Liability management is the name of the game

European debt markets will provide plenty of opportunity for stressed and distressed investing this year. Markets were difficult in the second half of last year, with a significant tail-off in M&A activity, but lenders and borrowers will still find ways to transact over the course of the year.

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2022 was a year of two halves

In Europe, following a record-breaking 2021, where most market participants were eager to deploy capital and do deals in the wake of the pandemic, the first six months of 2022 saw a continuation of this trend.

But then we entered a new phase of interlinked macroeconomic and geopolitical crises that meant the second half of the year was very different. The public debt markets generally ground to a halt.

This 'perfect storm' continues to be felt on a global basis.

These various factors will be familiar to readers: Russia's invasion of Ukraine, and the resulting energy crisis across Europe; rising inflation, due in part to higher consumer costs, and a steep increase in interest rates; the UK's economy almost came to a halt following the Truss government's interim budget.

Other issues include the slowest growth seen in China for almost a decade, the mounting tensions between that nation and the United States, and continuing supply chain issues caused by various factors like Brexit, the aforementioned war in Ukraine, inflationary pressures and labour shortages.

> However, there are signs some of these headwinds may be abating.

As of the time of writing, the US dollar/UK sterling exchange rate is at 1.22 and the FTSE 100 is back up above 8,000 points.

Recent news has also indicated that the UK and other European economies saw a marginal month-on-month growth in November and December. The news in January was that the UK (as was the case in other European countries), was going to narrowly avoid a recession. This has created a greater sense of positivity heading into the rest of 2023.

Many European market participants remain optimistic that deals will start to flow again soon. It may be that 2023 will reflect the post-Covid-19 landscape. Are the global geopolitical and fiscal issues just the 'new norm?' If so, will investors find ways to do deals despite these conditions?

Given the levels of dry powder among both private equity sponsors and direct lenders, will it be just a matter of time until the pressure to invest overrides the political and financial worries?

M&A activity

The general sentiment is that there is likely to be reduced M&A volume in the first half of the year.

History shows that M&A slows down during periods of volatility due in part to the gridlock between sellers and buyers over valuations, which had arguably reached unsustainable levels.

Deals are, however, unlikely to dry up completely.

Bolt-on acquisitions need to be viable, for instance. These would allow private equity firms to continue the buy-and-build strategy that has paid dividends in recent years.

Established lenders are more likely to continue providing funding to borrowers where they have a clear understanding of the business.

In addition, investors may need to be more opportunistic to find ways in which to get deals done.

For instance, we could see more corporate carve-outs. The same goes for mergers and public-to-private transactions where buyers may be able to take advantage of depressed equity pricing.

> Sectors such as technology and healthcare will probably offer some of the best opportunities.

These sectors have in the past proved to be resilient against the macroeconomic and geopolitical issues facing the markets today.

Being selective, especially early in the year, will be crucial in ensuring sponsors maximise their returns. When the right deal is identified, speed of execution and certainty will be key.

That leaves investors facing the question of how they will deal with any financing needs and whether debt will be available to them.

Financings to be done

The years of low interest rates and cheap money may be over for the foreseeable future, but the best companies will still be able to access debt. Certain sectors will still be looked at favourably.

There has been increased activity and positivity in the public debt markets in the first few weeks of the year and record levels of private debt were raised in 2021 and 2022.

This shows that there is more than ample liquidity in the market. In fact it is not dissimilar to what we saw in the aftermath of the pandemic.

Private debt's equity-like approach to investments, ability to write large cheques and detailed underwriting means such a source of capital may be suited in times of volatility even if it is more costly, particularly when the public markets offer no alternative.

We expect private debt to be busy, but perhaps not up to the levels of the past couple of years.

In the second half of 2022, we saw private debt funds firstly, supporting banks on deals they had underwritten where they struggled to sell the debt on to investors, as well as, secondly, providing anchor investments for institutional loans.

> More deals are likely to be underwritten with a view to selling to private debt funds.

continued on page 11

continued from page 10

Private debt has over the past several years shown itself to be a dynamic asset class in that it can participate in all parts of the capital structure.

The constraint around quantum is also a thing of the past, as we have seen over 2022 with the likes of Access Group obtaining over US$3 billion from a club of private debt funds. This will allow private debt to continue to compete directly with investment banks for opportunities.

The certainty around pricing and terms can be a big advantage for borrowers and their sponsors, another reason for optimism.

