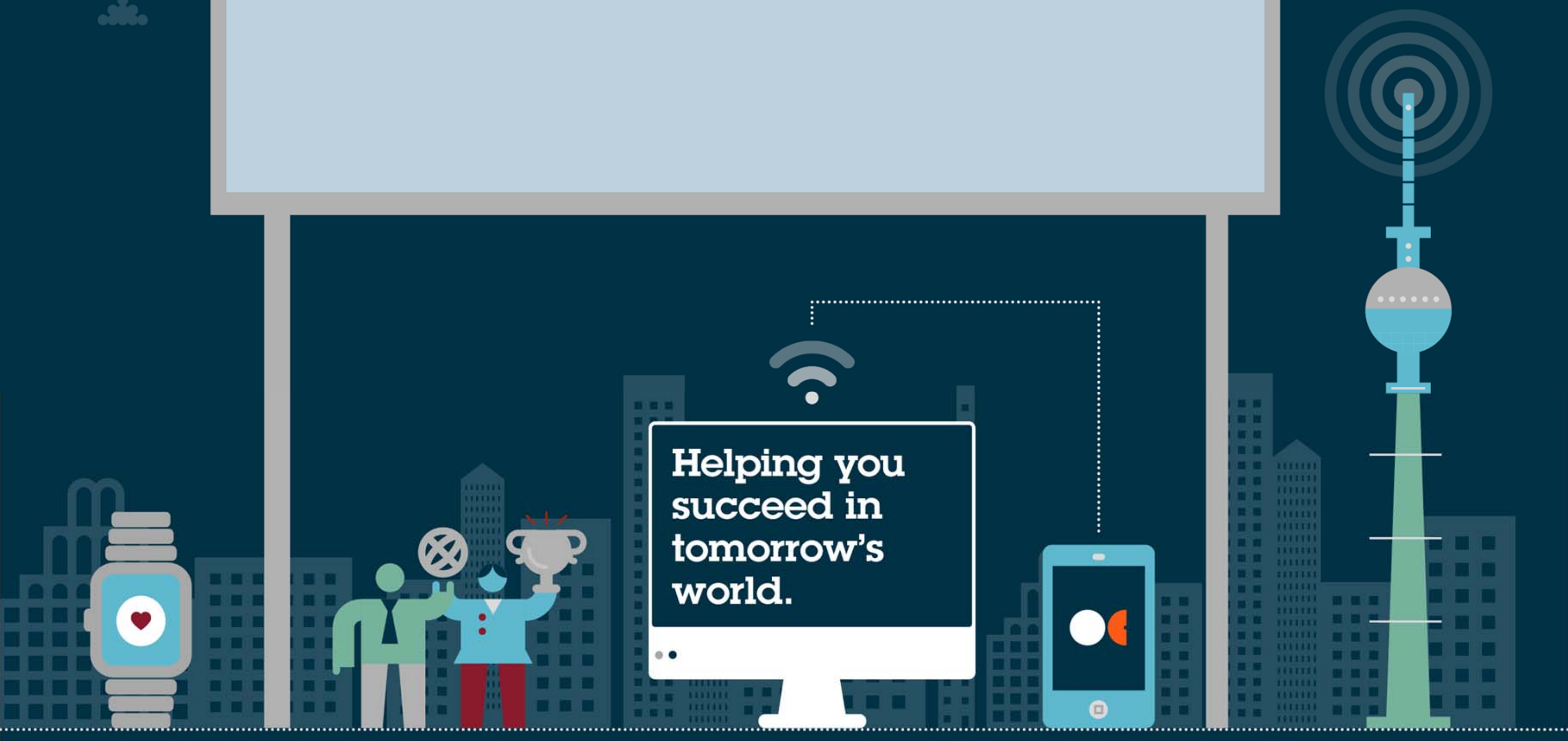
Recapitalisation:

Rebalancing the balance sheet

October 2020



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Covid-19 burdening balance sheets

The impact of Covid-19 has placed considerable financial stress on UK businesses. The immediate need for liquidity has in many cases been solved – temporarily, at least.

However, many businesses will over the coming months be faced with a need to manage what could be an unsustainable amount of indebtedness arising from legacy facilities, new and/or additional borrowings, as well as deferred payment obligations to counterparties. Such over-indebtedness will need to be tackled, both for the interests of the companies themselves, but also for the UK economy, employees and other stakeholders.

