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COVID-19

Private companies and COVID-19: Accessing the debt markets during and after the crisis

A typical crisis plays out over three time frames: **respond**, in which a company deals with the present situation and manages continuity; **recover**, during which a company learns and emerges stronger; and **thrive**, where the company prepares for and shapes the "next normal."

1. Respond

As an organization responds to crisis, resilient leaders are defined first by five qualities that distinguish between surviving and thriving amidst crisis. Next, resilient leaders evaluate specific actions across three dimensions within the context of geographic location and sector. Finally, learnings from those experiencing the same crisis conditions should be applied to manage the response.

For more information on the response phase, please explore The heart of resilient leadership: Responding to COVID-19.

2. Recover

Resilient leaders view recovery as a journey for their organization, teams and stakeholders. There are five imperatives within the **recover** phase to guide the business from **respond** to **thrive**:

1. Understand the required mindset shift
2. Identify and navigate the uncertainties and implications
3. Embed trust as the catalyst to recovery
4. Define the destination and launch the recovery playbook
5. Learn from other's successes

For more information on the recovery phase, please explore The essence of resilient leadership: Business recovery from COVID-19.

We have developed supporting material across these priority areas to support leaders as they develop the recovery playbook:

Valuing trust
Command centre
Strategy
Workforce
Business continuity and financing
- **Debt financing**

Supply chain
Customer
Technology and digital
Cyber
Mergers and acquisitions (M&A)
Environmental, social, and governance (ESG)

3. Thrive

Preparing for the next normal. Supporting materials to come.

Businesses across the credit spectrum should be actively considering their financing options

For private companies, accessing capital can be a challenge during ordinary times. The COVID-19 pandemic, which has quickly morphed into a global humanitarian crisis and economic disaster, has dramatically upped the stakes and added a new layer of complexity. To be sure, the impact on credit markets has been uneven. While government and central bank efforts to support debt markets have backstopped investment-grade issuers, many businesses in the public high yield and private middle market space are engaged in an urgent dash to find cash, with access to traditional financing tight and likely to get even more so in the short term.

Whether your company is in the have or have-not group, there is a compelling argument for managing debt-capital needs more actively during this crisis, which is likely to exceed many private companies' expectations for duration.[1] Consider that in a recent Deloitte survey of finance chiefs from 113 large North American public and private companies, nearly 60 percent predicted their business operations would return to near-normal by the end of 2020, and more than a quarter believe it will happen sooner than that.[2] Those forecasts for a full recovery may appear rosy in hindsight but are unfortunately being aided by buoyancy in public markets; as of mid-May, the S&P 500 had recovered significantly from the bottom reached on March 23, and was only about 16 percent below its all-time peak reached on February 19.[3] And yet, downgrades and bankruptcies have started in earnest and consumer behaviour may have been altered forever. The fact is that many private companies are still struggling to respond to the crisis and minimize its impact. Accessing capital has become a dire task for many, and ongoing dislocations in the debt markets haven't helped.

Still, as we will discuss, even the most distressed private companies may have options available to secure financing support or renegotiate their existing obligations, as the debt markets are still playing catch-up to the reality on the ground in some key respects. And companies in a better position owe it to themselves (and their shareholders) to revisit their debt-financing options and perhaps bolster their balance sheets. It will be the most well-capitalized companies that will be in an ideal position to recover and thrive, by taking advantage of the opportunities that surface when the pandemic is finally behind us.

