

SPECIFIC-CASE

WORKSHEET 7 OF 9

Bank Tightens Debt Covenants at Credit Renewal

Scenario: Your existing credit facility is up for renewal. The bank has informed you that the new agreement will include a lower maximum DER (from 2.5x to 2.0x) and a higher minimum ICR (from 1.5x to 2.0x). Your current DER is 1.9x and ICR is 1.7x. You need to decide whether to accept the new terms, renegotiate, or restructure the balance sheet before signing.



Financial Ratio Analysis

by Ibrahim Anwar

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What This Is For

A pre-renewal decision framework for the specific moment when the bank's new covenant terms land on the desk and both DER and ICR headroom are already thin. This is not a general covenant monitoring tool — it is for the 30 to 60 days between receiving the bank's proposed terms and signing the renewal agreement. In that window, the operator has negotiating leverage. After signing, the leverage is gone.

The worksheet calculates the exact position for each covenant under the new terms, identifies which adjustment options close the headroom gap most efficiently, and quantifies the cost of each adjustment — retained earnings held back, debt repaid early, dividend not distributed. Every option has a cost. The question is which cost is smaller than the consequence of signing with thin headroom and breaching the covenant in year two of a five-year renewal.

Benefits

What you get when you actually run this worksheet on a real situation:

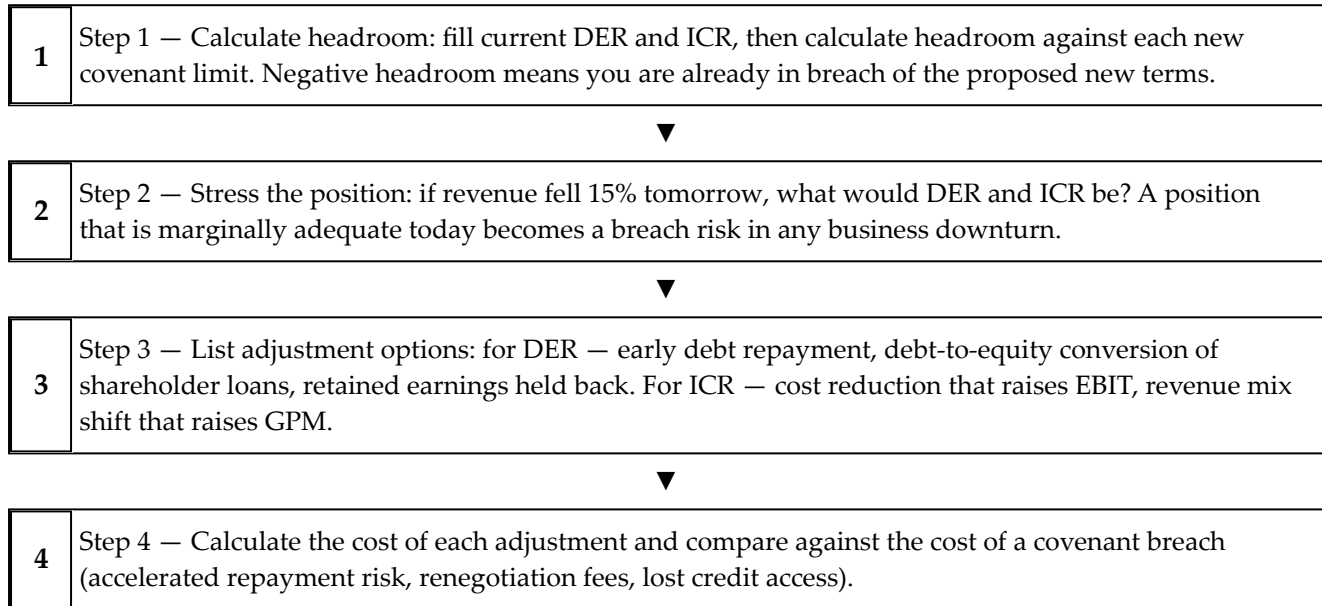
- Quantifies headroom under both new DER and ICR limits before any decision is made — the starting point for the negotiation.
- Lists three concrete structural adjustment options for DER with the resulting figure after each one.
- Identifies the specific cost line reduction or revenue mix shift that would push ICR from 1.7x to 2.0x.
- Provides the basis for the renegotiation conversation with the bank: headroom analysis under the proposed terms is the factual argument for requesting a wider limit.
- Creates a record of the pre-signing analysis that shows due diligence was done, relevant if a later covenant discussion becomes adversarial.

