COVID-19: The debt markets response

Debt & Capital Advisory
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23 March 2020 – The day global equity markets hit a low and credit spreads on publicly traded debt markets hit their highest level since 2009. What has happened in the last 4 months since then?

The extent of a materially deteriorating credit environment and expected increase in loan losses over the next 12 months are hard to assess for banks and therefore driving increasingly conservative behaviours.

Issuance in Australian public markets remains sporadic at best. US markets recorded some of the largest volume issuance ever – March 20, largest volume in a month; 1st week of April, largest volume in a week, c. US$250bn issued every month since March.

Australian funding markets are operating effectively. All BBSY tenors out to 6 months are ≤ RBA Cash Target Rate of 0.25%\(^1\), while the TED Spread\(^2\) in US is back to early Feb 20 levels indicating little concern for credit risk in the interbank market following unprecedented Fed intervention.

Against the backdrop of a really challenging global economic environment:

- Australia unemployment rate increasing to 7.4% in June quarter 2020\(^3\)
- US unemployment in excess of 11%\(^4\)
- China recording contraction in GDP for Q1 2020, its first decline since it commenced reporting quarterly GDP

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\(^1\) As at 21 July 2020
\(^2\) The TED spread is the difference between the interest rates on interbank loans (LIBOR) and short-term U.S. government debt
\(^3\) “Labour Force Commentary June 2020”, ABS 16 July 2020
This time it’s different …..


Uncertainty and Volatility
Credit spreads remain elevated

US Credit spreads have retreated materially from their March highs but are still 50-100% higher than Jan 20 lows, though A$ iTraxx indicates a near full retracement.

Funding markets have cushioned the increase in credit spreads, particularly for investment grade credits.
Financing market observations

This market event is different from the GFC – more driven by solvency concerns of borrowers rather than liquidity concerns of financial institutions at this stage.

### Banks: Observations

- Banks were in a better position to work through initial stages of the downturn than before
- Banks have been working through their backlog of credit requests much better, over the past four months
- However this may change when the economic reality catches up with the traded markets’ assessment of events, i.e. when stress appears in the loan books
- Formal messaging from banks includes:
  - Expect deterioration in credit quality and increases in loan losses in the coming 12 months to reduce capital buffers
  - Still too much uncertainty, so will be conservative
  - Some real and consistent differences are emerging in how individual banks are dealing with these uncertainties
  - We will have to see if some banks “put the brakes on” too hard and too quick
  - Dealing with banks in H2 2020 or into 2021 could be very difficult. If clients have (re)financing needs in this period – don’t wait, go now

### Liquidity

- **Liquidity** is still available, but it is costing more
- Extension requests of tenor are most common
- Tenor of requests for new liquidity or to loosen terms on facilities to facilitate clients through the “Great Lockdown” are trying to be kept as short as possible
- “New money” asks are hardest to achieve and access to significant new capital is scarce.
- Banks are very focused on which clients can get access and at what cost/return. Is it critical or “nice to have”? There is also a flight to quality.
- Transactions need to close very quickly to keep the lid on potential further price increases
- Bank cost of liquidity appears to have improved, predominantly due to RBA’s new Term Funding Facility, where all ADIs have access to 3-year funding from RBA at only 0.25% pa
  - The greater level of cheap liquidity for banks has been the main (favourable) difference between the GFC and this crisis
- Banks seems to have gotten over the initial wave of institutional clients (i) drawing down on unused lines and / or (ii) responding to requests for new limits. It appears a more “normalised” service has been resumed, however timeframes for borrowers to get responses from some banks are also extending as approval levels are changed

### Pricing

- **Pricing** initially moved materially higher, driven by anticipated increase in funding costs
- Period over which banks will “hold” pricing is considerably shorter than more market norm of 90/120 days – expect anywhere out to 30 days
- There are potential strategies for corporates to reduce this risk of increased pricing, but depends on credit quality
- Over the past month, price increases appear to be flattening out and in some sectors and rating bands, retracing from their initial highs
- **Tenor:** most banks are still offering tenors of up to 5 years for investment grade credits, but margins vary between banks and the difference between 2 and 4 year margins is currently anywhere between 20 to 50 bps, depending on the bank.
  - During the GFC, additional tenor was at a substantial premium, so this is an area to watch
  - “Sweet spot” at the moment is 3 years.
Financing market observations

