Loan Covenants and Relationship Banking in MBOs

David Citron, Ken Robbie and Mike Wright*

Abstract—This paper examines the role of accounting-based covenants and other sources of information in signalling financial distress in UK MBOs. Using an in-depth questionnaire and follow-up interviews to investigate the perceptions of senior UK MBO lenders, we find that: MBO loan agreements contain more covenants than general corporate lending agreements; monthly management accounts and telephone communication are more frequent first indicators of distress than are accounting-based covenant breaches; lenders with specialist MBO lending units are more likely to waive covenant breaches and less likely to recall loans in default than those without such units; syndicate members find both information flows prior to breach and subsequent action taken to be less effective than do syndicate leaders or sole lenders; and the presence of a specialist MBO lending unit provides the skills and reputation needed to establish a high degree of trust between the banks on the one hand and the MBOs and the equity houses on the other, but there is wide variety in the ways that banks manage these relationships. These findings confirm the expectation that the relatively more acute adverse selection and moral hazard problems inherent in MBO lending increase the demand for monitoring via covenants, and that the closer the lender/borrower relationship, the more effective the monitoring.

1. Introduction

A voluminous literature has now developed concerning the effects of management and leveraged buyouts, investigating the reductions in information asymmetry, reductions in internal agency costs, wealth transfers arising from the renegotiation of implicit contracts, and wealth transfers arising in former parent companies arising from the changed risk of the organisation (see Fox and Marcus, 1992; Jensen, 1993; Thompson and Wright, 1995, for reviews). A particularly important argument, and the focus of this paper, is that leveraged buyout firms achieve operating efficiencies due to the discipline and monitoring imposed by high leverage (Jensen, 1986; Wruck, 1990). Furthermore, if such firms become distressed, timely loan default should ensure that they are more likely to be rescued before their going concern value dissipates. Beneish and Press (1995a), however, find for non-LBOs in default that the cost of additional constraints imposed by lenders outweighs the benefits of increased monitoring.

Furthermore, studies of firms breaching covenants have focused on those firms that have violated accounting-based covenants alone (see, for example, Beneish and Press, 1993, and Chen and Wei, 1993, on the costs of breach; and DeFond and Jiambalvo, 1994, and Sweeney, 1994, on accounting responses to breaches). However, lenders often require a range of both accounting-based and non-accounting-based covenants, and it is possible that these interact as firms approach default. In this spirit, Smith (1993) suggests that research into technical default needs to be integrated into a broader view of the lending process (p. 301). Similarly Singh (1993) makes a plea for introducing more institutional detail into studies of corporate restructuring, by which he means 'a precise understanding of the actual mechanics of decision-making' (p. 164).

In order to gain a deeper understanding of both the formal and informal monitoring processes, this study uses (a) a questionnaire to investigate the perceptions of 29 UK MBO lenders on the loan monitoring process[1], in particular as borrowers enter financial distress; and (b) interviews with the majority of specialist MBO lending units among our respondents to investigate the nature of the bank/MBO relationship in greater depth. We focus on the MBO sector because of the relatively more acute adverse selection and moral hazard problems associated with MBO lending, as a result of which we expect close monitoring to be an important feature of the MBO lender/borrower relationship. In

*David Citron is at the City University Business School; Ken Robbie and Mike Wright are at the Centre for Management Buyout Research, University of Nottingham. They gratefully acknowledge financial support for CMBOR from BZW Private Equity and Deloitte & Touche Corporate Finance. Thanks also to seminar participants at the Universities of Nottingham and Leeds and City University Business School, two anonymous referees and the editor of this journal, who provided helpful comments on an earlier version. Correspondence should be addressed to D. B. Citron, City University Business School, Department of Accounting and Finance, Frobisher Crescent, Barbican Centre, London EC2Y 8HB. This article was submitted in June 1996 and accepted in April 1997.

[1] In what follows, unless otherwise stated, the term MBO is used as a shorthand for MBOs and MBIs.

this connection the paper draws on certain features of relationship banking, as a means of addressing agency cost problems, to place the insights of Jensen and Wruck into a broader view of the lending process. Thus Mayer (1988) sees the chief characteristics of close relationships as comprising 'procedures for evaluating prospective borrowers, monitoring the performance of borrowers and, most crucially of all, reacting to instances of financial distress' (pp. 1,180–1). Similarly, Holland's case studies lead him to the view that 'close relationships generally involve rich information flows ... high loyalty and commitment between parties and expectations of fair dealing and longevity of relationship' (1994:372).

Finally, previous research, in investigating different types of debt, has focused on the distinction between public and private lending. However, lender/borrower relationships are also likely to be affected by whether the lender is a sole lender or syndicate lender as compared with being merely a syndicate member (see Smith, 1993:298). This paper adds to previous research by exploring the implications of this distinction for MBOs in loan default.

The remainder of the paper consists of six sections. The theoretical framework for the research is contained in the next section and this is followed by a brief descriptive section on recent trends in MBO/MBI lending in the UK. Section 4 sets out the data and research methodology, and Sections 5 and 6 contain the findings. The paper concludes with a summary and discussion of implications for future research.

2. Theoretical framework

There is a well-known agency cost involved in the general provision of debt that arises from the potential conflict of interest between equity holders and debt providers (Smith and Warner, 1979). Debt covenants provide a means of controlling the moral hazard problems that may arise in monitoring management. For debt covenants to be effective in addressing moral hazard problems, there is a need for them to be set at appropriate levels, for there to be an associated regular flow of (unbiased) information from the borrower to the lender, and for there to be timely and appropriate action by lenders when such covenants are breached.

In a recent review of research into accounting-based covenant violations, Smith argues that 'further progress requires the integration of technical default into a broader view of the lending process' (1993:301). This is because accounting-based covenants are merely a subset of the undertakings that characterise the borrower/lender relationship. One aspect of research which has addressed this dimension is that of Rajan and Winton (1995), who examine the role of covenants as a contractual device to increase lenders' incentives to monitor, that is, they provide incentives for lenders to take action and obtain information on which to base action. A proper understanding of their role, therefore, requires an understanding of the wider context within which they operate.

One particularly important feature of this wider context is that the borrower/lender relationship rests on informal as well as formal contracts (Holland, 1994). Holland points out that agency theory provides a useful starting point for studying bank-corporate relationships, but recognises that the theory requires further development to be applicable to more complex relationships. Binks and Ennew (1996) address the issue of bank-client relationships in a principal-agent context, arguing that such relationships may help deal with asymmetric information problems through the building of trust and confidence, which results in an increased flow of information between the corporate client and the bank. There is also an emerging literature from a trust and procedural justice perspective which suggests that relationships are complementary to the traditional approach of agency theory, as they can be viewed as alternatives to costly formal contracts in the monitoring of financier-investee relationships (e.g. Welbourne et al., 1995; Sapienza and Korsgaard, 1996).[2] Sapienza and Korsgaard (1996), in a study of the relationships between venture capitalists and entrepreneurs, which have similar properties to those involving banks and corporate clients, explicitly link their approach to agency theory. In particular they find that timely provision of information to financiers promotes positive relationships (mutual trust and commitment, etc.) between investees and venture capital firms which in turn can be viewed as a bonding mechanism that reduces the principal's need to expend effort monitoring (p. 550).[3] This paper aims to contribute to this body of research by exploring bank-corporate relationships in more depth in the context of MBO lending. Accounting-based covenants are clearly an integral part of the formal contractual structure. It is likely, however, that their use will interact with both other formal and informal flows of information. This paper seeks to enhance our understanding of the functioning of accounting-based covenants in the wider setting of the formal and informal loan monitoring process.

