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European Financing Dynamics In The Second Half Of 2020

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Although companies across many sectors felt the impact of the Coronavirus (COVID-19) pandemic immediately, the true effects and likely impact will not be seen until later this quarter and beyond. Whilst some companies have been quick to launch amendment processes, many have been busy testing financial models, ensuring liquidity and trying to minimise expenditure, as is common during times of economic stress. As we advance through the fiscal year, it is likely that amendments and waivers will continue to be sought. In this article, we analyse some of the areas where borrowers will require greater flexibility and consider the potential dynamics vis-a-vis their creditors as they seek to agree an appropriate way forward in what may be a different short and medium-term environment.

IN DEPTH

Financial Covenants

Many amendments and waivers have focussed on the financial covenant(s), whether in the large-cap space with its prevalence of springing leverage covenants, or the mid-market and beyond, where lenders normally benefit from at least one maintenance covenant, again often a leverage covenant. Given the urgent need to bolster liquidity and avoid future drawstops, many borrowers have drawn (and maintained on balance sheet) revolving credit lines above the requisite threshold that requires the leverage covenant to be tested. Whilst the ratios have been set with headroom, the pandemic impact will continue to add significant pressure. We will likely continue to see amendments that reset covenant levels and add more headroom, whether indefinitely or for a short period of time. Lenders have so far been amenable to such requests where the requests have related to testing for a set period of time whilst the pandemic affects financials, with the Prudential Regulation Authority and the Bank of England urging lenders to be patient and await meaningful information. It seems unlikely that lenders would be willing to grant a reset for the life of the loan without some other incentive, but equally sponsors and their borrowers will want to ensure that any longer-term effects from COVID-19 are mitigated, especially in the context of any such incentive or risk-return adjustment.

An alternative and sometimes supplemental measure will be deferrals and waivers of financial covenants. Again, we expect these to be limited to those testing periods affected by COVID-19. Borrowers facing liquidity issues and cash flow shortages more generally will likely request (either alternatively or additionally) a suspension of the covenant(s). A suspension of a borrower’s springing covenant could be critical in providing the group breathing room by allowing them to fully draw down on revolving lines without the worry of maintaining covenanted levels. This has been and will continue to be beneficial to borrowers even where revolving debt is excluded for the purpose of testing leverage.

Finally, some borrowers may seek to test covenants on an historic basis. Substituting EBITDA from the current quarter with the previous year's EBITDA is an effective tool in creating headroom. Lenders may allow this substitution to run for two to three quarters before "real" EBITDA, as at the relevant test date, is used. Companies may elect to use the replaced EBITDA for one or more quarters, giving them the flexibility to "save" such usage in the advent of a strong performance as COVID-19 measures are eased.

Notably, the springing leverage covenant is only granted in favour of the RCF lenders, and therefore sponsors and borrowers need only approach a limited number of creditors (predominantly clearing banks), rather than a disparate syndicate, to seek such amendments and waivers. Clearing banks also remain subject to the pressures of public policy to show restraint and flexibility with borrowers, rather than seeking precipitant action against them.

For many such amendments and requests, there is likely to be a consent or waiver fee which will vary on a case-by-case basis. Alternatively, some increase in margin (to reflect increased leverage), call protection or some additional protection, e.g., a minimum EBITDA or minimum liquidity (13-week rolling cashflow) covenant may be included and tested on a monthly or quarterly basis. Whether breach of such covenant (or in some cases multiple breaches) will be subject to the usual default/event of default regime or will lead to some other triggers (e.g., enhanced information rights) will be subject to negotiation between stakeholders.

Adjustments

The market has seen a number of covenant amendments and waivers to date, but many borrowers have been able to avoid such requests by relying on cost-saving and synergy adjustments to ensure EBITDA remains more constant and to mitigate the impact of the pandemic. The ability to *pro forma* EBITDA with savings and synergies for acquisitions, disposals and group initiatives, in some cases subject to no overall caps and long realisation periods, has been well-publicised.

In addition to stabilising the business, directors will examine their M&A pipeline. The remainder of 2020 may see an increase in opportunistic acquisitions as companies look to grow EBITDA through synergistic bolt-ons made in a market where pricing is depressed. Equally, the often widely defined group initiatives will allow the group to implement various other operational cost-saving measures. In addition to *pro forma* adjustments, borrowers may look to rely on restructuring costs and non-recurring extraordinary items add backs to EBITDA. Whether such items allow for COVID-19-related add backs, the adoption of so-called "EBITDAC" has already attracted significant market commentary. Lenders may look to clarify certain add backs and *pro forma* adjustments as part of the negotiations around covenant resets or waivers.

Payments of Principal and Interest

Deferral of coupon payments is invaluable for companies because it boosts liquidity to be used elsewhere by the group, but companies should ensure that a deferred coupon can still be paid, potentially even on a compounded basis. This, or some other form of forbearance, will also be used as a pre-restructuring tool to ensure a company can safely negotiate with its creditors without payment deadlines looming. If there are impending maturities, companies may launch a full "amend and extend" process. Again, there is an economic cost to such a process, both in terms of fees and pricing, and lenders may look to tighten other areas of documentation that they deem too flexible in light of increased credit-risk.

