Executive Summary

We are in the midst of a black swan event. We are observing:

- The Australian financial system, banks and non-banks currently possessing strong liquidity positions, supported by the Reserve Bank of Australia ("RBA")
- Pricing across credit rating curves having jumped up significantly in the last two months
- Large corporates in the US, having drawn down undrawn credit lines to protect against a "credit crunch"
- Australian banks are changing lending appetites in the current environment, and also as just announced supporting small business and retail customers with payment holidays.

Prediction:

- It will be harder and more costly to access funding in the medium, if not in the short term

Solution – quick and decisive actions based on risk analysis now can assist to sure up funding and liquidity positions. This may promote i) certainty of funding and ii) price ahead of the curve. As per the Global Financial Crisis ("GFC"), cash is king and therefore certainty of funding should be driving decision making.

COVID-19 and the impact on debt funding in Australia.

The COVID-19 ("Virus") spread is a true black swan event and represents one of the biggest economic and social challenges to hit us all for generations. The potential impact on life and our health services may be enormous, and we wish all the very best as we move through this period.

As with any crisis, in an economic sense, there will always be winners and losers, for example supermarket chains are seeing unprecedented demand as households' stockpile, whilst it is well reported that the aviation, tourism, hospitality and general retail industries have been severely negatively impacted. Further, broader economic stress in now emerging as the impact of the Virus transitions from an initial supply-chain shock to Australia progressively adopting various social isolation measures to 'flatten the curve' of Virus infection rates. Depending on where your business is placed on the spectrum of impact, we provide some commentary with what we are seeing in the debt markets and potential considerations to take either advantage or protection in the current state of play.

Debt markets

Overall, there has been nervousness from debt markets investors and a general risk-off environment in capital markets resulting in limited bank debt and bond issuance activity in recent weeks, with this arising from both the direct risks arising from the Virus outbreak on corporate issuers along with the broader impacts of projected weaker economic activity.

This dynamic is likely to be an indicator of future lower availability of credit from both bond and bank markets, even with the benefit of central banks implementing broader liquidity measures, as was announced in the U.S yesterday and the RBA reducing the official cash rate to 0.25% yesterday, together with the Quantitative Easing measures and liquidity support to banks.

Whilst there has been limited issuances, which may distort the data, the following credit margin pricing impacts (pre-RBA and US intervention) have been reported over the last two months (as provided by Bloomberg)):

Spreads	3Y (16-Jan-20)	3Y (16-Mar-20)	% increase	5Y (16-Jan-20)	5Y (16-Mar-20)	% increase
AUD BBB	0.90%	1.11%	*23%*	1.08%	1.52%	*41%*
USD BBB	0.57%	1.48%	*160%*	0.81%	1.70%	*110%*
USD BB	1.23%	5.25%	*327%*	1.77%	5.17%	*192%*
USD B	1.75%	6.10%	*249%*	2.44%	6.29%	*158%*

As can be observed, in the last two months pricing across the credit rating spectrum has jumped by a large percentage in a relatively short period of time, with the most profound effect on the BB curve (which the vast majority of middle Australian corporates would align). The flight to safety appears to be in full swing. Of note, the shorter tenor is more heavily impacted, with the market expectation that in the longer term, pricing will revert as the Virus is controlled.

The cause of this jump is likely to be not only from the nervousness of investors, but also from concern from borrowers, seeking to sure up their liquidity positions. As widely reported by many news providers, Boeing drew down US$13.8Bn (A$24bn) of its undrawn revolving lines, to ensure its liquidity position through the Virus is protected. Further it has been reported that large Private Equity funds as well as other companies, are following suit, in order to avoid a potential 'credit crunch', via undrawn lines being cancelled by banks in the event bank liquidity dries up.

Subsequent government intervention may assist to allay such fears, and as we move through the crisis, and as the 'Virus curve' flattens we would expect to see pricing trend down, noting Governments will be carrying a significant higher debt load. The big unknown is, how long will that take?

The Australian context

Our discussion with various market participants and the Big 4 Banks unilaterally reveals, that 'they are open for business', well capitalised and incentivised to assist clients (where possible) to soften the broader economic impact and reduce the likelihood of defaults. Further, EY recently released that we estimate that there will be approximately A$100bn in non-bank corporate lending in 2020 (pre-Virus), with some funds recently raising large sums of funds to lend (and therefore are sitting on cash).