Bifurcation in the bond market

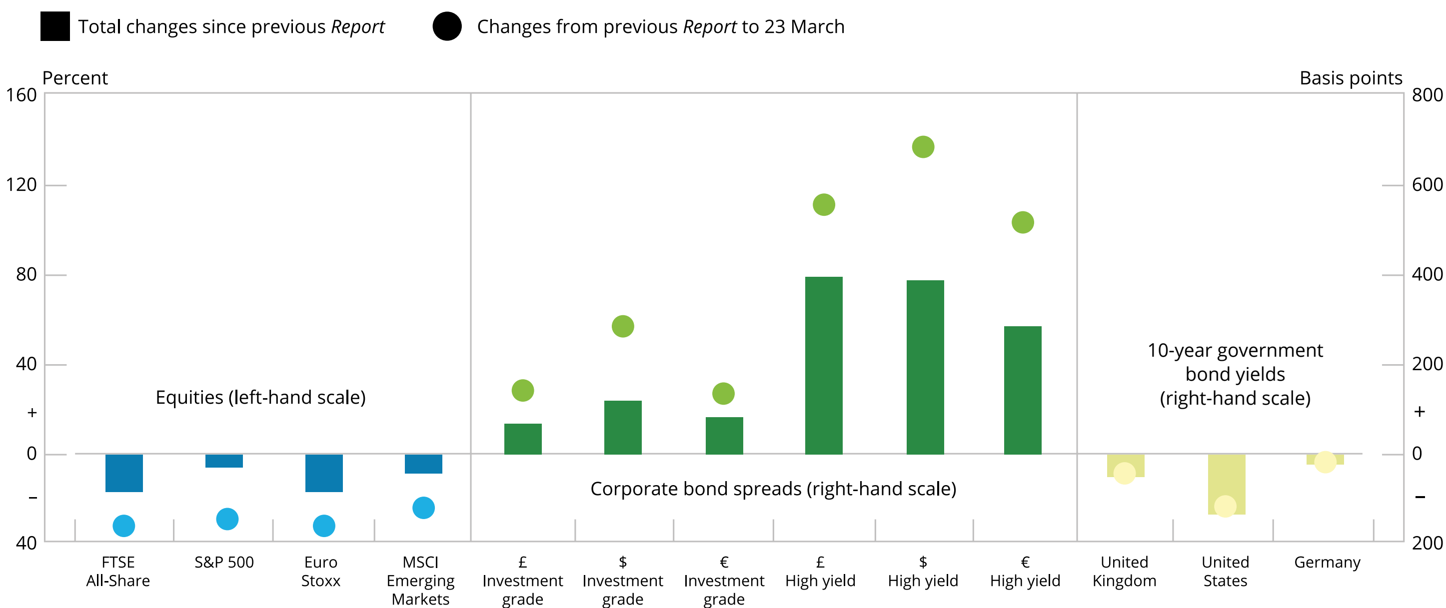
The economic fallout from the coronavirus has been particularly acute in the corporate bond market. Investors, worried about a sharp rise in downgrades and defaults, triggered the deepest corporate bond sell-off since the global financial crisis of 2008, withdrawing more than US$34 billion from the market by mid-March.[4] Global ratings agencies have downgraded ratings at the fastest pace in a decade (at Fitch Ratings, downgrades for the first four months of 2020 have already exceeded the average annual total from 2002 to 2019),[5] leading to a marked increase in fallen angels, or investment-grade issuers downgraded to high yield (or junk) status. As a result, global corporate defaults have started to surge as expected, and the amount of distressed debt quadrupled to nearly US$1 trillion in less than a week in late March.[6]

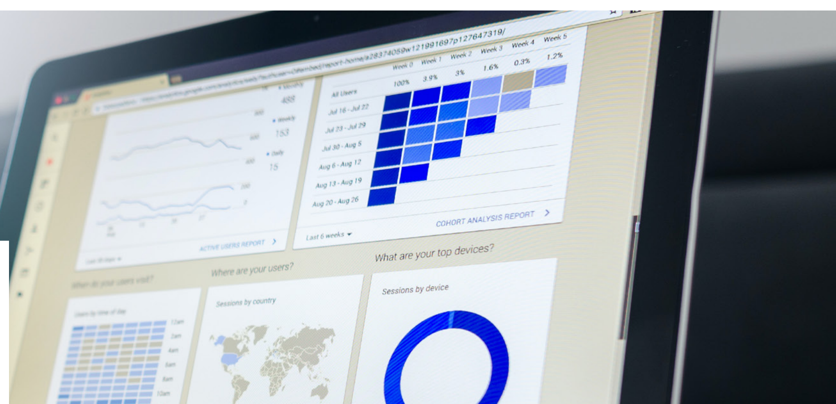
Bond markets have been a principal target of central banks' efforts to reduce stress and generate liquidity. In March 2020, the Federal Reserve announced a bond-buying program to calm the markets, but limited it to treasuries and government-backed mortgage bonds. In an unprecedented move a month later, it announced a US$2.3 trillion primary market facility, part of which is being used to support a broad range of junk debt through the purchase of fixed income exchange-traded funds (ETFs). To date, actual purchases of bonds and ETFs have been limited in the United States and most other countries have failed to even create programs to address the bond market.