Securitisation

- The initial impact of Covid-19 on securitisation markets resulted in new issuances grounding to a halt.
- The $15bn Structured Finance Support Fund ("SFSF") was passed into legislation in March. Following an initial slow start, it has now ramped up operations supporting the re-opening of the public market,
- As at 1st July, total investments of the SFSF have reached AUD2.72bn of which:
  - AUD394.6m has been in primary markets,
  - AUD841.4m has been in secondary markets; and
  - AUD1.48bn has been in the form of warehouse facilities (typically mezzanine tranches).
- Since commencing investing in secondary markets in early May, the AOFM (through the SFSF) has reportedly completed 109 individual transactions.
- Most of the public issuance since Covid-19 has been by non-banks and in RMBS, with banks retaining access to the cheaper Term Funding Facility.
- Pricing remains at elevated levels vs. pre-Covid levels with 'AAA' non-bank pricing at c.BBSW+150bps (vs. BBSW+120bps pre-Covid).
- Subordinated tranches have generally experienced a wider pricing movement vs. pre-Covid levels (c.+100bps)
- Senior private warehouse transactions are understood still to be completing, albeit on more conservative terms.
- Genuine third party mezzanine financing appetite for warehousing is currently more constrained, but is being supported by the SFSF.

Leveraged/Private Capital:

- Credit funds, alternative lenders and investment banks are all still active and looking at transactions. They have liquidity, but it will be more expensive
- Distressed Debt funds will be looking to existing portfolio and waiting for better opportunities as the focus changes from managing the outbreak to managing the economic fall out the response caused
- Credit funds, alternative lenders and investment banks are now looking to execute transactions (i.e. sufficient comfort around approaching credit and fixing pricing), but all lenders far more critical in their evaluations – need to ensure everything stacks up from a pricing / terms / outlook perspective
- Distressed Debt funds are wrapping up initial reviews of their existing portfolios and are searching for opportunities to invest in businesses which are struggling due to the economic fall out created by the virus response, provided they see a path to a turnaround
- Several large opportunities in the market (incl. VAH) will distract funds from being able to look at other new opportunities

Public Markets:

- Bond deals are being completed and credit spreads have reacted more quickly in this market
- Initially, only very highly rated names (AA/A) issued; however, over last few days more A/BBB names have issued, but still at elevated spreads.
- Public issuance, particularly in the US, has roared back to life. March '20 recorded largest volume of issuance ever. Last week of March, first week of April recorded the largest weekly issuance ever
- Potential liquidity and pricing support expected for Corporates and some 'Fallen Angels' who will qualify to participate in enlarged Fed PM & SM CCF programs, though noting 50% of HY market is below minimum rating levels set by the Fed
- High yield market volumes down significantly on Jan & Feb '20, but new issues returning with considerable divergence in spreads achieved for similar rating levels, depending on whether the market see additional potential future stress in the credit story
- The USPP market has seen a lot less volatility than the public markets. While issuance is lower than at this time in 2019, the market is open and activity is picking up, albeit at wider pricing compared to the beginning of the year
- Domestic bond market volumes remain focused on high grade offshore issuers, domestic repeat issuers and known brand names. Domestic banks have been tapping the RBA Term Funding Facility, and not issuing into domestic or offshore markets
Since the market dislocation in March, there have been many positive developments, in what are very uncertain and negative debt and capital markets. However, debt pricing remains elevated and most banks are introducing new restrictions to borrower requests for increased funding limits and/or amendments to financial covenants.

Despite some positive developments in recent weeks, we remain highly cautious about the future – our view is that financing conditions could deteriorate.

