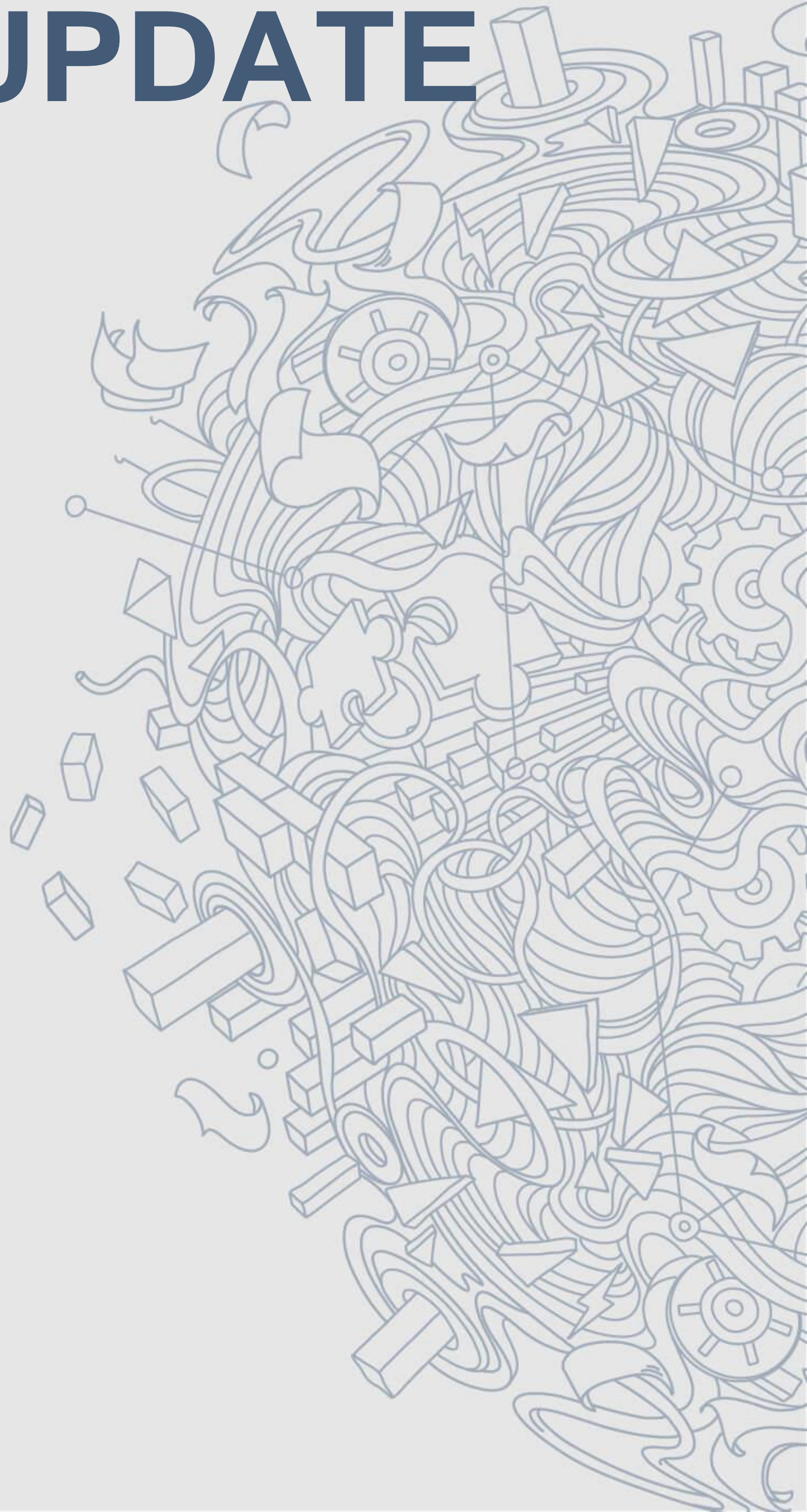
SPRING CORPORATE DEBT UPDATE



April 2020

ADDLESHAW GODDARD

INTRODUCTION

Welcome to the Spring edition of the Addleshaw Goddard Corporate Debt Update.

