A Tsunami of Loan Modifications is on the Horizon

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Most companies are past the decision of whether to draw on their bank facilities, but an even bigger challenge looms straight ahead.

By Meg Waters

As companies struggle to contain the economic fallout of the **Covid-19** pandemic, corporate treasury teams are laser-focused on liquidity. With **supply chains disrupted** and revenues drying up across myriad industries, the majority of U.S. businesses have made cash on hand a top priority. Yet credit markets are challenged (in some cases **seizing up**), and some banks are discouraging corporate customers from even **drawing down their existing credit facilities**.

By the end of the second quarter, falling revenues and profits will strain many companies' ability to meet loan covenants such as the ratio of their earnings before interest, tax, depreciation, and amortization (EBITDA) to their total leverage. Many treasury teams will find themselves between a rock and a hard place—the rock of their loan covenants and the hard place created by an external environment that is rapidly and unpredictably changing for the worse.

Reuben Daniels, founder and CEO of **loan arranger** EA Markets, expects the interaction of these pressures to result in a veritable tsunami of companies seeking loan modifications. The volume of requests for waivers and amendments will threaten to overwhelm borrowers and lenders. Treasury organizations that think they're likely to need a modification should already be planning out how they'll accomplish that goal. This is the first in a series of articles in which Daniels explains what treasury teams should be doing today to increase their chances of securing the covenant relief they may soon require.

Meg Waters: *Let's start with a description of what you're currently seeing in the corporate loan markets.*

Reuben Daniels: We've all seen videos of a tsunami, people standing on a beach, watching the tide rush out and wondering what's going on, then a tidal wave crashes and washes away the whole town. That's where I think we are—we're closely monitoring the shores of the loan market right now. In conversations with both borrowers and lenders over the past few weeks, I've heard that companies are just starting to think about upcoming loan modifications, and lenders are anticipating a surge of waiver and amendment requests over the next few months that could drown the loan market.

MW: *So, what about the current environment makes you think you're seeing the water rushing out? What indicates to you that a tsunami is on the horizon?*

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RD: In March, there were only a handful of loan modifications announced, but April is stacking up to have a tenfold increase in modifications. Loan modifications are not necessarily uncommon, but typically the vast majority of loans are refinanced rather than modified. As a consequence, loan modification requests are relatively infrequent. It's rare to have a large concentration in a short period of time, but I think that's what we may be facing in the second quarter. I expect that the volume of loan modifications will grow exponentially as companies grapple with the changing economic landscape and the new reality of their financial condition and updated forecasts.

In February and March, as this crisis started, we didn't see many waivers or amendments because lenders first triaged their most challenged situations in the hardest-hit sectors, such as travel, lodging, and energy. Those companies immediately drew down their bank loans or acted to replace lost funding in the capital markets, like CP [commercial paper]. Over the past eight weeks, there have been announcements of nearly $100 billion of new loans and over $200 billion of bank

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drawdowns, two-thirds of which were investment-grade borrowers.

From the corporate side, the first response of many companies has been to stabilize their operations, focus on getting their teams working from home and doing what they need to do to be productive in this new environment. Their second phase has been to make the necessary changes for their business to withstand this period of deep uncertainty, whether that's making structural changes, cutting costs, laying people off, or pursuing new strategic initiatives. Then the third step has been deciding whether to draw on their bank facilities. Unfortunately, some companies decided to draw even though they weren't in the most critical situations, which has probably not helped their position for negotiating loan modifications down the road.

MW: *That's interesting. Before we move on to the debt covenant issue, I'm curious about why you feel some companies have misplayed the decision of whether to draw on their credit facilities.*

RD: Companies that drew down their bank facilities without a compelling purpose have only replaced committed capital with cash balances that neither strengthen their balance sheet nor increase cash availability. What's more, these companies have risked antagonizing their lenders. Sometimes, drawing on a bank facility can be a powerful negotiating tactic because it gives the company possession of as much cash as possible in a scenario of financial distress.

