Sustainable Turnaround and Working Capital Solutions Post Covid 19

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Very few businesses have been immune to the impact of Covid-19. Previously well managed, profitable and cash generative companies are now experiencing sustained losses and cash flow difficulties as a result of temporary closure, reduced trade, non-payment by customers, supply chain failures or a combination of a number of factors beyond their control.

Government support measures such as the Job Retention Scheme, rates relief and grants, and restrictions on creditor and landlord enforcement have enabled most businesses to survive so far. These measures are only temporary, so as trade starts to pick up and support falls away, all of a sudden businesses will be faced with the true extent of their working capital requirement.

Whilst businesses are understandably desperate for immediate support and 'quick fix' solutions, they need to ensure they opt for a sustainable working capital solution in the longer term once there is more certainty post Covid-19.

Working capital will be required not only to cover trading losses and cash drain incurred during the Covid-19 affected period but also, as the business begins to gain traction and momentum, cash to support restoration and growth, returning debtors, stock and work in progress back to optimum levels. Companies will also need to adapt to the new normal which for many industries may mean a smaller market and different ways of doing business. Pre COVID trading expectations are unlikely to be a reliable measure against which to set late 2020 and 2021 budgets.

We anticipate the post Covid-19 economic landscape may look very different and usual sources of working capital support such as supplier credit terms or traditional lending and investor support may not be as readily available.

Most businesses are now likely to require a fresh working capital solution of some form and it may be that one or more routes are necessary to navigate an exit from Covid-19 and ensure long term viability.

Those lucky enough to secure a loan through the Coronavirus Business Interruption Loan Scheme need to be mindful of further burdening their company with additional long-term debt and personal liability for directors.

The newly enacted Corporate Insolvency and Governance Act 2020 ("CIGA") seems to point to an increased use of restructuring plans, such as CVAs and Schemes of Arrangement, as a primary turnaround tool.

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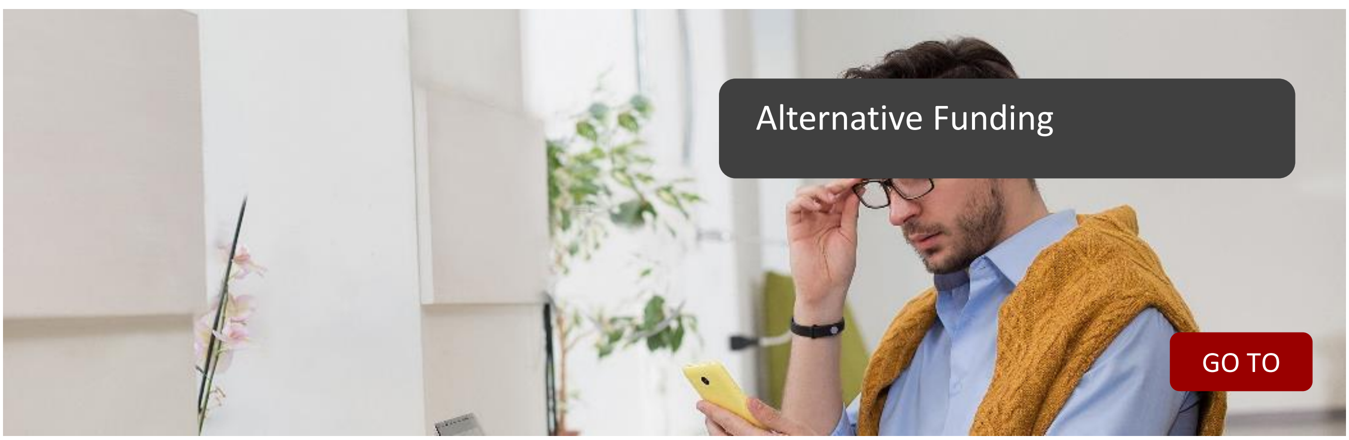
What are the options?



