liability mismatch: the possibility that the MRR facility may not be renewed after one or two years, or may only be renewable on onerous terms, makes it risky to use MRR proceeds to make long-term growth investments. The irony is that these may be the types of investments that create the most value for the company and its shareholders.

- **Interest-Only Period.**
  Banks typically offer term loans with short interest-only periods—in some cases as short as 6-12 months—after which the borrower has to begin repaying principal. This, too, can limit the borrower's ability to use term loan proceeds to make growth investments. And it can introduce the risk that principal repayments come due at an inopportune time for the business.

- **Step-Downs in Borrowing Base Calculations.**
  The formula for determining availability of funds under an MRR revolver may change over the life of the deal. We have seen credit agreements structured to reduce availability in the final months before maturity—for example, by calculating the borrowing base initially based on trailing five month recurring revenues, but stepping down to four months and then three months as the revolver approaches maturity. This can have the effect of accelerating principal repayment and increasing the borrower's vulnerability to short-term fluctuations in performance.

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In our view, terms like the ones described above allow bank lenders to keep their borrowers on a short leash. They can give lenders leverage to pressure borrowers to curtail their growth investments or raise additional equity in order to avoid a costly—and potentially fatal—restructuring. "Cheap" bank debt becomes very expensive when a borrower is forced to raise more equity, as many loan restructurings require.

Technical Defaults

Missing an interest or principal payment is an event of default under a credit agreement. Failing to submit timely financial statements may also be an event of default. Although the former may appear more serious, the law does not see it that way—a "technical default" is still a default. We believe companies should bear in mind that, although some events of default may seem innocuous, lenders can still use them to extract fees or tighten terms.

Conclusion

For growing technology companies, it is critical that your partnerships not only align with business interest but actually foster conditions for growth. Credit agreements can contain a variety of terms that limit a borrower's freedom to pursue its growth strategy. We believe technology businesses that are thinking about taking out a bank loan should pay close attention to the non-obvious restrictions—the "hidden covenants"—in the fine print.

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