Financing considerations in the post-COVID-19 market

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Over the next few months, as the COVID-19 crisis transitions into the reopening and recovery stages and data about the financial and economic impacts becomes available, many companies will continue to carefully assess their liquidity needs and financing options.

Here are some of the key trends we are seeing as businesses preserve access to their credit facilities and other important considerations for ensuring access to liquidity. We also discuss how public companies can ensure they are "market-ready" to access the capital markets on short notice and alternative financing options available to them as they emerge from the crisis.

Bank financing

Ensure continued access to credit facilities

With the initial effects of the pandemic being felt in March (the last month of the first quarter), most borrowers were able to maintain adequate financial performance through the first quarter of 2020 to take them through the quarter end financial covenant testing period without requiring any accommodation from their lenders.

Nevertheless, across the credit spectrum, many acted preemptively to obtain anticipated accommodations needed from their lenders. All borrowers now have their eyes on their projected position for the next several quarter ends to determine whether further accommodation from their lenders may be required to see them through the next phase and ensure continued access to their credit facilities.

To date we have seen a variety of amendments being entered into by lenders to enable borrowers to remain in compliance with their credit facilities (despite, in some cases, a total cessation of the borrower's business operations), though these amendments come at a cost to the borrower. Amendments in this environment have tended to focus on financial covenant relief. Typical amendments we have seen include some combination of the following:

- allowing add-backs to earnings before interest, taxes, depreciation and amortization (EBITDA) for specific losses incurred by the borrower related to the pandemic (e.g., costs relating to plant closures) and allowing credit for government support where the support is not required by its terms to be repaid;
- excluding certain quarters in the trailing four quarter EBITDA calculation and annualizing the remaining quarters (e.g., excluding the second and third quarters and annualizing the first and the fourth) or replacing EBITDA for a certain quarter with the EBITDA for that corresponding quarter in the prior year (e.g., using EBITDA for the second quarter of 2019 rather than the second quarter of 2020);
- resetting the financial covenants for the affected quarters to a level the borrower is projected to be able to meet; and

- waiving compliance with the financial covenants completely for a specified period.

There has also been significant discussion around the question of whether the COVID-19 pandemic has triggered a material adverse change or has had a material adverse effect (MAE) on the business, as those terms are defined in loan documents.

The occurrence of an MAE will typically act as a drawstop, and often an event of default, in Canadian credit agreements. While it is not being addressed in all amendments, some borrowers have been successful in obtaining some clarity around whether the effects of COVID-19 are considered to be an MAE, by adding in their credit agreements an exception to the MAE definition for the effects of COVID-19.

Lenders are, not surprisingly, leery of a blanket exception in circumstances that are ongoing and remain very uncertain, and so the exceptions that have been granted tend to be carefully circumscribed. For example, it may be agreed between the borrower and the lender that the anticipated and disclosed impacts of the pandemic, as outlined in financial projections provided to the lenders, will not be an MAE.

In return for the financial covenant and other relief, many lenders are adding to or tightening other restrictions in loan documents. An illustrative list includes:

- restricting distributions and other cash “leakage” out of the loan party group in order to ensure cash is preserved for operations;
- restricting acquisitions and other investments (which use cash and distract management focus);
- adding an anti-hoarding covenant, which restricts the amount of cash on hand that a borrower can have at any time, such that borrowers cannot draw more than what is reasonably required for ordinary course operations;
- adding a minimum liquidity covenant where financial covenants have been suspended or loosened that requires the borrower to maintain a specified level of unencumbered cash, cash equivalents and availability under working capital facilities, so as to ensure sufficient liquidity to meet current obligations;
- increasing short-term reporting obligations, including requiring a liquidity forecast and monthly updating (while annual budgets are commonly being pushed out); and
- adding a covenant to use commercially reasonably efforts to pursue governmental support (the add-back to EBITDA for government support amounts that do not need to be repaid being an added incentive in that regard).

As the economic shutdown continues, we expect to see other amendments emerge as borrowers address ongoing liquidity and compliance challenges under their loan documents.

Given the enormous uncertainty about the length and depth of the current downturn, we are seeing relief geared to the short term (e.g., through the end of summer or into the fall), with the expectation (and requirement) that companies are revising their business plans to allow for the negotiation of longer-term amendments to reflect the future “new normal.”

Enter into liquidity agreements

Many borrowers have been boosting liquidity by obtaining new debt commitments, either as an incremental add-on to an existing facility or as a new separate liquidity facility (read more on liquidity solutions here).

While there is a price to be paid through stepped-up interest rates for additional liquidity, we have seen numerous revolver increases and incremental liquidity facilities successfully implemented during the pandemic. While more difficult a task than during non-pandemic times, obtaining new debt commitments is often an important part of the liquidity strategy for borrowers going forward into the rebuilding phase.

Access government loan programs and other government support programs

The federal government has announced many programs to assist businesses during the economic crisis caused by the COVID-19 pandemic (read our latest on government assistance here). These programs include the Business Credit Availability Program under which small- and medium-sized businesses can access liquidity loans of up to $12.5 million (read our full commentary on the BCAP program here).

In addition, the federal government has recently announced the Canada Emergency Commercial Rent Assistance program, which provides forgivable loans to commercial landlords so that they may provide rent relief to tenants that are small businesses. The federal government has not yet announced any similar programs for large businesses.

