SLAUGHTER AND MAY

TREASURY UPDATE
LEARNINGS FROM LOCKDOWN

June 2020

A Hard Day's Night

Over the lockdown period, the ratio of government debt to national income in the UK has reached levels last seen when the Beatles first hit the charts[1]. The period has been a helter skelter for many finance and treasury teams who have had to take swift action to support their balance sheets until trading can return to more normal levels. Those eligible are making use of, or exploring, government liquidity support schemes alongside private sector debt financing.

Our financing team has helped numerous clients to amend covenant terms to unblock actual or potential drawstops and access additional debt capacity in various forms. As the initial wave of financing activity starts to subside, attention is turning to the long and winding road ahead. This briefing takes stock of the issues borrowers have faced and dealt with over the two months of lockdown and how those debt financing arrangements might need to evolve as the COVID period enters its next phase.

Money (that's what I want)

Lockdown put pressure on cashflows very quickly for many businesses. The onset of the pandemic coincided with the end of the audit cycle for those with 31 December financial year ends prompting borrowers to take swift action to secure access to sufficient amounts of debt finance to support going concern analyses.

Facility headroom, accordion facilities, incremental debt capacity and how and whether any spare capacity might be utilised were reviewed immediately. Debt documentation was stress-tested against financial projections, to identify potential covenant challenges.

Tomorrow never knows

Some borrowers were initially quite focussed on whether to draw down working capital facilities. For those with immediate cash needs, the priority was to identify potential drawstops and where necessary, clear them with lenders as quickly as possible, to ensure the funds could be drawn. Others mooted whether to draw available facilities as a precautionary measure, rooted in concern (on the part of the company or in some cases, its auditors) that a further deterioration in the business could prompt drawstops in the future. Remembering the 2008 crisis, there were also worries about whether the economic

[1] "UK government borrowing and debt surges", Financial Times, 22 May.

impact of COVID, or even related operational challenges, might affect lenders' ability to fund.

These decisions were in many cases difficult, requiring the desire or need for cash in hand to be balanced against lenders' views on pre-emptive drawing, in an environment where supportive counterparties could become crucial down the track.

Different companies came to different conclusions, but debate about emergency or "pre-emptive" drawdowns ultimately faded, to a degree, as it became apparent that governments around the world would make liquidity support available and regulators urged private sector lenders to support corporate borrowers.

Fixing a hole

The UK Government launched two liquidity support schemes for medium sized and larger businesses that were viable pre-COVID – the Coronavirus Corporate Financing Facility ("**CCFF**") and the Coronavirus Large Business Interruption Loan Scheme ("**CLBILS**").

In addition to the CCFF and CLBILS, the Chancellor has authorised a further "branch" of government help, known as "Project Birch"[2]. This appears to consider government support on a "last resort basis" to assist strategically important companies facing acute financial difficulties whose failure would "disproportionately harm the economy". Our understanding is that this avenue involves significant (quasi-forensic) accounting analysis, flexible funding structures (including debt and equity) and definitive sponsorship from a government department.

Within you, without you

The CCFF enables companies with investment grade-equivalent status pre-COVID to raise short term finance by selling commercial paper to the Bank of England. There were some teething problems, largely relating to how companies without public ratings might satisfy the investment grade status requirement, but the scheme has proved popular. Treasury teams in many potentially eligible companies were using commercial paper for the first time, but schemes have been set up efficiently, cost effectively and within very short timeframes in most cases.

More than 200 companies have applied for the CCFF, of which Slaughter and May is advising more than 50. The Bank of England's most recently published data indicates that only 53 issuers (out of a total of 152 approved so far) have used the scheme, suggesting the majority are viewing it as backstop funding.

The CCFF may become less attractive as the Government starts to rein in and refine the scheme, in particular for those who have entered the CCFF on a backstop basis. CCFF

[2] "Project Birch" plan to bail out stricken UK companies, Financial Times 24 May.

funding above initially agreed limits or for issuances with maturities which extend beyond 19 May 2021, will have strings attached in the form of dividend suspensions and restraints on executive pay (see our briefing of 20 May). This will affect new applications and borrowers whose applications have already been approved but wish to increase their funding limits.