Framework To Use

— Headroom-Options-Costs Sequence

Calculate headroom first, then identify adjustment options, then quantify the cost of each option before deciding.

FOUR-STEP RENEWAL DECISION SEQUENCE



How To Use

Follow these steps in order. Each one builds on the previous.

- 1 Fill the Current position column from your most recent financial statements. Do not use projected or forecast figures for the starting position — the bank will verify against actuals.
- 2 Fill the New covenant limit column from the bank's proposed renewal terms. Read the credit commitment letter carefully — some banks state limits differently across different clauses.
- 3 Calculate headroom for each covenant: for ICR minimum, headroom = actual ICR minus 2.0x limit. For DER maximum, headroom = 2.0x limit minus actual DER.
- 4 Fill the If revenue -15% column: assume EBIT falls 15% proportionally and recalculate ICR. Assume no change in debt levels and recalculate DER. The revenue assumption is conservative — it tests the covenant under ordinary business pressure.
- 5 Write the three DER adjustment options with the resulting DER figure after each. Calculate: how much debt must be repaid to bring DER from 1.9x to 1.7x? How many quarters of retained earnings (no dividend) would it take? Can any shareholder loans be converted to equity?
- 6 Write the ICR improvement calculation: $\text{EBIT needed to reach ICR } 2.0x = \text{Interest Expense} \times 2.0$. $\text{Current EBIT} = \text{Net Income} + \text{Interest} + \text{Tax}$. $\text{Gap} = \text{EBIT needed} - \text{current EBIT}$. Which cost line, at its current monthly run rate, if reduced, would close that gap?

Example Use

A distribution business with \$3.8 million annual revenue receives renewal terms for a \$1.2 million five-year facility. Proposed covenants: DER maximum 2.0x (from 2.5x) and ICR minimum 2.0x (from 1.5x). Current DER: 1.9x. Current ICR: 1.7x. Signing deadline is 21 days away.

Current DER 1.9x against new limit 2.0x: headroom 0.10x. Almost no room — any small additional borrowing or equity reduction breaches.

Current ICR 1.7x against new limit 2.0x: headroom -0.30x. Already in breach of the proposed new minimum. The owner cannot sign these terms as written without already being in violation.

Revenue -15% stress: EBIT falls 15%. Current EBIT = Net Income \$152,000 + Interest \$82,000 + Tax \$48,000 = \$282,000. At -15%: EBIT = \$239,700. ICR = \$239,700 / \$82,000 = 2.92x. Wait — that calculation is showing ICR improving under lower revenue, which is impossible. Let me recalculate: if EBIT falls 15%, EBIT = \$282,000 × 0.85 = \$239,700. ICR = \$239,700 / \$82,000 = 2.92x. That's wrong — EBIT of \$239,700 with interest \$82,000 gives ICR of 2.92x, higher than current. Actually EBIT needs to equal Net Income + Interest + Tax, so a 15% revenue fall hits the top line and reduces net income — but EBIT already adds back interest, so the denominator (interest expense) is unchanged. If EBIT falls 15%: \$282,000 × 0.85 = \$239,700. ICR = \$239,700 / \$82,000 = 2.92x. That cannot be right at current ICR 1.7x.

Rechecking: Current ICR 1.7x means EBIT / Interest = 1.7x, so EBIT = 1.7 × \$82,000 = \$139,400. If EBIT falls 15%: \$139,400 × 0.85 = \$118,500. ICR = \$118,500 / \$82,000 = 1.44x. Further below the proposed 2.0x minimum.

