TheCityUK | THE FIRST 10 YEARS

RECAPITALISATION GROUP

Interim update

June 2020

CONTRIBUTORS

"It has been truly inspiring to see how quickly the financial and related professional services industry has come together to devise solutions to support businesses and the UK economy through what will be some of the most challenging economic conditions many of us have ever encountered.

During this difficult time, all of the organisations listed below have given the time and skills of their top talent for free. Particular thanks goes to our Senior Steering Group and to EY who are leading this unprecedented industry effort, and have also contributed the foundational analysis and devoted teams to a number of the workstreams.

I'm encouraged by where we have got to so far, but recognise there is much work yet to do, and I thank everyone for their continued support and commitment to helping us develop this important new thinking at speed."

Sir Adrian Montague, Chairman, TheCityUK Leadership Council

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1. INTRODUCTION

Introduction and context to the Recapitalisation Group

The Covid-19 global pandemic has placed immense stress on UK businesses of all sizes and across all sectors. The UK government has responded quickly to this challenge with far-reaching stimulus measures including business funding packages, tax relief, support for UK workers and the self-employed. Significant numbers of UK businesses are using these schemes to provide liquidity and protect jobs.

Economic forecasts suggest that, over the next 12 to 18 months, these businesses will face tougher trading conditions than before Covid-19, making it harder to service both existing debt and any additional debt taken to weather the crisis or restart their business. The demands of this debt is likely to compromise the growth and viability of many UK businesses and, as a result, the UK economy.

At the encouragement of the Bank of England, TheCityUK has brought together member firms, industry practitioners and other stakeholders to form a Recapitalisation Group (RCG) to help consider the post Covid-19 recapitalisation challenge.[1] Specifically, the RCG is considering:

- the potential size and nature of recapitalisation demand from UK corporates
- the pools of private sector capital available to meet this demand.
- potential private sector or hybrid private/public sector solutions to address the recapitalisation challenge and support UK businesses.

In this formative stage of work, the RCG is focussing on unlisted small and mid-size businesses that qualify for CBILS and CLBILS support. These businesses employ over 16 million people and have more than £2trn in turnover.[2] Many are financed by closely-held equity and branch-based bank lending, with limited access to equity investors.

Many organisations across the UK are supporting the work of the RCG. We extend our thanks to the 51 organisations and 160 people who are contributing to this work.

Many others are looking at options to restart the UK economy. The RCG has aimed to understand the breadth of work underway, draw on the range of ideas being generated, and present a collective view from across the industry.

This report represents interim findings as of 5 June 2020 and will be followed by an update, setting out the recommendations of the RCG in the coming weeks.

[1] For more information on the scope of the RCG's work please refer to a letter sent to Andrew Bailey, Governor of the Bank of England, on 11 May 2020.
[2] These are typically businesses with more than 10 and less than 250 employees (BEIS).

2. EXECUTIVE SUMMARY

2.1 Objectives of this report

- Recapitalising businesses is a multifaceted challenge and there are many ideas and stakeholders to consider. This report provides an opportunity to gather feedback from this broad range of stakeholders on the emerging thinking of the RCG in advance of issuing a final report.
- In this report we:
  - Present interim findings on the nature and size of the demand for recapitalisation by UK businesses and considerations on the pools of private sector capital available.
  - Highlight potential considerations in addressing these challenges.
  - Provide our emerging thinking on a range of options and tools in order to solicit feedback.

2.2 Summary report findings

The challenge for the UK economy

- Our estimates[3] indicate that circa £100bn could arise in unsustainable lending volumes by Q1 2021:
  - Small and medium sized businesses are estimated to incur just over half of total unsustainable lending, amounting to circa £50-56bn.
  - Higher concentrations of unsustainable loans are estimated in the property; construction; and accommodation and food sectors (circa 50% of total unsustainable lending).
  - It is estimated that a proportion of lending provided from government lending schemes will become unsustainable, amounting to circa £32-36bn. (This is based on estimated total lending from government lending schemes of circa £111-123bn by March 2021; year-to-date lending currently amounts to circa £27bn (as of 24 May 2020).
- The recapitalisation needs of UK small or medium sized enterprises (SMEs) are particularly acute given the low volume of equity raised by SMEs (an average of £7.2bn p.a. from 2017 to 2019). Moreover, equity investment into UK SMEs has typically focused on growth capital (which has its own constraints) versus capital for rescue or turnaround and the vast majority of equity finance has been channelled to London-based firms.
- There are a broad range of capital providers who could meet the demand for capital, including institutional, retail and overseas investors. However, most of the capital held by these investor types is already deployed and the ability to re-allocate existing assets or allocate any remaining dry powder varies.
- Of the various capital pools, enhancing the role of Private equity, and unlocking capital from UK insurers (potentially through a long term debt solution) and from pension funds appear to be potential opportunities, although this requires significant realignment of risk and return dynamics and substantial operational and regulatory challenges would need to be considered.

[3] These estimates are based on a number of key suppositions and assumptions, including; the length of the pandemic, the measures taken to relax lockdown, and top-down interrogation of high-level data prepared in other contexts. We will review and refine the analysis as more current data becomes available, but the actual outturn will certainly be different, and we ask that you treat the numbers with caution. We have tried to produce a plausible scenario that will allow business, government and the actors in the financial services sector to understand better the scale of the recapitalisation challenge, and together to determine the best collective response to prepare business and the economy for a post-pandemic future.