Having navigated the uncertainty created by Brexit and the recent general election, Covid-19 is now presenting a new challenge which is dominating the global and domestic agendas.

We lead this edition with an article looking at Covid-19 from a funding and restructuring perspective. As we have already seen, the scale of the pandemic looks set to disrupt many sectors, at the very least in the short-term. Of course, corporates have been considering liquidity and their funding arrangements to ensure they are able to weather this storm.

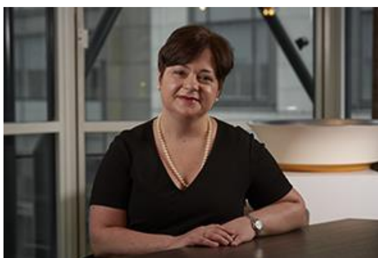
The article examines the possible impact of Covid-19 on funding arrangements, highlights what lenders and borrowers should be looking out for and offers pragmatic suggestions for the uncertain future ahead. We also look at the measures introduced by the UK Government (including in the now distant Budget 2020) which, together with Bank of England's two interest rates cuts, down from 0.75% to 0.1%, seeking to ease the short-term economic impact of the pandemic.

Following on from our last edition in which we examined the likely return of Crown Preference and the impact on the order of payments in an insolvency event, the Budget 2020 confirmed the reintroduction would proceed albeit that it would be pushed back until 1 December 2020. Lenders should also be aware that the "prescribed part" set aside from any floating charge for unsecured creditors on an insolvency will increase from £600,000 to £800,000 with effect from 1 April 2020.

As many were expecting, the Budget 2020 also announced an immediate cut back to entrepreneurs' relief. The relief reduces the capital gains tax rate to 10 per cent. on qualifying gains if certain conditions are met. As from 11 March 2020, the lifetime limit on qualifying gains to which the relief applies has been reduced from £10,000,000 to £1,000,000. If you have any queries on the Budget 2020 please do reach out to your AG contacts. Sector specific summaries of the Budget 2020 have also been published on our website and social media pages.

Prior to the outbreak of Covid-19, we hosted an event where a panel (including a debt adviser, a corporate banker, a restructuring accountant, an economist and one of our lawyers) gave their predictions of the market trends for corporate debt in 2020. In our second article, we look back at sentiment at that time, which includes themes that will remain relevant to the hoped for 'bounce back' in transactional activity.

Finally, we finish this edition with an update on the transition from LIBOR. Although now taking account of Covid-19, the Bank of England's Risk Free Rate Working Group is largely seeking to keeping to its target timetable and is now encouraging funders to cease issuing LIBOR-linked cash products by the end of the first quarter of 2021. We expect to see the market moving further to implement alternative rates despite the challenges surrounding the transition that still remain.



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LOAN FACILITIES AND THE PANDEMIC: CONSIDERATIONS FOR LENDERS AND BORROWERS

On 11 March 2020, the UK Government delivered its Budget for 2020 which contained the first of a number of measures addressing the impact of the Covid-19 pandemic on businesses. This included focused support for impacted SMEs: 'business interruption' loans, the abolition of business rates for retail, leisure and hospitality sectors with a rateable value below £51,000 and a refund for sick pay payments of two weeks for firms with fewer than 250 staff.

Since then further substantial measures have been introduced most notably the Coronavirus Job Retention Scheme and the five Government-backed funding schemes in the Covid Corporate Financing Facility, the Coronavirus Business Interruption Loan Scheme, the Coronavirus Large Business Interruption Loan Scheme, the Future Fund and the most recently announced 100%-backed 'bounce back' loans for the smallest businesses.

Separately we have seen the creation of 'support funds' by certain clearing banks to support customers' liquidity, together with the Bank of England's announcement that interest rates would be cut from 0.75% to 0.25% and then cut again to 0.1%.

It remains to be seen how successful these responses might prove for affected businesses in the medium and longer term as they maintain a stable balance sheet and manage liquidity whilst the consequences of the pandemic remain uncertain. Larger firms exposed to the effects of the pandemic will also have to take note of the Government's policy and be prepared to seek out equity and other support from stakeholders to help bridge to a period of improved economic stability. A collaborative, swift and open approach will of course be advisable as potential solutions are considered.

