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Managing Debt Covenants and Financial Ratios in a Challenging Environment

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Speakers

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Session CPE Requirements

You need to attend 50 minutes to receive the full 1 CPE credit.

There will be 4 polling questions throughout the presentation. You must respond to a minimum of 3 to receive the full 1 CPE credit.

Both requirements must be met to receive CPE credit

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Learning Objectives

1

Identify key strategies for structuring and management of financial covenants for loans and debt obligations

2

Recall the ramifications of missing a financial covenant and potential solutions or remedies

3

Recognize the impact of debt financing on the financial responsibility composite score and identify recommended practices for planning new debt financing initiatives

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State of Higher Education

Federal funding cuts and policy shift

Enrollment challenges

Budgetary constraints

Pressure to have the best facilities

Rising costs and debt burden

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Polling Question

What type of debt do you have outstanding?

- Public bonds
- Private (direct purchase, bank loan, etc.)
- Both
- None at this time – N/A

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Common Financial Debt Covenants

Debt service coverage ratio

- Ability to generate cash flow to cover annual debt service

Liquidity ratios

- Minimum days cash on hand, unrestricted reserves, current ratio

Leverage ratios

- Limits proportion of debt relative to total capitalization or net assets

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Common Nonfinancial Debt Covenants

- Reporting and disclosure requirements
- Maintenance of accreditation and legal status
- Restrictions on additional debt
- Asset maintenance and use
- Insurance and risk management
- Operational covenants
- Affirmative covenants

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Strategies for Structuring Covenants

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Key Covenant Structuring Considerations

Initial negotiation/implementation is crucial

- Covenant thresholds and parameters can persist for many years after initial implementation
- Institutions with greater credit strength have more leverage to push back against restrictive provisions

Set yourself up to successfully meet covenants

- Ratio thresholds should be consistently achievable in the normal course of business
- Testing on an annual basis is smoother for internal reporting and reduces potential points of failure

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Key Covenant Structuring Considerations

Prepare for worst-case scenarios

- Though not always achievable, some covenants are set up such that an initial miss does not trigger an immediate acceleration of debt
- Remedies may include a requirement to hire a consultant and implement their recommendations to stabilize operations

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Financial Responsibility Ratio (Composite Score)

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Polling Question

What is your experience with the composite score?

- Not a problem at all
- My auditors help me calculate it
- It’s an area of concern for us
- I love the composite score!

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Background

- Introduced in 1997
- Required for private nonprofit and proprietary institutions
- Provides a standardized method to evaluate financial strength of an institution
- One of several factors used by the Department of Education for financial responsibility

Composite Score Calculation

Determine the valuation of the:

Primary reserve ratio

Equity ratio

Net income ratio

Calculate a strength factor score for each ratio and calculate a weighted score

Add the weighted scores together to arrive at the composite score

Pass
1.5-3.0

Zone alternative
1.0-1.4

Fail
(1)-0.9

Long-Term Debt in the Calculation

Previously, all long-term debt was included in the primary reserve ratio up to the amount of the institution's PPE

New regulations in 2019 changed the calculation including the way long-term debt is handled

- Introduced the concept of pre and post implementation

Long-Term Debt Definitions Reminder

Implementation is defined as the 2019 regulation change that went into effect for submissions on or after July 1, 2020

Pre-implementation debt is FY19 debt and prior

Post-implementation debt is FY20 debt and beyond

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Latest Composite Score Updates

Dear Colleague Letter was issued on 12/20/24 to clarify treatment of debt and refinancing in the score

Additional examples and scenarios added for clarity

Key point: if refinancing debt that was considered pre-implementation debt (prior to July 1, 2020), avoid refinancing with new proceeds

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Scenario #1

Pre-implementation debt of $20M as of 6/30/24

Refinanced during FY25 for $20M (includes $-0-M in new proceeds)

