Note to clients
Debt capital markets update

28 MAY 2020

As we move through the next phase of the crisis, some consistent themes have emerged.

Most portfolios are showing similar profiles with a small number of borrowers benefitting from the crisis, some in immediate distress (where solutions have largely now been put in place), and the largest proportion not needing specific action yet. The approach from both borrowers and lenders appears to be, 'if we're not forced to act now, wait'. With few, if any, breaching March covenants and the reporting of June covenants still almost a full quarter away, that breathing space provides time to understand better the implications of the changes to the lockdown and trading. Whilst it is accepted that most portfolio names will ultimately need some level of attention, this further time will give forecasts at least some level of credibility against very little today.

For the banks, another reason for delaying action is to gain further clarity on how the Government guarantee schemes under CBILS and CLBILS can be applied to private equity-backed borrowers. The key stumbling block comes from the EU state-aid rules which restricts Government support of "undertakings in difficulty". With a core measure of this being a balance sheet test which treats investor loan notes as debt and not equity, few, if any, can clear the hurdle. To complicate things further, scope exists for different banks to interpret the rules differently, leading to potentially split opinions within the same transaction. Lobbying continues to seek a consistent approach and permit the exemptions to allow private equity-backed borrowers to be eligible.

The next instalment

Overall, lenders seem to be approaching this crisis as a number of instalments, the first of which has already passed with the second coming in anticipation of the June or September covenant tests. The third instalment is expected when the post-crisis environment is better understood and the impact on capital structures can be properly assessed. With few exceptions, the various support measures available to borrowers are simply adding more debt to balance sheets – be that the deferral of PAYE, VAT or NI, relief from landlords' actions, or even the furlough scheme which, whilst great news for employees, for those in most distress is simply deferring the cost of ultimately laying staff off. Even the CBILS/CLBILS schemes are just more borrowed money, the main beneficiaries of which are the banks. So, this third phase is expected to see capital raised to provide new, long-term solutions to broken balance sheets and some debt funds are already raising new capital in anticipation of this with talk of old-style mezzanine potentially making a comeback.

Businesses are looking beyond the downturn

Notwithstanding this sobering view, there are examples of how the crisis has also been a catalyst for positive change. Businesses have been forced to look even harder at their cost bases and consider more efficient ways of working, the benefits of which should all outlive the crisis. Companies which not only survive the crisis but evolve to thrive in it

"While lenders have now dealt with their most critical cases, most of the work required to deal with the fallout from the crisis is yet to come.

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will be the most sought-after credits in the future.

Lenders are still active

Despite the focus on portfolio assets, lenders have been active on the small number of new transactions across Europe – typically deals where either the sponsor has equity-underwritten the whole structure and is now refinancing, or where a deal was well progressed pre-crisis and has shown consistent trading performance since. It is no surprise that these deals are in sectors such as healthcare and IT services. With so few deals in the market and funds still keen to deploy, deals look well covered, but this has not stopped the anticipated repricing. Unitranche term sheets are showing a 100bp–200bp premium to pre-crisis levels with bank debt expected to price 50bp–100bp wider. For funds in particular, given the level of dialogue with LPs and the read-through to the liquid debt market, no one wants to underprice a new deal, although for the best credits competitive pressures still exist.

The peaks challenge

For the time being, however, new deals are a side-show with the focus remaining on existing credits and how the coming months will determine their fortunes. Whilst the Government believes we have now passed the peak of the virus, what's clear is that we have not yet approached the peak of the work required to deal with its impact on borrowers.

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