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COVID-19 Solvent?

by Jamie Sieman, ASA, Principal

The COVID-19 pandemic is causing economic turmoil in many sectors of the U.S. and global markets, wearing away the balance sheets of companies and triggering bankruptcies for many brick and mortar retailers, restaurants and fitness centers, as well as oil and gas, travel, hospitality, and gaming companies, and others. There are also tenants that have delayed (stopped) paying rent on their leased locations, which of course trickles downhill to property owners.

Companies that were highly leveraged coming into the pandemic have seen their situation exacerbated due to the current environment, forcing many to file for bankruptcy protection.

The current market volatility, in conjunction with the economic impact on businesses that either are still closed or operating at reduced capacity, is making it more challenging to value a business for debt or equity financing. A company's current liquidity and its ability to meet its current obligations is key to its success. The solution for some companies has been to raise equity in a "down round" financing, for others, they have sought more debt (not just PPP debt). But as liquidity declines and balance sheets become more leveraged, longer-term insolvency-related issues start to surface.

The issue is not that debt is bad for a company, but rather that much of this new "Covid debt" is being used to finance corporate survival rather than financing receivables, or growth and profit producing capital projects such as acquiring new manufacturing equipment and facilities. How can one develop reasonable financial projections for a business when it is unclear as to when the business can open again, will it close again, or whether there will be restriction to the way it can operate?

Given the complexities in the valuation of both debt and equity in the current environment it becomes more important that both boards and lenders protect themselves from fraudulent conveyance claims by getting a solvency opinion from an experienced independent third-party provider.

Directors Role

The responsibilities and duties of a company's directors are difficult enough during good times. However, in periods of questionable solvency, directors also need to consider the interest of the company's creditors so as not to expose themselves and the company to potential claims. A company's solvency may come into play in fraudulent conveyance, bankruptcy alter ego, and due diligence to shareholders and creditors.

Liquidity vs. Solvency

While liquidity is primarily related to a company's ability to meet its short-term obligations, solvency, within the context of a business, is defined as a business's ability, to meet its long-term debts and financial obligations. A Solvency Opinion is an opinion from an independent advisor confirming that upon the consummation of a contemplated transaction, that:

1. The company's assets exceed its debts;
2. The company will be able to pay its debts as they come due;
3. The company is not left with unreasonably small assets or capital.

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Consider a solvency analysis on a company that went through a recapitalization in 2019, or as recently as February 2020, and how different that analysis would look today.

SOLVENCY TESTS

There are three common tests used in a solvency opinion.

1. **Balance Sheet Test**: The balance sheet test determines whether, at the time of the transaction the fair value of a company's assets exceed liabilities. Assets are valued at their present fair salable value and compared with current and long-term liabilities and any contingent liabilities effective after the leveraged transaction.

2. **Cash Flow Test**: The cash flow test evaluates whether a company can meet its debt obligations as they become due. The company's projected cash flows are utilized as a basis for this test. Analysis is performed using various scenarios relative to key assumptions, like revenue growth rates (*no growth, inflationary growth, and historical growth*) and profit margins to estimate the impact of the company failing to achieve its projections.

3. **Adequate Capital Test**: The adequate capital test evaluates as to whether or not a company is expected to have adequate capital to pay its 1) operating expenses, 2) capital expenditures, and 3) debt repayment obligations. This analysis evaluates how much surplus capital a company will retain after a leveraged transaction with the goal of determining whether the company can withstand a downturn.

Finally, as the COVID-19 economy evolves, with the current impact on business cash flows and resulting higher leveraged balance sheets, the question of solvency will become a more pressing topic that companies and directors will need to address. A solvency analysis and opinion performed by an independent third-party can provide a level of comfort to the company's or board's internal analysis.

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