Considerations for solution development

- The RCG is focused on how the private sector can support the recapitalisation challenge. In the development of options a range of considerations have been surfaced for both the private and public sector. Key questions include:
  - Is there a market failure?
  - How quickly and at what scale does a solution need to be deployed?
  - What economic criteria should be applied to any intervention?
  - Should there be a link to long-term value?
  - How should businesses be engaged on the options available to them?
  - How can any mechanism be transparent, respected and with clear accountability?
  - What are the exit routes for investors and businesses?
  - Could the tax system be utilised?
  - Can regional imbalances be addressed?

A range of recapitalisation measures

- Following the findings of our initial market analysis, the RCG has mobilised 15 specific workstreams to develop potential recapitalisation options for SMEs.
- The workstreams have been seeking to design options which can address the considerations above while meeting the needs of the targeted segments of the UK economy – this has involved questions such as:
  - Which market segments to target?
  - What is the design of the recapitalisation instruments that will be delivered to companies?
  - What are the most appropriate enablement mechanisms for delivering the instrument to end users?
- Our analysis is still ongoing as workstreams continue to work through the design choices and a variety of technical considerations. The options presented in this report are not a finalised view and should be treated as formative in nature. They will be further refined during the next phase of our work as we look to address the broader policy design considerations and reflect feedback from stakeholders.

Market segmentation

- Our work has focussed on the circa 250k unlisted companies that sit above the micro/sole trader segment of the economy. This is not because there will be no stress in smaller companies. It is based upon a view that smaller companies are less suited to equity recapitalisation. We will examine whether there are aspects of our work that can be used or adapted for the micro end of the SME segment, as we progress.
- Our focus has been on companies that have an unsustainable debt burden and our work involves categorising and segmenting the market, determining company viability and the eligibility criteria for each form of recapitalisation instrument.
- Companies may also require equity funding for growth capital, which has typically faced constraints. The problem statement and use case for growth capital is different to that of capital for the recapitalisation of unsustainable debt. As such, the design and structure of growth capital solutions will require separate consideration from unsustainable debt solutions, and we have established a workstream to consider this.

Recapitalisation instruments

- A wide range of ideas for recapitalisation instruments are currently under development, with each instrument being developed with a draft term sheet that will govern its application, terms and exit. The range of instruments are grouped into:

  Debt recapitalisation instruments

  - Preferred equity – sitting ahead of ordinary shares but still treated as equity.
  - Contingent Tax Liability (CTL) – conversion of stimulus debt to a tax that would be payable out of profits and collected through the tax system.
  - Profit participating debt – an alternative to the CTL that links repayment to the generation of profits.
  - Forbearance – the simplified application of debt moratoria and rescheduling.
  - Debt forgiveness/grants – perhaps applicable in extreme distress.

  Growth instruments

  - Common equity – the provision of ordinary shares.
  - Preferred equity – the provision of preferred stock with defined term and dividend payment obligations.
- A number of factors will materially influence how many customers will be eligible for the schemes and the likely impact of the schemes on businesses. Key questions we are considering include:
  - How will we define scheme eligibility – will only defaulted loans be eligible or can loans be converted/forborne prior to the point of default?
  - How will customers be assessed for eligibility – would a rules based scheme that applies clear, inflexible criteria or a bespoke customer assessment be better?
  - Which loans will be eligible for conversion to equity? Will these schemes apply to stimulus lending only or will other lending be eligible for conversion?

Delivery mechanism

- It is recognised that existing execution capacity and funding appetite for such schemes will be insufficient for the scale of recapitalisation needed.
- Delivery mechanisms need to be considered – and delivery should consider the funding as well as the distribution of any chosen recapitalisation options.
- The ultimate choice and structure of any delivery mechanism will be influenced by some of the design choices that are outlined above – e.g. a scheme that requires a high degree of bespoke customer assessment, necessarily requires a much higher degree of infrastructure than a more rules-based scheme such as the Future Fund.
- The funding of any scheme will be a critical component of the ultimate design. Ways will need to be found to address the current risk/reward impediments to attracting funding as well as removal of current impediments to financing.
- The treatment of government-guaranteed debt will need to reflect the resolution of the guarantee, potentially by government stepping in as the recipient of new obligations created in respect of converted loans.
- Our focus is on seeking private sector solutions, but we will also examine the role that the public sector, in partnership, could play.

2.3 Consultation and next steps

- Following publication of this interim report, the RCG will be issuing a call for feedback from trade associations and their members. We aim to gather feedback from different segments of the business community on the findings of the report and the range of potential options.
- In addition, the RCG will continue to engage with a range of stakeholders who represent the interests of businesses, including parliamentarians, relevant select committees, and the devolved administrations across the UK.
- Identification and evaluation of potential options/tools will continue through 15 workstreams established under the RCG and led by TheCityUK member firms. The feedback received through this consultation process and from our continued engagement with government and regulators will be shared with the workstreams.
- The workstreams will also consider the implementation and enablement requirements of potential options as they progress their work to final recommendations.
- An updated report will be issued in the coming weeks that will underpin future engagement with stakeholders.