While these moves have helped to stave off a credit crisis in the immediate term, major differences in the support programs have led to a bifurcation among corporate borrowers. Investment-grade issues have surged thanks to the central bank backstops, leading yields on BBB-rated bonds to fall from a peak of 5.56 percent on March 23 to less than 3.5 percent as of mid-May.[7] Meanwhile, speculative-grade borrowers—encumbered by weak liquidity positions and scant refinancing prospects—are facing more restrictive borrowing requirements, and many have been forced to pull back. High-yield issuers that have been able to go to market have faced significantly higher borrowing costs. In the United States, for riskier high-yield bonds, the average spread over treasuries recently rose to more than 900 basis points, the highest since October 2011. Similar spreads in Asia have climbed to the highest level in at least a decade, and they have more than doubled in Europe. While credit spreads had pulled back to 6.8 percent as of June 1, they remain quite elevated compared with the end of 2019, particularly in high yield.

There have been large and sudden changes in a range of financial asset prices

Changes in equity indices, investment-grade corporate bond spreads, and 10-year government bond yields since the December *Report*[8]





Implications for private company borrowers

In short, the quantitative easing programs initiated by governments around the world have propelled the markets to function—for now. These efforts are likely to be of limited efficacy and will not amount to a cure for what ails many beleaguered companies, particularly private enterprises. In the United States alone, there is more than $1 trillion of corporate debt scheduled to mature in 2020, and not all of it will be refinanced.[9] Those bonds that are refinanced will likely start to crowd out capital available to the private markets.

As such, private company finance leaders should be preparing for what is likely to be a tougher credit environment. Companies across the credit spectrum should re-evaluate their capital needs to identify potential liquidity mismatches and seek to bridge the gaps. We have identified the following four areas of opportunity for meeting those needs, with financing considerations and possible constraints for each.

1. Tap COVID-19 emergency support programs

In addition to supporting the debt markets, governments around the world have unleashed a wave of targeted assistance programs meant to help sustain employers through the crisis.

Increasingly, they are now coming back to the table to provide support for post-COVID recovery efforts. Grants, forgivable loans, direct lending, credit guarantees, funding-for-lending programs, forbearance, and tax policy changes have been effectuated in markets around the world to help businesses invest in restarting their businesses while reducing their incremental capital needs. For example, in Denmark, the government passed a plan to pay a significant portion of fixed costs for small and medium-sized businesses (SMEs) that have experienced a revenue drop exceeding 25 percent. Australia's government is providing SMEs with temporary cash flows depending on their size and level of activity.

Before taking on additional debt, finance leaders should investigate whether they qualify for these government-led programs, as tapping them could help improve their cash positions, restart suspended operations, rehire employees, and fund other recovery efforts. As they consider applying for such relief, they should recognize that public scrutiny is increasing of companies in relatively stable situations that diminish public funds. Leaders should also consider the covenants associated with these funding programs. This could be a tough call given the deep uncertainty, and some companies may still want to move forward in order to protect themselves from further deterioration or position themselves to take advantage of opportunities once the recovery takes root in earnest.

Particularly if the need is present and the support could be put to immediate use, time will be of the essence in applying. There is only so much financial support governments will be willing to provide, and it will likely wane in the months ahead as businesses get back to work.

2. Maintain strong relationships with existing capital providers

Many lenders are wary of a major slowdown and the impact that's likely to have on their balance sheets. Globally, large public companies continue to draw down their credit facilities, which could put some banks at risk of breaching their regulatory minimums for liquidity if such borrowing continues apace and banks don't tighten down on those credit lines.

In this environment, new loans—particularly for borrowers with weaker credit–could be difficult to come by. But many private companies may be eligible for immediate debt support, such as interest relief or relaxing of debt covenants. Lenders are more likely to extend such relief to those with a long-term and established relationship.

But even those with shorter track records may increase their chances through transparent communications. Many companies have already brought their lenders up to speed on what they have done to react to the slowing outlook, such as reducing costs, hoarding cash, delaying investments, and sharing detailed weekly cash flow forecasts. In a survey of 3,260 executives on April 15, just over 30 percent said they were updating their cash flow and liquidity management plans weekly, with another 15 percent reporting even more frequent updates.[10] Going forward, private companies in any financial condition should ensure ongoing communication with their existing capital providers, including:

- A commitment to not draw down their existing operating lines of credit unless they absolutely need to (to help establish trust and goodwill with the lender)
- A response plan for addressing the credit requirements related to their suppliers, employees, and partners
- Timely notice of any expected breach of the loan facility (to help negotiate modifications or partial waivers of the financing terms)
- The use and availability of government credit programs
- Plans for near- and long-term funding requirements (to help lenders better anticipate future credit requirements)

