A Lender's Guide to Breach of Covenant Solutions

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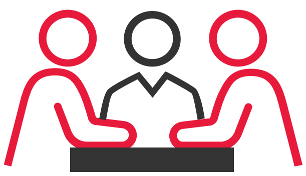
Covenant breaches can be costly to lenders in more ways than one. They often consume significant time and resources. Engaging a third-party advisor before a breach of covenant occurs, however, can help lenders save time and money. There is a range of options lenders may pursue to protect the value of their investment post-breach, but they may also need to act swiftly and efficiently even before the borrower trips the covenant. In this situation, a third-party advisor can provide strategic counsel on the way forward.

But how do lenders choose the right third-party advisor? What should they look for in a firm? There are several factors that lenders should consider when assessing which advisor may be best suited for their unique circumstances.

Key Considerations When Assessing Third-Party Advisors

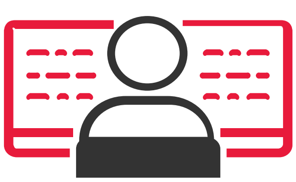


SEEK ADVISORS WITH INDUSTRY KNOWLEDGE

A lender should look for an advisor with vast industry-specific knowledge and experience with similar covenant breach cases. The ideal advisors should not only have a deep understanding of the mechanics of lending, but also experience managing the specific metrics of the borrower's industry to effectuate a speedy resolution.

ALIGN ON PREFERRED WORKSTYLE

Covenant breaches can happen to any size business, in any industry, so there is no "one size fits all" approach. A lender may opt for solutions based on the borrower and working history, which may also impact potential options laid forth by an engaged advisor. There may be nonfinancial factors that affect how business is conducted — for example, family-owned operations function differently than multinational enterprises (MNEs). Accordingly, different covenant violations will require different approaches. Consulting widely to find a third-party advisor with a nuanced understanding of industry practices and strong interpersonal skills is essential.



REVIEW THEIR TRACK RECORD

A lender should also consider an advisor's track record with previous clients. For example, has the advisor helped other lenders recoup all or part of their loans? Did they secure penalty fees? Lenders should review quantifiable results from multiple advisors before deciding on a third-party firm.

How Third-Party Advisors Can Help Resolve Covenant Issues

From the outset, lenders need to clearly communicate their desired outcome for the breached covenant with a third-party advisor, should a violation be imminent. The advisor should then be able to provide guidance on realistic timelines and returns, establishing a clear and mutual understanding of how an advisor can and cannot help the lender.

There are various tactics third-party advisors deploy to help lenders before, during, and after a breach of covenant:

Analytics and Advanced Modeling Tools for Risk Management

A third-party advisor can provide advanced analyses of industry-specific KPIs and operating metrics to help determine the cause of a breach of covenant. For example, an advisor may conduct a 13-Week Cash Flow Forecast to model the borrower's short-term financial performance. An advisor might also examine a borrower's accounts to ensure accurate reconciliation of incoming invoices and outgoing expenditures. The aim is to provide an accurate overview of the state of affairs that have already led to or could lead to a breach, and realistic recommendations on how the borrower can begin to course correct.

Status Assessments

Sometimes, a lender may see early warning signs of financial distress that suggest a borrower is at risk of a breach. In these instances, it may be in the lender's best interest to include a third-party advisor to examine a borrower's operating performance as a precaution. If a lender lacks in-house experience navigating breach of covenant, external advisory services can help bridge the knowledge gap. With accurate information of operating performance in hand, lenders can open the lines of communication with their borrowers sooner to look for solutions and potentially avoid breaching the covenant.

Restructuring Initiatives

If a breach of covenant has occurred, an advisor can help the borrower navigate cost-cutting decisions. Solutions may include reducing headcount, eliminating underperforming or expensive product lines, or renegotiating contracts with suppliers and vendors. In some cases, reducing these expenditures can open the necessary cash flow to meet the terms of the covenant.

Restructuring Alternatives

One of the main ways a third-party advisor often helps is through restructuring alternatives and navigating these options with the lender. Advisors may suggest extending lender rights under the covenant agreement to exert more financial control of the borrower's company. In some cases, it may be beneficial to replace the board of directors or install a Chief Restructuring Officer. When a covenant breach has occurred, an advisor may recommend selling the borrower's debt exposure option, though sometimes, the best position for the lender is to pursue bankruptcy proceedings.

Loan Workout Strategies

A third-party advisor may suggest developing a loan workout strategy as an alternative to restructuring. As part of this agreement, the lender may consider waiving penalties for past defaults in exchange for new rates and/or covenants through **an amended credit agreement** so that the borrower can continue business operations while meeting a new, mutually agreed-upon payment schedule and other established criterion.

Recovery Strategies

Third-party advisors can also develop recovery strategies to help recoup potential losses without the borrower taking any action to restructure their business. For example, an advisor may examine a borrower's precedent transactions to forecast their potential recovery. From there, they can evaluate how much capital a lender might expect to recoup. An advisor may then recommend the lender to sell its debt position — either quietly, likely incurring a loss, or publicly, announcing an intention to sell and gauging market interest. This shift can create added pressure for the borrower, encouraging them to improve their performance faster.

Another possible recovery strategy is equity financing. The advisor may approach capital providers, such as private equity firms or traditional banks in search of a new equity investment, to remedy the borrower's financial standing.

Leading the Way Forward for Lenders

In a breach scenario, lenders are looking to protect their investment and begin the process of mitigating losses without delay. BDO's experienced professionals can help lenders carefully navigate a covenant violation and work swiftly toward a desired resolution based on what would be most sensible for the lender's specific circumstance.

In today's uncertain economic landscape, it is critical that lenders can uphold a resilient posture and remedy issues, such as covenant violations, that may impact their larger investment portfolio. By working with a third-party firm like BDO, lenders can better mitigate the negative impacts of breaches and focus on value-add tasks ahead.

CONTACT BDO TO LEARN MORE ABOUT HOW AN ADVISOR CAN HELP YOUR ORGANIZATION NAVIGATE A BREACH OF COVENANT.

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