$20M of the refinanced bonds qualify for pre-implementation debt as of 6/30/25

Composite score will not be impacted significantly by this transaction

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Scenario #2

Pre-implementation debt of $20M as of 6/30/24

Refinanced during FY25 for $25M (includes $5M in new proceeds)

$-0- of the refinanced bonds qualify for pre-implementation debt as of 6/30/25

- Only the additional $5M in proceeds will be able to be qualified if spent on property, plant, and equipment

Composite score will likely decrease significantly

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Scenario #1

PRIMARY RESERVE RATIO	
110,972,798	Net assets without donor restrictions
26,849,127	Net assets with donor restrictions
(18,948,949)	Net assets restricted in perpetuity
(804,236)	Donor restricted annuities, term endowments, life income funds
(81,717,553)	Property, plant, and equipment/Right-of-use of asset (pre- and post-implementation)
(19,254,051)	Intangible assets
-	Post-employment and pension liability
20,000,000	Debt for long-term purposes and lease obligations (pre- and post-implementation)
(98,214)	Unsecured related-party receivable
36,998,922	**Expendable Net Assets**
94,719,173	Total operating expenses
-	Non-service component of pension/postemployment (nonoperating) cost (if loss)
-	Sale of fixed assets (if loss)
(155,572)	Change in value of interest-rate swap agreements (if loss)
94,563,601	**Total Expenses/Losses**
0.3913	**Primary Reserve Ratio**

Scenario #2

PRIMARY RESERVE RATIO	
110,972,798	Net assets without donor restrictions
26,849,127	Net assets with donor restrictions
(18,948,949)	Net assets restricted in perpetuity
(804,236)	Donor restricted annuities, term endowments, life income funds
(81,717,553)	Property, plant, and equipment/Right-of-use of asset (pre- and post-implementation)
(19,254,051)	Intangible assets
-	Post-employment and pension liability
-	Debt for long-term purposes and lease obligations (pre- and post-implementation)
(98,214)	Unsecured related-party receivable
16,998,922	**Expendable Net Assets**
94,719,173	Total operating expenses
-	Non-service component of pension/postemployment (nonoperating) cost (if loss)
-	Sale of fixed assets (if loss)
(155,572)	Change in value of interest-rate swap agreements (if loss)
94,563,601	**Total Expenses/Losses**
0.1798	**Primary Reserve Ratio**

Primary Reserve Ratio dropped by .2115

Composite score went from 2.7 (Scenario #1) to 2.2 (Scenario #2)

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Worst-Case Scenarios

Failing Composite Score and Debt Covenants

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Polling Question

Has your institution ever needed a waiver for a debt covenant?

- Yes
- No

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What if My Institution Fails the Composite Score?

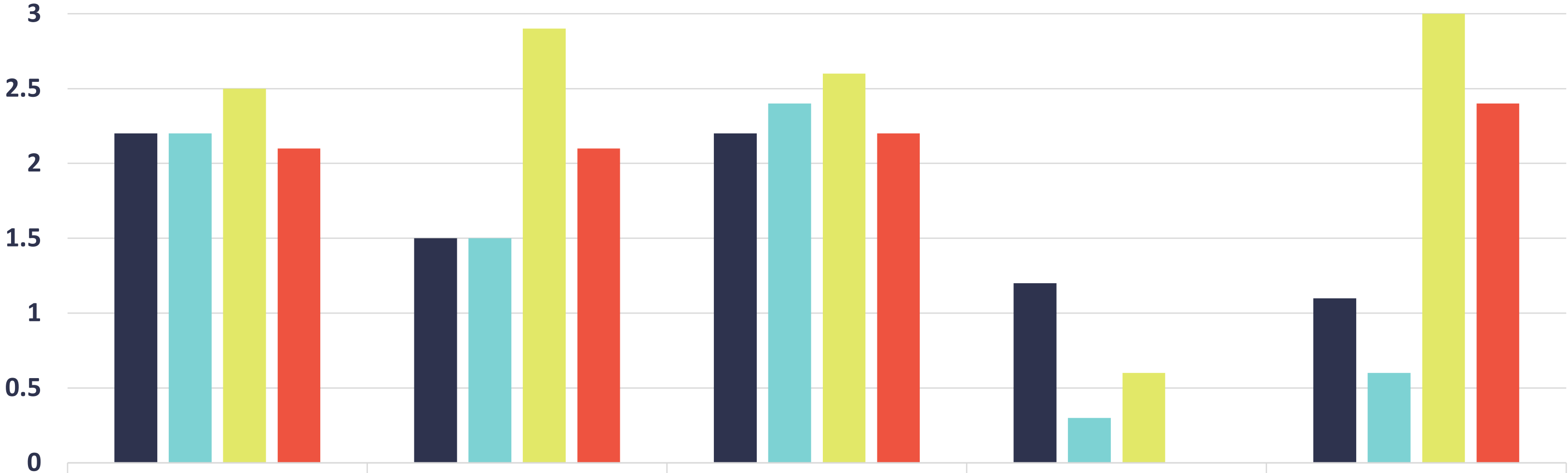
In the Zone (1.0-1.4)