While many businesses may have dividend and executive pay restrictions in place at the behest of the board, shareholders or private sector creditors, this evolution of the CCFF may push certain companies towards other options. Reactions from equity markets may also be a factor. The equity markets have reacted positively to news of CCFF eligibility in some instances, but in others, less so. We are aware of some CCFF issuers considering either removing themselves from the scheme or taking steps to explain their intentions in more detail.

Not a second time

The CLBILS was launched after the CCFF, with the aim of supporting a wider cohort of companies. The CLBILS enables companies adversely affected by COVID to access finance directly from accredited commercial banks with the backing of a government guarantee covering up to 80% of the exposure. Banks offering CLBILS facilities must be accredited by the British Business Bank to lend with the risk and capital benefits of the government guarantee.

There are some indications that CLBILS got off to a somewhat slow start due to some structural constraints that are currently being worked through. For example, the requirement for lenders to share at a senior level in credit support arrangements offered to pre-existing lenders is causing some difficulties for business with segregated asset pools supporting certain sources of finance. There also appear to be some discrepancies in the requirements of different lending banks.

CLBILS has recently been expanded (again, see our briefing of 20 May). Accredited lenders are now able to offer loans of up to £200million to eligible borrowers, with loans above £50million being subject to similar conditions as CCFF funding. Details of the expansion of the CLBILS were announced on 26 May.

With a little help from my friends

Coupled with other government initiatives (such as the furlough, although more significant employer contributions will be required from 1 August), the UK government's liquidity support schemes have been, and will continue to be, an important source of short term finance for eligible corporates. Borrowers are nonetheless actively looking to the private sector for additional finance, because they do not qualify for the government schemes, due to a reluctance to rely on government support or because they simply need more or different types of debt than those the available government schemes can offer.

We have worked on a number of refinancings in recent weeks as well as loan finance alternatives such as private placements and bridges to capital markets issuances. The capital markets have been surprisingly busy. As discussed further below, we have helped many companies issue new public debt and have seen a significant number of companies combine a debt deal of some kind with equity financing. The right liquidity options have been very fact specific in the context of COVID.

All things will pass

The debt capital markets were closed to all but the strongest credits at the beginning of lockdown, but have since returned with notable resilience. As investment grade bonds are typically virtually covenant-free, there is some impetus for issuers with the rating to access those markets to favour that option over bank lending.

To issue new debt, issuers need to have up-to-date disclosure within their prospectuses. COVID effects are being disclosed in a number of different ways. Many issuers are including a COVID risk factor setting out the specific impact that COVID has had on that issuer's business and more generally, the wider global economic and financial consequences of the pandemic. Some issuers are also adding COVID disclosures into existing risk factors where relevant. Issuers subject to the Prospectus Regulation must strike a balance between ensuring that disclosures are specific and helpful for investors, while acknowledging that COVID remains a moving picture with unknowable consequences over the longer term. Some issuers are complementing their risk factor disclosures by including a "recent developments" section within business descriptions.

Issuers also need to consider whether they can continue to make clean "no significant change" and "no material adverse change" statements within prospectuses: the view is being taken increasingly that these statements should be qualified by other disclosures within prospectuses. Again, the challenge for issuers is how to make these statements specific even where it may not be possible to quantify the impact of COVID on an issuer's financial position. Some regulators (including the FCA) are requiring issuers to confirm that they have considered these statements in light of COVID. Issuers must also be prepared to answer new COVID-related due diligence questions from their dealers and underwriting banks.

Listed issuers have also had to navigate the impact of COVID on the regulatory consequences that flow from having listed debt. In this area, there have been a number of helpful statements from regulators. The FCA and ESMA have reminded issuers of their obligations under MAR. In some circumstances the impact of COVID may amount to inside information in relation to their listed debt (though debt can be less sensitive than equity in this context). The FCA and ESMA have also made statements for listed issuers in relation to publication deadlines and forbearance for annual and half-yearly financial statements.