[2] Much of the now extensive literature concerning venture capital firms' monitoring of investee companies has taken an agency theory perspective, e.g. Sahlman (1990) and Mitchell et al. (1995) (who both include buyouts), but has subsequently been extended to include relationships (e.g. Korsgaard et al., 1995; Sapienza and Korsgaard, 1996). Procedural justice theory focuses on the importance of developing relationships in situations where the parties do not have direct or full control.

[3] They also note that this can mitigate fears of opportunism.

We select MBO lending as a particularly appropriate context for this investigation for a number of reasons. First, MBO lenders can be expected to make greater use of a wider variety of both accounting-based and non-accounting-based covenants in their loan agreements than are found in general lending agreements. This is because the problems of both moral hazard and adverse selection are likely to be more acute in MBOs than in general corporate lending situations.

Research into the agency costs of debt generally makes the assumption that the interests of management and shareholders coincide. Garvey and Swan (1994), however, summarising recent literature on management turnover in distressed firms, question the assumption that managers are always willing to act against the interests of lenders even when it means courting financial distress. Where managers are in fact significant equity holders, as in MBOs, and even though they are undiversified investors, there are strong arguments to suggest that share ownership provides increased incentives to invest in risky projects, so increasing the probability of failure. However, emerging evidence on post-transaction performance across the full range of buyout types indicates that managers engage in both cost-cutting as well as innovative, more risky activities, such as new product development (Wright, Thompson and Robbie, 1992; Phan and Hill, 1995; Zahra, 1995).[4] Wright, Thompson and Robbie (1992) find that 62% of their sample introduce new products which respondents claimed would not otherwise have been done. Zahra (1995) compares pre- and post-buyout commitments to corporate entrepreneurship and finds that after buyout there is an increased commitment to new product development, a greater emphasis on commercialising technology and a greater intensity of new venture efforts, but that research and development expenditure did not change significantly. Phan and Hill (1995) show that management equity holdings have a more significant impact on changes in growth strategies than does the role of debt.

The moral hazard problems associated with monitoring managers in buyout companies may be particularly acute because incumbent management's relative information advantage may persist for some time after the MBO has been effected. Such an advantage is likely to diminish over time as the flow of information to lenders, together with the monitoring relationship, may be expected to make them better informed. Finally, competition for lending to a buyout within a short timescale to deal completion also raises adverse selection problems in that such pressures may mean that management's assumptions about future performance are inadequately scrutinised.[5] Banks lending to an MBO may thus be viewed as facing a Winner's Curse type of problem, in the sense that the bank winning the mandate lends to an over-priced transaction (i.e. lends on more favourable terms than competing banks) because of a greater degree of asymmetry of information regarding the 'true' position of the firm, or a more favourable assessment of available information. This issue may be exacerbated, as MBO lending is typically lending by *new* bankers to a firm with changed ownership.[6] The bankers may thus use covenants as a means of circumventing costly information gathering about the new borrower, so attempting to alleviate the Winner's Curse problem ex post. For all these reasons, therefore, there may be greater incentives to emphasise the monitoring role of debt covenants in MBOs than in other forms of corporate lending. In addition, these incentives may be greater for UK MBOs than for US MBOs since vertical strip financing, which mitigates many of the agency problems discussed above, is less common in the UK than in the US.[7]

In addition, MBO lending is likely to provide a particularly fruitful context for studying the loan monitoring process, since lenders to MBOs are expected to place a strong emphasis on monitoring borrowers through close relationships. Smith and Warner (1979) argue that because contract renegotiation is less costly in private debt issues, covenant constraints will be set with less slack, so that technical defaults are more likely in private than public debt cases. This suggests that in the case of buyouts which go private and move from using public debt, there will be greater emphasis on the role of tight covenants. Moreover, the high degree of leverage in buyouts, and the typical links between the timing of predicated asset sales and exit and repayment of debt, emphasises the importance of close relationships between borrowers and lenders in order to ensure that such targets are met.

[4] Evidence relating to the motivations of management in undertaking a buyout also emphasises their desire to control and develop their own business (e.g., Wright et al., 1992).

[5] It is also possible that MBO managers and advisers collude against the debt supplier to complete a transaction because advisers are typically remunerated largely through completion fees. However, countering this point is the argument concerning reputation effects, such that behaviour of this kind may result in the banks being reluctant to deal subsequently with the adviser.

[6] The interview data reported below show that it is highly unlikely, especially in the case of divestments, that the buyout will have been a customer of the bank in its own right prior to the MBO.

[7] See, for example, Thompson, Wright and Robbie (1992). It may be argued that close relationships between venture capitalists and a network of banks established to effect transactions, as is often the case, may go some way to mitigating agency cost problems. However, the point remains that ultimately there are potential conflicts of interest between venture capitalists and banks.

While the empirical literature to date has focused on the private/public debt dichotomy referred to above, Smith (1993) hypothesises that private syndicated debt will be more costly to renegotiate than a private bilateral agreement. This paper provides initial evidence on this issue by examining the views of syndicate members in contrast to those of sole lenders.

The main objective of this research, therefore, is to extend our understanding of the process of monitoring MBO lending, with special reference to the role loan covenants play. It aims to achieve this overall objective by examining in particular MBO lenders' perceptions of:

1. The extent of use of covenants (both accounting and non-accounting-based) in MBO loan agreements and in comparison with their use in general lending agreements.
2. The process whereby they monitor their lending arrangements, in particular as borrowers enter financial difficulties.
3. The effectiveness of accounting-based covenants as signals of impending distress.
4. Alternative responses to breaches of covenant and how the choice of response is influenced by the nature of the borrower/lender relationship.[8] Different types of borrower/lender relationship are characterised in the paper first by the presence or absence of a specialist MBO lending unit and, second, by comparing the views of sole lenders/syndicate leaders with those of syndicate members.
5. The ways in which banker/MBO relationships differ from those found in general corporate lending.

3. Recent trends in MBO/MBI lending

The financing of MBOs and MBIs is typically structured to reflect conceptually differing layers of risk-return trade-offs, such that if initial assumptions with respect to forecast cash flow, etc., hold, each of the different types of funds provider will achieve their expected rates of return. These finance layers may be provided in horizontal or vertical strips (Jensen, 1986). In the former, different institutions provide separate financial instruments. In the latter, different institutions will, pro rata to their total investment, provide a mix of financial instruments. The layers of finance range from straightforward equity at one extreme to senior debt secured on the assets of the business and/or expected cash flow at the other.

In between these two extremes, the difference between secured lending plus what equity providers and management are prepared to provide on the one hand and the purchase price on the other is met by mezzanine finance. This may embrace preference type shares and a spectrum of instruments from senior to junior mezzanine debt. The findings of this paper, however, relate to straight debt finance and not to mezzanine finance. This was not a source of confusion with respondents since, although it is not a legal concept (Sterling and Wright, 1991), mezzanine finance is a widely used term within the buyout lending sector and there is a common understanding among bankers as to what it means.

The trend in average financing structures of UK MBOs and MBIs is shown in Table 1. Average proportions of senior debt peaked in the buoyant conditions of 1989, subsequently declined during the recession of the early 1990s and began to rise again as market value recovered in the mid-1990s. It should be noted that although the leverage levels in MBIs are lower on average than for MBOs, the difference is not statistically significant.

