Numis

Three things about debt – 22 March 2020

I'll keep this brief as I can as I'm sure like me you have more emails than you can possibly read. And there are no jokes – there's not a lot to laugh about.

But I wanted to share what I have been discussing with borrowers, banks and other funders over the past few days. Bear in mind that most of these conversations, particularly with CFOs, were before the extraordinary announcement by the Chancellor on Friday evening.

TLDR:

- The Job Retention Scheme is a game-changer
- More generally, corporates' problems will move quickly from a liquidity crunch to a solvency crisis – often, "more debt" is not the answer for any lender who wants to get this back at some point
- As well as the current two new schemes, the Government will need to guarantee / fund many more viable businesses as the banks' resources start to get constrained by borrowers' drawing on committed RCFs and new liquidity facilities
- Non-viable businesses will need a different solution and if equity isn't available from the market then it will either need to be government equity (for 'essential' industries like airlines) or something else…

Robyn and I have been on many client calls over the past few days but would like to do more – just let us know.

Please do keep well.

Mike

1. **<u>Corporate borrowers stress testing – Government lending schemes do not yet help enough</u>**

- Stress testing is revealing hidden operational leverage: forget IFRS 16, this is what "fixed charge" means.
- CFOs of strong business are seeing the impact of 3-6-9 months of scenarios and evaluating mitigation actions to see how they can survive without (a) making large-scale redundancies and (b) permanently damaging the long-term businesses by killing supply chain relationships.
- However, landlords are generally seen as fair game: there will be significant haircuts to rent paid on Tuesday e.g. 1 month not a whole quarter. And many tenants will be paying significantly less than this. Similarly Franchisees are likely to seek help / not pay Master Franchisors, whatever the contract says
- Often, the result of this stress-testing involves a funding requirement that cannot be entirely debt-funded: for many, it would never be possible to survive the resulting debt pile
- This "liquidity crunch" will very quickly become a solvency crisis – and (currently, though things can change quickly) directors cannot trade while insolvent, which includes no prospect of being able to pay debts as they fall due
- There is a real (and justified) sense from UK mid-cap that they have been left out by the two major liquidity schemes announced so far
  - Covid Business Interruption Loan Scheme – for SMEs with turnover other exclusions)
  - Covid Commercial Financing Facility – for borrowers which have been investment grade or which the Bank of England thinks would be (more to follow below on this)

- But more broadly, this interruption from Coronavirus is not going to be solved by additional borrowing: if I defer my haircut for 2 months, I don't have two later, and the lost output will lead to some firms being unviable
- The Coronavirus Job Retention Scheme is the first subsidy that will really permanently mitigate the impact on firms, particularly large employers
- Incidentally, corporates that came into this with large cash buffers may find that this does not mean they exit it in better position: this depends on how exactly the Govt "helps out" affected corporates (moral hazard is second order problem)

2. What banks have told us this week

- Banks appreciate the actions by the BoE to reduce solvency requirements and the encouragement to use the £1tn of available liquidity – and the various QE programmes announced provide proof the BoE is willing to provide more liquidity where needed
- Banks are readily providing waivers where these relate to Covid disruption – this is partly due to sheer volume of requests and also because I think the CEOs have been so encouraged by the BoE. These waiver requests should not be excessive: consider the impact on just the next 1-2 test periods, as beyond this there is no visibility
- Banks have also been providing additional liquidity to existing clients – but only where this ultimately is sustainable. The two bank of England schemes should help even those borrowers not eligible as they should reduce the capital and liquidity strain on these banks, enabling them to focus firepower on UK midcap
- But borrowers drawing down on committed loan facilities has had a huge impact on banks: aside from the liquidity drain, banks typically assume a facility is 35-45% drawn before default (on average) so moving much of this to 100% drawn will increase the capital allocation by 2-3x – which is a huge impact even for banks coming into this scenario well-capitalised (and with the additional relaxations)
- At this rate, while the banks have capacity now, this will not last forever
- The CCFF will need to be expanded and the banks have been discussing this to the BoE. Potential changes include
    - Including more indicators of "investment grade" including NAIC 2 designations and D&B Risk Indicators
    - Allowing the PRA regulated banks to vouch for the "investment grade" quality of certain borrowers using their PRA-approved methodologies
    - Wholesale guarantee by HMT of 50-75% of loans by banks to "investment grade" corporates as per their systems
    - It seems the BoE is particularly averse to helping the funding of private equity backed businesses, as in principle these have strong sponsors with (apparently) plenty of dry powder
    - More regulations out tomorrow and we will follow up with any further detail

3. Other funders we have spoken to this week

- There are a small number of well-capitalised debt funds that have dry powder and are now looking to make the most of it
- A good example is HPS's funding of Pizza Express this week: £70m to Pizza Express on super-senior basis at c. 7.5% - this is permitted under the loose terms of the existing HY bonds. It's basically a bet that Pizza Express will be one of the survivors of this and that its brand will be worth at least £70m - which doesn't seem unreasonable. Similar funds are GSO, Ares, Apollo, Alchemy. Return targets probably remain in >7-10% but now with the opportunity to do so with much less risk
- US Private Placement investors similarly have permanent capital – they have always preferred investment grade and will take this opportunity to lend to better rated corporates at higher rates

    - For UK corporate borrowers, the USPP investors will provide waivers along with the banks but are unlikely to provide more liquidity except on truly economic terms – they are not banks but have fiduciary duties to their pension / life policy holders
- Public bond market investors: if there is the potential for redemptions then these funds struggle to buy anything, even if its looks great value (great FT article here). Life insurers are providing a bid because they are permanent capital and care less about MTM – e.g. Danone's bond last week was bought primarily by French / European insurers (this is now 5pts down). "Real bid" prices are 3-6pts below screen level and any axe is not out for long
- Leveraged finance bankers: leveraged loan markets fell off a cliff last week as end-investors exercised little known redemption rights in Separately Managed Account agreements. Cineworld dropped a further 13pts in a day (new loans now marked at 60-64) and Action fell to 66-73. Buyers include hedge funds, credit opportunity funds. The big shoe waiting to drop is when CLO funds sell out of paper that has become CCC and thus ineligible; at least these vehicles have matched duration funding

I think that's enough for now…