Liability management will continue to grow

Whilst M&A activity remains muted, many financing opportunities will revolve around refinancings.

We have already seen borrowers with upcoming maturities move quickly this year to refinance. The 'maturity wall' will be greater in 2025 and 2026, but we should expect opportunistic borrowers to seek early solutions if the opportunity is there.

Equally, other liability management exercises such as 'amend and extends' will continue.

These will be reserved for good credits and will allow management teams and sponsors an extended period of time (usually one to two years) to realise longer-term investment objectives in return for a fee or margin uplift (which may still be cheaper than sourcing new financing in the market).

> Inevitably in a recession, some companies will need to undertake covenant resets or waivers, either on a standalone basis or combined into the 'amend and extend' process.

This will be less of a concern in the large-cap space where cov-lite deals are the norm.

These deals tend to have fewer early warning signs and the nature of incurrence-based covenants means borrowers can sit on their hands until a liquidity need arises.

This may lead to some more substantive work-out scenarios, although we don't anticipate there being a flurry of such activity in the first quarter of 2023 save for what is already in the pipeline.

Stressed and distressed debt opportunities

There should be opportunities for stressed and distressed debt investments in 2023, particularly where companies need liquidity.

Some demand could be for interim finance, but other needs could be longer term.

The macroeconomic and geopolitical issues affecting the markets will likely give highly levered companies some concern.

The situation now is different from the aftermath of Covid-19, where many thought that there would be an abundance of distressed debt opportunities. This did not materialise, in part, due to government support and insolvency reforms that focused on maintaining businesses.

Now government support programmes are no longer available, or are winding down, and many businesses are facing tightening cash flows as a result of rate rises and the difficulty in passing on costs to customers.

Despite this, we expect stakeholders to take the same pragmatic approach that they have taken over the past few years, where instead of going down a full restructuring route they will put more cash into the business or work with these businesses to undergo amendment processes to reset financial covenants and other changes.

> It is natural for people to debate default rates, and whilst these rates are unlikely to reach the levels seen in 2008 to 2009, they surely will not stay as low as they have been.

Years of very low rates and excess liquidity led to a low level of defaults. Default rates following the global financial crisis fell dramatically. Government support during the pandemic meant there was no increase to such levels.

More corporate insolvencies are likely in 2023, whether through a rationalisation of economic value through capital structures, court-led processes or wholesale ownership changes.

Investor push back

In 2022 we saw creditors increasingly push back on documentary terms. High yield bonds had become as borrower friendly as they had ever been. Wins were few and far between for creditors. This trend reversed last year, and there is likely to be more investor push back in 2023.

Given where the market had moved, some argued the concessions have been marginal and around the edges.

That said, with an increasing focus on leverage levels and leakage, we can expect continued focus from investors on ratio and basket capacity across debt and restricted payments and investments.

Equally, investors are increasingly focused on a truer or 'cleaner' definition of EBITDA.

We may see a reduction in uncapped EBITDA add-backs, for instance, including the exclusion of revenue-related add-backs together with tighter pro forma adjustments in the form of reduced or capped cost savings and synergies.

We also expect creditor requirements such as mandatory hedging, which had become a thing of the past, to reappear to guard against borrowers' potential inability to service its debt (or using up the majority of cashflow to do so).

> Now we have left the era of near-zero interest rates, lenders want to make sure borrowers are able to withstand any potential further rate rises and that they can service their debts.

Environmental Social Governance (ESG)

Despite economic uncertainty leading to pricing and terms being the focal point, ESG (Environmental Social Governance) considerations will continue to be important in 2023 transactions.

> We expect to see a continued laser-like scrutiny of ESG policies across both private equity and credit markets.

This is in part going to be driven by investors seeking to provide their money to so-called impact/green funds. Therefore any credit fund with a specific ESG strategy will need to back that up with tangible evidence to counteract any claim that they are 'greenwashing'.

In debt documentation, that will likely take the form of lenders taking a more rigid stance towards ESG ratchets (where you get a small reduction in the margin that you pay on your borrowing if you hit various ESG targets).

This will include the meaningful metrics required to be hit to get the benefit of those ratchets, or price increases if levels are not met, together with the proposed use of any cash savings.

Additionally, debt documentation may include the requirement to fill out an ESG questionnaire on an annual basis and for the ESG Key Performance Indicators (KPI) to be set out explicitly with more clarity and understanding of what is required for those KPIs to be achieved.