Another option for retaining cash and reducing the immediate interest burden on a group is to turn some or all cash-pay interest into payment-in-kind (PIK). The ability to turn off cash interest for a limited period of time is now seen quite regularly in mid-market private deals. Whilst such PIK rates are likely to be higher, borrowers and sponsors may be willing to incur additional long-term cost to ensure short-term survival, or at the very minimum to provide time to implement new measures. Where such option does not exist, lenders may impose certain conditions, particularly around a return to cash-pay interest.

Financial Reporting

The current environment has made compliance with financial reporting milestones harder. Management teams and auditors reporting on year-end numbers have struggled to make site visits, gather relevant information and undertake other ordinary-course pre-audit tasks. The resultant delays are likely to lead to a significant backlog, which in turn will require borrowers to request leniency in delivery deadlines. Borrowers that can avail themselves of the statutory extensions may seek parity with the reporting periods prescribed under their finance documents.

Lenders have remained understanding of such requests (whether under the guidance of the Bank of England and Prudential Regulation Authority or otherwise). We expect that trend to continue, but this may be an area where lenders try to regain some lost ground. In larger deals, reporting requirements have become skinnier with the removal of monthly management accounts and/or fourth quarter numbers. It would not be a surprise for lenders to require more regular updates, in terms of both numbers produced and more "face time" through lender presentations, calls and access rights, which in many cases are currently only triggered by material events of default. Equally, they may want to see unaudited year-end numbers prior to audited figures becoming available. There have been many examples already of lenders requiring enhanced financial information irrespective of the amendment request. For borrowers that anticipate stress or distress, it may also be a sensible gambit to maintain an active dialogue with creditors, particularly where debt is tightly held.

Debt Incurrence

During times of economic distress, liquidity is critical, and the ability for borrowers to incur additional indebtedness is the primary way to maintain liquidity. As mentioned, many companies have fully drawn their RCFs, but where this is not sufficient, they have looked to implement additional working capital lines. Where there is no pre-existing basket for incurrence, amendments will need to be sought. Alternatively, to the extent such debt is to be secured (which is highly likely to be a lender requirement at present) but there is no lien capacity to do so, amendments again will be required. Where a new money financing is intended to be on a super senior basis, sponsors and borrowers will need to be cognisant of various factors. Super senior money will be potentially easier to raise and cheaper for the borrower, but the addition of such tranche may require unanimous votes from the creditors to implement, or use of court-approved processes such as schemes of arrangement to reduce requisite consent levels. In larger credits, it may be possible to secure such new money (albeit potentially ranking *pari passu* with existing indebtedness) over assets not secured in favour of the lenders without the need to go to the syndicate.

Where borrowers are able to avail themselves of government-backed schemes, such debt may not be permitted, requiring amendments to existing documentation. Subject to the terms of such new debt, security and ranking may also need to be taken into account in such request.

One of the most common quid pro quos for additional debt incurrence is the injection of new equity (or subordinated debt). Implementing such indebtedness (often combined with amendments to any financial covenants) may be conditioned on additional funds from the shareholder(s). In some cases, irrespective of any required amendments, sponsors have already sought to inject new capital to support their portfolio companies.

If leverage is increasing as a result of such new indebtedness, lenders may require increased pricing to reflect the new risk profile of the credit. This can be achieved through an upward margin ratchet. Lenders may also focus on the group's ability to de-lever, and the relevant stakeholders should consider whether any kind of call protection is appropriate, particularly if new leverage is intended to be temporary. Many loans and bonds have flexible prepayment regimes where, primarily asset sales, have minimal requirements to prepay debt. Lenders may wish for such proceeds to be used to de-lever, but this must be balanced against retention of such proceeds which are essential for group liquidity. One possible compromise would be ensuring that proceeds of asset dispositions are prohibited from paying down junior or other *pari passu* indebtedness on a non *pro rata* basis (which is a common feature, particularly in the large-cap space).

Events of Default

Where a borrower does breach the terms of its loan documents and the applicable grace period expires, it will need to seek a waiver (or, in most cases, remedy the underlying default to the extent possible). Of equal importance, borrowers seeking to implement a restructuring/rationalisation often must certify an absence of defaults and should ensure that any proposed insolvency-related or non-payment events of default have been waived in advance so that the group can safely pursue such action. The current environment and regulatory overlay suggest that lenders will work constructively with borrowers to find solutions acceptable to all stakeholders. In default scenarios, directors should remain cognisant of their duties and potentially seek independent legal advice.

Conclusion

To date, lenders have been supportive to borrowers, and overriding market sentiment and public policy will encourage that trend to continue. It will be interesting to see how this stance develops in the coming months, as more companies realise the true impact of COVID-19. For the purposes of any future requests, open lines of communication between borrowers and their lenders will maximise the possibility of quick, mutually consensual outcomes for all parties.

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