The positive news is that there are various measures that companies can take to strengthen their balance sheets in order to improve their short and long term financial resilience. These include fresh equity investments, cash-retention tools designed to achieve deleveraging, and debt restructurings in or outside of formal procedures. We term these, collectively, "recapitalisation" and, in this note, we examine how they might be deployed, alone or in parallel with other solutions.

It is also worth appreciating that this is an opportunity for many companies, including those with more stable financial positions, to take stock of their position. Now is a good time for all companies to think about and consider the best structure for the long- and short-term financing of the business and examine the opportunities available for building the foundations for strong future growth.

01 Introduction

In July 2020, TheCityUK's Recapitalisation Group, an industry body representing UK-based financial and related professional services, published its "Final Report on Recapitalising Businesses post Covid-19". In addition to the impact the debt will have on businesses, this report also highlights the burden government-backed loan distress will have on the financial institutions that have originated loans and the risk of claims being made against such institutions.

TheCityUK estimated that by March 2021 there will be around £67-70 billion of unsustainable debt held by UK businesses, and that around £20-23 billion of that amount could come from the government-backed loan schemes – especially Bounce-Back Loans and those issued pursuant to the Coronavirus Business Interruption Loan Scheme.

Increase in debt from Covid-19

The impact of Covid-19 has placed considerable stress on UK businesses and, as highlighted by TheCityUK's Final Report, many have taken out new loans or extended existing facilities to weather the current storm. Many businesses will see their sectors and revenues pick up and will be able to service or repay this debt. However, some businesses will not pick up this quickly and as noted above, by March 2021, it is expected that there will be a significant amount of unsustainable debt held by companies.

This debt burden will have a knock on effect for future growth and investment and lead to many businesses simply being unable to continue to trade. Where companies are able to continue to trade, many will nevertheless seek to reduce their levels of debt.

The final report contained a variety of new recapitalisation options but these were contingent on the UK Government implementing the principal suggestion to establish a new "UK Recovery Corporation" designed to hold and administer the various recapitalisation instruments proposed. As yet, the Chancellor of the Exchequer, has indicated that the government does not intend to step in with further support.

This is not the end of the road for businesses seeking to manage their debt burden as there remains various measures that can be taken to strengthen the balance sheet. This note explores the potential options including additional equity investments (either from fresh or existing investors), debt-for-equity swaps, refinancing and debt restructuring but also the key considerations to take in choosing a recapitalisation strategy.

Consider appropriate strategies

Companies need both to decide on their preferred recapitalisation structure as well as their strategy for handling and negotiating with creditors. Both the strategy and tactics will be driven significantly by the legal rights and obligations of the various parties, as well as what is technically possible. This is a dynamic relationship in which parties' positions and aims will frequently change over time. In addition, particularly for companies facing severe financial challenges, directors can find themselves making some difficult decisions with potential personal financial consequences.

Recapitalisation can be an attractive option for some businesses and lead to a bright future, but it is important to consider the options carefully. While some of the recapitalisation methods we have noted are relatively straightforward, others can be more complex and will have important legal and tax consequences. Some solutions may also create additional issues in the future.

How OC can help

At Osborne Clarke, our full service offering allows us to help with all aspects of recapitalisations. We can tailor advice for your business on all types of recapitalisation structures including strategic advice, examining any tax considerations and executing and delivering the final solution. We routinely advise on recapitalisations both for creditors, debtors and investors, which means we can efficiently leverage our existing expertise and understand the position of all parties.

02 The basics

Recapitalisation – the basics

What is 'recapitalisation'?

Recapitalisation is not a technical term. Broadly, it means reconfiguring the debt and equity components of the balance sheet. In this note, we refer to "recapitalisation" as the umbrella term for anything designed to help a company to manage and/or reduce the level of its debt obligations – from a balance sheet perspective, but also from a debt service perspective.

Why now?

Pre-Covid, most companies will have had debt on their balance sheets, with some companies being more "highly-geared" (that is, having a greater proportion of debt relative to equity) than others. Performing businesses will have been able to meet their interest payment and capital repayment obligations as and when they arose and most operating companies will have had positive net assets (i.e. the sum of its assets being greater than the sum of its liabilities).

Covid-19 will for many businesses have radically changed that dynamic – especially those businesses that were highly geared at the outset.

In the first instance, revenues will often have fallen. That will have made the debt service burden harder to discharge. Some borrowers may consequently have deferred their payment obligations for a period. It may also have resulted in a diminution in the value of a company's assets, potentially making a business "balance sheet insolvent" (in other words, having a negative net asset position).