As such, both lenders and borrowers will be concerned with their financing arrangements, which are typically not designed to accommodate such steep drops in demand or widespread market disruption. Below we address some key concerns from both the borrower and lender perspective and pose some pragmatic suggestions for next steps that might be considered.

MATERIAL ADVERSE CHANGE ("MAC") CLAUSES

MAC provisions typically allow for a lender to withdraw funding in circumstances where the borrower is in a substantially deteriorated position than when they entered into financing. These provisions tend to be negotiated in some detail and will vary in form.

Documentation will commonly refer to situations where there has been a material adverse change to the business, operations, property, condition or prospects of the borrower group or their ability to perform obligations under finance documents or the effectiveness of guarantees or security.

In the absence of a more specific breach, lenders are usually reluctant to rely solely on MAC provisions as they might be difficult to enforce, being subject to the customary rules of contractual interpretation, and are therefore more commonly cited by way of supplement to other breaches.

Typically a lender would need to prove the effects of Covid-19 will have a sustained adverse effect on the borrower's business and that the effects are not temporary but will continue into the longer term (i.e., once the effects of the virus have subsided). Some businesses may have sufficient capital reserves, liquidity facilities and/or contingency planning in place to assist in managing the short- term effects, although it of course remains to be seen for how long the consequences will be felt.

Covid-19 has already found its way into the drafting of MAC clauses in transactions. One of the earliest examples was in Morgan Stanley's acquisition of E*Trade Financial Corp. where documentation specifically carved-out Covid-19 from the definition of MAC. It clarified that no *"[...] epidemic, pandemic or disease outbreak (including the Covid-19 virus)*" will amount to an event, circumstance, development, change, or occurrences that constitutes, or which will be reasonably likely to result in, a material adverse effect on "*the condition (financial or otherwise), assets, liabilities, business or results of operations*.". Similar drafting is now being commonly included in both new documentation and supplement to existing documentation.

Parties will also have been considering the terms of debt and equity commitment documentation as to whether funding can be withheld or withdrawn due to MAC or similar clauses. Whilst there remains significant capital across the market for deployment and sponsor appetite has been strong, equity investors, who bear the greatest risk, who may be more cautious of both new investments and following their money, if the effects of the pandemic are likely to significantly impact long-term returns.

WORKING CAPITAL FACILITIES

Revolving credit and other working capital facilities may include 'drawstop' provisions, designed to give lenders the ability to refuse further advances (rather than extending existing advances) in the event that there is potential for an event of default, though not yet crystallised.

Where lenders hold such a rights, they will likely tread carefully and consider the effect of restricting liquidity in these uncertain times on cash flow and prospects, thereby potentially jeopardising the borrower's ability to ultimately repay outstanding debt. Reputational considerations will also be forefront in lenders' thinking, in the context of the political and financial support committed by governments and institutions worldwide.

REPAYMENT

Of course, Covid-19 may well affect businesses' ability to meet scheduled repayments. Parties have engaged on this as a priority, with 3 to 6 month capital deferrals having been relatively forthcoming. Borrowers will be planning further ahead and may seek to enter negotiations with lenders as to whether further deferrals or softening of amortisation profiles might be appropriate. In the medium term, wider restructurings may be under consideration. In the shorter term, longer tenor interest periods are also being requested to conserve cash.

FINANCIAL COVENANTS

Designed as 'early warning systems', these provisions have of course been under focus, though with the effects of the pandemic on businesses so apparent (and with revenue often close to nil), profit-based tests have been (or are almost certain soon to be) breached for a number of weeks already.

With revenues so low, for the nearer term, lenders have focused instead on liquidity or assets tests designed to monitor the effects of cost management strategies and hibernation of the business against reserves. Such a testing regime might also be supported by regular cashflow forecasting obligations. As ever, the advice for borrowers is to seek early and proactive engagement with funders to seek a balanced and mutually-effective solution.

REPEATING REPRESENTATIONS

Borrowers will often be required by finance documents to make a number of representations to the lenders, which are deemed to repeat. As mentioned in connection with MAC above, we are seeing increasing inclusion of acknowledgements and carve-outs for the effects of the pandemic to avoid defaults purely as a direct consequence of the virus.