As such, we consider that the Banks and alternative lending market is currently in relatively good shape. But, and there is always a but, the same question arises, being for how long? Only this week, we have observed:

- A major bank advised that they will only issue a terms sheet with a three-day window. If it is not accepted in those three days, pricing can not be guaranteed.
- Quick turn off of credit to various sectors (directly impacted). We have observed and also heard of a number of banks put lending proposals on hold (with documentation already prepared), to await the outcome of the current volatility, and
- Commencement of market chatter of pricing increase discussions. Whilst the reductions of base rates will somewhat reduce the impact of rising credit margins, it is considered that this will only partially negate such increases. For example, referring to the US BB spreads and US swap rates (as sourced from Bloomberg), funding costs for three years has increased by approximately 3.5% p.a. Refer table below:

	3Y (16-Jan-20)	3Y (16-Mar-20)	Difference	5Y (16-Jan-20)	5Y (16-Mar-20)	Difference
USD BB spread	1.23%	5.25%	*4.02%*	1.77%	5.17%	*3.40%*
USD Swap	1.02%	0.48%	*-0.54%*	1.63%	0.60%	*-1.03%*
Increase in funding costs			3.48%			2.37%

Further, as the economic impacts (good and bad) flow through the system over the coming months, it is likely that Banks and other financiers, which have generally streamlined their work forces over the last number of years, may be inundated with requests for amongst other things i) increased liquidity (growth or survival) ii) variations in terms and conditions iii) potential covenant waivers and iv) unfortunately a rise in defaults. This increase in 'inquiry' volume, together with some financiers working remotely or quarantined or even worse falling sick and needing time to recover, may see the 'system' clogged with delay time for responses potentially impacting liquidity. Such scenarios may see Boards in precarious fiduciary positions.

So what to do?

Whilst debt price increases may be on the horizon, and depending on the economic state, the potential for reduced access to credit, as above, the current state of the lending market appears to be in good shape and well supported by the RBA.

Therefore, and as was observed during the GFC, quick and decisive actions now can sure up funding and liquidity positions over the coming period of uncertainty. Businesses should:

- understand its optimal capital structure and the availability of capital and liquidity needs tested via sensitivity analysis of various operating and market scenarios
- reassess covenant compliance and conduct rigorous scenario modelling to determine the probability of a breach
- consider alternative debt through to equity funding sources, to ensure you have access to capital in advance of your business requirements and peers who will be doing the same
- act now to secure needed funding to secure as much cash as possible from existing or new sources
- engage in early, open discussions with your existing lenders and other stakeholders about their current position and future needs

Strengthening the balance sheet now and securing potentially required liquidity lines, even in a higher price scenario, will help protect the business' on-going viability. We hope that this will only be in play for a short time, and should that be the case, then a new refinance process may be undertaken as quickly as possible to attract a better price. The short term increased cost of capital may be treated similar to an option or insurance premium. However should the current state last longer than a few months, this may keep the business in good stead.

End words

Wishing all safe and healthy times in the coming months and years ahead. As changes occur, we will keep you all updated.

Jason Lowe
Partner – Melbourne
Mob. 0412699778
E. Jason.lowe@au.ey.com

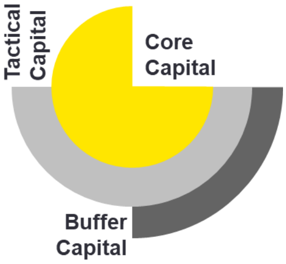
Sebastian Paphitis
Partner – Sydney
Mob. 0402274804
E. Sebastian.paphitis@au.ey.com

EY Capital and Debt Advisory - snapshot

Our team includes professionals with working experience within institutional and corporate banking as well as structured financing, have deep expertise across the debt capital spectrum.

Our strong advisory capabilities support our clients with end-to-end process management from debt and capital raising to capital management as well as tailored financial advice for a range of client-defined purposes including:

- Refinance of existing debt facilities on improved terms and flexibility
- Structuring debt platforms to optimise and align funding with strategic objectives
- Addition of alternative debt to diversify capital structure including public and wholesale note issuance and private placements
- Review of capital structures alongside credit analysis of loan portfolios as well as short and long term shadow credit ratings



Ernst & Young
Assurance | Tax | Transactions | Advisory
About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 152,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com.