Support from existing stakeholders

The following factors are important considerations for stakeholders

1. The strength of the management team.

2. The pre Covid-19 trading performance.

3. The strength of your balance sheet and value of your business (both pre and post Covid-19)

4. The size of the ask – Management must be realistic and take a conservative approach.

These will determine whether existing lenders and shareholders can seriously consider a request for the provision of the additional working capital required to return to a normal trading situation.

When forecasting working capital needs, Management needs to consider:

Reliance on Government Support

The Job Retention Scheme is due to continue until 31 October, however from August employers will have to make some contribution towards furloughed staff costs, potentially creating additional cost for no economic benefit.

The VAT deferral scheme ends on 30 June so in the absence of further guidance, businesses will need to recommence paying VAT from July onwards and will also be expected to bring PAYE and other taxes up to date, particularly where it has been funded through the JRS

Post Lockdown Support

For most industries, it is highly unlikely trading will return to normal for some time and there could be further social distancing/lock down measures introduced periodically. Management should ensure they take a conservative approach here and it is not unreasonable to expect trading levels not to normalise until 2021.

Receivables Risk

Some customers may not survive this period and companies could see material dilution of their debt books or longer repayment periods which will impact working capital.

Credit Terms

We are already seeing a squeeze on credit insured limits and a restriction on new policies so it is fair to assume that suppliers will be looking to reduce credit terms over a prolonged period. .

Alternative Funding

Financiers are already being inundated with requests for additional support from existing clients and third parties. Some will be better equipped to facilitate these requests than others and meet the needs of clients.

No matter how credible an application is, it may simply not be possible for the existing stakeholders to accommodate the request. Where the business has previously been profitable and cash generative there will always be other banks, asset based lenders and alternative financial institutions interested in supplementing the funding requirement or a complete refinance.

If directors have any concerns about obtaining the necessary support from existing lenders they would be best advised to contingency plan and work with their advisors make initial contact with other lenders now.

Coronavirus Business Interruption Loan Scheme ("CBILS")

The Government has accredited nearly 100 financial institutions to offer government guarantee backed loans to SME's of up to £5million and loans of up to £200million to larger businesses unable to secure regular commercial financing.

Accredited lenders, (banks and asset based lenders) to be able to seriously consider an application will need to satisfy themselves that the proposal being put forward by management is viable.

Recent changes to the requirements for adequate security and personal guarantees should now make these loans available to a wider array of businesses and it may even be worth re-applying if previously rejected.

Applying successfully

Lenders are likely to want sight of a credible business plan to mitigate losses during the Lockdown and return to normal trading together with audited accounts, latest management accounts and sensible trading and cash flow projections.

They will want to satisfy themselves that a business is well run, capable of making profits , generating cash and servicing any debt provided. Long term viability is as important as short term sustainability.

Engaging a specialist debt advisor can help considerably and has a number of benefits:

- *Allows management to focus on day to day decisions and managing through the current crisis.*
- *Ensures the information is provided and presented in a way lenders want to see.*
- *Streamlines the application and credit process to ensure quicker decisions.*
- *Gives access to a wide range of possible lenders and products ensuring the right and most cost-effective working capital solution is obtained.*

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Restructuring Debt

Some companies may find the impact of Covid-19 too severe to simply trade their way out of it or may not have the underlying strength of financial performance and balance sheet strength to obtain additional finance. There can be a number of reasons for this:

1. Liabilities and losses accruing during the Covid-19 period may be too great to accommodate out of cash flow once trading returns to normal.

2. Additional working capital pressures resulting from Covid-19, e.g. debtor stretch, contraction of supplier terms or supply chain issues.

3. Damages in respect of breach of contract arising in the Covid-19 period can't be commercially mitigated.

4. Future viability may be dependent upon a rationalisation of the business which would involve expending substantial capital.