Help!

Alongside the focus on liquidity and fundraising, a key COVID workstream for treasury teams has been to ensure that the business is in compliance with its banking covenants. Initial due diligence aimed at bolstering liquidity revealed a number of drawstops and weak spots in documentation, forcing borrowers to approach lenders for help in the form of amendments and waivers.

Some borrowers have also had to look at their capital markets instruments. The terms and conditions of most investment grade bonds contain limited covenants. The same does not apply to high yield issuers and other issuers with negotiated covenant packages, who have had to consider the challenge of consent solicitations or in some cases, virtual bondholder meetings.

The most common areas of vulnerability in loan agreements have included the following:

- **Provisions relating to changes in the business or a suspension or cessation of the group's business:** The lockdown forced companies to suspend or shut down their operations. Some changed the nature of their operations to fit the new circumstances. In our experience, a waiver of covenants or events of default on this topic has not been necessary in all circumstances due to the different fact patterns and variations in drafting.
- **Financial covenants and limits on debt incurrence:** The drop in income or profits resulting from suspensions, shutdowns, or simply slowdowns in trading flows, possibly coupled with an increase in drawn debt, has had a material impact on the ability of borrowers in many sectors to meet upcoming financial covenant tests. An immediate breach of covenant did not occur in most cases, but uncertainty about the business environment causes uncertainty about future covenant compliance. For those finalising accounts, auditors' views on covenant compliance have also fed into "going concern" considerations. Again, we have seen a range of approaches. Some companies have sought waivers of upcoming tests, others have sought to amend their covenants (with a challenge around forecasts and business plans). Others (for now) have determined to wait and see.
- **Provisions relating to reporting and audit:** Some regulators, as already noted, have relaxed audit timeframes, not least to permit auditors to scrutinise companies' going concern analyses in more detail. This has prompted affected borrowers to ask lenders to extend the time permitted for the delivery of financial statements in loan documentation. If the audit results or may result in a statement of material uncertainty or qualification, that also may have consequences under financing arrangements. For example, specific events of default that reference audit qualification are a feature of some loan agreements. Statements of material uncertainty are less likely to be mentioned specifically, but prompt an analysis of whether the events giving rise to that material uncertainty have implications under the loan agreement more generally.

- **Material adverse change representations and events of default**: A crisis always prompts focus on MACs. Companies (particularly with undrawn term loans or RCFs) were initially concerned about whether COVID or the lockdown could constitute an "event or circumstance", the starting point to consider whether a MAC is triggered, in the context of whether facilities should be drawn to maintain liquidity. MAC provisions in loan agreements, often turn on whether the event prompts a MAC in the "financial condition of the business" so come into particular focus when covenant challenges are anticipated. Again, in our experience whether waivers of MAC provisions are required or desirable has been quite fact specific.

These is no clear pattern in terms of the length or nature of flexibility being sought in relation to the above provisions, reflecting the bespoke nature of loan products, but most businesses seeking waivers appear to be looking for covenant holidays or relaxations of some sort into Q1/Q2 of 2021. Further, while the above are the most common issues we have seen addressed, they are not the only areas where waivers have been sought or considered. The vagaries of individual companies' lending terms, the need to manage different sources of finance on different terms has prompted quite an array of issues. It has been important for teams to maintain a broad perspective on the details of applicable lending terms and the position of the business.

We can work it out

On 26 March, just after the lockdown began in the UK, the PRA issued a "Dear CEO" letter on IFRS 9, capital requirements and loan covenants to UK banks, building societies and PRA-designated investment firms. The letter, among other things, contains guidance on the treatment of borrowers who breach covenants due to COVID. The PRA's expectation is that UK regulated lenders will consider waiving covenant breaches that arise specifically from COVID issues differently to those that arise because of borrower-specific issues, and in essence, treat borrowers sympathetically:

"[The PRA] would expect firms to [consider breaches] in good faith and not to impose new charges or restrictions on customers following a covenant breach that are unrelated to the facts and circumstances that led to that breach."

