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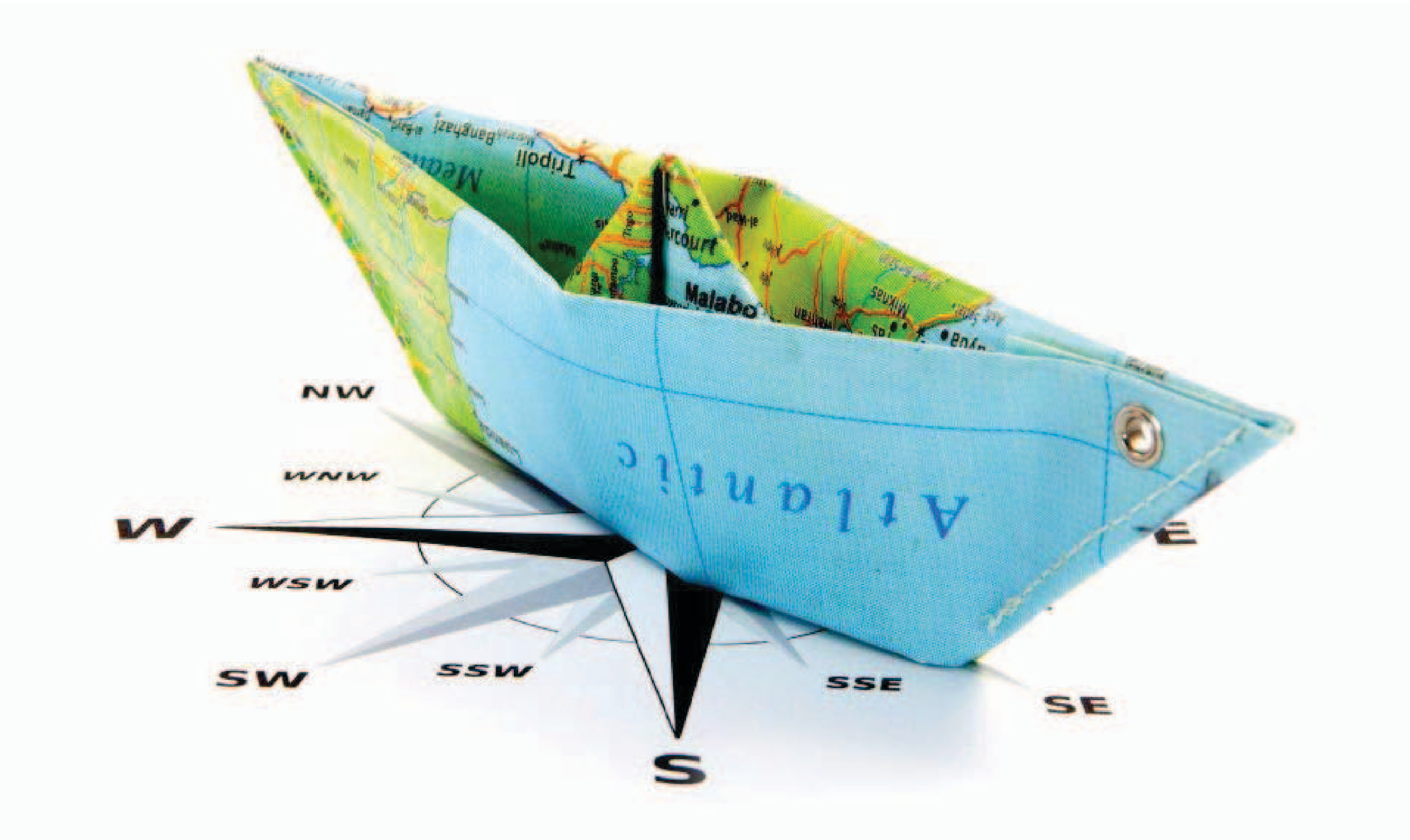
Navigating through turbulent times

Dealing with covenants, going concern and engaging with lenders



Supporting PE backed businesses – November 2012

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Introduction

Financing issues remain at the top of many CFO and Board agendas.

Market overview

Volatility remains a key theme in the debt markets, with windows of opportunity and periods of temporary closure impacting the ability of companies to raise debt finance and increasing the risk of executing debt financing transactions.

Polarisation is another key feature. The debt markets have for some time exhibited a polarisation in terms of lending appetite between large-cap companies which benefit from significant liquidity, often driven by institutional investors eager to put funds to work, and mid to small-cap companies which are more exposed to the vagaries in market appetite.

Market Drivers

The drivers behind this market behaviour are numerous and complex.

Macro-economic uncertainty is a factor which is likely to be familiar to all. Continued stagnation in growth across the UK and the Eurozone as well as one-off shocks to the system in the form of the potential risk of Greek exit from the Eurozone and bank bail-outs in Spain all act to create a handbrake on economic activity which feeds through into risk appetite and lending activity in the debt markets.

