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C-19 TREASURY: COVID-19 HEALTH CHECK

March 2020

On 11 March 2020, the World Health Organisation confirmed that the spread and severity of COVID-19 have escalated to the point of pandemic. As well as its human impact and widespread disruption to daily life, the outbreak has infected global financial and commodities markets, causing levels of volatility unseen since the global financial crisis in 2008.

As governments and central banks intervene across the globe to address the impact of coronavirus on communities, commerce and the financial markets, many of our clients are facing new and difficult challenges in relation to their financing arrangements.

In this note, we provide an overview of some of the most frequent questions and challenges we have dealt with as the situation has developed over the past weeks. As the effects of the pandemic intensify, these points may provide a framework for a COVID-19 health check or at least offer reassurance that corporate treasuries, and businesses more generally, are not alone in the issues that they face.

Liquidity

As travel bans and national lock-downs continue, many businesses are facing significant pressure on their near-term liquidity.

For some, this is due to a sharp reduction in cash inflows as customer demand has rapidly declined or is forecast to do so. For others, the opposite is true. As households and suppliers stock up on essentials in preparation for an extended period of self-isolation and reduced access to goods and services, manufacturers face sharp (and, for many, unseasonal) increases in working capital requirements to support a ramp-up in production.

Some borrowers are seeking to draw on revolving credit facilities (often beyond typical utilisation levels) to ensure that they have cash on hand. Others are looking to upsize facilities or enter into new liquidity lines to ensure that ongoing working capital demands can be met.

Considerations may include:

- Do we have access to sufficient liquidity to meet working capital demands?
- Can we rely on existing supply chain finance, or will disruption (either at home or abroad) affect our or others' access to funding that will, in turn, place greater demands on our working capital?
- When is the best time to approach lenders to upsize existing facilities or obtain new facilities? Is it better to start discussions early (at the cost of arrangement and commitment fees, but at a time of relative strength) or wait for further clarity (offering an initial cost saving, but potentially reducing certainty of execution)?
- Do our existing financing arrangements permit us to increase our debt levels?
- Have we consulted with our lenders to ensure that temporary disruption to working patterns will not affect the operation of our facilities and timetables for utilisation?
- Do we need to increase the frequency of our rolling cashflow forecasts and establish governance processes to ensure that the board is able to monitor the position?

Covenant compliance

As we enter results season, we have already seen a number of companies express concern that the wider macroeconomic impact of COVID-19 has already, or will shortly, lead to a decline in underlying business performance. Travel bans and quarantine requirements affecting many countries have had a profound effect on the transport and aviation sector, and the oil and gas industry is facing renewed challenges as oil prices hit historic lows in modern times.

In addition to the practical cashflow and liquidity implications described above, a decline in operating profit or an increase in net debt (or a combination of both) may put debt service, leverage and cashflow covenants under strain. The pace at which the situation is developing, and the volatility of financial markets, is also making it extremely difficult to prepare accurate forecasts.

Considerations may include:

- Do our projections suggest that we will remain compliant with financial covenants despite a downturn in performance or an increase in net debt to fund liquidity and working capital requirements?
- If our covenant headroom is forecast to fall below acceptable levels, should we consider approaching our lenders to obtain a covenant holiday or spike, or to agree amendments to the basis of calculation to exclude the impacts of COVID-19 on an exceptional basis?
- Are we subject to any more general covenants (e.g. regarding health and safety in the workplace) that could be put under pressure as we respond to COVID-19 challenges?
- Are we confident that we can obtain the necessary level of support for any amendments (particularly in relation to covenants in capital markets debt or widely syndicated bank facilities)? If not, should we consider backstop facilities or alternative arrangements as a contingency plan?

Access to debt capital markets

Volatility in the capital markets has led to a number of planned issuances being delayed or postponed indefinitely. It seems, though, that there is still demand for high quality, investment grade paper, perhaps driven by a reduction in yield on government bonds following widespread cuts in central bank rates. In contrast, issuance in the high yield bond markets has all but ground to a halt. Similarly, a number of public issuances of asset-backed securities have been paused, as sponsors and originators investigate alternative options to release capital (such as fully retained issuances and the use of central bank repo facilities).

Key questions include:

- What is our debt maturity profile over the coming months? Are we reliant on the capital markets for funding (e.g. to refinance existing bonds or to take out bridge facilities)?
- Do we have securities approaching call dates that we may wish to leave outstanding? If so, how and when should we message this to the market?
- Do we need to extend or upsize existing term debt facilities or enter into new facilities to provide an alternative source of funding to remove dependence on the capital markets?
- As a high quality, investment grade, issuer, do current conditions offer the chance to undertake an opportunistic issuance to take advantage of low rates and a flight to quality?

Material adverse change

If the situation worsens, lenders may face greater demands to make additional facilities available, and to take a supportive approach to existing lending (such as agreeing to covenant changes).

In these more stressed and uncertain conditions, borrowers reliant on committed but undrawn credit lines may wish to check whether their facilities contain material adverse change clauses, either in the form of events of default or repeating representations, that could be grounds for lenders to call a drawstop and refuse to advance funding.

Key questions include:

- Are any of our borrowings subject to material adverse change clauses that could result in committed facilities ceasing to be available when needed?
- Do we need to increase our cash at hand to reduce exposure to undrawn credit lines?
- Should we enter into regular and ongoing dialogue with our lenders to obtain reassurance that our facilities will continue to be available when required?

Audit

For many, the escalating COVID-19 situation has coincided with their annual reporting and audit cycle. As well as broader disclosure considerations, those facing funding, liquidity or covenant compliance issues may need to demonstrate to their auditors that appropriate arrangements are in place to support customary going concern statements. These issues are likely to face particular scrutiny following the FRC's decision in September 2019 to impose a more stringent standard in response to high profile corporate failures.

More generally, significant post-balance sheet adjustments, and practical issues presented by working restrictions imposed by companies and audit firms, may delay the timetable for completing annual audits and finalising financial statements. These delays may have knock-on implications on the ability of borrowers to comply with information and reporting covenants under private and public borrowings.

Key considerations include:

- Do we face funding, liquidity or covenant compliance issues that may be grounds to challenge our ability to continue as a going concern? If so, do we need to engage with our auditors to ensure that these are addressed and, if necessary, reflected in a statement of material uncertainty?
- Does what we say in our financial statements and audit report trigger consequences under our debt facilities (such as a requirement to engage with lenders or a default in its own right)?
- Do we need to establish an appropriate communications plan to address disclosures in our financial statements or audit report to ensure that we maintain the confidence of stakeholders?
- Will delays arising from COVID-19 working arrangements impact our ability to deliver our financial statements when required under financing documents?

Disclosure

Listed companies, and private companies with listed debt securities, will also be subject to ongoing disclosure requirements. Many of the issues considered above have the potential, if sufficiently material, to constitute inside information or material non-public information. Care must be taken to ensure that obligations to monitor and, where required, disclose such information to the public, are complied with and managed appropriately.

Companies should also consider whether they are subject to contractual reporting obligations that may be triggered by any of the circumstances described above, or by the broader macroeconomic impacts of COVID-19.

The situation relating to COVID-19 is rapidly evolving, and the extent of its impact on communities, commerce and the financial markets is unlikely to be clear for some time. For now, there is significant focus on storm proofing; we must plan for the worst whilst hoping for the best.

Through these challenging times our team is here to offer practical and technical guidance, and to provide a perspective on the experiences of others across the market. Please don't hesitate to contact your usual relationship contact.