ALL OUT OF OPTIONS

HAVE YOU CONSIDERED A CVA?

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Now that the UK economy is almost fully open for business again, many businesses can take stock of the financial damage caused by the pandemic and put in place their own restart plans. If they haven't already, in the coming months, a significant number of them could take the decision to cease operating simply because cash reserves have dwindled to nothing, debts have accumulated and trading relationships have long since broken down.

SMALL BUSINESSES AT RISK OF INSOLVENCY

A research study published at the start of the year by the London School of Economics' Centre for Economic Performance (CEP) and the Alliance for Full Employment (AFFE) warned of a wave of insolvencies by the spring, unless further policy action was forthcoming. Specifically, the study suggested that around 900,000 small businesses could be at risk of failing by April.

While the number of insolvencies originally predicted have not materialised, this may be partly down to Chancellor Rishi Sunak announcing further fiscal support measures with extensions to furlough, self-employed support, business grants, loans and VAT cuts, bringing the total cost of support to over £400bn and partly down to winding up petitions and enforcement proceedings being put on hold by way of legislation introduced within a few months of the pandemic affecting economies across the world. While this is welcome news for businesses convinced they can bounce back when the time comes, others are facing the realisation that their operational capacity has been drastically limited by social distancing rules, and in some cases, demand for their products or services may have changed or no longer exist. For these businesses, difficult decisions will need to be taken about their future viability, sooner rather than later.

As the economy starts to open up again, there will be greater risk of business failure and credit managers will need to be primed and ready to protect cashflow through this tricky trading period. For businesses with diminished cash reserves and debts that have mounted up during the pandemic, the risks will obviously be greater. If they take on too much new business all at once, this could result in overtrading, putting pressure on cashflow and testing lender relationships. Some lenders may require companies to commit to servicing or paying off debt before providing further funding for working capital.

SECURING LENDER CONFIDENCE

To avoid this scenario, businesses that are confident that they can generate revenues and restart profitably, may be able to ease some of the pressure on their business model by using restructuring tools such as the Company Voluntary Arrangement, abbreviated to CVA.

In the last couple of years, CVAs have been popular with High Street retailers and other businesses with large property portfolios to write down debts owing to commercial property landlords and renegotiate rents going forward. However, there is no reason why they couldn't also be used strategically to help business owners to take control of their challenging financial situation and put forward a plan to restructure their balance sheets and secure lender confidence.

The structure of the CVA is bespoke to the business in question and may take many different forms. On the one hand it may look like a debt compromise agreement, setting aside funds to pay creditors over a period of time and possibly at a lower value. Alternatively a third-party investor, such as a private equity house, could inject funding to facilitate a one-off payment of all creditors, thus clearing the debt and helping to obtain new working capital finance. In some cases, the proposed CVA plan could be based on a combination of the two – securing third-party finance and surplus income set aside for distribution.

A CVA won't be the right option for all cash-strapped businesses, despite their recent popularity. Sometimes CVAs work better than other insolvency processes as a means of protecting business continuity. For businesses where costs have risen and revenues dipped significantly, it may not be possible to generate surplus income, and in these circumstances, even the most well-considered CVA proposal is likely to fail. For this reason, it is vital that business owners and their finance teams take steps to ensure that their core business proposition is commercially viable before considering entering a CVA on route to recovery or supporting one.

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First and foremost, the business should prepare cashflow forecasts to gain a better view of where the business might be in six months or a year's time. The credit manager could assist in this process by providing an analysis of the debtor ledger, the likelihood of securing payment and the timeframe for payment. Once the forecasting models are in place, they can be used to gauge the impact that changes to the timeline of the Government's roadmap, for example, could have on the company's cash position. Alternatively, forecasts can be re-modelled to show the impact of a cash injection from some asset based lending, such as an invoice discounting facility, together with the associated costs.

When formulating a CVA proposal, the business owner may be able to persuade creditors to accept a reduced payment, on the basis that doing so could secure its future and preserve their trading relationship. For example, creditors might accept 10p or 50p for every £1 owed to them and be prepared to write off the remainder. Such agreements can help to reduce historic debt and underpin a business with otherwise solid foundations, giving lenders and investors the confidence to inject funding. It is important here for credit managers to carefully consider their policy and position on the historic debt versus the longer-term, more fruitful post recovery trading relationship.

UNDERSTANDING THE CVA OPTION

For any credit managers, it is important to understand how the CVA might be used in the coming months. For example, if a customer gives notice of a CVA, the credit manager will need to assess it to work out how much they are likely to receive, the timeframe for payment and what the prospects of future revenue are. Depending on the risk profile of the customer and the trading relationship, if the credit line is likely to continue to tighten and the relationship worsen, the business might choose to cut its losses and reject the proposal.

Alternatively, the credit manager might be challenged by the finance director to support them in compiling a CVA proposal. This is complex and requires advice and guidance from a trusted business recovery specialist to formulate the strategy on how to proceed. To succeed in winning the support of creditors and lenders, the plan will need to present a well-evidenced view of what future revenues, profits and cash collection will look like. It will also need to be structured in a way that is attractive to all stakeholders. However, timing is key; as businesses plan to restart, it is important not to move too soon. It is better to wait until the business can be certain of meaningful revenue and can see a return to operating profitably.

The pandemic has been a massive learning curve for managers at all-levels and, as businesses restart, credit managers will need to step up once again.

By adjusting from a cost-centric approach to award procurement contracts and closely review levels of compliance and delivery, the Government can help to ensure the continued operation of essential services and protection of taxpayers' interests, even if events take a turn for the worse.

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