Secondly, many businesses will have elected – or found themselves with little option otherwise – to manage payment obligations during the period of disruption through additional debt or deferring the underlying obligations, such as to suppliers, HMRC or landlords. The government emergency lending schemes, such as Bounce-Back Loans, the Coronavirus Business Interruption Loan Scheme (CBILS) and the Coronavirus Large Business Interruption Loan Scheme (CLBILS) have been a vital source of liquidity. However, this additional liquidity/indebtedness will ultimately need to be serviced and repaid – or restructured.

How recapitalisation helps

Recapitalisation is intended to improve a company's financial resilience.

Managing excessive debt is an important feature of giving businesses the ability to attract further investment and/~~or~~ free up resources to support future growth and investment. It also affords counterparties confidence in dealing with a business.

Conversely, failure to recapitalise early enough may ultimately result in directors (and their auditors) facing tough decisions around the viability of businesses to continue as a going concern. Both balance sheet and cashflow insolvency can flow from over-indebtedness and will need to be addressed. The legal trading landscape becomes much more complicated as companies approach the "twilight zone" of insolvency, with directors in particular needing to pay much closer attention to how they discharge their duties. Creditors and counterparties will also assess their relationships with businesses in this position.

Who is likely to recapitalise?

Various forms of recapitalisation are popular options for small and medium-sized enterprises (SMEs) who may find it harder to raise equity finance in the capital markets as a listed company might. Larger corporates have considerably better access to institutional investors than SMEs and have greater experience in equity raising.

Venture capital funding is typically focussed on high-growth entities and private equity funding typically targets the large and larger midmarket companies rather than SMEs.

There is also a regional imbalance to consider with around 70% of all money invested in businesses happening in London.

It is estimated that a higher concentration of emergency loans (around 45%) were taken by sectors worst hit by the current crisis including property, construction, accommodation and food sectors.

03 Potential solutions

Tools available for recapitalisation: an overview

For a company wishing to address excessive debt obligations through some form of recapitalisation, there are many options available depending on the specific circumstances of the business. We consider these in further detail over the coming sections, including what they do – and do not – deliver. Solutions might be categorised according to whether or not they entail the issue of fresh equity (or equity-like instruments).

Equity tools

Fresh equity can serve a number of purposes.

Firstly, it can be used to achieve a direct reduction in indebtedness by way of prepayment (thus reducing debt and debt service obligations). A debt-buy back might be an efficient way of achieving a proportionately attractive return on the cash.

Secondly, it can be retained by the business to improve the gearing relationship, offering comfort to actual and potential creditors that a buffer exists over and above the value of their aggregate claims.

It may also be combined with other restructuring solutions to achieve even greater impact. This may include the conversion of some debt into an equity (or an equity-like) instrument. This is sometimes referred to as a debt-for-equity swap.

The equity to be issued will need to meet the aims of the stakeholders. Pure equity in the form of subscription for ordinary shares is one option, but so too are preference shares and shares (or warrants or options) carrying bespoke profit participation rights as well as convertible debt.

TheCityUK report proposes potential solutions, such as a new form of preferred shares, a contingent tax liability or profit participating debt. However, these will require a level of government involvement to implement, which has so far not been forthcoming.

Non-equity tools

The most straightforward way to reduce debt obligations is repayment. Cleary, the source of such funds (if not equity) will be of paramount concern.

One potential source is the sale of parts of the business or specific assets. Valuation will be crucial.

Another would be deferral of material expenditure. For instance, capital expenditure and acquisitions my be capable of deferral. Retention of dividends might be another option pending bringing the debt burden under control.

More debt can also be the solution!

For instance, a refinancing – potentially coupled with one or more other tools, such as fresh equity – could afford the company covenant headroom, reduced amortisation and a longer period to deliver a revised, post-Covid-19 business plan necessary to achieve repayment or a further refinancing in due course.

Short of a full refinancing, it may be possible to renegotiate terms with existing lenders to allow breathing space while the business regrows. For instance, some interest could be capitalised to principal to support the debt service burden. Covenants may be relaxed to support going concern sign-off.

More materially, a full debt restructuring may be required with one or more groups of creditors. Although time intensive and likely to involve concessions, the ambition will be to leave the group with a "right-sized" balance sheet from which it can prosper. Again, this may involve a partial debt-for-equity swap – but other mechanisms which allow shareholders to retain control may also be available. Formal legal processes, such as a pre-pack administration or a company voluntary arrangement (CVA) might be available to support implementation.

