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CORONAVIRUS:
LEVERAGED FINANCE – IMMEDIATE FINANCING CONSIDERATIONS FOR FINANCIAL SPONSORS, UNDERWRITERS AND DEBT INVESTORS

The Coronavirus (Covid-19) pandemic has coincided with a critical time in the financial reporting cycle for many financial sponsor-owned businesses. For those with a 31 December financial year-end, their annual audited financial statements will be due within the next few weeks, but may already be regarded as out of date as events have escalated.

The prevailing hope and expectation is that the current disruption is temporary, and the rise in "cov-lite" and "cov-loose" financings in the European market means that, in many cases, the financing group will have more breathing space than in previous downturns; but the situation still requires immediate attention.

In this briefing, we look at some of the key financing considerations for financial sponsors and their investee companies, management teams, underwriting lenders and debt investors.

Key Consideration 1: Maintaining Liquidity

In such an uncertain environment, the first priority from a financing perspective is likely to be to ensure the financing group has robust sources of liquidity that are sufficient to enable it to cope with any market disruption.

1. **Drawing Undrawn Facilities**: depending on the financing group's financial position, in some circumstances it may make sense to draw down any undrawn facilities to the extent possible to maximise flexibility, notwithstanding the additional interest cost of doing so. This is particularly the case where general "material adverse effect" or similar MAC events of default may make it difficult to satisfy the standard "no default" and repeating representation drawdown conditions if the Coronavirus situation deteriorates further. It should be noted that, for deals with financial covenants that are only tested when there is a minimum RCF drawdown (i.e. "springing RCF" covenants), drawing such revolving credit lines above the threshold will necessitate the need to test the financial covenant.
2. **Working Capital Facility "Clean-Down"**: sometimes there is a requirement to reduce the cash drawings (net of cash on balance sheet) under a financing group's revolving working capital facility to zero for a set period of days in any financial year. A financing group would ideally satisfy its clean-down obligation as early as possible to get it out of the way, and maximise the time period until its next clean down obligation arises. Financing groups will also want to minimise the need to draw the working capital facility over a financial covenant test date to avoid a springing financial covenant test where applicable.

3. **Equity Cure vs. Pre-Default Equity Injection**: most financings will contain a limited number of equity cure rights allowing for the injection of equity following a financial covenant breach, and the pro forma recalculation of the financial default ratios, to remedy the breach. The pro forma recalculation may be either by way of addition to EBITDA or by way of debt reduction and recalculation of interest. However, where the equity cure proceeds are required to be applied to prepay the financing, the financing group may not actually receive a meaningful liquidity benefit from the equity injection. Depending on the circumstances and the treatment of equity injections in the financing documents, it may therefore be preferable to inject equity to support liquidity and the net debt position for purposes of testing financial ratios in advance of an expected financial covenant breach (where permitted), and to avoid or minimise constraints on how such additional funds can be applied or otherwise included in other calculations under the documentation.

4. **Impact on EBITDA and alternative sources of liquidity**: stakeholders will be assessing how EBITDA or similar financial metrics are being impacted (and whether the adjustments available in documentation will mitigate the impact of Coronavirus-related issues on EBITDA). EBITDA is a key metric not just for financial covenants but also for ratio-based permissions such as permitted debt incurrence and baskets for negative undertakings in many deals. The ability to proactively quantify the impact on EBITDA in real time, and the related headroom available for purpose of for example, determining the need for and sourcing of additional liquidity, whether by way of equity or using other basket based debt permissions, will be important in managing the overall liquidity impact of the Coronavirus as the situation develops.

Key Consideration 2: Optimising the Capital Structure

Many financing groups already had plans to refinance/re-leverage, and will continue to look to take advantage of the low interest rate environment and/or extend maturities when the position stabilises. In addition, the market volatility will present some borrowers and issuers with an attractive liability management opportunity.

1. **Speed and Ease of Execution**: for transactions not yet committed, the logistical challenges arising from office closures and remote working arrangements are likely to reduce speed of execution. In addition, the huge market volatility is likely to affect underwriting appetite in the near-term, particularly until underwriting lenders have reliable financial information quantifying the impact of Coronavirus on the relevant financing group. As a result, if a financing group is seriously considering a debt raising, early preparation is key to ensure that it is ready to launch quickly as and when market conditions allow.

2. **Accuracy of Disclosure**: a week is a long time in the current climate, and one of the challenges facing any prospective borrower, issuer or underwriting lender is the extent to which developments during the marketing phase need to be disclosed and adversely affect the marketing process.

3. **Quantifying the Impact**: there is current debate about the ability to add back the impact of Coronavirus to covenant EBITDA – and the debate will also arise in relation to "marketing" EBITDA. Financing groups who actively track, document and quantify such impact in real time will be better positioned to explain and illustrate the impact in the future.
4. **Debt-Buybacks/Liability Management**: with many leveraged loans and corporate bonds trading below par in a "risk-off" environment, many borrowers and issuers are looking at opportunities to reduce their debt burden through debt buy-backs. This is potentially an attractive option to maximise value where the cash to implement the buy-back is readily available, particularly where the debt is being bought back at a discount.
5. **Impact on pricing/terms**: with current levels of market volatility for deals not yet syndicated or launched, we anticipate increased likelihood of pricing increases/ tightening of terms in tougher market until underwriting lenders and investors are able to adequately price the impact of the Coronavirus on issuers and borrowers.

Key Consideration 3: Navigating Distress

Preserving yield or optimising the capital structure is one thing, but for those businesses further down the stress-curve, the considerations will be quite different, as will the priorities.

1. Our "***Financial difficulties triggered by the impact of Coronavirus: Issues for stakeholders***" briefing and other Coronavirus (Covid-19) materials which you will find **here**, explore these issues, including force majeure, material adverse effect, identifying/notifying of events of default, and communication with stakeholders.
2. **Fewer early-warning triggers**: restructuring dynamics may be different in the "cov-lite"/"cov-loose" era as lenders with fewer early-warning triggers (such as meaningful financial covenants) find themselves being brought to the table later than in previous downturns. As a result, there is a greater onus on sponsors and management teams to proactively address distress, and potential distress, situations, as there will be more limited external catalysts than in the past.
3. **Transfer restrictions**: debt investors will also need to be mindful of the transfer restrictions in many of the European leveraged loan transactions: often the documentation restricts transfers, assignments and sub-participations unless a material event of default is continuing (limited to non-payment or insolvency-related events of default) or to an entity on an approved lender list which may affect the ability of debt investors to exit their investment as a means of risk mitigation in a distress scenario.

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