Lending to MBOs and MBIs is typically secured by a legal charge. The buyout loan agreement will contain provisions regarding repayment of principal and details regarding interest, security arrangements and covenants (Sterling and Wright, 1991; Krieger, 1990). Essentially, covenants and security in the buyout sector are viewed as serving two distinct purposes.[9] Covenants are primarily viewed as a monitoring device once the decision to lend has been taken. They serve as a trigger alerting lenders that there are problems, and leading to the enforcement of security. The banker is likely to want an early signal of impending problems so that going concern value can be conserved, rather than waiting until the last minute and realising security. From the MBO managers' viewpoints, covenants can be seen as directing their attention to important dimensions of performance and provide a basis for discussing performance with the banker, which security does not. In extremis, security provides the means which enables the banks to take action to rectify a problem. It puts the bank in the driving seat rather than ranking them equally with all other creditors.[10]

4. Data and methodology

To gain an understanding of both the formal and informal dimensions of the borrower/lender

[8] This extends previous research in this area, which investigates how the lender's decision varies either according to the cause of the breach (Citron, 1992a) or according to the borrower's financial health and the characteristics of the debt instrument (Chen and Wei, 1993).

[9] These points were confirmed by our interviews with lenders (see below).

[10] Citron (1995) provides evidence on conditions attached to public debt in large listed companies and shows that floating charges have an accounting covenant to trigger timely default, while those with fixed charges have covenants relating only to the value of the secured asset itself.

Table 1
Financing structures of MBOs and MBIs

Type of finance (average) (%)	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1989-1995*
1. Management buyouts								
Equity	18.8	26.5	26.1	34.7	31.3	32.0	26.7	27.4
Mezzanine	17.0	10.0	6.1	5.9	5.6	4.9	6.2	8.6
Debt	57.6	52.7	44.2	43.0	44.9	48.7	49.2	49.4
Loan note	3.4	7.0	10.4	2.7	9.3	5.8	7.9	6.2
Other finance	3.2	3.8	13.1	13.7	8.9	8.6	10.0	8.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Sample (£)	2,879	1,452	1,399	1,932	1,650	1,935	2,473	13,720
(Number)	114	125	99	117	121	138	133	847
2. Management buy-ins								
Equity	26.2	26.0	30.5	38.3	37.0	28.9	32.5	31.8
Mezzanine	12.0	8.2	15.3	9.3	6.8	3.3	7.3	7.8
Debt	51.3	34.1	47.3	46.7	47.9	40.7	49.3	46.2
Loan note	7.7	21.4	2.9	3.1	1.9	15.2	7.8	8.7
Other finance	2.8	10.3	4.0	2.6	6.4	11.9	3.1	5.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Sample (£m)	372	479	481	481	607	944	2,361	5,726
(Number)	54	42	42	41	42	71	101	393

Source: CMBOR/BZW Private Equity/Deloitte & Touche Corporate Finance

relationship, we use a survey questionnaire combined with selected follow-up interviews as being the most appropriate research tools for examining the perceptions of one of the parties in this relationship, the MBO lender, drawn from as large a population of lending institutions as possible (Kerlinger, 1986).[11] The survey questionnaire follows closely the methodology used by Citron (1992a) in relation to the attitudes of lending bankers to the use of accounting ratios in loan contracts. In particular, we adopt these approaches to overcome major difficulties relating to obtaining access to highly sensitive information, especially that relating to the actual operation of covenants. Given also that the respondents were senior executives in organisations that generally comprised a small number of individuals, and were involved in small numbers of transactions per year, the potential problems of relying on perceptions rather than actual documents should be minimised. It should also be borne in mind that we are dealing with a sector characterised by a high degree of interrelatedness between the various banks and among the executives themselves. Syndication is common, and executives with specialised skills move between specialist units of competing banks, suggesting a high degree of common understanding of terminology.

4.1. Survey Questionnaire

A draft questionnaire was piloted with a number of bankers, venture capitalists, accountants and academics. The questionnaire was predominantly structured, but also included open-ended sections to permit a freer expression of respondents' views. The questions were drafted with a view to investigating MBO lenders' perceptions of issues 1 to 4 set out at the end of Section 2 of this paper. The questionnaire dealt with issues concerning covenants under the principal headings of background data; extent of use of covenants and which specific ones are used; first indicators of distress, speed of learning about distress and which covenants are breached; what actions are taken once covenants are breached, and perceptions of the effectiveness of accounting-based covenants. It is recognised that the results do not provide direct evidence on actual cases of MBOs in default, but rather rely

[11] A copy of the questionnaire is available from the authors on request.

on respondents' views. The potential problems arising from memory and perceptions are of course common to all questionnaire-based research, but may be minimised here for the reasons outlined in the previous paragraph.

Following the piloting of the questionnaire, it was decided to frame the questions such that MBO and MBI-type deals were linked together. This is because banks operating in this market will tend to lend to both MBOs and MBIs. The banks with whom the questionnaire was piloted were consistent in their view that the setting of covenants is a second tier decision related to monitoring after the main decision whether or not to lend has been taken. Banks pay particular attention to the credibility of the management in an MBI, followed by assessment of the market position. Typically, banks reported that if they did not obtain satisfactory results during their due diligence process, they were more likely not to lend at all rather than lend either a reduced amount or under significantly different conditions. However, our subsequent interviews (see below) did reveal some difference between the banks in respect of the 'tightness' at which the covenants are set, and these are discussed at the end of Section 5.

The Centre for Management Buyout Research (CMBOR) database shows that 62 bank departments representing 58 bank groups participated in at least one buyout debt financing in the period 1989 to 1994. Mailing of the questionnaires to all these departments was undertaken in late November 1994, with a follow-up letter sent a month later.

We addressed the questionnaire to the heads of the relevant departments or other senior colleagues with whom CMBOR has regular contact through its buyout and buy-in surveys, in order to obtain organisation-wide perceptions of the process.[12] Discussions with senior executives involved in this form of lending indicated that banks had clear organisational policies on the approach to be adopted, so that the discretion of individual executives with respect to lending decisions would be extremely limited. Moreover, such specialised lending departments tend to be small (in our sample, more than three quarters had fewer than 10 executives) who would typically interact closely on a relatively small number of transactions per year. On this basis we were justified in addressing the questionnaire to only one person in the organisation.[13]

A total of 29 complete and usable replies were received, representing a response rate of 50% of the bank groups surveyed. A further six incomplete replies were received. Reasons for non-response concerned the paucity of new advances made over the previous three years, or problems in providing information in the required format. Analysis of the responding banks revealed that they covered a substantial proportion of the buyout senior debt market, with most of the principal and longest established buyout debt providers included. Tests were carried out on the representativeness of the sample, and on the basis of three demographic criteria for which comparative information was available, no significant differences could be identified. These involved the mean number of transactions, mean total transaction value and the nationality of the respondent and non-respondent banks. The mean number of transactions of respondent banks was 31.1 (standard deviation 63.2) and for non-respondents it was 28.8 (standard deviation 81.7), with there being no statistically significant difference ($t = -0.11$). The mean value of transactions was £937.1m for respondents and £861.4m for non-respondents, the differences again being not significant ($t = -0.17$).

A test was also carried out comparing the differences in nationality of the respondent and non-respondent banks. On the basis of dividing banks into UK, other EC and non-EC categories, no significant difference could be identified using a chi-square test (chi-square $= 0.025$). As a result of the small sample size, non-parametric tests have been used to test for significant relationships in the data. Face-to-face interviews were held with those banks that were unwilling to respond to the questionnaire but who were willing to discuss general issues relating to debt covenants; two of these were considered to be important participants in the buyout senior debt market.

Banks responding to the survey, or participating in the face-to-face interviews, accounted to 82.7% of the total number of senior debt buyout financings identified by CMBOR in the period 1989 to 1994. Respondent banks had made an average £101m of advances per bank over the previous three years and extended gross facilities totalling £3.7 bn. They had at the time of survey a total of about £2 bn outstanding on their buyout loan books.