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However, like some of the large companies that have received criticism for participating in the federal government's Payroll Protection Program, borrowers who draw on their facilities when they don't really need to are adding to the strain on their banks. Lenders will remember how borrowers engaged through this crisis.

There are three fundamental reasons to draw on a bank facility. First is concern that your lender won't have the wherewithal to fund when you actually need it. Second is that you have capital commitments, like an acquisition or debt refinancing, for which other intended sources of capital have gone away. Third is that you're concerned about the company's ability to meet its obligations as a borrower. Very few people are predicting bank liquidity concerns that would justify drawing for the first reason. Lenders typically understand drawing for the second reason. But every draw that doesn't fit one of those two categories looks to the banks right now like a risk, for the third reason.

MW: *What are some examples of why companies are drawing down their bank facilities at this moment in time?*

RD: So, suppose you're the treasurer for a big company that is drawing on its facility today. You're probably not drawing because you think your major global bank is not going to have the money. Are you drawing because you have an upcoming maturity? Or because you are having trouble funding CP? Or maybe you're T-Mobile and you've agreed to buy Sprint, and you have an acquisition facility that was designed to be funded in this type of scenario. These are perfectly sensible reasons to draw.

But what seems to be happening right now at some companies is that senior managers and directors are saying, "I sit on three other boards. Those companies have all drawn on their revolvers. I read that private equity firms have instructed their portfolio companies to draw, so we should, too. Let's put the cash on our balance sheet." The problem is that the message they may inadvertently be sending is, effectively: "I'm concerned about my ability to meet my covenants and borrowing obligations."

Lenders have started to anticipate this behavior by adding anti–cash-hoarding covenants that prevent a borrower from drawing down a facility just to add cash to the balance sheet. Companies that have drawn on revolvers to stockpile cash should be prepared for a less accommodating lender if they later have to return to request loan modifications.

MW: *Aren't there also some companies out there that have legitimate concerns about whether they will be able to draw on their facility when the time comes and they really need it?*

RD: Yes, that's definitely true. Every company faces specific facts and circumstances, and identifying the optimal path is always a nuanced journey. In this case, the lender totally matters.

For simplicity, let's consider lenders to fall into one of two categories: the regulated banks or the non-bank direct lenders. In the prior example, I was referring mostly to regulated banks who, today, have essentially unlimited capital access. On the other hand, non-bank direct lending has been a booming market over the past 10 years. There are literally thousands of non-bank direct lenders, each with a different lending mandate, industry specialization, return expectation, risk profile, and so on. These non-bank direct lenders may have less capital access than the regulated banks do, but they are also subject to fewer constraints and can be more aggressive than the regulated banks.

Your decision as a borrower about whether to draw on your facility must be informed by what type of lender you have. If it's a major bank, you may be more confident that the bank will continue to have access to capital and will be in a position to fund your loan when you need it. Whereas if you're borrowing from a non-bank direct lender, you may have more concerns about whether they will be able to fund your facility. In that case, it's certainly understandable to draw.

MW: *So, if a company isn't worried about the lender's ability to fund and has no specific funding need, are you suggesting that it should do nothing right now?*

RD: Not at all. On the contrary, a constructive way to navigate this crisis is to approach lenders with a proposal along the lines of "We are financially positioned to weather this storm; we are going to make the changes required and are working to maintain our financial flexibility to handle the uncertainty ahead. The conservative path forward includes increasing our cash balances through capital-market transactions and additional bank loan capacity, together with the loan modifications required to access that additional capacity."

We have seen many companies come to the bank market with this approach and increase their access to capital quickly and efficiently. For instance, AT&T recently announced a new $5.5 billion term loan facility to provide additional flexibility. They had the ability to draw on $15 billion in bank revolvers but elected not to. As the CFO stated on their last earnings call, continuing to have the revolvers available "provides us with significant financial flexibility." They decided that they were better off increasing their overall cash availability instead of drawing on their bank facility.