In particular, banks and other lenders want to know their corporate borrowers are engaged in vigorous scenario planning to see their way through the current crisis and for recovering lost business. The key is to be realistic on both downside and upside scenarios, and to develop a set of contingency plans for each. Aflac Inc., a Columbus, Georgia-based insurance company, developed a tool kit that includes stress-testing parts of its business to figure out how much debt it needs to raise. The process informed its recent issue of yen- and dollar-denominated senior unsecured notes being used to bolster its capital structure.[11]

3. Pursue other traditional credit opportunities

One way or another, companies need to take advantage of any incremental capital they can raise while the low-rate environment lasts. That may be with existing lenders or other providers—do not assume that all banks and other capital providers look at the attractiveness of a specific situation the same. Clearly, the availability and pricing of additional credit will depend on the issuer's financial outlook. While central bank interventions have eased capital-raising concerns for investment-grade corporates, those with lower credit ratings (such as high yield), or private mid-market companies, may have more difficulty obtaining new capital and should expect borrowing spreads to widen from what has been experienced in the more recent past.

For high-yield issuers in more stable financial condition, now may be the time to lock in relatively low long-term rates to pay down short-term operating debt. But traditional credit opportunities may even still be available to those whose businesses have been hit hard by the shutdowns—so long as they act quickly.

Many first movers across industries that have been directly affected by the COVID-19 crisis have raised significant long-term capital. Cruise-line operator Carnival Corp., for example, was able to raise US$4 billion in new bonds, even as the pandemic ravaged the travel industry and the company couldn't predict when its ships would be able to sail again. To be sure, the company is paying a high price—the bonds offered a yield at par value of 11.5 percent, compared to the 1 percent yield it agreed to pay in an October 2019 bond issue in Europe. The bonds are secured by a first-priority claim on the company's assets, including its vessels. But the rates paid on the bonds were reportedly far below what the company had been considering paying a group of hedge funds to provide emergency cash.[12] And the move signified the immediate survival of the company, which employs about 150,000 people, was no longer in question.

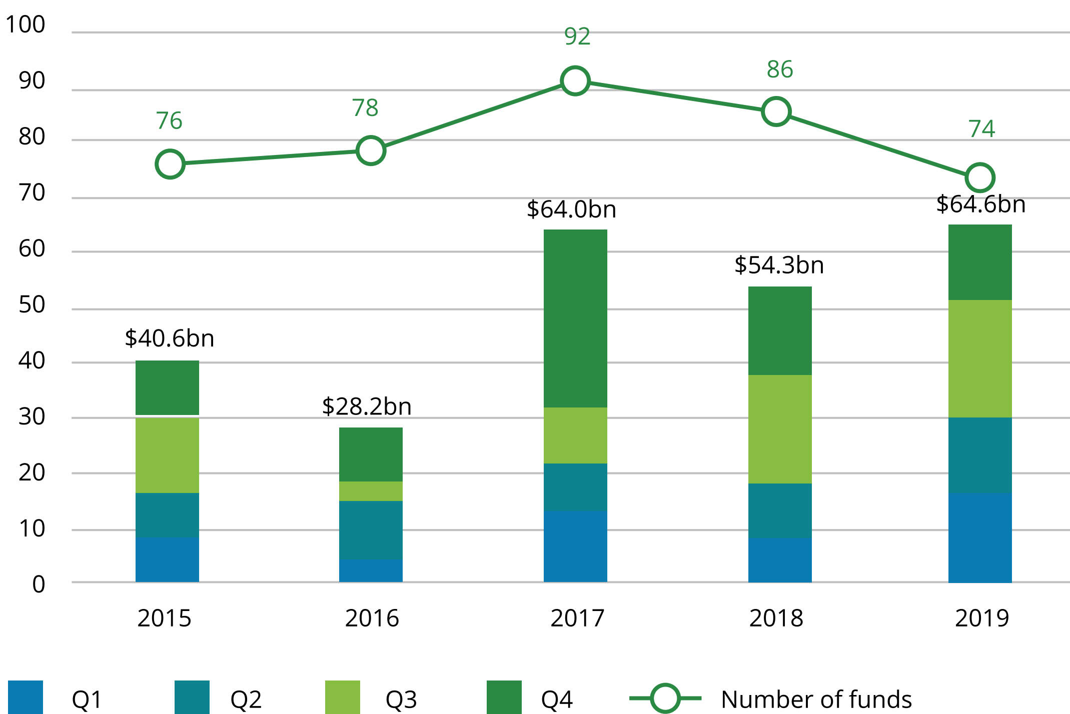
The lesson here is that companies in industries directly affected by the crisis may still be able to get ahead of their funding requirements, and those facing delayed, indirect economic impacts may be able to take advantage of lower borrowing rates before they potentially rise along with defaults. As with any debt issuance, companies need to consider their capacity to cover the interest expense in a variety of economic scenarios.