[12] The covering letter with the questionnaire specifically asked for an overall view. The letter said: '...In order to obtain an overall view of the monitoring, operation and triggering of covenants, ...[T]he enclosed questionnaire asks for senior debt providers' perceptions on key elements of their covenant writing and monitoring as well as on the circumstances most likely to surround a breach and the type of action taken when this occurs....'.

[13] This point is emphasised in respect of four cases where it was known that banks had two units devoted to buyout lendings. In each case, one of the units responded indicating that another unit in the bank was the appropriate respondent, with these other units providing completed questionnaires.

Analysis of respondents' job titles showed that they held senior positions of responsibility. Bearing in mind that terminology for the same job may differ between banks, the distribution of job titles was: seven directors, six heads of structured/acquisition finance, four senior managers, three assistant directors, two assistant general managers, one assistant vice president and six managers.

4.2. Follow-up Interviews

To explore the complex issue of relationships further, we attempted to recontact all the banks in the sample with specialist units. We succeeded in contacting 19 (86%) of the 22 respondents with specialist units. In the remaining three cases this was not possible as either they had ceased to participate in the buyout/buy-in market since the questionnaire survey, or we were simply unable to establish contact. In other cases, the person completing the questionnaire had left but we were able to interview their replacement. A separate follow-up checklist questionnaire was designed on the basis of issues emerging from the mail questionnaire survey. This instrument included issues concerning the rationale for establishing the specialist unit; questions concerning the differences between MBO/MBI versus corporate lending; differences, if any, between lending and covenant setting between MBOs and MBIs; the likelihood that MBOs/MBIs would have been clients prior to the transaction; whether the specialist unit continued to monitor the MBO/MBI after the transaction or whether it was passed on to a relationship manager; similar questions relating to the post-flotation relationship; and views about the longer-term relationship and issues concerning the relative importance of security versus covenants in MBOs (a copy of the checklist is available from the authors). Nine face-to-face interviews were conducted, lasting between one and two hours, and involving one or two of the authors in each case. In addition, interviews with 10 more of the respondents were conducted by telephone.

5. Results

In this section, we report the results of the questionnaire survey, together with material from the interviews where relevant. The findings from the interviews which focus on the nature of the bank/MBO relationship are contained in Section 6.

5.1. Covenants Used in MBO Lending Agreements.

Accounting-based covenants. Consistent with the expectation that MBO lenders exert a relatively high degree of control and monitoring over their customers, the great majority of respondents indicate a greater use of accounting-based covenants in MBOs than in their general lending. However, the contrast is greater when compared with plcs (93% of respondents making greater use in MBOs) than with private companies (61% making greater use).

Respondents also indicated that MBO lending is universally both secured and covenanted for all sizes of loan. As noted in the discussion of MBO lending above, for MBOs security and covenants are used to reinforce one another. In addition, virtually all MBO lenders (97%) indicate that term of loan is irrelevant as far as covenant decisions are concerned, consistent with the universal covenanting of MBO loan agreements.

These findings contrast with the incidence of accounting-based covenants in general bank lending, where a significant increase occurs in covenant use as loan size increases; also there is some evidence of less use of covenants in secured than in unsecured loans, suggesting that, in general lending, covenants and security are substitutes for one another (Citron, 1992a). In addition, term to maturity is strongly positively associated with the use of accounting-based covenants in the high credit quality UK public debt market, where the chief risk is that credit-worthiness may deteriorate at some future date (Citron, 1995). A sizeable minority (25%) of general bank lenders indicated the same positive relationship with term (Citron, 1992a).

MBO lending agreements contain on average both more and a greater variety of accounting-based covenants than do general bank lending agreements. Table 2 shows that respondents cited five accounting-based covenants that are each used in over 80% of lending agreements as finally negotiated. Three of these five are also widely used in general lending agreements—minimum net worth, profit-based interest cover and gearing (Citron, 1992b). However, MBO agreements generally contain two additional covenants not commonly found in other UK loan contracts—cash flow to total debt service and dividend restrictions. This appears to reflect the premium that lenders to MBOs place on short-term cash generation for reinvestment in the business and for the servicing of debt.

Sweeney (1994) suggests that 'tighter constraints in private bank agreements are expected (than in public debt agreements) if bankers have a comparative advantage in dealing with and helping managers deal with financial difficulties...' (p.290). This is because private agreements are less costly to renegotiate, since bankers typically have closer relationships with borrowers than do public debt holders. Similarly, because the relatively large number of accounting-based covenants in MBO lending agreements increase the likelihood of violation, our findings are consistent with MBO lend-

Table 2
Frequency with which respondents use various accounting-based covenants in MBO lending agreements

Covenant	*Frequency (%)*
Cash flow to total debt service	92
Dividend restriction	89
Minimum net worth	86
PBIT-based interest cover	83
Gearing	82
Cash flow-based interest cover	62
Other interest cover	44
Net current assets/borrowings	29
Proportion of good debtors below certain days outstanding	29
Current ratio	20
Quick asset ratio	17
Industry average margins	15

Note: Percentages are calculated by reference to the mid-points of the various response categories (0-5%, 6-35%, 36-65%, 66-95%, 96-100%); n = 29 respondents.

ers having a closer relationship than the general bank lender.

Non-accounting-based covenants. Smith and Warner (1979) classify covenants into four categories: production/investment; financing; dividend; and bonding. The first three groups seek to control management behaviour, while the purpose of bonding covenants is to reduce monitoring costs. However, previous research contains little systematic evidence on use of non-accounting covenants. Table 3 shows non-accounting covenants to be of major importance in MBO lending. We show that, in the view of respondents, as many as 10 non-accounting covenants are used almost universally (90% of time or more on average).

Most of the non-accounting covenants found in MBO agreements fall into three of Smith and Warner's categories (dividends are restricted by an accounting-based covenant). Two key bonding covenants requiring the supply of information are ranked first (audited accounts within specified period) and fourth (monthly management accounts within specified period). Almost universally-used controls over production/investment policy are charges over assets and restrictions on mergers, asset disposals and capital spending. Restrictions on additional borrowings is a widely used covenant seeking to control financial policy.

Thus non-accounting covenants play a vital role in MBO loan agreements, and central to these are covenants requiring the supply of accounting information. The large number of covenants seeking to control production and investment policy reflects the inherent difficulty of directly controlling this class of behaviour (Smith and Warner, 1979).

In summary, our findings confirm that MBO loan agreements contain a large number of both accounting-based and non-accounting-based covenants, including an emphasis on cash flow-based covenants.

5.2. Monitoring MBO Loan Agreements

As seen above, great reliance is placed on the buyout company supplying the bank with up-to-date accounting information, and in particular monthly management accounts. The vast majority of buyout companies (85.5% on average) submit monthly accounts within 30 days of the end of the month. The importance placed on the information contained in the audited annual accounts was seen in almost nine-tenths (89.2%) of the respondents sometimes asking for covenants to be certified by the client's auditor each year. Of those banks requesting such information, three-fifths (61%) of buyout covenants were certified in this way.