Consequently a well constructed CVA, Scheme of Arrangement or Restructuring Plan may represent the best way forward for directors to formally obtain a creditor repayment holiday and/or some debt forgiveness to claw back the impact caused by Covid-19.

What is a CVA?

- The CVA was introduced as a rescue tool in the 1986 Insolvency Act.
- Simply put it is an Insolvency process but one which recognizes that not all insolvent companies need winding up and are capable of rescue.
- Allow for the directors of a company to put forward commercial proposals to their creditors and shareholders for the rescue of their company, usually involving a restructure of some or all liabilities.
- Directors remain in control of the company, unlike other insolvency procedures such as Administration.
- CVAs are approved by non-secured creditors who choose to vote (more than 75% must vote in favour as well as more than 50% of non-connected creditors).The terms are binding on all creditors, barring secured creditors, whether they have voted in favour or not.

  Since introduction, whilst an excellent rescue tool, it has received mixed reviews principally because:

  a) It was often abused and applied to companies not capable of being rescued.

  a) More recently, the process has been rolled out as a panacea for numerous retail chains, the main aim being to reduce overhead costs by driving down rent payable, much to the dissatisfaction of landlords.

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Why a CVA and what makes a CVA successful …

- Buys breathing space by freezing creditors allowing an affordable period to repay them out of future profits and cash flow.
- Enables a rationalisation of a business without the need to expend substantial working capital.
- Opportunity to compromise some liabilities and potentially recover losses sustained during Covid-19.
- Can secure a refinance or additional capital where previously the lending proposition was unattractive due a weak balance sheet or considerable working capital pressure.
- The new Corporate Insolvency and Governance Act allows for up to a 40 business day moratorium (with the option to further extend) giving protection from creditors whilst a CVA is negotiated and approved by creditors.

There are 3 key ingredients to a successful CVA:

1. An honest and capable management team whose rescue proposals will hold credibility and merit serious consideration of all stakeholders;
2. A profitable, core business (post rationalisation if appropriate) capable of generating sufficient cash to service its CVA obligations.
3. Sufficient working capital post CVA to drive the business forward bearing in mind there is likely to be a further restriction on credit terms with suppliers.

Schemes of Arrangement

A Scheme of Arrangement is an alternative insolvency procedure similar to a CVA, whereby a proposal to restructure a company's debts is negotiated and approved by creditors, however it requires support of 75% of creditors of each particular category and Court approval to be binding.

It is therefore typically a more complex and expensive process, however it has a number of advantages which may mean it is more appropriate than a CVA in certain situations:

1. They have greater flexibility than a CVA and are often used for complex financial restructurings such as debt for equity swaps, introducing new financing, re-setting of payment terms and the release of security or guarantees.
2. Dissenting secured creditors can also be bound by the terms, enabling their debt to be compromised / restructured. By comparison, secured creditors cannot be bound by the terms of a CVA unless they opt to vote on its terms.
3. Creditors can be categorised in different ways as long as they have similar characteristics and expected return in an alternative scenario.

CIGA Restructuring Plan

One of the main challenges of having Scheme of Arrangement approved is the 75% threshold for each category. Often one class of creditor can block a Scheme if they feel hard done by, even if the alternative is actually worse or they are 'out of the money' in any scenario.

A key feature of the CIGA is the introduction of the ability to force dissenting classes of creditors to agree a Restructuring Plan where it is in the interest of creditors as a whole and a particular class's interest are not unduly prejudiced. Effectively, the Court can 'Cram Down' certain creditor classes to ensure the survival of the Company.

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Get in touch

Whilst businesses are understandably desperate for immediate support and 'quick fix' solutions, they need to ensure they opt for a sustainable working capital solution in the longer term once there is more certainty post Covid-19.

Most businesses are now likely to require a fresh working capital solution of some form and it may be that one or more of the above routes is necessary to navigate an exit from Covid-19 and ensure long term viability.

If you would like advice on how Moorfields can assist you please contact for a free of charge consultation.

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