SLAUGHTER AND MAY/

Slaughter and May Podcast
Plan, prepare, restructure?

Megan Sparber	Hello and welcome to the latest in the Slaughter and May podcast series. I'm Megan Sparber, PSL Counsel in the restructuring team at Slaughter and May and I'm here today with Andrew Jolly, who is head of the risk team and Ian Johnson, head of the restructuring and insolvency team at Slaughter and May, to reflect on what they've seen in the market at the moment and consider how businesses can be prepared for whatever lies ahead. The COVID-19 pandemic has obviously affected and disrupted large sways of the economy, but COVID-related restrictions, the extraordinary measures that we were seeing on businesses have eased significantly and the vaccination programme is bedding down and the economy is largely open for business again. We haven't seen a huge wave of restructurings and insolvencies, even with several curved balls perhaps most notably with significant disruption to the supply chains that we're seeing at the moment. But, Government support is winding down and temporary protections which were preventing creditors from taking action against debtors are being withdrawn with some notable exceptions which still apply to commercial landlords. Ian, can you tell us what you're seeing in the market at the moment? Are businesses struggling or are they getting back on their feet?
Ian Johnson	The overwhelming trend is that most businesses are surviving and have come through the pandemic in reasonable shape albeit, in many cases, increased levels of debt and liabilities and the consensus view is that the market as a whole is pretty quiet and quieter than people might expect given the headwinds that the sectors have faced and the sectors that we saw being most active during the pandemic were sectors that were challenged anyway and had issues pre-pandemic including the oil and gas sector, because of challenges with either having too much debt or oil price-related issues, and businesses that touched the consumer in some way where their challenges were exacerbated by the pandemic such as retail, gyms businesses and some of the smaller airlines but the overall sense is that we haven't seen a trend of more large scale restructurings to come in the near term and I'll hand over to Andrew to provide his perspective on the corporate activity that has stemmed the flow of more full blown restructurings.
Andrew Jolly	Thanks Ian and I think, yes, that's right, I think from the corporate side immediately at the onset of the kind of pandemic, so going back 18 months or so, many companies rightly thought that they would need to access new capital and have liquidity constraints and concerns etc. and they were able to access it whether that be through the debt markets or through the equity markets by raising new equity share capital. Consequently throughout the ensuing period Government support, stakeholder support, and ongoing liquidity in the market has

	enabled companies to, including, you know across all sorts of sectors to continue without needing any kind of restricting activity and to survive, in some cases, prosper, which has partly increased market confidence. As we get to now and as Megan you kind of indicated at the start as those Government schemes start to be turned off there are other economic headwinds then we are, beginning to see, a slight change in confidence across business again, across lots of different industry sectors and seeing things like, the point Ian mentioned, in terms of consequences of distress in the supply chain, beginning to see signs of inflation obviously and, you know, whether it be a temporary issue or otherwise, labour shortages – all of which will kind of impact or begin to impact businesses across various sectors.
Megan Sparber	So, there are reasons to be optimistic but there are some notes of caution that I'm hearing from both of you about the possibility of further disruption and obviously boards and financial, legal and commercial functions within businesses have been under pressure to identify and, where possible, to mitigate potential risks but for a long term that's not new. But since the start of the pandemic it has been much more challenging to predict what lies ahead. Andrew, how can businesses be proactive in their approach to risk management?
Andrew Jolly	I think businesses are proactive in their approach to risk management. This is not new, risk is, risks change but the fundamentals do not and companies look at future strategy and economic and sector changes and developments and how they may affect them kind of on an ongoing basis and need to find the time to do so. Effectively it is part of normal board and for the C-Suite business effectively. The pandemic has accelerated certain elements of risk and certain behaviours in society as we have seen and a push to kind of build back better and so the risks may change. How one deals with them and the framework one has in place or corporate should have in place to deal with them i.e. the fundamentals kind of have not changed and the key to risk is firstly I think to realise that the job of business or the role of corporates or people involved in risk within kind of businesses is not to eliminate risk. That's impossible, it should not be the aim. It's to identify risks, understand risks, determine one's own appetite for them i.e. one's own risk appetite, and then mitigate and manage them effectively, and that is true in relation to risks that go to financial resilience and liquidity etc. issues which is the subject we're focussing on today as it is, other risks like kind of cyber or workplace accidents or incidents etc. and so the first stage is identifying the risks businesses face, you know ongoing process, reporting in one's annual report and those risks can be external that generated internal ones, they can be structural, they can be inherent, it can be a bit like the pandemic itself, a big bang very sudden risk. It could be something that develops over time and that is true in relation to kind of financial resilience as much as anything else. Analyse and understand the risks and consequences of those risks materialising. Evaluate one's risk