CESSATION OF BUSINESS

An event of default may also be triggered if all or a material part of a borrower's business is suspended or ceases to operate. In the context of businesses implementing cost saving and mitigation strategies for hibernation and furloughing employees, where government or supranational public policy may recommend or dictate that the public are not permitted to engage with such businesses, again we are seeing these strategies being accommodated and carved-out from what would otherwise typically grant lenders default rights.

SUSPENSION OF PAYMENTS AND NEGOTIATIONS WITH CREDITORS

The typical market form of insolvency event of default often captures the commencement of informal measures (such as negotiations with creditors or threatening to suspend payments) in relation to actual or anticipated financial difficulty. This can cover the rescheduling of any indebtedness with any single creditor, including a company’s landlords and trade creditors, regardless of the value of those liabilities. The extent to which any particular approach or negotiations with a single or class of creditors might trip this provision will however always turn on the drafting of the relevant provision.

SUMMARY

The Covid-19 outbreak has created significant uncertainty in markets for investors, corporates and lenders alike. We expect it will still take a number of weeks still for the longer term impact to be capable of assessment with any certainty.

It may be in a borrower's interest to report regularly to lenders, keeping them informed and notified of any potential event of default as soon as they are aware, bringing them alongside business decisions and performance as it evolves. In addition to reporting obligations detailed in finance documents, if lenders are given early notice, they are often better prepared and would seem more likely to respond to positively to requests. This will be especially pertinent in syndicated arrangements, where the process will take longer to organise voting on terms between the different lenders.

We expect a continued on cash and cost management alongside stakeholder engagement to seek relative stability. Hopefully a collaborative and collective approach will see us through – as remarked by a client, "We are all in it together!".

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A LOOK BACK AT WHERE WE WERE: PANEL DISCUSSION

At the time of releasing this article, around one in five people around the globe are currently under a government enforced lockdown as result of the Covid-19 pandemic, causing wide-spread disruption to society, businesses and the economy. This has resulted in one of the fastest and deepest global economic shocks in history. With the situation changing daily, it is difficult to predict the long term effects of the pandemic.

During this uncertain time, most businesses are simply focussing on survival. It remains to be seen how successful the UK government's efforts to support, and then reboot, the UK economy will be.

Only a few months ago, there was good cause for optimism about economic prospects and how that might create the right environment for strong corporate activity.

At the end of January 2020, we hosted a panel event where a debt adviser, a corporate banker, a restructuring accountant, an economist and one of our own lawyers shared their predictions on the market trends for corporate debt in 2020. This article looks back at that discussion which we anticipate will remain relevant as and when people and goods are able to move more freely again and normal trading resumes.

LOOKING BACK AT 2019

In 2019, against an uncertain political and economic backdrop, most large corporates sought to avoid risk. Many had refinanced in the previous year and had secured debt facilities with options in place to extend maturity and increase quantum. They held back from M&A activity and did not roll out bold expansion plans. Instead, most waited for the prevailing political and economic uncertainty to settle.

"There are risks and costs to action. But they are far less than the long range risks of comfortable inaction."

John F Kennedy

A POSITIVE 2020?

However, inaction is rarely an effective long term business strategy. Whatever your politics, the start of 2020 brought a promising outlook for the UK economy following a decisive general election in December 2019 and the aversion of a cliff-edge Brexit, offering some clarity and a sense of greater stability and certainty. As a result, we saw an almost immediate increase in transactional activity which was sustained into the first couple of months of 2020.

That activity stemmed from two sources. The first being the backlog of activity that might otherwise have taken place during 2019. This being the usual transactional activity – disposals, acquisitions, expansion, joint ventures - driven by strategic agendas. The second source being the increased financial distress in some sectors resulting in assets coming to market. Such distress was often the result of management teams failing to adapt expeditiously to a rapidly changing world rather than the result of a general downturn in the economy. Casualties included businesses in the high-street retail, consumer, casual dining, outsourcing and construction sectors. It may have been the case that the then current debt terms unwittingly exacerbated the situation. Given competition in the debt markets, such terms are frequently fairly loose, it can often be the case that a large liquidity need does not crystalize until it is too late to achieve a solvent restructuring.