3. THE UK RECAPITALISATION CHALLENGE

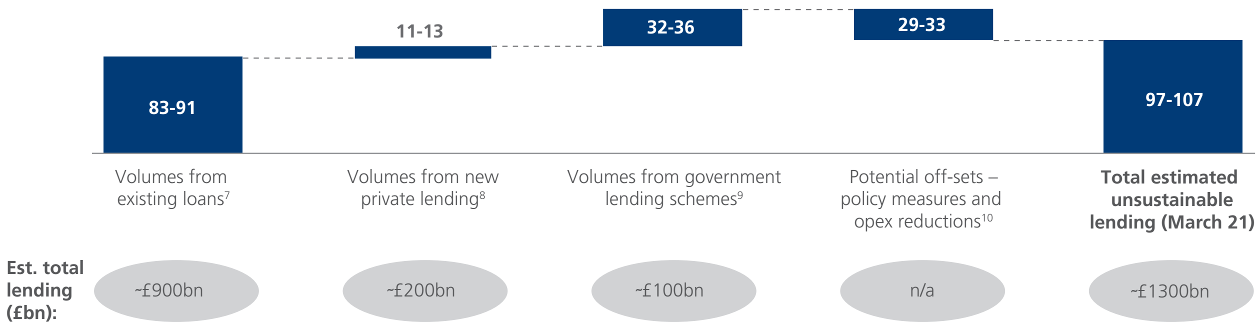
3.1 Our estimates indicate that circa £100bn could arise in unsustainable lending volumes by the end of Q1 2021

- The RCG has estimated the value of unsustainable lending volumes that could arise over the period Q2/20-Q1/21. These represent lending volumes which UK companies may struggle to service given revenue shocks arising from the Covid-19 pandemic.
- Our estimates here are based on a number of key suppositions and assumptions, including; the length of the pandemic, the measures taken to relax lockdown, and top-down interrogation of high-level data prepared in other contexts. We will review and refine the analysis as more current data becomes available, but given the rapidly changing dynamics in the economic environment, policy development and business response, the actual outturn will certainly be different. We have tried to produce a plausible scenario that will allow business, government and the financial services sector to understand better the potential scale of the recapitalisation challenge, and together to determine the best collective response to prepare business and the economy for a post-pandemic future.
- The scope of our analysis is limited to the assessment of non-financial services companies, i.e. it excludes consideration of lending volumes provided to the financial services sector. As such any references to lending volumes and associated unsustainable lending amounts relate to non-financial services companies only.
- The stock of unsustainable lending could reach circa £100bn by the end of March 2021. These volumes take into account both the existing stock of lending balances and new lending volumes provided through the period Q2/20-Q1/21. Incremental lending from the recently established government lending schemes have been taken into account as part of this analysis. These comprise the Coronavirus Business Interruption Loan Scheme (CBILS), the Coronavirus Large Business Interruption Loan Scheme (CLBILS) and the Bounce Back Loan Scheme (BBLS).
- Our estimates of unsustainable lending take into consideration the potential impact of revenue shocks at a sector level and potential offsets from operational cost reductions and supportive policy measures. These estimates have been based on projected forecast change in revenue by Q2/21 vs. a Q4/19 reference period.
- As part of a preliminary phase of work, the RCG previously disclosed estimated unsustainable lending volumes of £90-105bn. Since then, our estimates have been refined to take into account various government initiatives seeking to off-set the financial shock experienced by UK companies, updated economic data, and expanded to cover all government business lending schemes in operation at time of writing (28 May 2020).

• Separate to recapitalisation requirements arising from potential unsustainable lending, there may be additional cash replenishment needs due to depletion of existing cash balances to finance cashflow deficits (available cash balances estimated at circa £85bn)[4] and cover any incremental lending.

Figure 1: Estimated amount of unsustainable lending, March 2021, £bn[5,6]

Source: EY Analysis; ONS; BOE; HM Treasury



[4] Bank of England: Interim Financial Stability Report (May).
[5] EY Analysis; BOE; ONS; HM Treasury; Nb. All estimates for unsustainable lending volumes relate to private non-financial corporations (PNFCs) .
[6] Figures representative of PNFCs only (Private Non-Financial Service Corporations) per the ONS.
[7] Existing lending and associated unsustainable loan balances representative of / correspond to balances as of 2019 y/e; estimates of loan balances reflective of lending volumes net of insolvencies under a steady-state (assumed at circa 1.5% of lending balances pre-insolvencies).
[8] New private lending relates to provision of lending volumes from the private sector, i.e. excluding government business lending schemes.
[9] Government lending schemes include analysis of CBILS, CLBILS and BBLS. Nb. Commercial paper volumes from the Covid-19 Corporate Finance Facility (CCFF) program have not been included as part of this analysis.
[10] Policy off-sets and operating cost off-sets include estimated reduction in labour / net employment and non-labour variable costs in response to revenue shocks and business rate reliefs.

