Note to clients

Debt capital markets update: Covenants

8 APRIL 2020

For many, the end of the March quarter saw the first test of covenants during the COVID-19 crisis. Whilst the backward-looking nature of financial covenants means few companies should face breaches this time, the number that will breach rises dramatically as we move through the second quarter and beyond.

Mid-market access to government-backed schemes

Following the lockdown, the first week was largely occupied with rapid and deep reviews of contingency plans by businesses and of portfolios by private equity, debt funds and banks. All were attempting to assess the scale of the impact caused by this crisis and of potential funding needs. The second week saw the level of direct interaction between borrowers and lenders ramp-up as those that require immediate liquidity sought the necessary funding.

As has been well reported, the Government initially announced two schemes to back-stop facilities provided to those companies raising liquidity facilities from banks:

- Coronavirus Business Interruption Loan Scheme (CBILS): available to businesses with turnover of up to £45m where loans of £5m are available with 80% backing by the Government, or

- Covid Corporate Financing Facility (CCFF): accessed through selling commercial paper to the Bank of England for businesses which are, or could demonstrate they would have been, investment grade before the crisis.

These two initiatives left a “squeezed middle” of mid-market companies that could either not satisfy these tests or potentially needed more than the £5m the CBILS scheme provided.

In response to this, the Government recently announced the Coronavirus Large Business Interruption Loan Scheme (CLBILS), which extended the original CBILS scheme to companies with turnover of up to £500m.

Whilst this move has been welcomed, full details of the scheme’s eligibility have yet to be published and there is an expectation there will be some type of means-testing, potentially meaning those companies with shareholders deemed capable of providing further funding, such as private equity, may not qualify.

Absent any Government support, any debt raise becomes a commercial negotiation with, almost certainly, incumbent lenders. Lenders then face the reality of a higher credit risk on the future repayment of any additional funding whilst having to balance this with potentially worse consequences of not providing support.

Regardless of how leveraged a borrower was before the crisis, it is simply the protective measures the Government has asked the nation to take that has caused the looming liquidity problems and not a failing of the business model or of management – it is this backdrop and the sheer scale of what is unfolding that is driving considerable forbearance from many lenders. Nonetheless, the reality of putting in place and negotiating new facilities at this time has raised several interesting debates.

Let’s take the topic of covenants

Whilst we do not yet know how long the crisis will last, it is reasonable for businesses to explore the possibility they will be unable to operate as normal for a period of up to six months. There are few, if any, borrowers who would be able to comply with existing financial covenants where they are unable to trade for six months. Indeed, only a few weeks ago this scenario would have been ridiculous to model as part of a covenant negotiation.

> Lenders are having to consider if a traditional credit approach is the right one to ensure borrowers can emerge from this crisis without irreparable damage.

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So, faced with mass covenant breaches throughout this year, lenders are being asked to waive forthcoming breaches.

A key point for debate here becomes how many future breaches should be waived. Assuming a business was not facing a covenant breach before the crisis, it would be reasonable to provide the opportunity for the business to comply again once it has had the chance to deliver a clean last 12 months (LTM) trading history. Until that point, or at least until good progress towards that has been made, it would seem unreasonable for a breach to be triggered purely by the inclusion of the crisis period in the LTM. To this point, some lenders are discussing replacing the crisis period with a prior trading period until that washes through the covenant.

The more immediate question, however, is what conditions/covenants should accompany new liquidity facilities. For borrowers that are raising emergency funding to see them through a period of perhaps zero revenue, the idea of an ongoing test to ensure continued availability to that funding seems crass. What financial metric should be tested and, more importantly, what are the consequences if the test is not met? If the answer is a draw-stop, then that simply defeats the object of the whole exercise. Whilst the government has announced a relaxation of insolvency rules to protect directors from otherwise inevitable wrongful trading claims, management teams must still think they have access to funding whilst juggling payments to creditors, some of which themselves face immediate liquidity issues.

Whilst the answers to these questions will always be case specific, many lenders have great sympathy for the challenges borrowers face and recognise that unusual circumstances call for unusual measures to ensure we all have a market to return to once the crisis passes.

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