A critical issue in the identification of potential covenant breach is the frequency with which covenant monitoring is carried out and whether it mirrors the submission by buyout management of their monthly accounts. Responses indicate somewhat surprising differences in attitudes between banks (see Table 4). Only about two-fifths (39.3%) of respondents appear to monitor covenants on a monthly basis, that is, in line with the submission

Table 3
Frequency with which respondents use various non-accounting-based covenants in MBO lending areeements

Covenants	*Frequency (%)*
First charge over specified assets	98
Audited annual accounts within specified period	98
Cross default clauses	98
Monthly management accounts within specified period	97
Restrictions on changes in ownership	96
Restrictions on additional borrowings (from other sources)	96
Maintenance of adequate fire, theft and other insurances	96
Restrictions in mergers/acquisitions	92
Restrictions on asset disposals	91
No capital expenditure beyond certain limits without approval	90
Compliance with environmental laws and regulations	87
Compliance with other laws and regulations	84
No redemption of preference shares while loans outstanding	81
No undisclosed tax liabilities	78
Charges over keyman insurance	74
Keyman critical illness policy	49
Requirements for certain accounting policies	48
All banking to be transferred to bank within specified period	38
Restrictions on directors' remuneration	34
Restrictions on senior management's remuneration	28

Note: Percentages are calculated by reference to the mid-points of the various response categories (0-5%, 6-35%, 36-65%, 66-95%, 96-100%); n=29 respondents.

of management accounts. Almost a half (46.3%) do so on a quarterly or less frequent basis.[14]

5.3. *First Indicators of Financial Distress*

The way in which MBO lenders first become aware of impending problems was investigated by asking respondents to state how frequently a wide range of alternative information flows provided this first indication. This extends previous research that has focused predominantly on which accounting-based covenants are the first to be breached (Beneish and Press, 1993; Sweeney, 1994).[15]

As shown in Table 5, respondents rank accounting covenant breach only third in importance among initial indicators of distress (43% average likelihood).[16] The two most important sources are based not on contractual default, but on good banker/borrower communications—monthly management accounts (69%) and telephone communication from management (68%), as is the fourth, written communication from management (41%).

This result is confirmed by responses to the question: on average, how soon after a covenant is breached do you learn about the breach? To which the most frequent response was 'on warning given before'. While 62% of respondents acting as sole lenders or syndicate leaders (n=26) reported that they were given such prior warning 'almost always' or 'very frequently', only 15% said they received it only 'occasionally' or 'almost never'. The issue of whether bankers who are non-lead syndicate members receive less timely information than sole lenders/syndicate leaders was explored by asking for responses to the same question when acting as a syndicate member (n=21). As expected, there was some evidence that in this situation there was likely to be somewhat greater delay in detecting problems, with 19% indicating that they were given prior warning 'occasionally' or 'almost never', and only 48% receiving it 'almost always' or 'very frequently'. Using the Wilcoxon matched-pairs signed-ranks test to compare the responses of the 19 respondents who responded to both questions, they were found to be significantly different with $z = -1.69$ ($p = 0.045$, one-tailed).

Non-accounting covenant breaches rank low as first indicators of difficulties (seventh; 25%) as expected, since these are predominantly negative covenants, i.e. covenants that proscribe certain actions, violation of which is relatively easily avoided simply by avoiding the proscribed actions (see

[14] Banks may view the requirement to supply monthly accounts as imposing an important discipline on management to produce information.

[15] The Beneish and Press (1993) and Sweeney (1994) studies analyse instances of firms that actually breached accounting-based covenants in the 1980s.

[16] The percentages shown in Table 5 sum to more than 100, since it is possible that several factors may simultaneously be initial indicators of distress.

Table 4
Frequency of monitoring covenants

Average frequency with which covenants are monitored	*% of respondents monitoring with stated frequency (n=28)*
Monthly	39.3
Every second month	14.3
Every third month	32.1
Less frequently	14.3
Total	100.0

Healy and Palepu, 1990; Beneish and Press 1993; Sweeney, 1994).

5.4. *Role of Accounting-based Covenants in Signalling Distress*

This section examines lenders' views on the effectiveness of covenants at signalling difficulties and the relative frequency with which the various accounting-based covenants are breached.

Although communication from management is a more frequent first indicator of difficulties than actual covenant breach, it is possible that anticipated covenant breaches stimulate timely management communication. This issue is raised by Beneish and Press (1995b), who study cases of debt service default and bankruptcy that are not preceded by accounting-based covenant breaches. They conclude, however, that accounting-based covenants may not always provide warnings of future difficulties. The implications of this finding were explored further here by asking respondents open-ended questions about (a) their perceptions of the effectiveness of covenant breaches at signalling financial difficulties, and (b) circumstances in which borrowers may have entered financial difficulties without any accounting-based covenant breach.

Effectiveness of covenants as signals of difficulties. Of the 25 responses regarding the effectiveness of covenants, 11 banks considered that they were extremely effective, a further 13 that they were good indicators subject to certain qualifications, and only one respondent felt that they were not good indicators.

While covenants are thus perceived as effective in signalling financial problems, many respondents emphasised the importance of the relationship between the bank and the buyout customer in this process. Generally, financial information received for covenant monitoring could be seen as acting as a catalyst for discussions with management and, in particular, provides the discipline to force management to address issues that they might otherwise be inclined to avoid.

Table 5
First indicators of impending difficulties when sole lender or syndicate leader

Indicator	*Average frequency with which item is indicator (%)*
Monthly management accounts	69
Telephone communication from management	68
Breach of accounting covenants	43
Written communication from management	41
Overdraft levels	36
Notification from lead equity institution	28
Breach of non-accounting covenants	25
Failure to pay interest on due date	13
Failure to pay scheduled capital repayment	13
Audited annual accounts	13

Note: Percentages are calculated by reference to the mid-points of the various response categories. The banks were asked to report for each item the distribution of the frequency with which it was the first indicator (in the ranges 0-5%, 6-35%, 36-65%, 66-95%, 96-100%). There is also the possibility that several factors may simultaneously be the initial indicators of distress, and as such the sum of percentages for all the items is greater than 100.
n=25 respondents.

However, a number of banks stressed that with good regular monthly financial reporting, bankers should anyway be in a position to anticipate breaches of covenants. Thus the actual reporting process may be just as important, if not more so, than the covenants themselves. If banks have a close relationship with the customer and understanding of the business with regular dialogue, impending problems may be solved before covenants are themselves breached.[17] Covenants to trigger actions by the bank may only have to be used where this relationship is not as strong as it should be, or where management and their backers are running out of solutions. Indeed, one respondent stressed that it did not seek to use covenants to trip borrowers up, but as a means to provide input into the process by which financial performance deterioration is corrected.[18]

A further qualification on the effectiveness of covenants is their appropriateness at the time of the buyout and the influence of the passage of time since buyout. Covenants need to be set at a realistic level against the original management plan for the first few years. If assumptions in the original buyout proposal are unrealistic, or cash flow generation is inconsistent or soft, then problems are likely to arise. Additionally, the process of winning the bank mandate may have resulted in the negotiating out of certain covenants, which will decrease their overall effectiveness. While the lender's ideal position is to provide effective signalling of financial distress through covenants, this may have been eroded through competition from other banks and the influence of the equity institution.

Furthermore, with covenants sometimes originally being set on financial models looking forward five to 10 years, breaches may in fact be occasioned by changes in business which are planned and agreed by all parties some time after buyout. Banks need to take account of such changing circumstances.

Cases of financial distress without prior breach of an accounting-based covenant. To explore this issue, we asked respondents under what circumstances they had encountered such cases. Fourteen banks (almost half of all respondents) described such instances, covering a wide variety of situations. Responses covered several main types of situation, including managerial issues (e.g. managerial 'misbehaviour', sudden resignations, death/incapacity of a key manager, false accounting, unauthorised pension transfers), problems of both an operational and market nature encountered by the buyout company (e.g. regulatory changes, environmental problems[19], protracted disputes with customers, the loss of a major contract) and the nature of the original covenants which may not have covered certain financial eventualities (e.g. excessive stock build-up, the level of trade creditor liabilities, third party claims, off-balance sheet agreements).