3.2 It is estimated that circa £32-36bn of lending provided through government lending schemes will become unsustainable

- UK government has established three business lending schemes in response to the Covid-19 pandemic to enhance businesses access to financing and improve their liquidity position, the CBILS, the CLBILS and the BBLS. The Bank of England has also launched the Covid Corporate Financing Facility (CCFF) program which provides liquidity to companies in the form of commercial paper; this has not been included as part of this analysis.
- Each of these schemes focus on different segments of the UK's business community. The BBLS focuses on micro and small businesses – offering facilities of up to circa £50k, CBILS focuses on both small and medium sized businesses – offering facilities of up to circa £5m and CLBILS focuses on large businesses offering facilities of up to £200m (recently increased from £50m).
- As at 24 May, lending provided across these schemes totalled circa £27bn, with the majority deriving from the recently introduced BBLS (circa £18bn in drawdowns) and CBILS (circa £8bn in drawdowns). BBLS has only been in operation for circa three weeks at time of writing.[11]
- Uptake in CLBILS has been more limited, with total lending provided reaching circa £820m since scheme commencement on 20 April with the recent rate of new weekly applications slowing further over 17 May – 24 May.[12]
- By the end of March 2021, we estimate that total lending volumes provided from government schemes will reach circa £111-£123bn. A proportion of these loans will be potentially unsustainable due to ongoing economic challenges. This proportion is estimated to total £32-36bn.

Figure 2: Estimated amount of unsustainable lending from government lending schemes, March 2021, £bn

Source: EY Analysis; HM Treasury

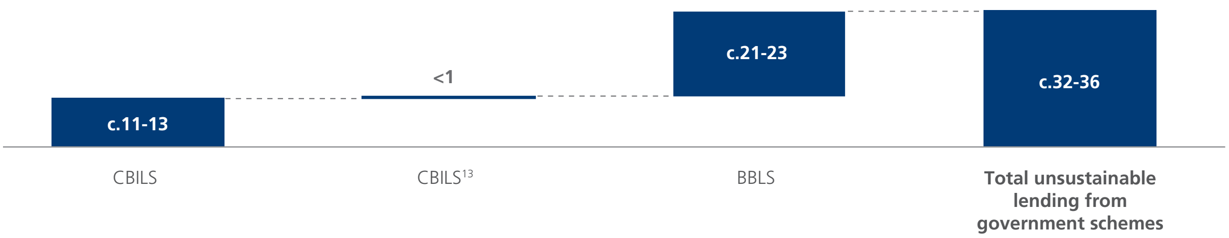
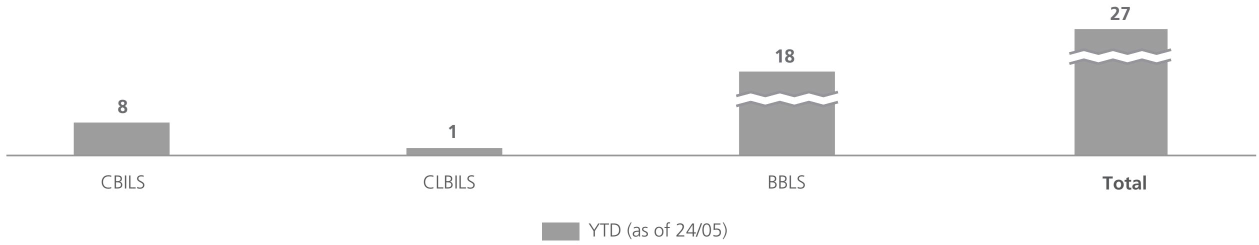


Figure 3: YTD lending from government schemes, £bn

Source: HM Treasury



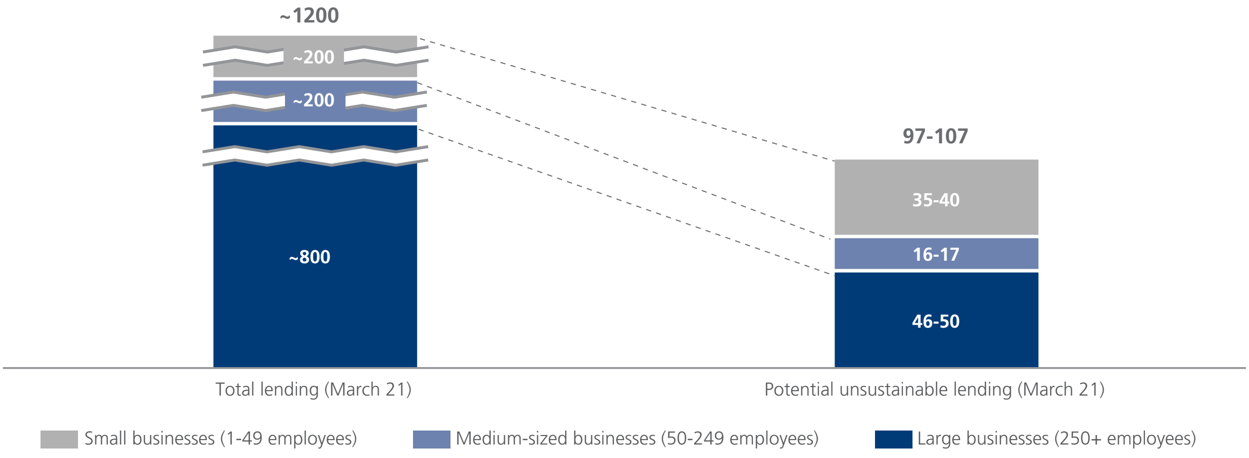
[11] HM Treasury.
[12] Ibid.
[13] Limited unsustainable lending expected from CLBILS scheme, primarily due to relatively low forecast take-up; forecasts may be revised pending further data availability.