4. Consider alternative funding sources

Given the relative paucity of traditional credit for many affected private companies in the middle-market space, it may be necessary to consider alternative forms of capital to get through this challenging period.

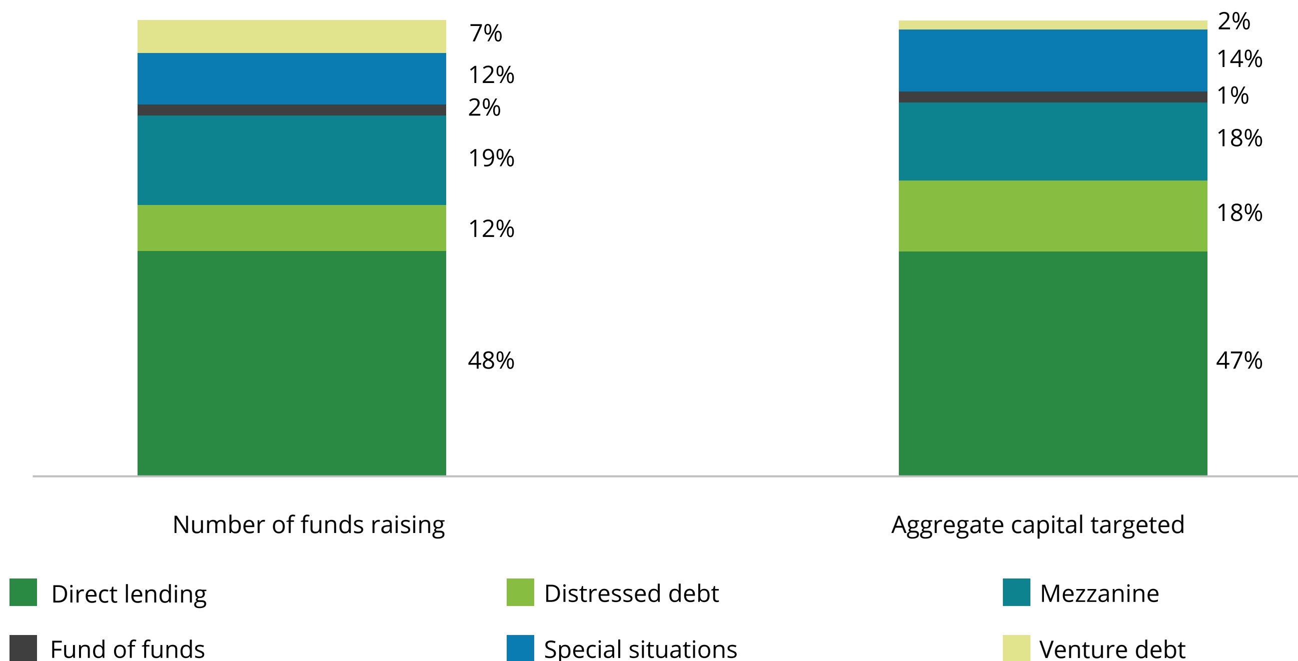
As banks continue to retreat, the US$812 billion global private-lending market is booming.[13] Unlike during the global financial crisis, private debt funds today have significant capital to support lending, with more than three times the assets under management than at that time. According to the Spring 2020 Deloitte Alternative Lender Deal Tracker, fundraising by global direct lenders increased to US$64.6 billion in 2019, up from US$54.3 billion in 2018.

Global direct-lending fundraising by quarter[14]



While direct lending firms are still assessing the damage to their existing borrowers, the more opportunistic among them have been more active in lending to companies in the current environment. In addition, special situation funds—which look to invest in unusual events and off-market opportunities—are now growing almost on par with distressed debt and mezzanine funds, according to Preqin. In the months ahead, some direct lending funds are likely to be rebranded as "credit opportunity" funds, with an increase in flexibility of their mandate, in order to take advantage of the current climate.