**Our key recommendation** is that borrowers plan and act immediately to take defensive positions on their financing. Prudent measures include:

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| 2. **Liquidity position** – make sure you establish a robust rolling cash forecasting discipline  
   a. identify any need for increased liquidity  
   b. extend the duration of liquidity forecasts | 2. Given the speed of market movements, multiple options to secure liquidity need to be capable of being executed immediately  
   a. Consider the time and dollar cost as an additional insurance premium - necessary cost but hope to never have to trigger it. |
| 3. **Debt facility maturities** – any debt facilities expiring in the next 12 to 18 months should be extended now. One to two-year extensions are easier to process for the banks than longer term ones | 3. Financiers are looking for a holistic approach to management of the impact of the crisis on an organisation if they are being asked to provide new liquidity  
   a. Our experience is, those that are well prepared, even in badly impacted sectors, receive a better reception from financiers, where Corporates demonstrate a plan to share the burden across stakeholders |

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**Takeaways**

- **Tactical**
  - Covenant headroom – run different forecasting scenarios and identify the need for any financial covenant relief
  - Liquidity position – make sure you establish a robust rolling cash forecasting discipline
    - identify any need for increased liquidity
    - extend the duration of liquidity forecasts
  - Debt facility maturities – any debt facilities expiring in the next 12 to 18 months should be extended now. One to two-year extensions are easier to process for the banks than longer term ones
  - Consider period end reporting. Is your organisation susceptible to asset impairment charges and how could these impact financial covenants? Will you be in compliance with all financial covenants, etc.?

- **Strategic**
  - Determine whether the increase in liquidity is best sourced from debt or equity – or both. Any new equity requires any financial covenant breach / headroom issues being addressed ahead of the equity raising
  - Given the speed of market movements, multiple options to secure liquidity need to be capable of being executed immediately
    - Consider the time and dollar cost as an additional insurance premium - necessary cost but hope to never have to trigger it.
  - Financiers are looking for a holistic approach to management of the impact of the crisis on an organisation if they are being asked to provide new liquidity
    - Our experience is, those that are well prepared, even in badly impacted sectors, receive a better reception from financiers, where Corporates demonstrate a plan to share the burden across stakeholders
Our integrated financing offering

Our independence from the funding source and extensive market experience allows us to structure and arrange the funding solution that best fits our clients’ needs.

- Structuring the debt (i.e. preparing an appropriate term sheet for the credit)
- Writing information memorandums, presentation materials and any other relevant marketing material
- Identifying and approaching banks or other debt investors
- Helping to process bank Q&A
- Negotiating any variations to the term sheet
- Documentation and financial close

We help our clients in successfully reaching financial close by providing end to end project finance/ non recourse debt finance advisory services including:

- Financing strategy
- Commercial analysis
- Deal structuring
- Debt Sizing Analysis
- Debt Sculpting

We are able to assist organisations:

- Assess the governance around the management of financial risk, specifically the risk appetite and how it translates into the treasury policy including what is reported to management and the board
- Setting up a corporate treasury function, including building the various models for liquidity, FX and interest rate forecasting, setting up banking arrangements and management/board reporting
- Assist organisation comply with the various financial instruments standards (AASB 9, AASB 7 and AASB 13), including derivative valuations, hedge effectiveness and journal entries
- Determine the best treasury technology solution for their needs
- Optimise the existing treasury technology platforms(s)
- Develop a RFP, run the treasury system vendor selection process and subsequent implementation including testing
- Define the structure of the hedge considering market environment, treasury policy, business strategy and regulatory considerations
- Bank Selection - run a competitive process to select the hedge counterparties
- Negotiations - Credit / execution and other dealing spreads
- Ensuring the pricing is transparent (and the lowest available) via a Pricing spreadsheet

Broader applications of our specialist capital markets advisory include:

- Global debt market analysis
- US Private Placement agent capability
- Bank RFP documentation and selection process
- Assistance with transaction marketing and legal documentation
- Commercial & financial advice to Government on major infrastructure projects
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