Each business will need to consider its ability to incur government support loans under the terms of its credit documents. These loans are not and will not be "easy money". The government support loans are subject to many, if not all, of the same considerations a borrower would have to address if it were to incur regular third-party debt. A careful consideration of the restrictions on incurrence of debt in existing debt instruments will need to be undertaken, and borrowers will need to ensure they are able to continue to meet their financial covenants on an ongoing basis, as this debt will in most cases be included in the same way as third-party debt in covenant calculations.

Public company financing

COVID-19 has had a major impact on public company capital raising as extreme volatility in the stock market has resulted in a significant downturn in equity offerings. By contrast, bond markets have remained active through the COVID-19 crisis, with many issuers successfully raising significant proceeds at favourable rates. In fact, the U.S. bond market has reportedly hit record new issuance highs in the first quarter of 2020 and the month of March.

As the pandemic continues, stock market volatility will present periodic market windows which may quickly close. And as investors retreat from the equity markets, bond and convertible debt financings may gain in popularity. Companies that want to be in a position to opportunistically access the markets on short notice will be well-served to put in place a universal shelf prospectus or consider the adoption of an ATM (at the market) program. Cross-listed issuers that want the flexibility to access U.S. markets may also want to explore putting up a cross-border shelf prospectus or cross-border ATM program.

Universal shelf prospectuses

Universal shelf prospectuses, under which an issuer may sell securities to the public from time to time without further regulatory review and on an accelerated timetable, are relatively common and can be put in place by an issuer in a few weeks.

Typically, a universal shelf prospectus gives issuers the flexibility to issue equity, preferred shares, debt securities (including convertible debentures), subscription receipts and warrants over a 25-month period—a broad suite of securities that can be issued depending on the issuer's financing needs and market demand at any given time.

In order to take down securities under a shelf prospectus quickly, issuers will also need to maintain regularly updated electronic data rooms to enable underwriters and their counsel to conduct due diligence on a quick turnaround time—issuers that want the flexibility to access markets regularly and with speed may consider permitting legal counsel to conduct diligence on a quarterly basis to ensure all parties are in a state of readiness to launch an offering with minimal notice. Issuers will also need to ensure their disclosure documents are up to date, including appropriate risk factors to reflect current conditions[1].

Once a shelf prospectus is effective, the issuer and its underwriters will have the flexibility to speak with potential investors about a potential financing (including the proposed size and price of the offering) in order to gauge the interest of investors in the financing. These "soft-sounding" investor communications are a useful way for an issuer to test the market in advance of a public launch, and mitigate the risk of an unsuccessful offering after it has been announced.

Equity offerings under a shelf prospectus in Canada are typically done on a "bought-deal" basis where the underwriters take all of the marketing risk following the public launch and the issuer has increased certainty of financing. In the current environment, bought deals may not be as widely available—however, a bought deal commitment may be available following these soft-sounding activities or other investor outreach by an issuer that indicates positive market sentiment, such as the announcement of quarterly results or a non-deal roadshow.

Once a shelf takedown has priced, the offering can close quickly (in less than a week), mitigating execution risk between pricing and closing. In the current environment, issuers should expect that underwriter termination rights may be available if there is an escalation or material development related to COVID-19 following pricing—accordingly, minimizing the amount of time between pricing and closing will be critical for issuers looking for greater financing certainty.

ATM (at the market) programs

ATM programs, under which an issuer may sell securities under its shelf prospectus from time to time at prevailing market prices over a stock exchange, are relatively new to the Canadian market but are gaining momentum.

Under current rules, issuers must obtain exemptive relief from certain Canadian securities law requirements before implementing an ATM program[2]. Once an ATM program is in place, it can be a very simple and cost-effective way for an issuer to issue equity. There is no marketing under an ATM program, and instead, the company periodically sells equity through a dealer to investors over the stock exchange (similar to any other exchange trade).

Canadian ATM programs are subject to certain limits on the equity issued—typically, no more than 25% of the daily trading volume and an overall cap of no more than 10% of the market value of the issuer's outstanding equity securities.

Although an issuer is more constrained under an ATM program in the amount of equity it can issue at one time (since sales under an ATM typically take place over a period of many months or up a year), the cost of an ATM program is much lower than a conventional public offering since the shares are issued at the prevailing market price (not at a discount) and dealer commissions are lower.

In addition, against the current backdrop of rapidly changing market conditions, an ATM program significantly minimizes any potential execution risk since sales typically occur at the issuer's discretion periodically over an extended period of time following the launch of the offering.

Private placements

As an alternative to a public offering, we may also see PIPE (private investment in public equity) transactions gaining popularity (read our full M&A outlook here). PIPEs may be particularly attractive to private equity and pension fund investors that are sourcing alternative investment opportunities at the same time that public companies are facing heightened liquidity needs.

A PIPE transaction resulting in the issuance of less than 20% of an issuer's voting securities and within permitted private placement discounts under stock exchange rules can generally be completed quickly and without shareholder approval.

For PIPEs of greater than 20% of the outstanding voting securities or priced beyond the maximum permitted discount, issuers who can demonstrate sufficient financial hardship may be able to rely on exemptions from the shareholder approval requirement.

Compared to a public offering, a PIPE can offer increased flexibility and financing certainty, and may be an attractive option for issuers with less visibility on the market's receptivity to an offering.

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[1] As a reminder, issuers that choose to delay any of their filings this year, as permitted by Canadian securities regulators in light of COVID-19, cannot file a prospectus until their continuous disclosure record is current.

[2] Amendments were proposed by Canadian securities regulators last year that would eliminate the need to apply for exemptive relief to conduct an ATM offering. Although these amendments are not yet effective, the new rules are

expected to come into force in 2020.