

Algebra: Finance

J.R. Simplot Company

Job Description: Indebtedness compliance reporting, prospective lender correspondence, asset leasing, and various other financial analysis projects.

Problem:

Financial Indebtedness Covenant (this is an example problem. Amounts are not actual, as the company does not release financial information).

A Company needs cash to expand its current production facilities and has decided to borrow from the bank. As one of the conditions of borrowing from the bank, the Company agrees that its leverage ratio (total borrowings to total shareholders' equity) will not exceed 1.25 to 1.0. The Company has no current borrowings. Shareholders' equity is composed of shareholders' contributions of cash and accumulated company earnings.

1. If current shareholders' equity is 300, what is the maximum amount the Company can currently borrow?
2. If the Company wishes to reserve 50% of its maximum available borrowing for future needs, how much will it borrow currently?
3. If the Company needs to borrow 425 for the expansion and earns 10 per month, how many months must it accumulate earnings before qualifying for the loan of 425? (Remember current shareholders' equity).

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Solution:

1. Maximum borrowing = $1.25 \times$ Shareholders' equity (Financial Covenant)

$$375 = 1.25 \times 300$$

2. Current borrowing = $50\% \times$ Maximum borrowing

$$187.5 = 50\% \times 375$$

3. Borrowing needs = $1.25 \times$ [Current Shareholders' Equity + (Monthly Earnings \times Number Months)]

$$425 = 1.25 \times [300 + (10 \times \text{number of months})]$$

$$425 = 375 + 12.5 \times (\text{number of months})$$

$$(425 - 375) \div 12.5 = \text{number of months}$$

$$4 = \text{number of months}$$