SLAUGHTER AND MAY

Slaughter and May Podcast
Debt finance post-lockdown: Prepare for the worst, hope for the best

Mercedes Galindez	Hello, and welcome to today's Slaughter and May podcast. My name is Mercedes Galindez, and I work with the financing team here at Slaughter & May. Today we will look at some of the key issues for companies thinking about debt financing, refinancing or restructuring in the coming months, and some of the themes that are starting to emerge. I am here with Matthew Tobin, Partner and Head of the firm's Debt Capital Markets practice, and Kathrine Meloni, who is a special adviser in the finance industry. Now, as we move into post-lockdown phase, corporates are starting to review arrangements that were put in place during the March-June period. Kathrine, what are the current options for corporates looking to finance or refinance?
Kathrine Meloni	As the summer drew to a close, we certainly started to see a number of companies re-evaluate their financing arrangements, and the top priority has generally been their main bank facilities. I think there were concerns that credit committees could become quite busy in the relatively near future, if there is a second round of COVID related amendments, coupled with ordinary refinancing requirements to manage. So it is prudent for companies to start exploring their options as much in advance as possible. In terms of what's happening in the loan market, we have seen some signs that banks are tightening lending criteria, as well as pricing and, in some instances, terms to. Now this is quite familiar territory for us, banks are typically cautious in post-crisis recovery periods, and this time of course we have the additional pressure of not being quite sure whether the crisis is over or not and, what we find in this type of environment, is that lending relationships come quite sharply into focus and borrowers look carefully at where their support will come from. So the departure of one or two banks might not make a big difference to those who have a wide banking group, but it will affect others significantly, and those borrowers will need to look into the best strategy for keeping the lending group together until the outlook is more stable. That might lead this to the conclusion that it's best for now to avoid a full refinancing, and instead companies might look at amend and extend transactions with a view to blocking in their key banks as far as possible. The options will depend very much on the dynamics within the bank group and the terms of the borrower's existing loans, so are there extension options, are there according or incrementing facilities that can be exercised. Existing lenders generally have a discretion to participate in these types of option, but they do provide a means of testing relationships. There may also be other ways of pushing out the maturities of syndicated loans where the borrower isn't confident of the support of the full syndicate, depending on the documentation terms. It might be possible, for example, for some borrowers, to incentivise lenders, to roll their commitments into a new tranche of debt with improved terms and achieve that without the consent of the whole lender group. This is the so called hollow tranche idea. We've also seen a revival of the forward start structure that was developed after the global financial crisis. This involves extending the maturity of an existing facility by entering into a parallel loan on improved terms, again to incentivise lenders to stay in. The forward start loan then becomes available for drawdown on the maturity of the existing loan.

	The advantage of routes along these lines over a full refinancing is generally a bird in the hand is worth two in the bush. Lenders are more likely to drop out of a new deal than an amendment to the existing deal. There are also advantages for borrowers who are happy with their existing documentation and don't want to reopen the documents more fully, as may be the case on refinancing potentially involving new banks. A point that all borrowers will no doubt be aware of, is that from now on, whether they are amending or refinancing loans, if those loans reference LIBOR, the topic of replacement rates will need to be addressed so borrowers who are coming to the market now also need to think about how and when they are likely to be ready to switch from LIBOR and factor that into their discussions with Lenders. So there is quite a lot to think about, the possibilities and the best option for a particular borrower, tend to be fact specific, including as to whether loan finances the sole solution or whether there are reasons to look at other sources of debt.
Mercedes Galindez	Thank you Kathrine. So Matthew, what are the alternatives to loans?
Matthew Tobin	So, one of the issues that many companies have faced with the loan product during the COVID situation is a realisation that they're subject to covenants and that the covenants may be an issue in circumstances where the loaner most required. So, as a result of that, companies have looked at alternative uncovenanted products and of course that the classic product which is uncovenanted is the investment grade bond. So we've seen lots of companies enter into the bond market, which has been pretty strong in the period through lockdown. Both companies that have existing programmes in place, but also debut issuers. In addition to the straight bond market, we've also seen a number of companies access the convertible bond market, which is slightly less vanilla market, but which has been a very useful source of liquidity for some, obviously depending on where the share price is. That market is attractive for another reason, which is that the execution times for doing a convertible, are actually pretty short because there is no requirement generally speaking for listed companies to produce the prospectus or an offering memorandum in connection with a convertible issue. As an alternative to the public markets, companies have also looked to the private placement markets, the US private placement markets, those that are widely used traditionally by UK and other European companies and, although the documentation is based on new documentation, actually for most UK, European companies, actually local law is not an issue if they want to have consistency with the loan documentation. That market isn't covenant free and typically the covenants will follow the loan documents, but it has been a good source of liquidity and also we've seen a number of exercises, in terms of renegotiating covenants as a result of the issues that companies have faced. In terms of other alternatives away from the traditional bank market and the traditional public markets or USPB markets, we have also seen direct lending coming to the fore, particularly for companies in the crossover or the leverage market, and what we've seen is that many credit funds have got significant amounts of capital to deploy and as pricing widens in the leverage of debt markets, there is scope for those funds to compete directly with the banks.

