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Lenders Should Prepare Now for the Distressed-Debt Aftershock of COVID-19

Just as aftershocks always follow a large earthquake, financial crises can also generate shocks that roil balance sheets long after the initial onset of crisis. The consequences can be particularly devastating for those companies whose financial foundations have deteriorated through overleveraging during the past 10 years.

Corporate foundations weakened by too much debt

An April 2019 report from Deloitte compared the rising corporate debt of the top 1,000 U.S. nonfinancial companies during the past economic expansion (2010-2018) and found the following key points:

Corporations have favored debt securities (bonds) over loans

The percentage of bonds most susceptible to being downgraded to junk status has jumped

The net debt to EBITDA ratio has fallen

The interest coverage ratio (i.e., earnings before interest and taxes divided by the interest expense) has declined.

The practical impact of these changes is that, despite experiencing a decade of great economic expansion, corporations' ability to repay their debt has, ironically, deteriorated over time. This problem is further exacerbated by the fact that during this same time period overall corporate debt has continued to rise (albeit at levels comparable to the past two economic expansions). The debt load now held by many companies—coupled with their relatively limited liquidity—is a major foundational risk with which lenders will need to contend.

The coronavirus earthquake and aftershocks

Coronavirus exploded on the scene in the form of a public-health crisis, but that crisis' aftershocks are threatening to spill over into other forms of distress. Equity markets have sharply declined in the past month, and businesses across many industries are preparing for significant disruptions to their operations. The aftershocks of the coronavirus earthquake include:

Supply disruption due to international and national containment measures

Decreased consumer spending due to numerous event cancellations

Decreased consumer spending driven by fear of an impending recession created by both the coronavirus and the corresponding massive drop in the stock market

Decreased productivity due to both quarantine efforts and workers' attention being focused on coronavirus containment efforts (including seeing things that were previously thought to be inconceivable of happening—e.g., the NCAA tournament without live spectators, cancellation of major festivals, etc.)

Most corporations will feel the financial impact of these effects as the crisis ripples through the US economy. For instance, quarterly earnings are anticipated to be substantially lower due to lost worker productivity and decreased consumer spending. This, in turn, will impact the bottom line and make it more difficult to service debt—particularly for highly leveraged companies. As distress mounts throughout the economy, assets could undergo a massive repricing, and company valuations could also be revised downwards for some time. Companies with relatively strong cash positions will have opportunities for greater expansion through the acquisition of assets from financially strapped companies. This will likely speed consolidation in various industries.

Operationally, the crisis will also speed up some strategic thinking that was already percolating through the economy. Supply chain diversification, for example, will become a more urgent matter to consider, whether that means more geographical diversification in lower-wage countries, or repatriating some parts of the supply chain where it makes economic sense to do so.

What should lenders do?

Just as it was only a matter of time before the coronavirus hit many Americans, so too it is only a matter of time before lenders will see a big uptick in financial distress for many of their borrowers. What should lenders do to prepare for this impending storm?

To begin, lenders should identify their borrowers who are most susceptible to financial risk and carefully watch the "leading indicators" of financial distress. This includes not only monitoring common factors (e.g., loan-to-value ratios, the borrower's aging payable report, key revenue indicators, etc.) but should also include other key factors such as the borrower's net debt-to-EBITDA ratio and interest coverage ratio.

Importantly, lenders need to understand their borrowers' business ecosystems. What are the key factors outside the business and borrower's balance sheet that could have immediate and severe impacts? Understanding third-party risk, particularly in a fluid, crisis-like environment, can make a material difference in adjusting loan criteria.

Also important is the borrower's ability to repay other debt—both secured and unsecured. A borrower who is at risk of not being able to pay unsecured debt is at substantially greater risk of going into a receivership or bankruptcy proceeding.

Finally, it is wise to re-evaluate prior loan documentation practices. In the event a loan perfection issue is identified, a workout scenario provides a good opportunity to redo loan documents to not only give the borrower some more time but to also quietly clean up past mistakes while insuring that loan payments continue to be made.

Be strategic about workouts

If the coronavirus-related commercial disruptions prove to be as significant as forecasted, there will undoubtedly be an uptick in loan defaults in the coming months. The more difficult question will be whether these defaults are the result of a one-time event from which the borrower can recover or whether the initial shock sets off a process from which the business cannot recover. Setting internal benchmarks in advance can provide clear guidance for dealing with an onslaught of troubled loans. These benchmarks ideally include the following:

What criteria must be met by the borrower in order to be eligible for some sort of loan extension by the bank?

What criteria must be met for a borrower to be eligible for a forbearance agreement? What key terms will the lender demand as part of a forbearance agreement?

Which borrowers are good candidates for a receiver? Does the lender know which people or entities it can quickly call upon in the event that a receivership becomes an urgent necessity?

At what point will the lender begin non-judicial UCC collection efforts?

What are the red lines that, when crossed, will result in the lender pursuing litigation?

The odds of an economic downturn are increasing with each passing day. Like past recessions, this will mean fewer loans being generated by banks and less revenue. In a very real sense the next six months will be a time of unprecedented economic uncertainty; it has been a very long time since the global economy has experienced serious disruption due to a public-health crisis, and there is much about the novel COVID-19 illness that we simply do not know at this point. How will the economy grapple with government-mandated quarantines and trade restrictions? Will these quarantines and restrictions be effective in the short term? Or will they simply slow but not stop the spread of COVID-19 thus resulting in more prolonged quarantines, trade restrictions and lost worker productivity?

Making new loans under these unprecedented conditions will be very difficult. Will the new loans require new loan covenants to better protect lenders? Will certain “force majeure” clauses be added to provide certain grace periods to avoid loan defaults? Lenders will need to carefully analyze these and other considerations, but a good start for lenders in ensuring their own health is in reevaluating the existing loan books and adjusting certain assumptions about the macro-economy. The projections used to score credit in the recent past likely don’t fully capture risk.

Contact us

If you have questions about the distressed debt aftershock of COVID-19, contact Michael Fielding or your Husch Blackwell attorney.

Husch Blackwell has launched a COVID-19 response team providing insight to businesses as they address challenges related to the coronavirus outbreak. The page contains programming and content to assist clients and other interested parties across multiple areas of operations, including labor and employment, retailing, and supply chain management, among others.