Potential equity-based solutions

Equity injection (existing shareholders)

Companies may seek to approach their existing shareholders with a view to injecting additional equity in to the business to improve the debt:equity gearing or to refinance the existing debt.

The options available to companies and what may be possible will depend on: (i) the terms of any existing equity and debt instruments, and (ii) whether the company has the support of all of the shareholders, its board and any third-party lenders. Where the fundraising is not consensual, there will be less flexibility around how it can be structured, as any new class of securities may need to fit within the parameters of the existing equity and debt instruments, including intercreditor arrangements.

Where a management team benefits from an equity--based management incentive plan, it is important to consider how they will continue to be incentivised. An injection of new equity may dilute management to a level that is no longer attractive, or the debt levels may be such that management's equity is "underwater". Incentivisation may be achieved by way of, for example, the issue of fresh equity to management or the provision of a cash bonus.

It is important to take account of the company's constitutional documents. Where these contain pre-emption provisions, the company will need to offer any new shares to all shareholders who benefit from those provisions, which could impact on the timing of the fundraising. Additionally, the company's constitutional documents should be checked for any emergency fundraising provisions that will allow for an accelerated fundraising with a "catch-up" right for all other shareholders.

2020 has further demonstrated the relative ease in which listed companies have been able to raise money from new or existing investors through the use of secondary fundraisings. Earlier this year, it was reported that companies quoted on the AIM market had raised £2.8bn through secondary fundraisings during the first six months of the year.

We have also seen a return to rights issues for the larger corporates as well as the use of the Primary Bid platform giving retail investors a chance to participate.

Equity injection (new investors)

Where existing shareholders lack the appetite or the ability to inject further funds, companies may identify third parties to inject fresh capital into the business with a view to restoring debt:equity gearing or to refinance debt.

New shareholders may also be able to offer alternative benefits including: (i) a new outlook or approach to respond to the current challenges faced by the business, and (ii) potential new skills, expertise and experience.

A further equity injection could take many different forms, such as ordinary equity, preference shares or a convertible loan, or any combination thereof.

The terms of any new class of security will need to be modelled to calculate the return to the existing and new investors. In particular, new investors will consider:

- Coupon – does the new class of shares carry a fixed return?
- Ranking – does the new class of shares carry the right to a preferred return?
- In order to implement the terms above, does the company need to make any changes to the rights attaching to existing classes of securities?

The company should bear in mind that any change of control of the company may have wide reaching impacts beyond shareholder harmony including termination provisions within customer and supplier arrangements. In addition, existing debt facilities should also be checked for any pre-existing equity cure provisions and the tax and accounting treatment of preference shares or convertible debt would need to be considered.

Debt-for-Equity Swaps

Basic principle

Debt obligations are converted into equity in the borrower or another company.

For the company, this removes or reduces the debt burden, potentially improving the cash flow position of the business. On the other hand, the lender will be moved down the priority ranking of creditors in return for an ownership interest and potential growth through its 'investment'.

Commercial considerations

There are a number of commercial considerations before opting to use a debt-for-equity swap.

- How much of the company's debt should be converted into share capital and the corresponding valuation of the shares issued?
- What is the economic entitlement of the lender's shares?
- What voting rights should attach to the lender's shares and should the lender have (or even want) control or a say in the proceedings of the company?
- What rights to transfer, or restrictions on transfers, will apply to the lender's shares – and to the other shareholders?
- Is the lender willing or able to be a legal shareholder or would it prefer warrants/options or to appoint a nominee to hold its legal ownership?
- Will the lender (or a representative) be a director or an observer?
- What is the impact of a change of control on key customer or supplier contracts?
- What are the potential concerns for the company from any publicity?

An example

In light of these considerations, one solution could be to issue shares that are as similar to the original debt as possible such as redeemable preference shares. These could then be convertible into ordinary shares or have a participating dividend to provide some ownership upside. The instrument might have a fixed redemption date, with early repayment provisions for certain defaults.

Tax issues

It is further important to consider certain tax issues such as whether there is a taxable profit. This may depend on whether the debt is a "loan relationship" or a "relevant lending arrangement".

HMRC may view a swap as a release, particularly if there is to be an onward sale of shares at less than face value of the debt.

