Keeping Capital Working in Difficult Times

Staying Away From the Edge

2025

In this quick guide, we focus on working capital and consider ways a business can seek to preserve all important liquidity through challenging and unpredictable periods.

Supply chain issues, the battle against inflationary price hikes and other external stressors mean businesses globally are being challenged. What can senior management do in order to manage and mitigate risk to a company's financial health and stay away from the edge?

Practical Tips

- Ensure you know and understand what insolvency means in the relevant jurisdictions in which the business operates.
- Engage professional advisers; understand and take advice from those advisers about their legal duties, key finance arrangements and key decisions.
- Hold regular meetings to consider the financial position of the business and how present challenges may have impact.
- Prepare short-term cash flow forecasts and review these regularly. Think about flexing these for sensitivities such as disruption to supply chain/illiquidity of your customers/ concerns in respect of loan repayments, etc.
- Prepare contingency plans to deal with predicted issues facing the business stemming from challenges in the world today.
- Engage with banks, other lenders and shareholders – implement a structured regular communications schedule to brief primary financial stakeholders to reinforce trust and avoid surprises.
- Protect and prioritise key suppliers.
- Do not neglect internal compliance reporting – avoid unnecessary breaches and consequential challenges in relationships with lenders.
- Minute key decisions and the reasons for those.
- Communicate with your people/customers/suppliers.

What Is the Edge and Where Is It?

Through any difficult trading period and times of economic distress, it is vital that senior management considers the possibility that, at some point, a business could be in financial distress. Whether or not that distress has been caused by financial problems, difficulties in supply chains or changes to vital relationships, a business can very soon be at the end of the road with seemingly no light at the end of the tunnel. At this point, management may begin to feel pressures mounting from multiple sides, pushing the business further towards the cliff edge where chances of recovery appear to be slipping away. In some cases, the business may have to be restructured, if it is insolvent or likely to become so. It is, therefore, important for senior management to recognise financial distress in its business, accurately reflect on the severity of that distress and to understand what the relevant test is for insolvency in the jurisdiction where the company is situated; in other words – where is the edge?

Largely, whether a company is insolvent turns on the company's ability to pay its debts as they fall due, and/or whether, on a balance sheet basis, its liabilities exceed its assets. Understanding where the edge is will help inform decisions about what advice and steps should be taken during a difficult economic period. In the UK, for example, taking action to protect the position of a company's creditors before the company is technically insolvent (i.e. before it has reached the edge, or point of no return) is vital if directors are to protect themselves from potential personal liability.

Understanding when a company is insolvent and what the obligations of senior management are to the company and its creditors prior to the edge is, therefore, key to ensuring that the right decisions are made in relation to the company's financial position and continued trading.

Having an awareness of what restructuring tools are available to offer support to a business that is near to the edge will also help. Depending on the jurisdiction, some are more flexible than others, and some offer the benefit of a "breathing space", enabling the company time to restructure without creditor pressure. The UK is renowned for having some of the best restructuring practices in the world. In cases where a company operates cross-border, there might also be opportunity to choose the best place to restructure.

Managing the Edge

If a business is facing liquidity challenges, it is inevitable that stresses on finances will result in a business defaulting under its financing arrangements.

So, what can businesses do to keep safe as they look across their customary sources of working capital?

Creditors

Businesses will want to ensure that their creditor lines are not just sufficient, but also assured.

Finance agreements will typically include a range of default triggers. Typically, a default will have a range of consequences. The main one being that a lender is no longer obliged to lend, and may demand repayment of monies it has advanced.

Businesses should maintain an honest and open dialogue with their lenders throughout this period, working with them to agree forbearance and adjustments where possible. Cooperating in the search for constructive solutions provides the best chance of avoiding surprises and maintaining credit lines.

Businesses should take advice early and review the terms of their finance agreements in light of the prevailing situation. Every business will have different sensitivities, but it is worth noting some of the defaults that are most commonly considered when a business's financial position deteriorates.

Material Adverse Change

A material adverse change (MAC) is commonly seen in agreements. Typically, such a clause will occur where there is a materially adverse change affecting a range of aspects of the borrower group, its operations, property, condition (financial or otherwise) and its ability to perform its obligations under the finance agreement.

Lenders are generally reluctant to rely on a MAC as the basis for withdrawing support. The drafting of such clauses necessarily lacks precision, and the English courts have given little guidance on these clauses, let alone in circumstances resulting from universal events such as the COVID-19 pandemic and the war in Ukraine.

Whether or not a MAC will be triggered will, therefore, depend on a range of factors – the wording of the relevant contractual term (and the law that governs it), but also on that business's particular characteristics, notably whether it is in a sector that is particularly exposed to disruption as a result of challenges presented by these uncontrollable pressures. For an event to be material, it is generally accepted that it must not be temporary and must significantly affect a party's ability to perform its obligations.