Private debt funds in market by fund type (1Q20)[15]



These alternative debt funding sources are allowing some companies the flexibility to avoid pursuing potentially more costly transactions in which they give up equity in the business—or sell it outright. But they come with potential downsides. For one, the loans are more costly than bank loans (all-in spreads can be two to three times the cost of bank loans), and significant diligence needs to be completed on these potential lenders as many have short histories. For another, unlike bank-provided term debt, there are significant differences between the terms and conditions of private debt depending on the provider, making it critical to shop around. Regardless of the extra effort required to access this capital, such funds are filling gaps in working capital, capital purchase needs, and even acquisition opportunities for many private firms in the midst of the COVID-19 crisis. Private debt may be poised to play a bigger role during the recovery as banks remain cautious about extending new credit. New York-based Apollo Global Management, for instance, plans to raise US$20 billion over the next year, emphasizing credit strategies that aim to take advantage of market dislocations.[16]

Finally, for those private companies willing to give up a stake in their business, private equity (PE) firms are increasingly coming into play. PE firms had some US$2.5 trillion in uninvested capital—or “dry powder”[17]—amassed on the sidelines before the onset of the crisis, and now they are aggressively raising more money to capitalize on the demand for capital caused by the pandemic. PE fundraising in the first quarter of 2020 was the highest quarterly total since 2015, and 30 percent higher on a year-over-year basis, according to Private Equity International preliminary data.[18] April saw that pace continue, with funds being raised that focus on opportunities created by the pandemic-afflicted economy. Bain Capital, for instance, recently said it plans to raise about US$9 billion for its next global buyout fund.[19]

As PE firms offer cash support, companies are already moving fast to take advantage. New York-based Outfront Media secured a US$400 million investment from Providence Equity Partners and Area Management Corp. for convertible preferred stock carrying a 7 percent dividend.[20] As with any form of alternative capital raise, companies have to balance the cost of the capital versus taking on a partner and giving up some flexibility in making decisions around the business. Even before the crisis, however, the number of companies making this decision had grown dramatically over the last 10 years, with assets under administration for PE investors having grown from US$1.4 trillion in 2008[21] to US$4.1 trillion by 2019.[22] Given the hundreds, if not thousands, of PE capital providers available (depending on the geography), significant diligence needs to be carried out when looking for the ideal PE partner, both from a cultural perspective as well as securing the right terms and conditions.

A critical time for quick thinking

The COVID-19 pandemic has created a level of uncertainty few private companies have ever had to face—and, by all counts, it’s unlikely to fully clear for the next several years. Given the wide variety of potential outcomes stemming from the crisis, it’s critical for finance leaders to plan for the worst case, even while they hope for the best.

Now is the time to get ahead of a more troubled debt-raising environment, as the market for available capital will likely become more crowded as downgrades and defaults increase. All credit relationships need to be considered, whether they are traditional players such as banks, or alternative lenders such as private debt or private equity providers. Those enterprises with thorough contingency plans will be in a far better position to weather the storm, while those with stronger balance sheets will be primed to take advantage of dislocations within their industries and shift into higher growth mode as the recovery accelerates and the “next normal” evolves.

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Supporting materials

1 Dbrief survey results

2 COVID-19 CFO Poll Results

3 S&P 500 Yahoo Finance

4 High-Grade Bond-Fund Outflows Hit $35.6 Billion, Smashing Record

5 Fitch Ratings – Corporate, Financial Institution Downgrades On Pace for Record

6 BNN Bloomberg – Distressed Debt Balloons to Almost $1 Trillion, Nears 2008 Peak

7 Fred Economic Data – ICE BofA BBB US Corporate Index Effective Yield

8 Sources: Bloomberg Finance L.P., ICE/BofAML, Tradeweb and Bank calculations.
(a) Changes are from 4 December 2019 to 23 March 2020 and 4 December 2019 to 29 April 2020.

9 S&P Global Intelligence – The 2020 Maturity Wall

10 Deloitte Survey

11 Business Wire – AM Best Assigns Issue Credit Ratings

12 The Wall Street Journal – How Fed Intervention Saved Carnival

13 Source: 2020 Preqin Global Private Debt Report, page 3

14 Source: Spring 2020 Deloitte Alternative Lender Deal Tracker, page 16

15 Source: Preqin Pro. Data as of April 2020

16 The Wall Street Journal – Apollo

17 Forbes – Debt Markets

18 Q1 Fundraising Shows Strong Start to Year with Covid-19 Blow to Come

19 Bloomberg – Bain Capital

20 PR Newswire – Outfront Media

21 Consultancy UK – Private Equity

22 Global Private Equity Assets Surpass $4tn for First Time

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