3.3 SMEs are estimated to incur around half of total unsustainable lending, amounting to circa £50-56bn

- The UK has a total business population of circa 5.9 million (as of 2019) of which the vast majority (circa 99%) comprises of SMEs defined as businesses with up to 249 employees.[14]
- SMEs comprise circa 52% of UK turnover (as of 2019) and circa 60% of UK employment (as of 2019), larger businesses, defined as those with 250 employees and above account for circa 48% of UK turnover and circa 40% of UK employment.[15]
- We estimate the amount of unsustainable lending volumes to be fairly evenly split between SMEs and large businesses, with SMEs accounting for circa £50-56bn in potential unsustainable lending volumes and large businesses circa £47-51bn.
- ONS surveys on the business impact from Covid-19 indicate that circa 30% of SMEs are either unsure or not confident with regard to the sufficiency of their financial resources to continue operating throughout the coronavirus outbreak. For larger businesses, circa 23% of respondents responded similarly.[16]
- Further surveys of SMEs (BBRS) indicate that c.45% of respondents who have taken out a loan from a government business lending scheme may not repay them.[17]
- The UK's business community also includes a population of circa 1.6k listed entities; these businesses typically have greater options for financing than SMEs.

Figure 4: Scenario projections of estimated amount of unsustainable lending and total lending by size of business, March 2021, £bn[18]

Source: EY Analysis; HM Treasury; ONS; Bank of England; UK Finance



[14] Department for Business, Energy & Industrial Strategy (BEIS) [Nb. Business segment definitions per BEIS]
[15] Ibid.
[16] ONS Business Impact of Covid-19 Survey (BICS) results (May 2020)
[17] BBRS (Business Banking Resolution Service): The impact of Covid-19 loan schemes on business banking dispute resolution (May 2020)
[18] This analysis is based on a number of key suppositions and assumptions including the top-down interrogation of high level data. Estimates may be reviewed and refined over time on further availability of data sources.

3.4 By the end of March 2021, higher concentrations of unsustainable loans are forecast in the property, accommodation and food, and construction sectors, comprising circa 50% of total unsustainable lending

- Our analysis indicates that the sectors most likely to experience higher levels of unsustainable lending are those with higher initial levels of borrowing who also suffer from larger net shocks on revenues resulting from the Covid-19 pandemic.
- We forecast that the top three sectors which could be affected by unsustainable loans are property, accommodation and food services, and construction which collectively comprise circa 50% of total volumes. These sectors also comprise circa 45% of total estimated lending balances (with the property sector alone accounting for circa 28%).
- Sector net shocks as a consequence of the Covid-19 pandemic have been projected based on a forecast change in revenues by Q2/21 (vs. a Q4/19 reference period) and estimates of potential off sets arising from operational cost reductions and supportive policy measures (which are expected to conclude after the forecast period). We estimate the top three impacted sectors to also comprise accommodation and food services, transport and storage, and construction which range in impact between 11-25%.

Figure 5: Estimated proportion of total unsustainable lending and total lending balances by sector, March 2021, %[19]