It may however be possible to waive part of the debt rather than issue shares if considered as "connected company debt".

Consideration should also be given to accrued interest. If this is capitalised, consideration needs to be given to the withholding tax treatment. If it is waived, is the waiver of accrued interest taxable or is an interest deduction foregone for the amount waived?

Potential Non-equity Based Solutions

Refinancing (existing lenders)

Companies may seek to approach their existing lender group with a view to refinancing one or more tranches of expensive, amortising or maturing, outstanding debt.

Companies wish to stabilise their business or access to capital through sufficiently extending maturities, and limiting short-term debt service and covenant testing.

Crucially, this may also allow shareholders to retain control and manage capital whilst the business pursues a modified business plan designed to respond to the challenges and opportunities presented by Covid-19.

For companies looking at refinancing, it is important to consider various aspects such as:

- engaging a debt adviser;
- ranking of the new debt;
- avoiding or limiting prepayment fees;
- existing lender consents or pre-emption rights;
- flexibility to allow future equity injections;
- the availability of government-backed schemes, such as CBILS and CLBILS, to benefit from fee waivers and interest holidays;
- retaining as favourable terms as possible from existing arrangements, as well as enhanced pricing;
- postponed payment of "up-front fees";
- tax issues; and
- guarantees and security.

Refinancing (new lenders)

Under this solution, one or more new institutions replace an existing lender allowing the company to consolidate its indebtedness and benefiting from longer-dated maturity and gaining certainty of financing.

It may also be feasible to introduce new lenders into an existing structure, potentially benefitting from existing credit support.

Consider:

- engaging a debt adviser;
- ranking of new debt relative to any remaining debt;
- existing lender consents and pre-emption rights;
- the type of lender including banks, direct lenders or alternative capital providers (including distressed and special situation lenders);
- asset-based lending to take advantage of valuable assets on the balance sheet;
- ancillary requirements going forward, including BACS, CHAPS, direct debit, letters of credit and credit card facilities;
- avoiding or limiting prepayment fees;
- new lender due diligence requirements;
- tax issues; and
- operational and strategic flexibilities for the new debt.

Potential Non-equity Based Solutions

Debt restructuring

Under this solution, there is a variation to the quantum, payment profile or ranking of the existing indebtedness.

This may potentially be accompanied by fresh equity or other change to the equity capital structure. It would not be uncommon also to include at least a partial debt-for-equity swap.

It might also take advantage of one or more formal restructuring tools, such as a CVA, a scheme of arrangement or an administration, and be used in conjunction with implementing a strategic and/or operational turnaround plan.

Things to consider include:

- engaging restructuring advisers;
- availability of moratoria to provide breathing space to negotiate and implement;
- reviewing existing documents to identify rights and options;
- identify whose consent is required to execute a proposal and the ability to 'lock-up';
- identifying mutually acceptable solutions (against the backdrop of a formal process where required);
- tax implications of solutions for stakeholders;
- diligencing the impact of solutions on key third party contracts and arrangements;
- contingency planning and seeking to retain control of the process; and
- publicity and PR.

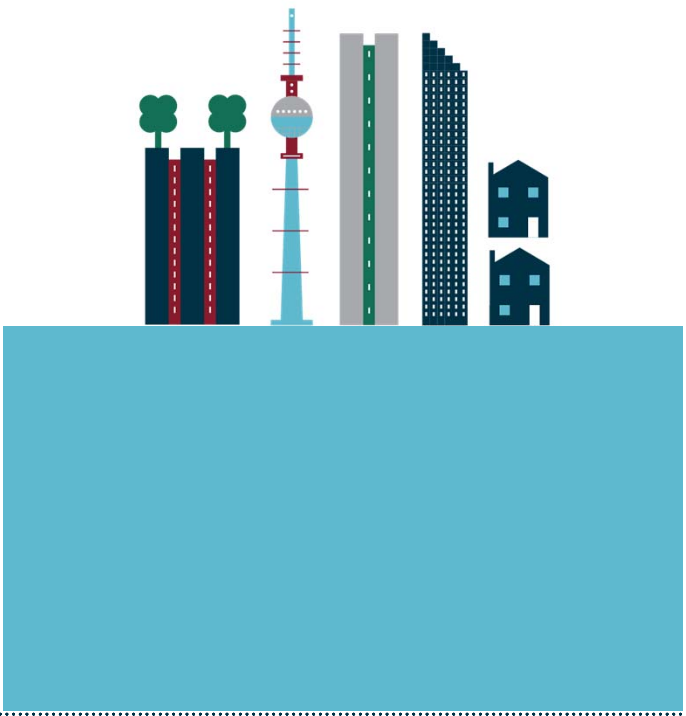
Debt buy-back

A borrower, group member or shareholder/private equity house may acquire a portion of its debt at a discount to par value thus reducing the debt burden on the company.