MW: *Is the sudden, somewhat panicked rush to shore up cash on hand similar to what happened during the last global financial crisis?*

RD: It's similar in that the economy is clearly in crisis. It's different in that the last financial crisis was more of a crisis *of* the financial system, while this is more of a crisis *on* the financial system. The last time, we were concerned about a failure of the banking system, and companies were more concerned about their lenders' ability to meet their funding obligations. This time, we seem to be more concerned about a failure of the borrowers and the pressure that widespread failures will place on the banking system.

In 2009, the market was concerned about the 'Wall of Refinancing' and the volume of loan and debt capital that required refinancing by 2011. We climbed that wall, but we had three years to find sources of financing and to get maturity extensions.

In some ways, today's challenge is significantly more daunting because nearly all companies are simultaneously experiencing the adverse impacts of this economic shutdown, and they will all need to address these issues at the same time. In just 90 days. This concentration of loan modifications, for both the corporates and the private equity sponsors that control many middle-market corporates, could be unlike anything we've ever experienced before.

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MW: *And in this crisis environment, what are the loan modifications that you expect companies to be requesting? Will it mostly be extending when payments are due because of the critical cash-flow problems many organizations are expecting to face?*

RD: Well, there's no one-size-fits-all answer to that question. There is an extensive list of potential loan modification requests for both affirmative and negative covenant relief. These could include reporting and covenant test relief to asset carve-outs and limitations on liens. The key is to determine the modifications that are most important to the financial health of the company, balance those against the priorities of the lender, and position the totality of the modification proposal in the most desirable way.

One of the more common loan modifications we expect in the near term will be to request deferral of principal and interest (P&I). We are aware of some direct lenders waiving P&I for the month of April, saying, "Don't pay us this month. We will add this month's interest onto the principal amount," and then the borrower will repay the higher principal over the remaining term of the loan.

Another common modification will likely be covenant relief with regards to leverage. For instance, we're familiar with a company that has a step-down leverage test in their credit agreement. They are considering requesting a six-month delay on the scheduled step-down to give them additional financial flexibility right now.

For companies that expect to breach a covenant, their loan modification requests will be significantly more complicated and protracted.

MW: *How so?*
RD: When a company requests a loan modification, the lender will look for concessions. The more meaningful a modification, such as avoiding a breach of a covenant, the more significant the lender's demands will be. Borrowers can prepare creative alternative proposals to avoid the most difficult concessions and improve the outcome of these negotiations. However, the negotiations could become difficult quickly.

Borrowers requesting a modification will have to prepare updated financial information for their lenders. This is not so simple when borrowers do not yet have a full grasp on how, exactly, the economic shutdown is going to impact earnings, leverage, and cash flows in the future. Still, lenders are disinclined to give any relief without understanding the borrower's risk profile. If the market has the deluge of loan modifications we expect, lenders may not have the bandwidth to engage in prolonged and complex discussions.

MW: *So, have many companies begun to request loan modifications?*

RD: A few have announced loan modifications, but the majority of those have been companies that are directly and significantly impacted by the economic shutdown. As we are finishing the first quarter's earnings season, treasury teams are beginning to realize that the second quarter—with a full period of market impact—could devastate financial statements and adversely impact covenant compliance. So they are starting to consider what modifications they might request.

What many of these companies don't necessarily appreciate is that this situation is affecting nearly every other company in the country, regardless of industry, credit rating, financial history, or size. The system will be seriously strained when all these companies try to squeeze through that little loan modification door together.

In fact, the volume of transactions could be nearly unmanageable. There's this enormous tidal wave of waivers fast approaching, and neither the borrowers nor the lenders have the resources to negotiate the best possible outcome in every situation. For lenders, loan modifications are more of a cost center that offers relatively limited economic value and no league-table status. Private equity sponsors, who infrequently execute loan modifications during regular times, will have to address most of their entire portfolio of companies all at once—and at the same time they are also managing all the other critical strategic and operational challenges of those businesses, not to mention their own fund-level investor and capital management responsibilities.

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The next few months of loan modifications could prove to be a titanic test for lenders, companies, private equity sponsors, and the financial system as a whole.

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