ICR improvement needed: EBIT needed to reach 2.0x = \$82,000 × 2.0 = \$164,000. Current EBIT \$139,400. Gap = \$24,600 additional EBIT needed per year. At a monthly level: \$2,050 per month in additional gross margin or cost reduction.

Two options: (a) a 1.5 percentage point increase in GPM — on \$3.8M revenue, that is \$57,000 additional gross profit per year, more than closing the gap. (b) reduce the warehouse lease cost — renegotiating from \$7,500 to \$6,500 per month saves \$12,000 per year, half the gap.

For DER: the 0.10x headroom means even one quarter of retained earnings without dividends (approximately \$38,000 at current net income) added to equity reduces DER to 1.86x and widens headroom to 0.14x. Not large, but defensible.

Owner's decision: present the ICR gap calculation to the bank and request that the ICR minimum remain at 1.5x for year 1 of the renewal, moving to 1.75x in year 2, with a commitment to the GPM improvement plan already in progress. This is a specific, data-backed negotiating request — not a general objection to the new terms.

The Worksheet

Tear this out, copy it onto a fresh sheet, or fill it in directly.

Bank Tightens Debt Covenants at Credit Renewal

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ITEM	CURRENT POSITION	NEW COVENANT LIMIT	HEADROOM UNDER NEW TERMS	IF REVENUE -15%	ACTION REQUIRED?

Reflection Prompts

After filling in the worksheet on the previous page, work through these.

1. Row labels: DER · ICR · Equity (\$) · Interest-bearing debt (\$) · EBIT (\$) · Interest expense (\$). Fill current position from your most recent financial statements. Calculate headroom under new covenant limits: for ICR minimum, headroom = actual minus limit; for DER maximum, headroom = limit minus actual. Any negative headroom means you are already in breach of the proposed new terms — write the magnitude explicitly.

2. DER adjustment options (write calculated results for each): (a) repay \$___ of short-term debt before signing — new DER = ___; (b) retain profits for ___ quarters without distributing dividends — equity increases by \$___, new DER = ___; (c) check whether shareholder loans on the balance sheet can be formally subordinated or converted — if yes, new equity = \$___, new DER = ___. Write the option that creates the most headroom at the lowest cost.

3. ICR improvement: EBIT needed to reach ICR 2.0x = Interest Expense × 2.0 = \$___. Current EBIT = Net Income + Interest + Tax = \$___. Gap = EBIT needed minus current EBIT = \$___. Which cost line, if reduced by \$__ per month, closes this gap within 12 months? Alternatively: which revenue mix adjustment increases GPM by ___ pp, producing the equivalent EBIT increase? Write the specific line and the calculation.

Tips and Traps

TIPS

- ICR headroom of less than 0.5x at the time of signing is a warning — not a breach, but a signal that one bad quarter can push it into breach territory. Banks know this too; presenting a plan to widen ICR headroom before signing strengthens the renewal relationship.
- The renegotiation window is the 30 to 60 days between receiving the proposed terms and signing. After signing, you cannot renegotiate a covenant threshold without a waiver request — which is a different conversation, at a much weaker position.
- If the bank refuses to move the ICR threshold, request a measurement frequency change: annual covenant testing rather than quarterly testing gives the business more time to recover from a seasonal trough.
- When presenting the headroom analysis to the bank, show the downside scenario voluntarily. Operators who demonstrate they have stress-tested the covenants before signing tend to get more flexibility than those who appear not to have considered downside conditions.

TRAPS

- Signing a covenant that is already in breach on the signing date, expecting to 'improve ratios shortly after.' The breach is contractual from day one, regardless of the operational timeline.
- Using forecast or projected financial statements to calculate headroom rather than the most recent actuals. Banks verify against actuals — headroom calculated from optimistic projections is not headroom.
- Treating DER and ICR as independent covenants. A new loan that repairs ICR headroom (by increasing EBIT through an asset financed by the loan) simultaneously raises DER. The two covenants interact — calculate both after every proposed adjustment.