This solution may give a borrower or owner an insight into the lender perspectives, although information and voting rights are usually disapplied.

Things to consider include:

- source of funds;
- review documents for restrictions on buybacks and processing, sources of financing, treatment of bought back debt, financial covenant treatment and fees payable to implement;
- subsequent ability to waive debt if not extinguished on a buyback;
- tax implications of the proposal; and
- evaluating against the other options available.



04 Restructuring and insolvency

Restructuring and insolvency

For many reasons, seeking a consensual solution is usually desirable as it helps protect against value erosion in a formal restructuring or insolvency. Stakeholders should seek solutions as early as possible as our experience shows that early engagement maximises the prospect of a successful turnaround. However, in some situations where debt and liquidity issues make trading unsustainable, using a range of formal restructuring and insolvency tools may be appropriate.

Where consensual solutions cannot be found and insolvency tools are needed then these are commonly not exclusive. There are many situations where, for example, a pre-packaged transaction may be coupled with equity raising and a debt-for-equity situation. We have set out below the core restructuring tools that are available to businesses which commonly leave some liabilities behind via an insolvency process.

Pre-packaged transaction (usually through an administration)

This commonly involves an accelerated M&A process where a buyer is identified, a deal is negotiated with the proposed administrator and then documented. Soon after the appointment of an administrator the business and assets (sometimes excluding onerous parts) are sold to a buyer avoiding a business trading during an administration which carries risk and is often not possible if funding is unavailable. There have been some pre-packaged transactions where secured creditors "credit bid" for the business and assets and due to the value break are able to exert significant influence over the process. Additionally, where secured and onerous liabilities sit at the top of a corporate structure, there have been a number of recent cases where the use of a pre-packaged transaction has been confined to non-trading entities that hold secured and other debt with a very limited impact on the trading entities.

A pre-packaged transaction can all be done quickly, reduce costs (compared to a trading administration), reduce risk (due to certainty of execution) and impact positively on strategic suppliers and employees (with TUPE usually applying).

Sales to a connected party will encounter particular scrutiny (with further legislative changes expected) and administrators are under regulatory duties to ensure that the sales and marketing process is as extensive as possible plus there is a requirement to be transparent to the creditors. There can sometimes be complaints that value is not maximised and there are reputational risks, but these can be managed as part of a controlled process with the outcome commonly being in the best interests of lots of stakeholders compared to a liquidation or the risk of a close-down scenario.

Company voluntary arrangements

A CVA needs support from 75% in value of creditors and the directors retain control of the entity with an insolvency office holder having only a limited role. CVAs have been used extensively in some sectors to deal with landlord claims and to "right size" real estate portfolios with material changes to landlord terms. CVAs will continue to be popular restructuring tools, particularly where the underlying business is viable as demonstrated by its pre-Covid-19 performance but it is not possible to compromise secured or preferential claims without their consent. This means that CVAs may be inappropriate to resolve some debt scenarios. Furthermore, the success rate of CVAs is difficult to measure, but there have been a number of businesses that have failed and used an administration process soon after a CVA is approved or where successive CVAs are proposed.

Schemes of arrangement

This involves a compromise with creditors and schemes offer considerable flexibility, including the ability to bind secured and unsecured creditors with no insolvency practitioner being appointed. But they are costly and there is no cross-class cramdown, which means some classes of creditors can exercise a ransom position.

Restructuring plan

Introduced in March 2020 and similar to a scheme of arrangement, a restructuring plan offers a cross-class cramdown mechanism which can be very helpful in debt restructurings where some secured creditors are "out of the money". The value break in some of these situations will be key and we expect that there may be some disputed valuation issues that will give rise to uncertainty and litigation.

Contacts at Osborne Clarke LLP

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We have always been happy to embrace change and the opportunities it creates – because it's those opportunities which enable us to help our clients succeed.

We have a unique, diverse and approachable culture, and it is not just an added extra, it is fundamental to our success. So we cherish and protect it, we live by our values and reward the behaviours that support them. And our clients value this as much as our people.

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