Bank retrenchment across Europe has been a consistent theme over the past 4 – 5 years as lenders look to solve their own balance sheet problems and improve their capital ratios in line with Basel III and EU directives. The UK banking market has been no exception and the main UK clearing banks have struggled to fill the lending void left by the retreat of foreign banks from the market whilst also attempting to repair their own balance sheets and lending books.

Exacerbating this issue of market liquidity has been the decline of the CLO-structured institutional investor. CLOs are fund vehicles which rose to prominence across 2000-07 and have been a significant driver behind available funding liquidity in the debt markets across the past 10 years. The past 12 months has seen a number of these vehicles reach the end of their reinvestment periods and drop-out of the market without raising new funds. This trend is set to continue over the next 18 – 24 months as more funds reach the end of their reinvestment horizons and will further reduce the available liquidity in the debt markets.

The wider refinancing challenges have also had an impact on how banks and other exiting lenders view and approach current exposures and portfolios. Taking the experience gained from refinancing and restructurings over the past four years, lenders are generally much more proactive and expect the same from borrowers.

Conclusion

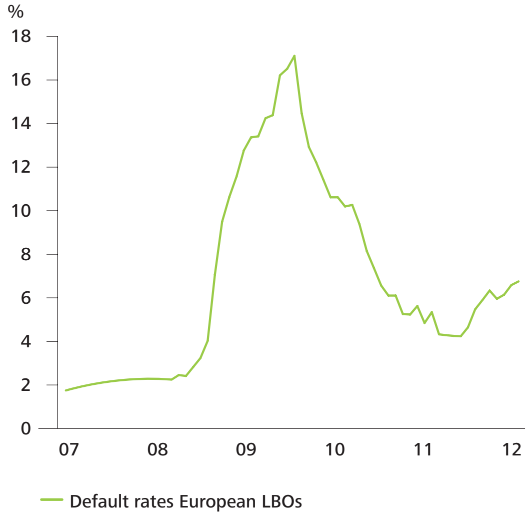
Set against this volatile and uncertain market context, many borrowers are facing a uniquely challenging time when entering into discussions or negotiations with their banking syndicate. This document focuses on 3 key issues which could be of help to CFOs as well as board of directors in navigating the turbulent times in the debt markets.

What do companies need to do?

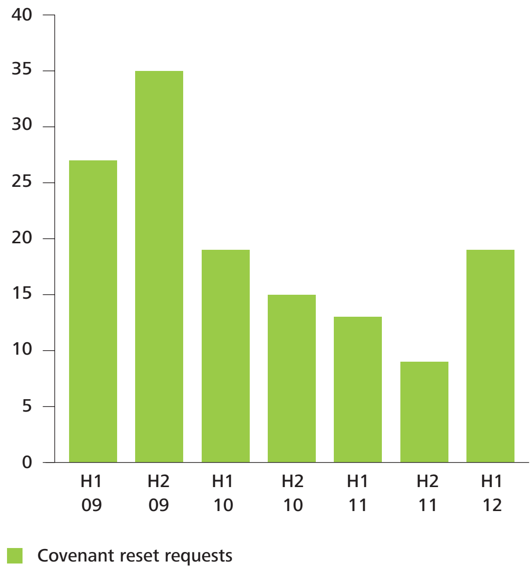
Covenants	• Understand their position and focus on their financing issues early;
Going-concern	• Act quickly and ensure they have robust forecasting and review processes in place;
Engaging with Lenders	• Be prepared to engage early with lenders and ready to drive the process; • Be proactive to retain control and optionality.

Market context

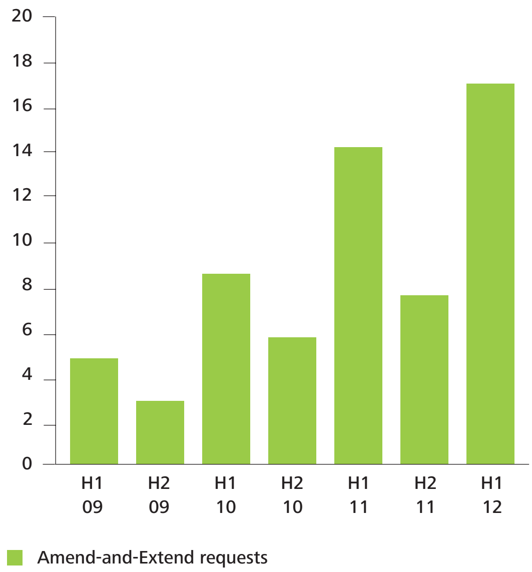
Percentage of PE owned credits entering default is increasing again …