Respondents were also asked to what extent breaches were avoided by creative accounting on management's part. Reassuringly, only one out of 26 respondents felt that this usually happens and none that it was almost always the case. Nevertheless, almost three-fifths (57.7%) felt that breaches were sometimes avoided by creative accounting on management's part. Quite apart from the possibility that MBO management may avoid such actions because of fear of the consequences of being caught, this finding also suggests the importance of informal monitoring relationships in reducing the incentive for managers to take such actions.

Accounting-based covenants most likely to be breached. Given the central role of accounting-based covenants in signalling distress, which of these covenants are the most likely to be breached? Table 6 shows that profit and cash flow-based covenants are, in the view of respondents, the most likely to be breached. The two balance sheet ratios (gearing and minimum net worth) rank fourth and fifth respectively.

Comparing the frequency with which a particular covenant is used with the likelihood of its being breached, the main discrepancy occurs with dividend restrictions that are almost universally present but rarely breached (see Table 6). This is in line with evidence that negative covenants, such as dividend restrictions, are unlikely to be breached (Beneish and Press, 1993; Smith, 1993). Once dividend restrictions are ignored, however, there is a highly significant positive correlation between respondents' rankings for inclusion in contracts, and the rankings for likelihood of being breached. The implications of this finding require further investigation, however. It could be that certain covenants are used frequently because they are effective indicators of distress. Alternatively, it

[17] This point might suggest that trust is an important aspect of the relationship between bankers and MBO management. Detailed discussion of this point is beyond the scope of this paper, but fuller understanding of this issue would need to include analysis of the incentives to maintain or not maintain a situation of trust and the explicit and implicit contracts put in place in anticipation of breakdown in trust. We touch on the issue of trust in our summary of findings from the interviews, below.

[18] This, of course, only represents the bank's perspective and further research, which is beyond the scope of the present paper, might usefully be directed to ascertaining management's views on this issue.

[19] For instance, one bank reported problems resulting from the deregulation of the dairy industry, which led to a general increase in milk prices and gave supermarket retailers the option to contract directly with producers rather than being obliged, as formerly, to purchase through the Milk Marketing Board.

Table 6
Frequency of breaching various accounting-based covenants by firms that are in breach

Covenant	*Likelihood of breach[1] (%)*	*Likelihood of breach (Rank)*	*Average likelihood of inclusion[2] (%)*	*Average likelihood of inclusion (Rank)*
PBIT-based interest cover	47	1	83	4
Cash flow to total debt service	44	2	92	1
Cash flow-based interest cover	42	3	62	6
Gearing	30	4	82	5
Minimum net worth	26	5	86	3
Other interest cover	18	6	44	7
Proportion of good debtors below certain days outstanding	7	7	29	8=
Net current assets to borrowings	5	8	29	8=
Quick ratio	5	9	17	11
Current ratio	5	10	20	10
Dividend restriction	3	11	89	2

Notes: [1]Means of actual percentages stated by respondents; n = 25, 26 or 27.
[2]See Table 2.
The Spearman rank correlation coefficient is 0.88 (significant at the 0.01 level, one-tailed) when dividend restrictions are excluded, but only 0.49 (not quite significant at the 0.05 level) when they are included.

may be that certain covenants are frequently breached simply because they are used more frequently.

We shed further light on the relative effectiveness of various accounting-based covenants as signals of distress by comparing the results here for UK MBOs with two US studies on actual first-time covenant breaches not specifically in LBO situations (Beneish and Press, 1993; Sweeney, 1994). The two US studies are remarkably similar and both stand in contrast with this paper's findings.[20] They both find net worth and working capital to be breached most frequently. In contrast, UK MBOs are perceived most likely to breach three entirely different covenants—profit-based interest cover, cash flow to total debt service and/or cash flow-based interest cover. Working capital covenants are rarely used in the UK, so it is not surprising that they are rarely breached. However, the net worth covenant is widely used and it may underperform as an indicator of trouble, since three ratios that are used less frequently (cash flow-based interest cover, PBIT-based interest cover and gearing) trigger breaches more frequently. These findings require further research, since likelihood of breach is a function not only of how often a covenant is used, but also of how tightly it is set; this last point has not been investigated either here or in the US studies cited.

[20] It is possible that differences between these results and those for the US may be influenced by the differing time periods of the studies, but the focus here is not on how frequently firms enter distress (which is influenced by macroeconomic factors at different times), but on the relative importance of different accounting covenant breaches.

5.5. *Variety of Speed of Banker Reactions to Breaches of Covenant*

It is expected that close banker/customer relationships result in attempts to preserve a distressed borrower's long-term going concern value. This is because close monitoring and open lines of communication provide timely signals of impending problems, and possibly also because of the loyalty and commitment between the parties involved in relationship banking (Holland, 1994). This expectation was tested by asking respondents about the average likelihood of their adopting each of four progressively severe courses of action once they had learned about a breach of covenant—discussion with borrower/equity investor group; waiver of covenant breach; renegotiation of loan document; and recall of loan. In recognition of the fact that the negotiation process is often drawn out, respondents were asked what actions they would take both within six months and within two years of the breach. Finally, in order to explore the relationship issue further, the results were partitioned according to whether or not the respondent's bank had a specialist unit for MBO lending. The presence of a specialist unit is used here as a proxy for a closer customer relationship, as it is indicative of a commitment to MBO lending and

Table 7
Time taken for various actions by banker after learning about breach of covenant

Action	*Within 6 months: Specialist unit (n=20) (%)*	*Within 6 months: No specialist unit (n=7) (%)*	*Within 6 months: Total (n=27) (%)*	*Within 2 yrs: Specialist unit (n=20) (%)*	*Within 2 yrs: No specialist unit (n=7) (%)*	*Within 2 yrs: Total (n=27) (%)*
Discussion with borrower/equity investor group	82	89.3	83.9	84.0	90.7	85.7
Waiver of covenant breach	66.2	47.1	61.2*	70.2	47.1	64.2*
Renegotiation of loan document	32.7	35.0	33.3	44.7	50.7	46.2
Recall of loan	3.9	5.7	4.4	10.7	24.3	14.2**

The percentages are means of actual percentages stated by respondents

*difference significant at 5% level (one-tailed)
**difference significant at 1% level (one-tailed)

of the availability of resources to monitor such loans.[21]

The evidence as shown in Table 7 suggests that, in the view of respondents, many breaches are relatively minor and can be dealt with through discussions with management rather than the more drastic measure of recalling the loan. The possibility for percentages reported to sum to more than 100 rests on the possibility of sequential actions during a two-year period because the position of an MBO may deteriorate progressively, so that a waiver may occur initially, followed by the subsequent more serious actions as the situation deteriorated. In over four-fifths (83.9%)[22] of cases there would be discussions with the borrower and equity investor groups within a six-month period, and in over three-fifths (61.2%) of cases overall there would be a relatively quick waiver of the covenant breach. Moreover, a significantly higher percentage of cases dealt with by specialist units (66.2%) are likely to have their breach waived within six months than those without specialist units (only 47.1%) ($z=-1.93$; $p=0.027$, one-tailed using the Mann-Whitney U test). This difference becomes more pronounced by the time two years have elapsed, by which time the percentage of waivers among specialist units is stated to increase to 70.2% while that among bankers without specialist units has not changed ($z=-2.21$; $p=0.014$, one-tailed).

Respondents perceive more detailed renegotiation of the loan document to take longer to achieve, being completed in one-third (33.3%) of cases within six months, although in only a half (46.2%) of cases is this course of action achieved within two years. Actual recall of the loan is stated to be very unlikely in the short term, and even in the two-year time framework only 14.2% of loans are likely to be recalled. However, the likelihood of recall within two years is perceived to be significantly higher among banks without specialist units (24.3%) than among those with specialist units (10.7%) ($z=-2.45$; $p=0.007$, one-tailed, using the Mann-Whitney U test).