Financial Covenant Breach

A business may be experiencing a material deterioration in EBITDA or other measures of financial performance, affecting compliance with any maintenance financial covenants included in its finance agreements.

Prior to the end of the relevant testing period, it is difficult for lenders to declare a default as a result of a financial covenant breach. Even if a business is tracking well behind the relevant ratio, until the relevant financial testing period has completed, there is always the theoretical, if not realistic, possibility that performance may improve unexpectedly. Beyond that point, lenders will want relevant financial reporting data to substantiate any assertion of a default.

If a particular financing agreement provides financial covenant cure provisions (typically in the form of equity contributions), businesses should consider whether investors would be willing to make such further contributions and, if so, what the contractual restrictions are on such contributions.

Cross-default

These provisions can be drafted very widely. The challenge they present is that, by their very nature, they necessitate a comprehensive view of all relevant financing arrangements to which the business is subject. A large international business may have a complex group structure, with different group companies party to individual financing arrangements across a wide spectrum of financial products. Some of those arrangements may themselves contain cross-default provisions that will also need to be taken into account in negotiations. Businesses should check their swap agreements carefully in this exercise.

Insolvency and Insolvency Proceedings

The scope of typical default provisions in this area can be wide and will intervene well before actual insolvency. For example, standard UK Loan Market Association wording provides that a default could be triggered by any "step … being taken in relation to … a[n] … arrangement with any creditor of any member of the [borrower] group" or by a borrower commencing "negotiations with [any of] its creditors with a view to rescheduling any of its indebtedness". Nevertheless, most loan documents will contain an express default provision relating to entering into an insolvency process or failing to meet the required threshold under a cash flow or balance sheet test.

Consequences of Default

Lenders are likely to condition their forbearance, consent or waiver in relation to an actual or pending default with a request for further information about the financial health and performance of the business.

The occurrence of a default will trigger many consequences in a typical finance agreement, all intervening well before a lender may decide to accelerate outstanding advances under the facilities.

A default will likely constitute a drawstop, entitling a lender to refuse to make any further advances, including those to replace existing revolving loans. Failure to anticipate such a risk may present a sudden threat to the business's solvency.

In general, a business should expect the terms of its finance agreements to provide for an automatic tightening upon the occurrence of a default. For example, certain permissions, notably around the leakage of value from the business away from the creditors, will be suspended, and the benefit of favourable rates within a margin ratchet would be lost.

Stock-in-trade and Receivables – Asset-based Lending

Consideration by businesses, as to whether they can leverage the assets held on their balance sheets in order to raise working capital, may constitute a good alternative option by which a company can inject valuable liquidity while the effects of the current economic climate continue. Lenders may find it easier to structure loans based on the value of a company's inventory, plant and machinery, property, and receivables, rather than against the future cash flow of a business, which is inevitably uncertain at this time.

In addition, the involvement of key customers of the business, in any discussions with lenders to restructure debt, is worth considering, as global supply chains are being severely disrupted. Certain sectors that are heavily dependent on the continued existence of the supply chain and "just-in-time" delivery – for example, the automotive sector – are likely to be adversely impacted by any failures in the supply chain and will be looking to protect their supply chains where possible. We note that such customers are often willing to structure mutually beneficial arrangements, whereby order can be delivered in exchange for security over receivables/other assets.

A supplier financing facility may help to shore up supply chains by ensuring valuable suppliers are paid on time and remain loyal where supplies may be short. Prioritising valuable suppliers with favourable payment terms should be considered.

Such liquidity may help reassure important credit insurers as they see working capital maintained and suppliers paid on time.

Managing the price of supplies may be complex in the prevailing environment. For example, airlines will need to keep fuel price hedging contracts under careful scrutiny as the oil price fluctuates in these uncertain times.

Cash

Careful and conservative treasury management is key.

Businesses should remind themselves of any restrictions in their finance agreements around the movement of cash, ensuring, for example, that they can pool cash close to costs to minimise the risk of cash traps that may threaten liquidity.

Under those agreements and account terms, banks may have (or accrue upon a default, for example), the right to set off monies in certain circumstances.

Currency hedging agreements and exchange rate management should be kept under review, as the developing economic situation, with interest rate rises, brings increased volatility to the currency markets.

The key to managing working capital is understanding the legal and contractual parameters within which the business is operating, careful planning, and maintaining an open dialogue with key stakeholders.

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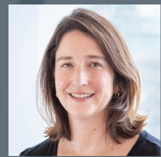

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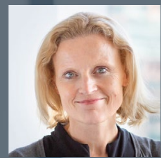

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