… macro challenges putting covenants under pressure …



… and owners are trying to deal with the maturity wall by buying time …



Source: S&P LCD ELLI, tracking larger LBO universe in Europe

Covenants

With frequent interpretation debates, robust review of covenants and cure mechanics can have significant value implications …

EBITDA	• No definition under IFRS/UK GAAP, definition in the Facility Agreement is therefore absolutely key. • Areas for interpretation: – Ability to proforma EBITDA for synergies – revenue or costs? – Requirement to certify/audit potential synergies and deliver in fixed time period? – One-off items (including restructuring costs): "IFRS definition"? – Minority interests and results of associates and joint ventures. – Impact of acquisition accounting (unwinding of purchase price allocations). – Pension costs. – Real estate cost.
Cash flow	• Treatment of Retained Cash? • Capex – maintenance or development? • Cash sweep timing/flexibility?
Total Debt	• No definition under IFRS (unlike UK GAAP). • Net debt of unconsolidated companies. • Impact of foreign exchange, especially closing rate vs. average rate issues for Debt Service ratios. • Leases – finance lease versus operating lease. • Impact of debt buy-backs.
FX and derivatives	• How are foreign exchange gains/losses and results of derivatives reflected in EBITDA and/or Interest Cost: – Are they accounted for within or below EBITDA? – Are the definitions silent or explicit? – Realised versus unrealised. – Operational versus finance related. • Premium paid (e.g. on foreign exchange options or interest rate caps).
Interest	• Interest on Investor Loans. • Treatment of amortisation on capitalised debt issuance fees. • Treatment of commitment fees.
Information undertakings/ legals	• Timing requirements for compliance certificate to be delivered? • Timing of when a default occurs – when the certificate is delivered or when the Board forms the view that a breach is unavoidable? • Requirement to provide a look forward – compliance with covenants or forecasts?

Recalculate?

Cure?

Reset?

Going concern

Directors need to focus early on going concern and liquidity risk, with full and appropriate disclosure required.

Going concern is an area of increased public and regulatory scrutiny, with detailed guidance provided to directors by the Financial Reporting Council. In forming their conclusion on going concern, directors will need to exert judgment and evaluate which of the three outcomes is appropriate to the specific circumstances of the company.

Any material uncertainties will result in a modified (but not qualified) audit report.

Outcome	Consequence for the directors' statement on going concern	Consequence for the auditors' report
No material uncertainties	Disclosure explaining the conclusion	Clean
Material uncertainties leading to significant doubt about going concern	Disclosures explaining specific nature of the material uncertainties and explaining why the going concern basis has still been adopted – significant judgement required	Emphasis of matter paragraph (but not qualified)
The going concern basis is not appropriate	Disclosures explaining the basis of the conclusion and the accounting policies applied	Emphasis of matter paragraph (but not qualified)

What should portfolio company directors (including NEDs) be doing now?

- Request board papers providing comprehensive analysis of all going concern and liquidity factors, including:
  - Cash flow forecasts for at least 12 months after the signing date, showing cash headroom based on committed facilities;
  - Detailed covenant forecasts, showing level of headroom; and
  - Downside sensitivity forecasts, showing impact on cash and covenant headroom.
- Ensure the company has robust forecasting and review processes.
- Ensure early discussions with the auditors, particularly in relation to their views on uncommitted facilities, facilities up for renewal or forecast covenant breaches. Agree appropriate downside sensitivities.
- Review disclosures early and, where considered appropriate, communicate to lenders and other key stakeholders.

Top tips around going concern

- Review covenant definitions early to understand any flexibility in areas such as "exceptional items". Watch out for the detail (e.g. "modified" audit opinions resulting in a breach).
- Classification of debt between current and long term. If covenants have been breached, debt will need to classified as a current liability (i.e. due within one year) unless the facilities agreement is drafted such that the company was not technically in breach as at the year-end date. This is likely to lead to material uncertainties. Discuss potential solutions with auditors before year end. Review agreements in detail and engage lawyers where necessary.
- Ensure all key subsidiary accounts are signed at the same time as the group accounts. This avoids the need to revisit going concern at the time of subsidiary sign-off, with a potentially different answer.

Engaging with lenders
Current lender attitudes

After 4 years of intense work-out activity, lenders are being significantly more proactive. Additional challenges arise from differing lender agendas and complexity of debt structures leading to some inertia in decision making.

Current developments

- Active review of highly leveraged portfolio companies without necessarily evidence of underperformance.
- A number of lenders actively seeking exits from leveraged positions and entire non-core sectors to bolster balance sheets (single names and portfolios).
- Streamlining of workout teams with restructuring experience dispersed to relationship teams.
- Limited deal flow but also increased bank regulatory pressures means amendments are more expensive.
- Differing agendas in clubs and syndicates (UK banks, European banks, CLOs, hedge funds, other).

