CLIENT ALERT

The COVID-19 Pandemic: Key Issues Facing Sponsors & Their Portfolio Companies

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Executive Summary

The COVID-19 pandemic underscores the importance of immediate and near-term strategic management by sponsors and portfolio companies.

While there is no evidence of widespread refusal to fund existing financing commitments, anticipated market conditions present challenges, including significantly reduced new money lending commitments being issued by traditional banks. Private direct lenders are marketing their ability to step in to fill that market gap, but likely at much higher cost to borrowers.

Portfolio companies will face negative impact of COVID-19 through at least 2020; particular attention should be given to liquidity and working capital needs, taking into account industry-specific and macro factors related to COVID-19.

For example, the energy industry has been especially hard hit given the price drop in crude oil. Many sponsors and portfolio companies are seeking advice at the sponsor and portfolio company level with respect to liquidity strategies, including potential revolver drawdowns and various hedging strategies. While certain large public companies and sponsors reportedly have drawn down (or directed that portfolio companies draw down) revolvers in full, including broadly across portfolios, many sponsors are reviewing on a case-by-case basis, taking into account the specific needs of a portfolio company and relevant credit agreement provisions.

Sponsors and portfolio companies should also assess and seek to minimize business disruption risk stemming from COVID-19's effect on key vendor and other commercial partners.

Sponsor & Portfolio Company Shared Considerations

By working closely together, sponsors and portfolio companies can best situate themselves to minimize harm related to the COVID-19 pandemic.

- Be aware of potential covenant compliance issues related to the COVID-19 pandemic:
  - Given the timing of the pandemic, we have observed that 1Q2020 covenant testing has lower risk of being materially impacted by COVID-19 pandemic.
  - Greater uncertainty exists regarding covenant testing for 2Q2020 and beyond.
  - Possible COVID-19-related add-backs for compliance testing should be analyzed and considered sooner rather than later.
- Other operational covenants include without limitation:
  - Liquidity and working capital considerations, such as preemptive revolver draws and anti-hoarding provisions as well as ABL borrowing base redetermination issues;
  - The possible effects of governmental orders, including facility or operational shutdowns; and
  - Issues that may result from non-performance of material contracts or leases.
- Litigation and risk management matters to consider include:
  - Conducting a disciplined analysis of individual contracts, credit agreements, etc.; expect courts to focus on specific terms and effects rather than general conditions;
  - Building a record of compliance / non-compliance with contract terms; exercising informational rights;
  - Paying careful attention to privilege protocols around internal communications; exigent circumstances beget regrettable e-mails;
  - Evaluating possible insurance coverage related to COVID-19 effects; and
  - Assessing key supplier and business partner disruption and related legal rights and obligations.

PE Sponsor Considerations

PE sponsors should be proactive in assessing particular portfolio-level issues by developing and conducting test-run business disruption contingency plans with portfolio companies most affected by the COVID-19 pandemic. This includes, in some instances, reach-out by sponsors to key portfolio vendor and supply-chain relationships to better assess their own business disruption risk and contingency planning.

Sponsors should assess portfolio companies liquidity needs to proactively identify viable solutions, which in some instances may be sponsor-led. At Willkie, we review with sponsors potential follow-on or recycling limitations in their particular fund cycle, which may limit or otherwise complicate regular-way or stressed liquidity solutions. In some instances, we are advising sponsors regarding sponsor-led solutions, e.g., GP-anchored deals in the secondary market.

Sponsors should also consider coordinating with auditors at portfolio companies to identify in advance any audit issues stemming from the COVID-19 pandemic, including as to timing of delivery and any potential difficulties regarding a clean audit opinion.

Portfolio Company Considerations

Portfolio companies should consider the immediate, medium-term, and prolonged effects of the COVID-19 pandemic, including the impact on relationships key to the company’s operation.

Regarding liquidity & drawdown issues, portfolio companies should analyze borrowing conditions, including R&W bringdowns and specific assessment of MAE language, review potential borrowing-base redetermination and issues stemming therefrom, and analyze possible springing covenant issues related to near-term drawdown of capital.

To address covenant compliance issues, assess the ability to utilize add-backs related to COVID-19, e.g., “extraordinary, unusual, or non-recurring losses,” and review potential operational or reporting covenants (e.g., ratings requirements, inspection of books & records) as well as potential grower / ratio basket issues arising from impact on earnings. It is important to work with auditors to understand potential clean opinion issues or limitations stemming from COVID-19, e.g., prospective covenant compliance issues within subsequent 12-month period.

Other selected issues to consider include the possibility to tap insurance policies to minimize harm, e.g., business disruption insurance, analyzing key commercial contracts in light of COVID-19, e.g, force majeure provisions, and exploring opportunistic debt buyback strategies.

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