Source: EY Analysis, HM Treasury, ONS, Bank of England

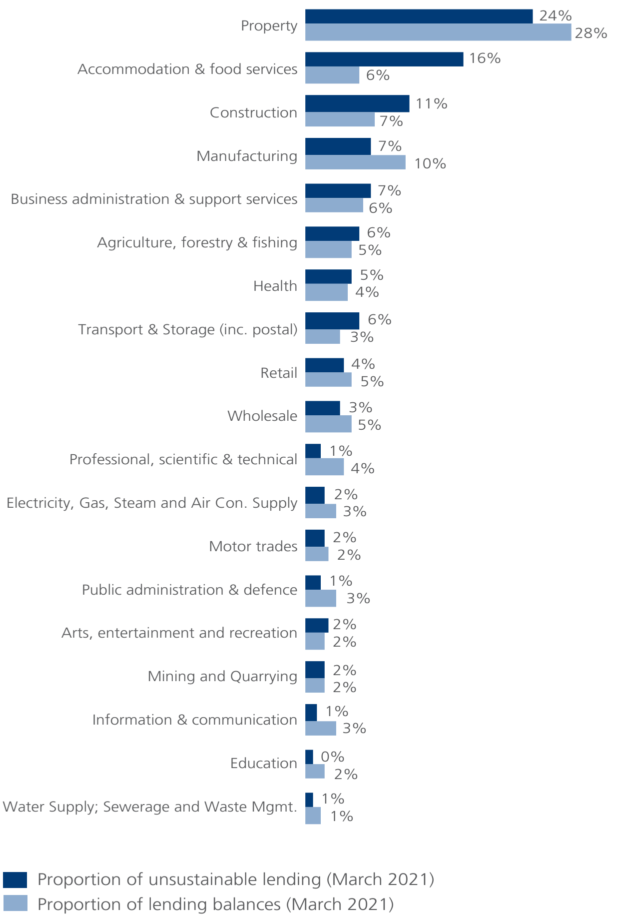
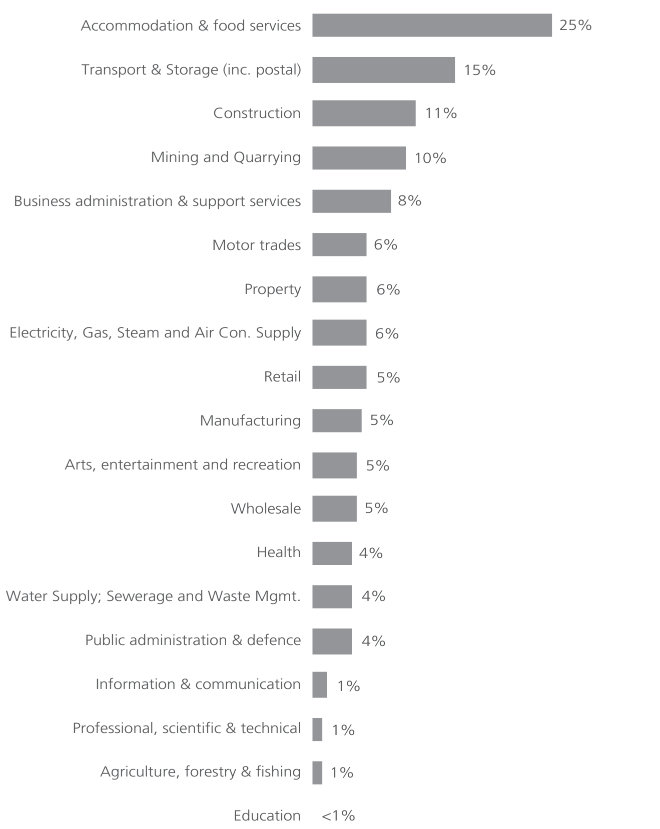


Figure 6: Estimated net shock on revenues by sector, % (Q1/21 vs. Q4/19)[20]

Source: EY Analysis; ONS



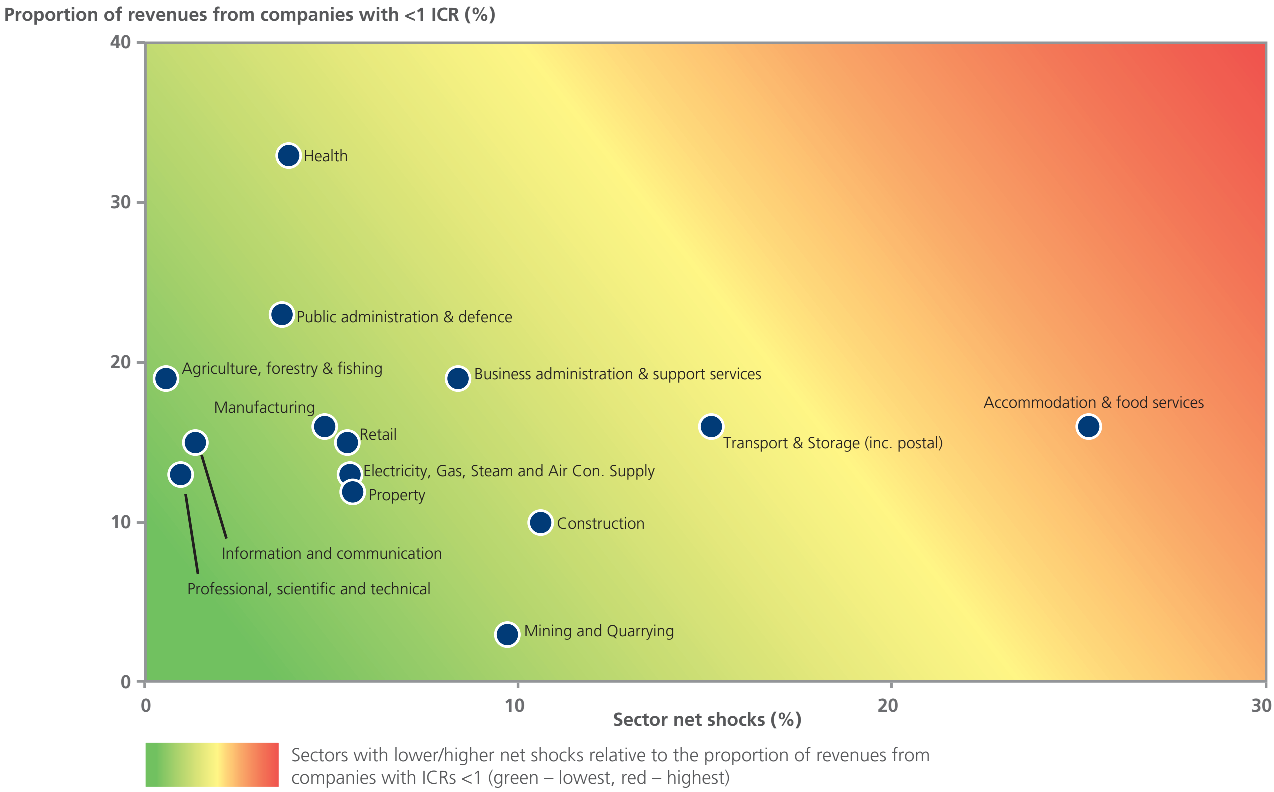
[19] Estimated proportions of unsustainable lending represent each sectors proportion as a percentage of the total.
[20] Sector net shocks on revenues based on forecast change in sector revenues, and estimates of operational cost reductions and policy off-sets