Appendixes

Appendix A – ICR Improvement Calculation Template

Current EBIT = Net Income + Interest Expense + Income Tax

Net Income : \$ _____
 Interest Expense : \$ _____
 Income Tax : \$ _____
 Current EBIT : \$ _____

ICR at proposed new minimum: 2.0x

EBIT required at 2.0x ICR : Interest Expense × 2.0 = \$ _____
 EBIT gap : Required EBIT minus Current EBIT = \$ _____
 Monthly EBIT gap : EBIT gap / 12 = \$ _____

Option A – cost reduction:

Which cost line? _____ Current monthly: \$ _____
 Reduced to: \$ _____ Monthly saving: \$ _____
 Months to close full gap: EBIT gap / Monthly saving = ___ months

Option B – GPM improvement:

GPM pp increase needed: (EBIT gap / Annual Revenue) × 100 = ___pp
 Mechanism: _____ (price increase / supplier renegotiation / mix shift)

Appendix B – DER Reduction Options Summary

Current DER = Interest-Bearing Debt / Equity = \$___/\$ ___ = ___x
 Target DER = 2.0x (new covenant limit)
 Current headroom: 2.0 – Current DER = ___x

Option 1 – Early debt repayment:

Amount to repay: \$___ (reduces numerator)
 New DER: (Debt – Repayment) / Equity = ___x
 Source of repayment: _____ (retained earnings / asset sale)

Option 2 – Retain dividends (build equity):

Quarters without dividend: ___ Net income per quarter: \$___
 Equity increase: \$___ New DER: Debt / (Equity + Increase) = ___x

Option 3 – Shareholder loan conversion:

Shareholder loan balance: \$___ Can be formally subordinated: Y/N
 If converted to equity: new equity = \$___ New DER: ___x
 Bank acceptance required: Y/N – verify before presenting as an option



WHERE THIS WORKSHEET COMES FROM

Financial Ratio Analysis

Read Your Own Financial Statements Before the Bank Reads Them for You

by Ibrahim Anwar

This worksheet is one of nine in the *Financial Ratio Analysis* companion worksheet pack. The full pack is grouped into three categories: high-volume worksheets you can run weekly, niche-search worksheets for rare but high-value situations, and specific-case worksheets that walk you through a single concrete scenario.

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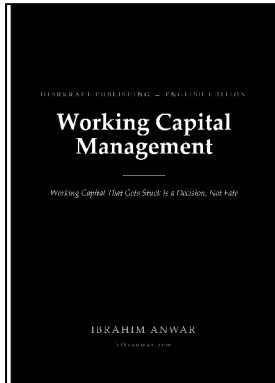
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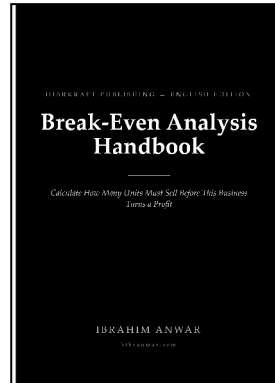


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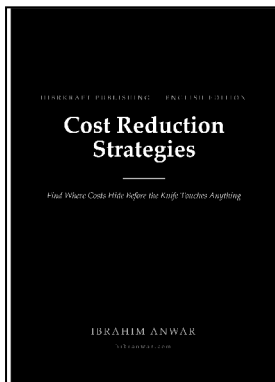


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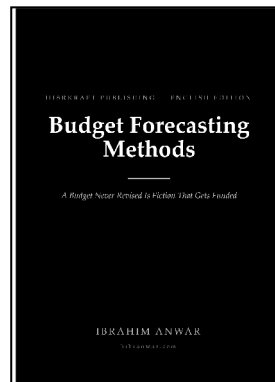


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