Covid-19: Key considerations on financing arrangements

30 March 2020

As the Covid-19 coronavirus continues to spread, borrowers need to proactively manage their current financing arrangements, particularly when their liquidity and credit profiles are rapidly changing and traditional business models need to be adapted.

In the current environment, existing financing arrangements may no longer be appropriate or replaceable. Lenders themselves are experiencing challenging times and may no longer be in a position to provide the flexibility or support you have become accustomed to.

In the wake of the ongoing pandemic, companies are facing a number of challenges that have triggered simultaneous shocks to demand, supply and finance — each of which will have at least some effect on potential, committed and future financing transactions.

As the impact on corporate profits become more apparent, borrowers could have a hard time to comply with their financial covenants. Highly leveraged companies that experience disruptions to their supply chains or reduced demand, could struggle to service their loans.

To prepare for the growing number of uncertainties, we highlight some key aspects that borrowers must consider as financial markets continue to be disrupted.

I. Focus on cash flow and liquidity preservation

In this complex environment, **liquidity management is essential** and preserving and/or accumulating cash should become a top priority. Companies should make a quick, but thorough assessment of short-term cash requirements and draw-down on existing credit lines as far as possible in order to support increasing (future) working capital and liquidity needs.

Check whether **current bank lines can be stretched**, or whether **trapped cash can be freed up** to create headroom, or potentially be used as a backstop in case supply chains become disrupted.

In addition, be aware of **compulsory cash sweep arrangements** in current loan agreements, which could jeopardise your liquidity profile.

Acting now, even if your company is not in need of immediate cash, can help stave off the possibility that you are unable to access funding later.

II. Proactively initiate discussions with your lenders

Current lenders have invested a considerable amount of time to understand your business. In times like these, they would be your best source for liquidity and/or additional funding. It is, therefore, critical to be clear on what you expect from them and engage with them often and openly on a number of key topics:

— Evaluate compliance of upcoming **financial and non-financial covenants** based on a number of scenarios and, if required, be specific on which parts of the **credit documentation** need to be amended or waived. In addition, consider any **potential add-backs to EBITDA**, when documentation does allow, to account for the non-recurring impact of the coronavirus.

— With the first quarter of 2020 coming up, ensure timely submission of your **quarterly reporting and compliance certificates.** In the current economic climate, these reports fulfil an important signalling function to financiers.

— Lenders as well as auditors will have **additional information requirements**. Make sure you have access and insight into current (and possibly also future) financial information, including working capital and cash flow developments.

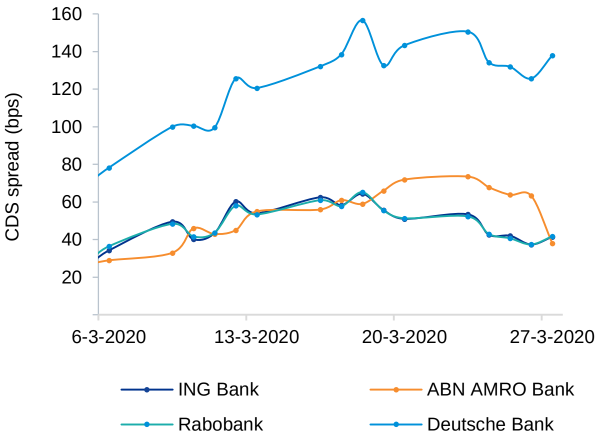
— Companies need to consider any **potential going concern issues** and prepare additional disclosures, especially if there is a material uncertainty. This will undoubtedly be a key focus of many current and forthcoming audits and be further scrutinised by lenders.

III. Prepare for a rising cost of credit

The negative impact of the Covid-19 outbreak has already caused a noticeable **deterioration in credit quality** of borrowers (and also of several lenders). This will have a major **impact on the pricing** at which lenders are willing to advance funding. According to some estimates, the cost of funding could increase by as much as 150bps or higher.

CDS spreads — which are considered to be a good proxy for the cost of funds — of the major banks active in the Netherlands, have seen a substantial spike since the first week in March 2020.