	appetite and then seek to mitigate those risks in the financial, in terms of financial resilience with appropriate capital and access to funds etc. Quite sensible, straightforward stuff and then managing those risks thinking ahead as to where are the pinch points, what could go right, what could go wrong? If things go wrong, how would one deal with it and plan ahead for those so that it is planned for should the worse happen rather than something new which has to be dealt with.
Megan Sparber	Not all crises can be avoided and sometimes things don't go to plan and that can have very significant consequences for businesses and their financial health. Ian, you've worked with companies who are experiencing a wide range of challenges and that causes them different degrees of difficulty. Is financial distress something that businesses really can anticipate and plan for?
Ian Johnson	So as Andrew touched on the annual audit process is a process that forces boards and management teams to look ahead for the next 15 to 18 months to pick out material risks and uncertainties and I think in the current environment it's even more important to sort of reflect on what is needed for the period ahead and to try and spot things before options become more limited. So, a couple of examples, if as part of your review of your business plan and the year ahead you know that you need to do a significant refinancing, an equity raise or achieve an outcome on a significant piece of litigation or get disposals executed then what it is important to war game is, what is plan B or plan C if any of those routes that are key to your business viability are not possible and in times of distress it does mean that groups do need to look at their group structure more on a company by company basis to look at whether actually the disposal or the taking on of more debt is right for the relevant company and what we would say in terms of process, it is important to sort of think about contingency plans at an early stage, identify the risks and potential problems and think about what could either lead them to be more of an issue and understand, as well as the corporate structure, the other linkages within the group. So, the financing arrangements, the key commercial contracts. If an event doesn't go the right way, does it have other consequences under covenants or other arrangements that lead to other issues that might need to be managed and what are the most appropriate back up plans and we'll talk more about the cascade of options of those plans and do you have the right understanding of those options and the right amount of time in order to execute them in an orderly way and do you have the right back up from the right management team and advisers to see you through those challenges. So, using not just the audit cycle but on an ongoing basis discipline around stress testing, risks and ways to manage them is a key lesson learnt.
Megan Sparber	A company facing financing challenges is probably going to have a range of strategies that it can consider and the ones that will be most relevant will presumably be determined by a number of variables -

	what the capital structure looks like, where the assets are and material contracts - but also how imminent the problem is and significant and severe it is. For businesses that have identified that there is a challenge or a risk ahead but they've still got plenty of runway, what options are likely to be considered as a first port of call, Andrew?
Andrew Jolly	Good question, I think as Ian and you both touched on there's a kind of a menu and managing actual or potential financial difficulties, okay first of all isn't a linear exercise and B, in part at least, at a steady state phase is something which needs to fit in with wider business plans effectively, and there are a funnel of options that, you know, can be considered, depending on the circumstances. So there is no right order but broadly, I think a business might think of divestment or sale of material assets, you know, may not be possible but a balance sheet restructuring to perhaps dispose of non-core assets. The availability of that will obviously depend on the price one might get for one's non-core assets on ability to any interest in the market to buy them. Of course that would both: (a) raise cash, if it was done where you can get a proper price for them and also reduce funding requirements. You know, secondly, and this is not exclusively, things can often be done in combination of course, you're looking at financing options, whether it be to amend and extend existing bank debt or look at other kind of debt, topping the bond markets or other forms of debt like convertible bonds, which would, you know, dilute the equity. And then thirdly, shareholder support, as I touched on earlier as companies did at the start of the pandemic, you know tapping the equity markets, through an equity raise, you know effectively to right size the capital structure of the group for the envisaged financial difficulties that may be perceived to be on the horizon or may be forthcoming.
Megan Sparber	There are a number of options that you might consider upfront. If we're looking further down the funnel or the list of options where their might be a need to consider some form of fundamental restructuring. I'm conscious there were some permanent new additions to the restructuring toolkit that were added in June last year by the Government at the same time as they were introducing temporary measures to help businesses facing the effects of the pandemic but these were reforms that had been in the pipeline for a long time and were expected to be quite game changing. Ian, how do businesses navigate this extended list of options with these new procedures that they could be considering?
Ian Johnson	The list of options is informed by both the business plan, the performance of the relevant group and directors' duties. So the menu that Andrew has stepped through are the more conventional means, so your duties as a board are firmly pointing towards shareholders. And as you go down the menu, you're maybe thinking of options that address debt, if you might have too much debt, and deal with creditors and have regard to their interests which is where your duties can shift