Finally, in order to investigate the effectiveness of syndicates in dealing with covenant breaches, we asked the 22 respondents who act as non-lead syndicate members about the differences they perceived in the use of covenants between the position when they acted as a non-lead syndicate member and that as the deal leader or sole debt provider. Respondents indicated, on average, a 47%[23] expectation that there would be a longer delay in implementing action in response to covenant breach for non-lead syndicate members, and only a 12% likelihood that action would be implemented sooner. Applying the Wilcoxon matched-pairs signed-ranks test to the entire range of responses to these questions, the difference in responses is

[21] The 22 banks with specialist units had made significantly more UK MBO advances in the last three years than the seven without such units (an average of 15 advances compared with 4.6; t-value = 3.26, $p=0.003$ two-tailed) and the total net value of these advances was significantly higher (£128.1m versus £20.9m; t-value = 3.82, $p=0.001$ two-tailed).

[22] The percentages in Table 6 are the means of the actual percentages cited by respondents.

[23] Calculated by reference to the mid-points of the various response categories (0-5%, 6-35%, 36-65%, 66-95%, 96-100%).

Table 8
Frequency of modifications to loan agreements in response to breach of accounting-based covenants - MBOs vs general private lending

Modification	*MBO lending (n=28) mean %*	*General private lending (n=33) mean %*
Dividend restrictions	75	63
Capital spending restrictions	65	61
Increased interest rate margin	54	47
Injection of new equity	46	–
Relaxation of accounting-based covenants	46	42
Merger and acquisition restrictions	39	–
Additional security	38	67
Issue of share options	25	–
Replacement of all or part of secured debt by mezzanine-type debt	22	–
Conversion of some debt into equity	20	–

Notes: **1.** The mean percentages have been calculated by reference to the mid-points of the various response categories (0-5%, 6-35%, 36-65%, 66-95%, 96-100%).
2. The results for general private lending have been derived from the data used to construct Table 4 in Citron (1992a).

found to be significant, with $z=-3.06$ ($p=0.001$, one-tailed). Regarding the effectiveness of action once taken, there was a 55% expectation that such action was less effective from the syndicate member's perspective, and only a significantly lower 14% likelihood that it would be more effective ($z=-3.29$; $p=0.001$, one-tailed).

In summary, therefore, the timing of responses to covenant breaches appears to indicate that banks take a flexible and perhaps pragmatic approach to the breach of covenants. Clearly in some cases covenant breach may be relatively minor and discussions will clarify the extent of financial problems and determine whether they are of a relatively temporary nature. In more problematical cases it takes longer to arrive at a decision to renegotiate the loan arrangements and documentation, or possibly to recall the loan.

There is also evidence that banks with specialist MBO units are more likely to waive covenant breaches and less likely to recall loans. To the extent that the presence of a specialist unit is a valid proxy for relationship banking, these findings confirm expectations that close relationships are conducive to preserving the going concern value of borrowers in distress. Moreover syndicate members, who have a less close relationship with borrowers than either sole lenders or syndicate leaders, indicate that responses to covenant breaches are slower and less effective.

5.6. Renegotiation of Loan Agreement Subsequent to Covenant Breach

Virtually one-half of MBO covenant breaches result in the loan agreement being renegotiated within two years of the breach (Table 7). As shown in Table 8, the most frequent modifications cited by respondents are dividend and capital spending restrictions. These are aimed at preserving the borrower's asset levels and, in the case of dividend restrictions, at enhancing the bank's position vis-a-vis that of the equity providers, who in MBOs are typically likely to use various quasi-equity instruments with cumulative dividend rights.

MBO lenders tended not to rate the taking of additional security highly, which contrasts with findings on contract renegotiations in a general lending context where additional security is the most frequently cited modification (Citron, 1992a). This probably reflects the high degree of security taken in MBO lending when the loan is first made, and hence there may be little scope for taking more.

Banks appeared to be reluctant to enter into major restructuring options through reclassification of the debt. Thus the conversion of some debt into equity and the replacement of all or part of secured debt by mezzanine type debt was not scored highly.[24] It was also very unlikely that share

[24] There is some incidence of this kind of restructuring, no-

options would be issued to enhance the bank's potential position. Surprisingly, the injection of new equity has a less than 50% likelihood of occurrence.

6. Interview evidence

6.1. The Nature of the Bank/MBO Relationship

The preceding analysis of the operation of covenants strongly suggests the existence of close bank/MBO relationships rather than their mechanistic application. By the same token, covenants (and security) provide a 'hard' constraint, providing scope for action should relationships break down. The 19 interviews with specialist MBO lending units were conducted to obtain deeper insights into the extent and nature of the relationships between banks and MBOs.

The banks perceived themselves to be involved in two sets of relationships: one with management in MBOs and one with venture capital firms and intermediaries. Specialist units were established to address both these relationships in order to provide a focus for the very different skills required to structure and monitor buyouts from other forms of corporate lending. Being a lead provider was reported to be crucial to the development of a relationship with MBO clients, as all primary contacts are channelled through the lead (agent) bank. To be perceived by venture capital firms as a serious lead provider of debt for MBOs, banks had to have a specialist unit.

In general, bank/customer relationships can involve a number of dimensions: the existence of trust and confidence between banker and management; a two-way exchange of influence as well as finance; the longevity of the relationship; and the provision by the bank of additional services to the company. The overall finding from our interviews is that, while the ways in which these dimensions develop differ as between MBO and general corporate lenders, there also exist important differences among specialist MBO lenders themselves.

With regard to longevity of relationship, it is important to distinguish between the relationship between the specialist unit and the MBO, and the relationship between the bank as a whole and the MBO. First, it was unlikely that the MBO company would have been a client prior to the MBO. This was partly because many of the banks in the market are not clearers, and partly because the clearers themselves would tend to have a relationship with the parent company rather than with the subsidiary being divested as an MBO. The second stage in the length of the relationship relates to the situation subsequent to completion of the MBO deal. Fourteen of our 19 interviewees reported that after negotiating the transaction it remained in the specialist unit, at least until flotation or other exit. The remaining five banks passed the MBO company to a relationship manager in the branch network and kept either a shadowing role or no effective role in further monitoring. These five banks involved the main London and Scottish-based clearing banks, although in one clearing bank the MBO was kept within the specialist unit.

The principal argument for retaining the MBO with the specialist unit was the expertise that had been built up about the company during the MBO completion process. As a result, the specialist units saw themselves as being more able than a general relationship manager to provide a speedy and efficient response if and when problems began to emerge. In addition, the non-clearers with specialist units, and especially the non-UK banks, saw MBOs as a part of a long-term strategy to develop their corporate client book, one interviewee referring to the specialist unit as the 'nursery'.

In those cases where the MBO was passed on to a general relationship manager, we found significant variation in the timing of the handover and in the post-handover role of the specialist unit. The handover to this manager could be either quite soon after the buyout, or delayed for several months or even years depending, for example, on whether the company had de-leveraged so that there would be no expectation of covenant breaches. Some banks would involve the eventual relationship manager from the outset so that he would be able to establish an early relationship, while in other cases the relationship managers were introduced at a late stage.

The post-handover shadowing role also varied from simply maintaining informal contact, through receiving the same regular accounting information, being consulted by the bank's credit committee on whether covenant breaches should be waived, to becoming directly involved if the company needed restructuring or to make acquisitions. It was thus clear that the relationship was viewed from an overall bank perspective, with the specific tasks required to service the relationship being segmented between different departments.