Transactional activity involving European assets or a European supply chain has tended to be more cautious due to the continued lack of certainty around the relationship between the UK and the rest of Europe. Of course, the Covid-19 pandemic could result in further incidence of business distress, for more than one reason, but this may largely be due to impact on the supply chains of many businesses.

FINANCING CONSIDERATIONS?

Whilst there were opportunities for acquisition activity, it was apparent that many private equity funds had significant capital to be deployed and therefore any corporate hoping to bag a bargain needed to be prepared to face fierce competition and be in a position to move swiftly.

This preparation comprised several elements. For example, it would likely be important for the board to set clear parameters for any proposed transactional activity and delegate authority to a small team to drive forward execution within those agreed parameters.

In terms of debt funding any acquisition, management teams should first review their existing facilities and consider the following:

- Is there sufficient headroom in the existing facilities to fund the acquisition?
- Does the purpose permit the funding of acquisitions?
- Are there any restrictions on acquisitions such that consents and/or particular forecasts or due diligence are required?
- If the existing facilities are not sufficient, is an accordion facility available such that it may be possible to increase the size of the existing facilities?

Accordion facilities (and term extensions) are typically uncommitted. That said, historically it was the norm for lenders to agree to increase and/or extend, often at the same pricing. Consequently, negotiations focused on having the shortest possible period for lenders to confirm their consent. But things have now changed and as a result a lender that is forced to make a swift decision may simply decline the request.

WHAT CHANGES HAVE THERE BEEN?

Regulation and policy have affected the pricing models of banks and therefore some banks are actively exiting facilities which no longer meet their return hurdles. Unless a bank's returns hurdles are met, they are unlikely to either extend the term of, or increase the amount of, the existing facilities. In fact, some lenders may already be waiting for the next available opportunity to renegotiate the pricing of an existing facility. Therefore any corporate anticipating a debt funded acquisition must speak to their lenders and test and agree in principle their appetite and pricing requirements. If necessary, this may mean making changes ahead of any acquisition opportunity. Those changes might include:

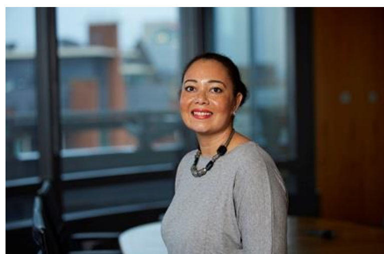
- Changing the mix of lenders, since the pricing models (and therefore appetite) varies between lenders. If forced to do this in the heat of an acquisition, the resulting delay may cause the acquisition opportunity to be lost;
- Agreeing in principle increased pricing and/or other structural changes such as the strengthening of guarantor coverage and/or the provision of security;
- Changing ancillary facility providers. Potential lender income from ancillary facilities should be understood and directed to core debt providers appropriately in order to gain maximum access to core funding;
- Considering a mix and match approach to funding. There is no shortage of available bank debt. The question is simply one of the terms on which it is available. It may therefore be appropriate to leave the core debt facilities intact and put in place short term event driven funding which is then refinanced in the public bond or private placement market.

The key takeaway here is the importance of an open and proactive dialogue with funders.

Finally, it is important not to forget the logistics of putting in place any changes. The process is not always simple and the preparation of any required forecasts, due diligence and completion of KYC and anti-money laundering checks will have an impact on the transaction timetable.

THE MEDIUM-TERM FUTURE?

Lenders are taking an increasingly active interest in climate change and sustainability. We are already seeing (and have advised upon several) facilities which offer a beneficial margin adjustment if certain sustainability objectives are met. We expect that trend to continue such that a corporate's plans for sustainability, and its execution of those plans, may become a common part of a lender's decision to fund.



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LIBOR TRANSITION UPDATE

The anticipated transition from London inter-bank offered rate (**LIBOR**) to alternative risk free rates (**RFR**) continue to develop, though the impact of current Covid-19 pandemic has now been recognised in the recommended timetable. The incoming changes were discussed in our Summer 2019 Corporate Debt Update article, which can be read here.