Impact on companies

- Workout teams involved earlier with 'minor' breaches taken more seriously.
- Increased fees with re-pricing to current market conditions.
- Lender approach frequently focused on accelerated de-gearing and/or exit through a combination of:
  – Equity injections;
  – Ratchet mechanisms to incentivise orderly disposals or re-banking; and
  – Market testing exercises to establish feasibility of a quick exit.
- Lenders increasingly demanding businesses are well advised – limited patience/tolerance for disorganised management teams.
- Mixed messages coming from different lenders provide challenges in managing a work-out process.

Result

Companies need to be prepared to engage early with lenders to:

- maintain control;
- understand different agendas; and
- be ready to drive the process.

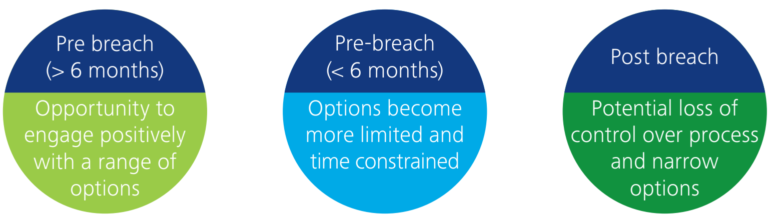
Engaging with lenders
Maintaining control

Early action is critical with a focus on cash, stakeholder engagement and a robust plan to underpin negotiations …

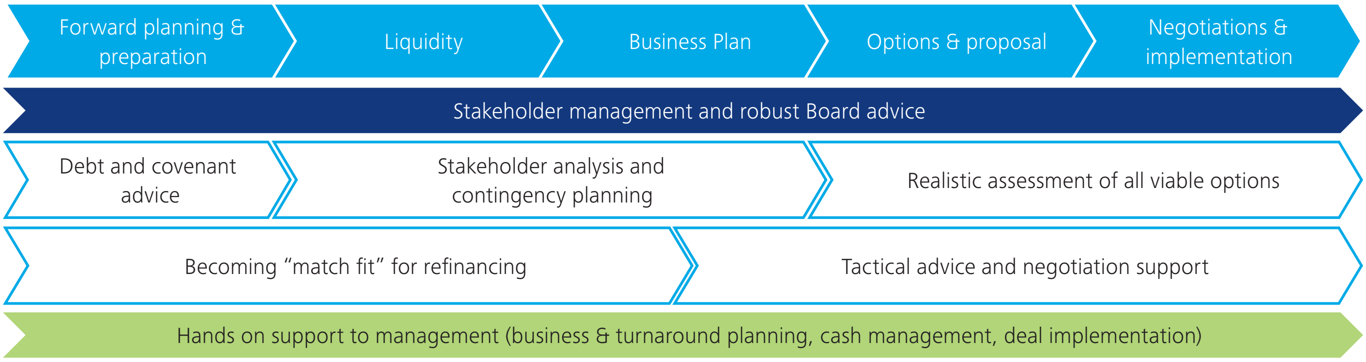
Stabilise and manage liquidity	• Understand short term liquidity and mitigating actions. • Prepare robust forecasts and manage cash centrally with accountability at operational level. • Senior management need to lead the charge on cash – strengthen team where necessary. • Determine and communicate support required from key stakeholders (lenders, shareholders). • Assess Directors’ position if liquidity threatened.
Engage with key stakeholders and manage relationships	• Analysis of stakeholders and their positions – Companies need to understand: – Corporate structure, debt structure and legal position. – Financial and non-financial stakeholders and their key motivations. – Who can invest and who is capital constrained. – What is the likely impact of insolvency on stakeholders. • Pro-active management of all stakeholder groups: – Creation of communication strategy for all parties. – Aim for management to be seen as proactive, credible and motivated.
Prepare a clear and credible plan	• Consider all options and have a contingency plan. • Clear strategy with robust financials, underpinned by action plans/accountability and ownership in the organisation • Realistic objectives, capable of withstanding external review and being “bankable”. • Focus on funding requirement and its impact on the position of stakeholders.

Taking action prior to a breach gives greater ability for the company to manage the process …

- Communicate on a regular basis with key stakeholders (banks hate surprises).
- Understand causes of problems and demonstrate clear thoughts, actions and timetable.
- Consider real estate commitments and opportunities to restructure/release value.
- Anticipate and meet key stakeholder requirements.
- Maintain information flow and dialogue to help mitigate the risk of detailed and costly review by lender advisers.



How Deloitte can help



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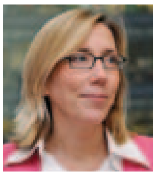

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Notes

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