In Practice

Authors Donald Lowe, Fiona Swords and Michael Leadbeater

The rise of the liquidity covenant in leveraged and corporate loan documentation: is cash "King" once again?

In this In Practice article the authors examine the rising use of liquidity tests to help parties navigate the difficult financial conditions prompted by the COVID-19 pandemic. Often introduced at times of disruption or distress, aligning the mechanism to the particular patterns of a business' cashflow is crucial and requires careful negotiation.

Lockdown and the ongoing economic turbulence in the UK has, in some cases, rendered the typical suite of EBITDA and cashflow-based covenants an insufficient test of a business' strength. Lenders are instead reaching for liquidity forecasting and covenant tests to provide them with better visibility of a company's financial health and, where EBITDA levels are unusually low or simply unpredictable, a liquidity covenant can offer the borrower improved stability and a reduced risk of covenant breach.

JUST ANOTHER FINANCIAL COVENANT?

The role of the liquidity covenant in facilities agreements is generally two-fold: to act as both a financial covenant (testing the level of liquidity forecast or achieved against set amounts) and an information undertaking.

Taking the financial covenant first, this can be tested on a historic and/or a look-forward basis against the company's forecast or actual cash reserves. Typically, a breach of either metric constitutes an Event of Default (subject to any cure rights), entitling the lenders to accelerate the facilities and take enforcement action. On occasion, a breach of the look-forward test may instead give rise only to additional disclosure obligations.

The liquidity covenant may supplement or replace the more typical suite of financial covenants, either for a fixed period of time or until certain conditions are met. Its role is to bolster the lenders' oversight of the company's financial position and offer earlier opportunities for lender intervention where necessary. Where the other covenants are switched-off, it works to bridge to the point when the borrower's financial position is more settled and EBITDA and cashflow-based covenants can once again be calculated meaningfully on a "last 12 months" (LTM) basis.

The covenant may be set to a constant amount on each test date or might fluctuate to accommodate expected variance in cash levels in accordance with the budget, either as a result of seasonality or other pinch points in a business' recovery or cashflow position. As with any financial covenant, a degree of headroom should be built into the default levels.

Lenders will generally require the liquidity covenant to be tested more frequently than the usual quarterly covenant testing regime. On occasion this may be monthly, meaning the additional reporting can be folded into existing monthly reporting (where present), but commonly and, particularly where the company is more distressed, this will be bi-weekly or even weekly.

For facilities that pre-date the pandemic, discussions around liquidity forecasting and covenants tend also to arise as part of a wider conversation with lenders around amendments or waivers required to weather this challenging period. As with any amendment process, but particularly pertinent at times of business distress, this presents an opportunity for the parties to renegotiate other aspects of the facilities agreement which were otherwise settled. Liquidity covenants may go hand-in-hand with additional information undertakings, board observer rights and a more restrictive "Permitteds" regime (tightening the carve-outs from key negative undertakings) focussed on minimising cash leakage, particularly in relation to acquisitions, distributions and payments out.

INCREASING THE INFORMATION FLOW

Turning to the information undertakings, the frequency and level of detail required will vary depending on what is feasible for the borrower to provide and how much additional oversight the lenders reasonably require (closely related to how distressed the borrower is perceived as being). Consideration should also be given as to how the information undertaking aligns with the liquidity testing regime.

In the majority of cases the borrower will be required to provide:

- a 13-week cashflow forecast dealing with the look-forward analysis on a weekly, bi-weekly or monthly-basis; and
- confirmation that its liquidity levels meet the covenant requirements.

Forecasts will typically include liquidity projections on a week-by-week basis, although there are situations which might necessitate daily-levels being forecast/met as opposed to only the week-end position.

SO WHAT DOES "LIQUIDITY" ACTUALLY MEAN?

When we consider a company's liquidity, we tend to think immediately of its cash reserves, and "Cash", (as defined in the relevant facilities agreement), will always be one part of the liquidity calculation. But when is "Cash" not cash?

Biog box

Donald Lowe is a partner, Fiona Swords is a senior counsel and Michael Leadbeater is an associate in the Finance department at Travers Smith LLP. Email: donald.lowe@traverssmith.com; fiona.swords@traverssmith.com and michael.leadbeater@traverssmith.com

- "Cash" held in blocked accounts (including holding or mandatory prepayment accounts) or which is not otherwise immediately accessible might be excluded.
- Lenders may also seek to exclude cash already allocated for a particular use – this can be difficult to evidence and is often resisted by borrowers as it fetters management's ability to reallocate cash resources as required.
- Companies typically stretch their creditors to maximise cash reserves. However, given the strain this can place on commercial relationships and business continuity, lenders may exclude "Cash" attributable to excessive creditor stretch for key suppliers.
- Where certain payments under the finance documents (including amortisation instalments or amounts payable under hedging arrangements) would otherwise skew the liquidity numbers, the parties may agree to exclude these.
- The treatment of quarterly rent payments may also warrant careful consideration in some cases.

Alongside "Cash", "Cash Equivalent Investments" (ie cash held in readily accessible specified financial products) can also count towards the liquidity calculation, and in a typical sponsor-backed financing structure other ready sources of liquidity should be considered, namely:

- Available commitments under a company's revolving credit facility or other available credit lines – however, where the drawing conditions are not met at the relevant point of calculation, the lenders may argue that the commitments are in fact no longer "available" and should therefore not be included.
- For stronger credits, equity or shareholder loans committed to be injected imminently into the borrower group (typically in relation to an equity cure) should be considered. Amounts already funded will, to the extent they remain on a group's balance sheet, be captured as "Cash".

CAN A CURE BE ADMINISTERED?

Where an equity cure right is achieved in historic negotiations relating to other financial covenants, this can – but does not always – extend to a right to cure the liquidity covenant. Lenders may object to the borrower being able to cure what is often regarded as a more clear-cut test and in doing so mask an imminent liquidity issue; however, sponsors will likely push for this flexibility to support a business through a temporary dip in performance.

When applied to a liquidity test, the cure amount is deemed to increase cash and applies only for the testing period in respect of which the test has been, or may be, breached. Limitations on the number of cures and cures in consecutive testing periods will typically apply unaltered, however it is increasingly common to see minimum cure amounts being included in the amendment documentation to ensure that certain liquidity levels are hit following the cure.

WHAT NEXT?

Liquidity reporting and testing regimes will no doubt continue to mature and flex as parties' needs develop through the pandemic and into a "new abnormal" economic landscape. These are terms where the market "norm", whilst a useful guide, should be taken with a pinch of salt given the variance in the macro contexts in which they are deployed and the underlying liquidity requirements of the borrower.

One thing is for certain, however. The incorporation of a liquidity test warrants careful negotiation; it is an exercise littered with opportunity and risk for both parties and should not be viewed as a purely mechanical and isolated tweak which will fade into irrelevance in six months' time. It begs the question: is cash "King" once again? ■

Further Reading:

- In Practice: COVID-19 and the impact on Financial Covenants (2020) 5 JIBFL 337.