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Addressing Cash Flow and Credit Impacts Related to COVID-19

By Robert Mercado and Michelle Johnson | Wednesday, April 22, 2020

It is too early to determine the impact COVID-19 will have on contractors. Unfortunately, the expectation is that it will have a significant negative impact on a contractor's financial strength and abilities to meet cash flow needs. Although unpredictable, unprecedented situations are the very reason it is crucial to position contractor's year-end financial statements to meet banking requirements and maximize surety credit.

Two common practices for contractors are obtaining a line of credit from a bank and entering into various long-term debt agreements in order to finance the purchase of vehicles and equipment. More often than not, included in the line of credit and financing agreements are various terms and conditions a contractor is required to meet. Often, terms require contractors to meet certain financial covenants ratios. Typical ratios outlined in debt agreements are:

1. liabilities to tangible net worth and
2. debt service coverage ratio (DSCR).

Liabilities to tangible net worth is a comparison between a company's total liabilities and the company's net worth, also known as stockholder's or member's equity. This ratio is used to determine how much a company is leveraged. The higher that leverage, the greater the risk would be for the bank to issue the loan. To minimize their risk, banks place a limit on this ratio such as 3:1, liabilities to equity.

The DSCR is a calculation that measures the cash flow available to pay a company's current debt obligations. The DSCR is calculated as follows:

> *(Net income + Depreciation + Amortization + Interest) – (Unfinanced capital expenditures) – (Distributions paid to stockholders) divided by (Total principal payments on long term debt + interest)*

Normally, banks will require this ratio to be above 1.25:1. Maintaining a compliant ratio is critical for the company's year-end financial statements and to stay in good standing with the lender.

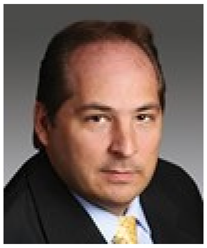
Surety credit is based on various factors including financial requirements. Those requirements are mainly related to a multiple of the stockholder's equity or working capital, which is the difference between the company's current assets and liabilities, adjusted by the following:

- Minus:
  - receivables outstanding more than 90 days;
  - 50% to 100% of inventory;
  - prepaid expenses;
  - amounts due from related parties including affiliates; and
  - credit worthiness of any note's receivable.
- Plus:
  - cash surrender value of life insurance.

Financial institutions and sureties view contractors' year-end financials to prevent or reduce risk. Good accounting practices for year-end planning can reduce financial scrutiny of financial covenants and, at the same time, maximize surety credit. The following actions should be heeded when preparing for and prior to year-end:

- Collection of any receivables that could be outstanding 90 days or more. These funds can be used to pay down liabilities, which will reduce the liabilities-to-tangible net worth ratio.
- Where possible, inventory should be kept to a minimum. Contractors should only have inventory that entails a long lead time to obtain.
- Contractors should examine items that are considered prepaid. Agreements that require upfront payments can be modified prior to year-end in order to minimize these amounts at year-end.
- Amounts due from related parties should be paid in full. This will increase cash flow to pay down current liabilities.
- A lending institution can subsequently finance vehicle and equipment purchases that were not originally financed or that were purchased with cash. This will increase working capital and reduce the impact on the DSCR.
- Owners of construction companies can lend funds to the company and subordinate these amounts to the bank and surety. This cash would increase the working capital. In addition, the subordinated debt would be considered equity to the bank and surety.

Prudently preparing for a contractor's year-end is essential for the company's viability and success. If vigilant and aggressive, financial planning and projections will ensure compliance with banking requirements and maximize surety credit and, in turn, ensure growth and stability for future projects and profits.



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