3.5 Within the next 12 months, some sectors may be impacted earlier by both higher net shocks (i.e. revenue shocks less off-sets from operational cost reduction and policy measures) and a lesser ability to absorb these shocks

- Sectors' ability to absorb net shocks on revenues in the near-term (as defined as revenue downturn partially mitigated by cost reductions and policy measures – the x axis in Figure 7) arising from the Covid-19 pandemic will in part be influenced by their ability to cover their existing financing costs.
- As an indicator of a sector's ability to absorb these net shocks, we assess the proportion of each sectors' revenues deriving from companies with limited means to meet their financing costs (i.e. companies with Interest Coverage Ratios (ICR) of < 1; the y axis in Figure 7).
- Based on these metrics, accommodation and food services, transport and storage, construction and business admin and support service sectors all appear to represent sectors facing both higher net shocks (ranging between circa 10-25%) and a lesser ability to immediately absorb these shocks (whose revenues deriving from companies with ICRs of <1 ranging between circa 10-20%).

Figure 7: Heat-map of estimated sector net shocks vs. proportion of sector revenues from companies with Interest Coverage Ratios (ICR) < 1 (%)[21, 22]

Source: EY Analysis; Bureau van Dijk, S&P Capital IQ



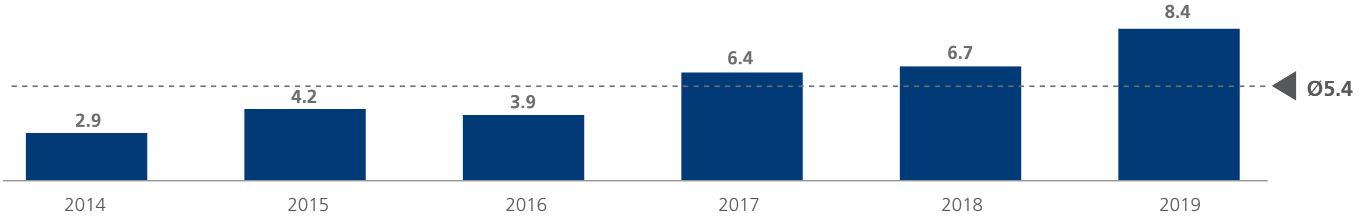
[21] Interest coverage ratio is defined as earnings before interest and tax as a share of interest paid and interest capitalised; ICR less than 1 includes those companies that are unprofitable and have interest expenses; interest capitalised is only available for listed companies.
[22] Sector net shocks based on forecast change in sector revenues (forecast change in revenue by Q2/21 vs. a Q4/19 reference period) and estimates of operational cost reductions and policy off-sets.

3.6 The current challenge faced by SMEs is particularly acute given the low volume of SME equity finance in recent years

- Access to equity investment varies by size and type of business.
- Listing, in particular, brings potential access to capital: the market remains relatively deep and liquid, and listed companies continue to access markets for new equity in crisis periods:
  - Following the global financial crisis, LSE-listed corporates raised a cumulative circa £145bn in 2008 and 2009 (further issuance), of which 50% is related to banks
  - Since Covid-19, UK large corporates are starting to raise equity to strengthen balance sheets and working capital – from February to the end of May 2020, UK listed businesses raised >£24bn in equity.
- Likewise, large corporates typically have better access to institutional investors and equity raising experience, whereas smaller companies have limited experience with professional investors and often rely on branch-based bank lending. While equity finance raised by UK SMEs has doubled since 2016, it remains under £10bn p.a, significantly short of the potential demand for capital.

Figure 8: Total equity finance into UK Smaller Businesses, £bn

Source: British Business Bank (2019 figure is a provisional estimate based on EY Analysis)



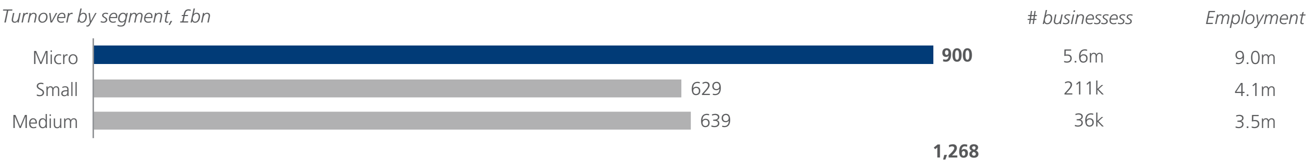
- There are a number of challenges which currently impede SME access to equity markets:
  - venture capital (VC) specific funding is typically focussed on high-growth entities, which therefore limits the breadth of businesses potentially targeted
  - private equity (PE) backed funding will typically be highly geared and targeted at large and larger-midmarket companies rather than SMEs
  - issues faced in agreeing terms around valuation, control, governance and dilution
  - the relatively high cost and time of target scanning, fundraising (six to nine months on average for VC, according to the BBB) and completing due diligence in relation to deal size
  - difficulties deploying capital at scale
  - reduced SME demand, partly due to lack of awareness and equity raising experience.