Experience so far suggests that in general, lenders are approaching waiver requests pragmatically and flexibly, but are scrutinising the scope and content of requests very carefully. Credit committees are questioning whether borrowers have asked for more than the minimum required (by the business or its auditors). For example, is a covenant holiday really needed or can the business comply with the same covenants, relaxed for a period? How long does the waiver or relaxation need to last? Borrowers have had to make available information on the base case and worst case impact of the crisis on both their performance and covenant calculations to justify their requests.

Borrowers have had to think carefully about the best strategy for a successful process. In instances where the consent of multiple lenders or groups of lenders is required, it has been helpful to refine proposals with a small group to test the water, before submitting

the request to the wider group. The identity of the consenting group has also affected the content of some consent requests. For example, some UK borrowers have found that overseas lenders (who are not subject to the authority of the PRA and are more focussed on supporting their home market) might require different incentives or have different priorities in giving consent.

You really got a hold on me

The key to a successful process for many has been to anticipate what lenders might require to incentivise or enable them to consent. In most cases, it seems that lenders (certainly UK lenders) have not been seeking additional fees. However, lenders are looking for additional covenant protections during the waiver period in many cases.

Common requests include tighter information covenants, for example more regular financial statements and cash flow forecasts. Some borrowers have been asked to continue to test their financial covenants as originally set during the waiver period, to provide lenders with an information benchmark.

We have seen a number of borrowers subjected to minimum liquidity or EBITDA requirements during the COVID waiver period, often in exchange for a relaxed or abandoned leverage test. Tighter restrictions in other areas, for example, on debt incurrence, acquisitions, disposals and dividends have also been a quid pro quo for consent in a few instances.

Lucy in the sky with diamonds?

There has been a certain amount of discussion in the market about so-called “corona clauses”. As far as we are aware, this term has no specific meaning, and there is no standard provision that fits this description. However, we are seeing terms in new and amended facilities that attempt to accommodate the impacts of the pandemic that might be described as “COVID related”.

For example, financial covenants and other provisions in new facilities and refinancings need to accommodate the temporary impacts of the crisis. If customary financial covenants are relaxed from “normal” levels, lenders may look for the same kinds of quid pro quo provisions as described above in the context of amendments and waivers. Rather than subjecting the group to minimum liquidity covenants or the delivery of monthly financials over the life of the facility, the agreement might acknowledge the COVID link and provide for the relaxation of more restrictive aspects once certain targets are achieved or time limits expire.

There have been reports of EBITDA add-backs and adjustments to neutralise COVID impacts in a handful of leveraged deals. In our experience, lenders and borrowers are focussing on EBITDA calculations and how unusual income and losses flowing through businesses currently should be reflected. This has resulted in adjustments in some cases. For

example, if a company is receiving government payments in respect of furloughed employees it may be prudent to note those amounts as a specific add-back. However, provisions “neutralising” or discounting COVID losses are not the norm in the loan market, the issue instead being addressed via covenant targets or relaxations.

Here comes the sun

The summer has arrived in the UK, many of the financings and consent processes initiated at the beginning of lockdown have been finalised, or are coming towards a conclusion. Attention is now turning to the next phase. How might the debt financing needs of the business be affected as the lockdown measures are eased and government support is withdrawn? A continual review of the liquidity position of the business in the context of the developing situation will be key, no doubt assisted by the need to focus and report on newly imposed covenants.

It seems inevitable that some of the solutions borrowers have put in place during the early weeks of lockdown will need to be revisited and unpicked or refined, as we move forward. Some businesses will be looking to move away from COVID related restrictions as the path towards recovery becomes clearer. This might involve the refinancing or abandonment of standby arrangements. Maintaining a dialogue with lenders will be important, in particular for those who have relied on Government funding, which will need to be refinanced as it is withdrawn or evolves. Those whose path to recovery will be longer will be keeping a close eye on the development of government initiatives, including potentially the relaxations to insolvency laws aimed at supporting those worst affected over a longer period.

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