- Heightened cash monitoring

Failing (Less than 1)

- Heightened cash monitoring
- Provisional certification
- Letter of credit

Does the Composite Score Predict Closure?



	Cabrini College PA	Notre Dame College OH	College of Saint Rose NY	Alderson Broaddus University WV	University of Saint Katherine CA
2019	2.2	1.5	2.2	1.2	1.1
2020	2.2	1.5	2.4	0.3	0.6
2021	2.5	2.9	2.6	0.6	3
2022	2.1	2.1	2.2		2.4

All 5 schools closed in 2024 citing financial reasons

Source: Financial Responsibility Composite Scores | Federal Student Aid

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Debt Impact of a Covenant Failure – Bank Debt

Limited number of investors (often a single lender)

Negotiation, restructuring, and waivers are all viable paths to take to arrive at a resolution for a covenant miss

Institutions with strong, long-term relationships with lender(s) may be able to work more easily to agree on a strategy to address the issue

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Debt Impact of a Covenant Failure – Public Debt

Multiple bondholders (depending on issuance size/number of maturities)

Significantly more complex to pursue waivers or negotiation with many unique investors

Covenant misses may not immediately cause debt acceleration, but will generally come with unfavorable consequences; acceleration more difficult to avoid if it comes to pass

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Audit Impact – Debt Covenant Failure

Contact auditors and lenders early

Request a waiver

Waiver must be obtained before the audit report is issued

If no waiver obtained:

- Debt becomes current if covenant violations make it callable by the lender
- Impacts potential going concern analysis
- Impacts to composite score
- Financial statement disclosures

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What is the Process of Obtaining a Waiver?

Discovery and notification

- Internal tracking should make CFOs aware of potential for a covenant miss during the fiscal year in most cases
- Lenders and auditors should be notified of the covenant miss upon confirmation that a violation has occurred

Planning and discussion

- Leadership should evaluate the cause of the covenant failure and plan how to remedy underlying issues going forward
- To obtain a waiver from lenders, it is crucial to be prepared to clearly present the reasons for the failure along with a viable path forward towards future covenant compliance

Obtaining waiver

- Lenders may require concessions to grant a waiver (e.g., increase to rate, collateral requirements, etc.)
- Coordination between auditors and lenders is key as audit and waiver requirements are often intertwined
- If a waiver cannot be obtained, seeking other refinancing options or debt paydown are the two primary alternatives

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Polling Question

I would like someone from CLA to contact me to discuss the following services:

- Consulting on debt structuring and/or covenants
- Consulting on composite score calculations
- Financial modeling or composite score modeling
- Nothing at this time

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Strategies and Ways to Prepare

Financial modeling

- Operational projections + impact on debt service coverage
- Cash and liquidity forecasting

Composite score modeling

- Key levers and how they impact the score
- Scenario planning

Beneficial prior to debt issuance and managing existing debt and/or new financial challenges

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Thank you!

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