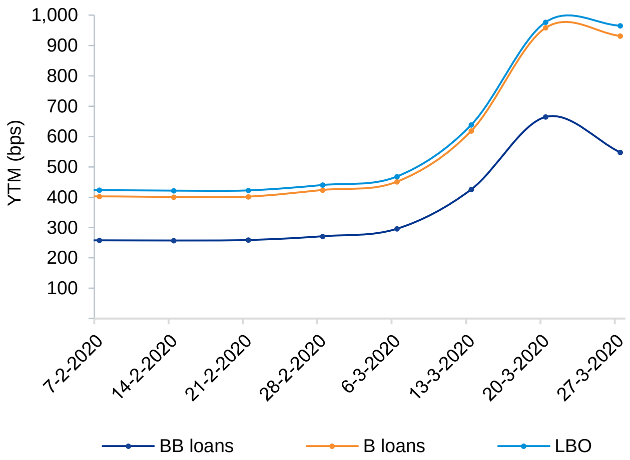
Figure 1: 5-year CDS spreads



Source: Bloomberg

The current unrest in the market is further evident in the S&P European Leveraged Loan Index (ELLI). The index reflects the performance of loans syndicated to European investors and provides a good indication of the **risk premium that investors demand** in the market today. The higher the premium, the more expensive it becomes for companies to finance themselves.

Figure 2: S&P European Leveraged Loan Index



Source: LCD, S&P Global Market Intelligence, S&P European Leveraged Loan Index

By 27 March, the yield on the S&P ELLI for single B-rated loans was at 931bps, compared to 440bps less than a month ago. The sharp increase comes as liquidity continues to dry up across the asset class.

The increase in funding cost in combination with lower corporate profits can also have a number of unintended tax consequences. **The Earnings Stripping Rules,** implemented by the European Commission in 2019, limit the net borrowing costs that are deductible up to a maximum of 30% of the fiscal EBITDA, above the EUR 1m threshold.

Fortunately for most companies, the sudden shift in pricing does not impact them until they have to refinance their existing loans or need to raise additional funding. But, as the current market conditions become more prolonged, many borrowers **will have to adjust to a rising cost of borrowing**.

IV. Beware of imminent debt maturities and longer processes

Debt markets could be shuttered for some time and predictions about how long these markets will remain closed seem to vary on a daily basis. Banks have shifted their focus inward and are managing the liquidity of existing portfolios, while disruptions to their day-to-day operations have weighed down on their deal capacity.

According to Bloomberg, hundreds of European companies will have to repay or refinance almost EUR 100bn in debt over the coming months.

Companies with facilities maturing in the coming 6-12 months **should prepare and initiate the (re)financing process well in advance**. The choppy markets and extended holidays over the summer period will undoubtedly slow down the financing processes, while discussions around commercial terms and documentation will be more restrictive and tilt strongly in favour of lenders.

V. Consider alternative funding sources

Let us be clear: It will not be straightforward for most businesses to secure credit in this environment, especially if they operate in a vulnerable sector severely impacted by Covid-19.

New financing requests will be scrutinised and the hurdles to get approvals will be as high as ever. Be aware that your current financiers may not be in a position to offer you the same financing package as before and refinancing overleveraged companies without a cash infusion from equity holders might be nearly impossible.

Companies should use this opportunity to **explore alternative lenders** and focus on diversifying their funding sources.

Over the past decade, Europe has experienced a massive influx of **new players into the private credit market**. Many of these players are currently sitting on significant quantities of dry powder and which they are looking to deploy to solid companies. But they will also become more selective about which deals to back.

Government programmes may bring the corporate sector with much-needed relief and it is imperative that you understand how to gain access to such programmes. The Dutch state is likely to extend the scope of the Corporate Finance Guarantee and use commercial banking channels as a gateway, but details and exact criteria of a stimulus package are still unclear at this point in time and likely to be focused more towards SMEs.

The Covid-19 pandemic presents organisations with a number of new challenges, while at the same time stakeholders will be expecting a lot from their management teams. By focusing on cash flow and liquidity while controlling leakages, you can provide your business with the financial cushion and flexibility to weather the storm.

*For more information and thought leadership on the impact of Covid-19 on organisations, please visit our **KPMG NL Covid-19 insight centre**.*

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