The banks retaining the company in the specialist unit after MBO would almost always seek to pass it on to a relationship manager after flotation, since the company's characteristics would have changed significantly by this point. The picture was complicated by the common practice of companies putting their core banking requirements out to tender at the time of obtaining a stock market listing.

The MBO specialist units reported considerably greater interchange of information than in general corporate lending, both at the pre-lending stage

tably in the case of Isosceles (Gateway Stores), the largest buyout in the UK. In 1993, £923m of debt was restructured into £256m bank loans, £400m deep discount bonds and £267m preference shares (Wright et al., 1995).

and in post-lending monitoring. Pre-lending, the bank would have greater access to all senior management in MBOs, whereas for corporate lending they would be more likely to deal solely with the finance director and have access only to public information. After completion, MBO lenders typically obtain monthly management accounts, including a sheet summarising the position on all covenants, and are likely to at least discuss these by telephone. Meetings may take place monthly but are more likely to be quarterly, twice yearly or ad hoc if there are specific issues to address. There is thus considerable flexibility as regards contacts, since the banks consider that if a good relationship has been built at the time of the deal completion, the MBO manager will be proactive in contacting the bank as required.

Where the MBO is passed on to the relationship manager and the specialist unit continues with a shadowing role, the latter is likely to receive the same information at least for one or two years. The specialist unit will typically undertake its own analysis and discuss the results with the relationship manager, and possibly hold meetings involving all three parties. In such cases, the specialist unit may need to invest considerable effort in managing internal relationships with the bank's own relationship managers. It is important to note that meetings and reporting will be driven by the lead bank in syndicates. Hence there are greater opportunities for lead banks to establish closer relationships, although syndicate members can arrange their own visits.

In contrast to MBOs, monitoring of general corporate lending is likely to involve less frequent information, fewer meetings and greater difficulty in cross-selling other products, as such clients can select the lowest price provision from their panel of banks. Banks lending to MBOs will often attempt to provide other services such as overdrafts, forex, mergers and acquisitions, particularly as this enables them to have a fuller picture of the MBO's performance and so improves their monitoring capability. It should be noted, however, that syndicate members may be in a weak position to sell other products, as these can often be placed only with the syndicate leader. The non-clearers especially reported that they will attempt to cross-sell products to strengthen the relationship during the MBO phase. This may put them in a more favourable position to continue the relationship as one of the company's panel of banks when the MBO floats, albeit through the bank's corporate finance division and not via the specialist unit itself.

Banks retaining MBOs in their specialist units after completion appeared to learn about problems no quicker than those who passed MBOs on to relationship managers. Covenants tended to be reviewed every one to three months whether the banks retained the MBO in their specialist unit or not, though there was a slight tendency for the former to do so more frequently.

A possible alternative mechanism to the relationship role of specialist units for controlling potential conflicts with MBO borrowers is the maturity of MBO loans. The mail questionnaire survey shows, however, that for 97% of the sample the inclusion of accounting-based covenants is not affected by the term of the loan. MBOs were reported in the interviews to involve loans with a longer notional maturity (seven to eight years) than for general corporate lending (up to five years), with the former tending to pay this down in a much shorter period (typically within two years), while the latter renegotiate the finance on a continuing basis. Moreover, the banks did not report a distinction in the nature of their MBO relationships as a result of any differences in loan maturities that do exist.

6.2. MBO vs MBI Lending

As discussed earlier, banks report no difference in the types of debt covenants used in MBOs versus MBIs. However, the interviews revealed some difference between the banks in respect of the 'tightness' at which the covenants are set. Some banks set the tightness of MBI covenants as for MBOs, on the basis that they would generally not lend to cases where they had concerns, or occasionally where they had been more conservative in their MBO lending. Others, by far the minority, either took the view that they should set the covenants a little tighter and monitor the MBIs more closely for a short period until they were convinced that the company was progressing satisfactorily or, by way of contrast, that MBIs should have more headroom in the setting of covenants to allow the company's performance to fluctuate by a greater amount while it was effecting restructuring, without needlessly triggering covenant breaches.

7. Summary and conclusions

This paper examines MBO lenders' perceptions of the role and effectiveness of covenants in the wider context of the loan monitoring process and, in particular, as their customers enter financial difficulties. The findings are based on lenders' views expressed via a questionnaire survey and interviews, and therefore do not necessarily reflect how they actually do react in particular cases in practice. However, the process of negotiating a loan agreement, monitoring subsequent performance and dealing with breaches of covenant are an integral part of the lender/borrower relationship, and the findings of this study are of value as reflecting the views of one of the partners in this relationship.

A key group of findings relates to the existence of close relationships between MBO lenders and their customers as evidenced by the extensive use of both accounting-based and non-accounting-based covenants, and the widely expressed view that impending distress is frequently communicated early, in advance of actual loan default. Once covenants are breached, discussions are stated to ensue quickly and virtually universally. Waiver, which occurs in almost two-thirds of cases, is also perceived to occur relatively quickly, but loan renegotiation or, less frequently, recall, take longer to resolve.

The paper probes the influence of banking relationships further, using the presence of a specialist MBO lending unit as a proxy for closeness of relationship. As expected, lenders with such units state that they are both more likely to waive covenant breaches and less likely to recall loans in default.

Syndicate members indicate that, compared with sole lenders or syndicate leaders, they are less likely to be informed of covenant breaches prior to their occurring, and that subsequent corrective action is likely to both take longer to implement and be less effective. These findings confirm expectations that, from a syndicate member's perspective, resolving default may have more in common with public debt than one-to-one private debt.

While MBO lenders proclaim the effectiveness of accounting-based covenants, initial evidence was obtained on the important issue of instances in which such covenants have failed to signal distress. These included either cases where distress was caused by factors not encompassed by accounting measures (e.g. management problems) or poorly set covenants.

Interviews with specialist MBO lending units shed light on specific features of the bank/MBO relationship. While these relationships exhibit high degrees of trust and two-way information exchange, they do not necessarily also find expression in longevity of association. Practice in this respect varies widely. The strong relationship that uniformly exists around the time of completing the deal is unlikely to have been present prior to the buyout, but there is a diversity of experience as to whether it continues post-completion or even post-exit.

This investigation into the process of monitoring MBOs and resolving loan default, and of the nature of the bank/MBO relationship, raises important issues for further research. The finding that the frequency with which accounting-based covenants are breached is positively related to their use leaves open the question of how effective covenants are at signalling distress on a timely basis. This question is reinforced by the preliminary findings reported here of cases where financial difficulties have occurred without covenants being breached.

In addition, it would be of interest to develop more powerful measures of banking relationships than those used here, to better investigate their costs and benefits. Further research might involve: a detailed examination of the management of the individual elements of banks' portfolios; a survey of both the bank and management parties to an MBO; a large-scale survey of MBOs/MBIs; or a second survey of the banks involved in MBOs/MBIs.

The finding that management accounts are often monitored less frequently than they are submitted requires further investigation, in particular regarding the actual role of accounting-based covenants and periodical accounting reports to bankers. For example, do bankers see the regular provision of accounts as an important discipline on management, is the frequency of detailed scrutiny related to the age of the relationship and the establishment of a sound track record, etc.?

The evidence presented in this paper is consistent with Holland's view that, although agency theory provides a useful lens through which to view bank-corporate relationships, further development is required. While the survey suggests that covenants are important contractual monitoring devices, evidence from the interviews emphasises that relationships between banks and MBOs are a highly important aspect of the operation of covenants. This is not to suggest that relationships replace covenants, since ultimate sanctions are necessary where relationships break down or where relationships are insufficient to deal with problems, such as when bankruptcy is the appropriate course of action. Further examination of the link between agency theory and relationships appears to be an interesting and potentially important area for further research.

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