A 23 March 2020 statement from the Bank of England (**BoE**), the Working Group on Sterling Risk-Free Reference Rates (**RFRWG**) and the Financial Conduct Authority (the **FCA**) confirmed that the various major benchmark reform milestones set in relation to the Sterling RFRs should still be targeted, given their view that "*the transition from LIBOR remains an essential task that will strengthen the global financial system*".

However, in the context of the Covid-19 pandemic, on 29 April 2020 the RFRWG released the following statement "*…the FCA and the Bank of England recognise that it will not be feasible to complete transition away from LIBOR across all new sterling LIBOR linked loans by the original end-Q3 2020 target. There will likely be continued use of LIBOR-referencing loan products into Q4 2020 in particular, to maintain the smooth flow of credit to the real economy. Taking this into consideration the RFRWG recommends that:*

- *By the end of Q3 2020 lenders should be in a position to offer non-LIBOR linked products to their customers;*
- *After the end of Q3 2020 lenders, working with their borrowers, should include clear contractual arrangements in all new and re-financed LIBOR-referencing loan products to facilitate conversion ahead of end-2021, through pre-agreed conversion terms or an agreed process for renegotiation, to SONIA or other alternatives; and*
- *All new issuance of sterling LIBOR-referencing loan products that expire after the end of 2021 should cease by the end of Q1 2021."*

In further developments, the Bank of England (**BoE**) has announced a 10% "haircut add-on" for all LIBOR linked collateral from 1 October 2020, rising to 40% from 1 June 2021 and 100% from 31 December 2021. This is intended to boost the transition to their preferred RFR, Sterling Overnight Index Average (**SONIA**). SONIA, as detailed in our previous update, is an average of the interest rates that banks have paid to borrow sterling from other financial institutions on the previous day. Whilst SONIA is the preferred LIBOR replacement for sterling, there are other RFR alternatives available, with Secured Overnight Financing Rate being prevalent for US Dollars. It is recommended that any existing LIBOR arrangements that continue past 2021 will either need to (1) be converted to an alternative RFR or (2) include robust fall-back provisions in the contract. The first of the two options seems to be the preferred, long term solution as there are questions around the sustainability of the existing LMA fall-back provisions. Therefore, it is crucial that borrowers (and lenders) begin to establish their LIBOR exposures and ensure a plan is in place to manage the imminent changes.

SONIA-based bilateral loans have already been issued to National Express, SSE, Kennedy Wilson Europe Real Estate II and ABP, using the compounded in arrears methodology with a five business day lag.

The BoE is determined to support the transition to SONIA, recently announcing that it intends to publish a compounded index for the new benchmark from July 2020. This index is hoped to simplify the calculation, reduce uncertainty and increase flexibility (as it will be publically available). This means that borrowers should be able to use the index to calculate the compounded rate for certain products. The BoE is also considering publishing a set of compounded SONIA Period Averages but this is subject to responses received to their discussion paper. In a speech given by Andrew Hauser, Executive Director for Markets at the BoE on 26 February 2020, he said "*these initiatives* (the "haircut" and compounded index) *are aimed at turbo-charging sterling transition, helping the market deliver against its commitment to transition away from LIBOR and further de-risking sterling markets*".

In terms of documenting loans, unless adopting an RFR at issuance, loan agreements referencing LIBOR would need to be amended to refer to a replacement rate. The Loan Market Association has issued consultation drafts of 'reference rate selection agreements', which seek to streamline this process by adopting of a framework agreement. With this approach, the parties agree commercial terms for the selection of the applicable RFR and then authorise the agent and the obligors to make the requisite amendments to the facility documentation.

Some parties are seeking to build in their own bespoke mechanisms to switch to RFRs (recently included in Shell and BAT financings) which cater for systems developments. As mentioned above, the LMA is also looking at template wording for such switch mechanisms.

To conclude, this year remains crucial for the LIBOR transition and so if you have any questions around the impact of it and if there is anything that we can do to assist with your management of it please do not hesitate to contact your usual AG contact or one of the lawyers listed below.

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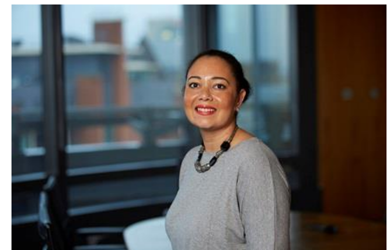

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