	The other thing I'd say, lastly in terms of alternatives, is the unitranche market, where unitranche facilities are being used increasingly outside the sponsor-led market. Just by way of explanation, unitranche facilities are term loans that are split effectively behind the scenes between senior and junior lenders, so there is no intercreditor arrangements which the borrower is party to and they carry the additional advantage of being covenant light so similar to the institutional TLP market.
Mercedes Galindez	Thank you Matthew. You mention ESG linked products, and certainly many companies have stated that they will be pursuing green recovery plans. Could you expand a little bit on how financing arrangements can be aligned with the ESG objectives of a company?
Matthew Tobin	That's a very topical question, and I think financing arrangements are a great way to showcase green recovery plans and a sustainability agenda for a company and that's been a really key driver for companies going in to the ESG bond market, and also a rather smaller ESG loan market. That's a good way of showing off what's happening generally in terms of an ESG agenda for the company. What we've seen is a renewed interest, actually it's a continuing interest this year in ESG issuance in a number of different sectors. Excitingly, we've also seen ESG issuance enter into new products, so, for example, ESG convertible bonds, which is something which hasn't been seen before. The other exciting development on the ESG front is that, whereas I think I would have said 6-12 months ago that there isn't really a pricing advantage in terms of an ESG tranche, actually we're seeing greater price tension arising as a result of introducing an ESG tranche or ESG investors in a product. So, there is a pricing benefit now which potentially wasn't there before. The only caution I'd add in terms of an ESG tranche or an ESG product, is that in terms of execution, you need to factor into the timeline some extra time to develop the ESG framework and to get the second party opinions in relation to the framework, which wouldn't be there in relation to a vanilla issuance.
Mercedes Galindez	Thank you, and timelines are definitely important. We're all hoping for a fast recovery but what happens if the path to recovery is longer than expected? Kathrine, do you have any thoughts?
Kathrine Meloni	Well a couple of thoughts, yes. Many of the COVID period covenant relaxations that we saw were offered for a reasonably short period, so lots of companies will be faced with those covenant relaxations rolling off in the first or second quarter perhaps of next year. Now, if the path to recovery is longer than that and there's a second wave of lockdown, or the companies' profitability and results turn out to be more permanently affected by COVID, we might see another round of balance sheet support measures in the form of liquidity facilities and covenant relaxation requests. So I think some companies will be preparing for that. Businesses that have been and continue to be the hardest hit by the effects of the pandemic may find that their capital structure requires more permanent adjustments and they need to do some kind of restructuring, and that might lead to the company rescue measures introduced by the Corporate Insolvency and Governance Act in the UK. So, for example, the new moratorium and restructuring plan process being road tested further. So Virgin Atlantic launched a restructuring plan under the new Act, which was sanctioned recently, and we're aware of several others in the pipeline.

Mercedes Galindez	Thank you Kathrine. Matthew, as a final point, I was wondering what happens to any excess cash. Some businesses will come out of lockdown with a significant amount of excess liquidity.
Matthew Tobin	That's completely right Mercedes, in the sense that what we've seen, and for a number of different clients, is that they've built up their liquidity in lockdown. One of the initial responses to the crisis was to drawdown facilities, particularly revolving credit facilities, although I think it's probably fair to say that most of those have now been repaid so they're still there in terms of liquidity but no longer drawn down. I think we've seen a number of companies put in place extra facilities, often short term facilities during the lockdown, or, as I said before, issue bonds. So, for a number of companies, there is a build-up of cash on the balance sheet. I think it's too early to say that that cash is going to be repaid immediately. I think the reason the excess cash was there was generally to address a downside scenario, which has not yet happened, but may still happen. So I think it's too early to say that actually, that excess cash is not required because clearly what we're seeing is a time which is very uncertain. Having said which, there will be some requirement likely next year to exit government backed schemes and to repay that funding. There may be a desire on the part of companies to exit government schemes if the conditions that are attached to those schemes become more onerous and, indeed, in terms of exiting the governments' schemes, typically that's pretty straightforward in terms of repaying the government funding. Another option, in terms of what to do with cash, is obviously to invest it, whether in CAPEX or in M&A and, whilst M&A was pretty severely depressed at the outset of the downturn, what we've seen is private M&A actually being pretty strong as against predictions over the last few months and, indeed, we've seen some green shoots in the public M&A market to.
Mercedes Galindez	So pulling that all together, what are the key takeaways for corporates?
Kathrine Meloni	Well, I think Mercedes picking up on our title, 'Prepare for the worst, hope for the best', I think the best advice at the moment is to look into all of the possibilities for managing your debt and your liquidity position, prepare your story very carefully before you approach the banks, and allow plenty of lead time.
Matthew Tobin	My key takeaway would be in terms of contingency plans, have a number of contingency plans because this situation is tremendously fast moving and actually being flexible and being able to turn from one plan to the other if one plan doesn't succeed because of market conditions, or whatever the case may be, is going to be really important during this situation. So, my suggestion would be, flexibility is key.
Mercedes Galindez	Thank you both. That brings us to the end of today's podcast. Thank you all for listening. You can find further details on our recent publication, 'Debt finance post-lockdown: Prepare for the worst, hope for the best', which is hosted on our website. We are also hosting a legal update seminar on the UK's Corporate Insolvency and Governance Act on 16 September for those who are interested to learn more about that. If you would like more information about anything we have discussed in this podcast, please feel free to contact Matthew, Kathrine or your usual Slaughter and May contact. Thank you and goodbye for now.