	in times of more financial difficulty or risk of insolvency. So, if you're moving lower down the options it is usually because you've concluded that the more conventional options are either not available, or not sufficient to address the capital structure, but as you get lower down that menu, to get agreement of all parties might be quite difficult. So doing a more fundamental extension of debt, if not everyone is on board in a complex capital structure, can be challenging. So, as you alluded to, we do have tools in order to ensure agreement can be reached with creditors and other parties without getting 100% of people on board and that has always included in the UK schemes of arrangement and CVAs. But as you say, we now, during the pandemic had introduced a new court base restructuring plan process that allows companies to cram down creditors even if not all of the classes in the restructuring are on board. So if there are different types of creditors who are being asked to give something up, some form of compromise, then it is possible to do that just, for example, with your financial creditors, without the support of your trade creditors or your landlords. So examples include: Virgin Active, a gyms business, during the pandemic who used the restructuring plan successfully to address their financing arrangements, but to also address operational costs as well by involving landlords in that structure. And I think as we go through this menu of options, the good thing is the companies and boards is that there are powerful tools that mean that the views of the majority can help a company address issues with its capital structure and also we've got more flexibility now to attempt operational restructurings, as well as financial ones, in a way that has a bit more flexibility than we had when we just had the Companies Act Scheme of Arrangement.
Megan Sparber	You've worked on a diverse range of situations and seen economic cycles in which the risks that businesses have faced have been really varied. What are the key learning points that you've identified for businesses who want to get ahead of any potential problems, Ian?
Ian Johnson	So I think the key message that I'd like people to take away is the importance of proportionate parallel planning. If you do need to adjust the path that you're on, it will take time to pivot and the more planning and advance work that's been carried out, the more orderly that will be. So, a couple of examples, the court-based process that I talked about previously to negotiate with stakeholders, creditors and others usually will take a minimum of two to three months and to actually implement through a court process, you're generally looking at around two months, given court hearings required and the timeline. All of that means in total at least four to five months to go through a restructuring that might require that sort of process which takes time, and could be very public. So the more planning that is done in advance, if you do find as a business that you do need to move from a conventional capital raise or a key disposal but isn't successful to another form of solution, then keeping in the background some level of parallel

	planning rather than just going sequentially to the next option can mean you'll be in a better place to execute any fall back plans more smoothly.
Andrew Jolly	Yes, I fully agree with that, I think there'll be a theme here which is planning but I think there can be a reticence, in my experience, a reluctance in some cases to think about the contingency planning because there's a faith in Plan A and there's a desire to do Plan A, whether that be a new debt or an equity raise or a disposal, but none of those three kind of solutions can be guaranteed and so one does need to think about other options, a contingency plan and then within that it is the planning point and I'd pick up two subsidiary points. One is understanding the triggers i.e. at which point thoughts might need to switch or at what time issues may come more strongly to the fore. And part of that is through the annual audit processes Ian mentioned and thinking about going concern but also, more often than that, forward cash flows and looking at business plans against them. Ability to meet, kind of one's financial covenants when they're tested etc. that's one point. And the second point in the planning is to, it is not an area of risk where one can, say war game it, in the way one could with say, cyber, but to think and plan who will your advisers be. Did an area where specialist advisory support is helpful? For two reasons, one: the specialist support and also because management in the business have a day job and Plan A to seek to execute and so the resource is important but also maintaining confidentiality. I think people are slightly reticent to think about contingency planning because there's a risk that it becomes known, you know, or knowledge that restructuring planning is ongoing then people think well that's what the business believes will be the outcome and therefore not see it as the contingency that it is and therefore a risk that becomes kind of a self-fulfilling prophecy. So even at a basic level one wants to think about well how would we do our contingency planning and in a way that enables us to have the right resources to continue the business and Plan A and also access the information we need while maintaining strict confidentiality around it, because that's important.
Megan Sparber	So planning is absolutely key and although the resilience that we're seeing in the market at the moment is promising, there is merit in being well-prepared for things to shift and being agile in your risk identification and management policies. No crystal balls, no "one size fits all" solutions but it should be possible to have well laid plans in place that should maximise the options available to manage the changes that lie ahead.