Conclusion

2023 will bring its own set of challenges. That is not to say there will not be lots of opportunities, across both performing and non-performing assets.

continued on page 12

continued from page 11

The difficult economic backdrop may be mitigated by the liquidity still in the market.

If the debt markets continue to offer little respite and refinancing opportunities, borrowers are going to have to get increasingly creative in sourcing financing or recalibrating their balance sheets.

Some market participants expect the debt markets to reopen quickly and pricing to level out at more sustainable levels in the earlier stages of the year.

At that point, all that is needed is a narrowing of the bid-ask spread for deal volume to pick up.

As history has shown, it only takes a few transactions for the debts markets to fully reopen and for M&A confidence to return.

Sidley represent successful Britishvolt bidder

The successful bidder for the main assets of Britishvolt, an ambitious project to build a gigafactory in the UK, was advised by Sidley, led by London restructuring partners Mark Knight, Jifree Cader and Adam Runcorn, together with Australian boutique KordaMentha, led by Scott Langdon and Julian Derrick.

Although Britishvolt's plans to build a UK£3.8 billion car battery factory in the North East of England ended in Administration at the end of last month, the buyer has plans to build a similar kind of plant.

The successful bidder is David Collard, an Australian businessman currently based in New York, and formerly of PricewaterhouseCoopers.

Collard's Recharge Industries is already planning to build a battery plant in the Australian city of Geelong, and the company reportedly made a bid of about UK£30 million for the Britishvolt site, although this figure has not been confirmed.

The Australian company was launched in 2021 by Scale Facilitation, Collard's New York-based investment vehicle that has backed a handful of start-ups in the medical technology and green energy sectors. Collard commented after his bid for Britishvolt was accepted:

> "We're thrilled to be progressing with our proposed bid for Britishvolt and can't wait to get started making a reality of our plans to build the UK's first gigafactory."

"After a competitive and rigorous process, we're confident our proposal will deliver a strong outcome for all involved," said Collard.

Dan Hurd, Jo Robinson and Alan Hudson of EY Parthenon were appointed Administrators of Britishvolt at the end of last month. The Administrators were advised by Dentons.

Before it fell into Administration Britishvolt was seeking close to UK£200 million in funding to keep it running until later this year, when it expected to receive orders from carmakers. One of the start-up's biggest challenges was its lack of significant, ongoing orders.

Britishvolt's in-house technology was at a late prototype stage and required more funding to commercialise.

Collard will have to apply again if he hopes to secure the UK£100 million grant that the British Government had formerly pledged to Britishvolt.

It is understood the Government is keen to see the new project succeed.

Flybe to close

The joint administrators of Flybe Limited, David Pike and Mike Pink from Interpath Advisory, confirmed on 15 February that discussions with parties regarding a sale of the airline have now concluded, and the business will be closed.

The Administrators, originally appointed on 28 January, put out a statement saying:

"Despite significant interest from a number of credible parties, it has not been possible to develop a transaction in the available timeframe and as such, the Joint Administrators will now commence the process of winding-down the business and identifying options in relation to the sale of specific rights, interests and assets.

"As a result, a further 25 employees have been made redundant with immediate effect."

Pike said: "Over the past two and a half weeks, we've held intensive discussions with a number of operators with a view to rescuing the airline and preserving the value in its assets.

> "Unfortunately, there was a challenging set of circumstances at play, including the 'use-it-or-lose-it' rules related to slots, complexities with European recognition of a potential Temporary Operating Licence and the high costs associated with preserving the company's operating platform, which meant there was a limited window in which a clear path forward could be set."

"Furthermore, it was clear from the outset that there was only a limited number of parties who had the necessary strategic fit and who could navigate the complexities of such a transaction to get a deal over the line. We thank those parties for their engagement," said Pike.

"However, it is with regret that discussions have now been brought to a close without a deal being agreed.

"We'd like to thank a number of stakeholders, including the CAA and the company's lessors, who gave us the time and support we needed to ensure we were able to explore every available avenue to rescue the business," said Pike.

We'd also like to thank those employees who have been working closely with us since our appointment, and who have worked with diligence and professionalism in this unsettling period.

"Over the coming days, we will continue to work with the lessors to return the aircraft records to them, and will also continue to provide support to those employees who have been impacted by redundancy.

"We are particularly grateful to those operators and other organisations across the aviation industry who have reached out to us directly to offer support in finding new roles for employees," said Pike.