• While the focus of our initial work is on unquoted small and mid-market businesses, it has become clear that the challenges facing smaller micro companies have increased substantially over recent weeks.

• Smaller micro companies are an important part of the UK economy, with circa 5.6 million microbusinesses employing circa nine million people and accounting for circa £900bn turnover in 2019.

Figure 9: Key segment statistics, 2019

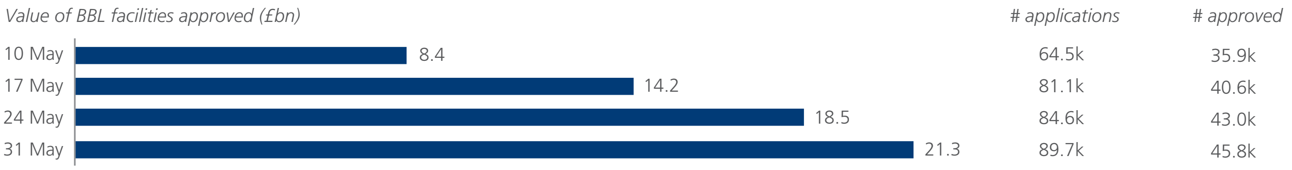
Source: BEIS, Business Population Estimates



• Microbusinesses have been utilising government stimulus measures including the BBLS, aimed at micro and small businesses and the Coronavirus Job Retention Scheme (CJRS). The amount lent to microbusinesses under the BBLS continues to increase.

Figure 10: Bounce Back Loan Scheme (BBLs) – volume and value

Source: HM Treasury/gov.uk



• Recent reports indicate that the level of financial distress amongst microbusinesses and BBLS borrowers has intensified.[23]

• Our initial work indicates that some of the recapitalisation instruments considered in this report could apply to microbusinesses. We will continue to gather insights on the applicability of options for the UK's smallest businesses as we progress our work.

Potential recapitalisation options more relevant to microbusinesses	Ref. page:
Contingent tax liability (CTL)	47
Forbearance schemes	50
Conversion to grant	51

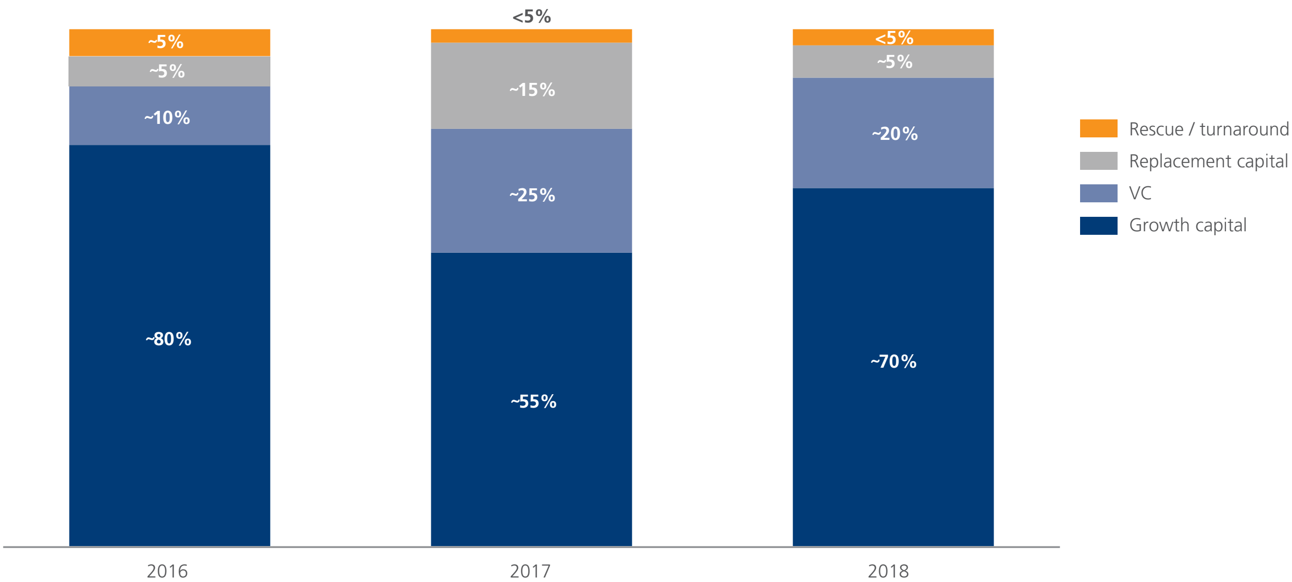
[23] BBRS, The impact of Covid-19 loan schemes, May 2020; FT "UK banks warn 40-50% of bounce back borrowers will default", May 2020.

3.7 Equity investment into UK corporates has typically been for growth capital versus rescue/turnaround

- The existing level of equity investment (excluding buy-out) into UK SME businesses is heavily skewed towards growth capital, which has its own constraints and challenges. Capital for rescue/turnaround accounts for <5% of UK SME investment flows versus circa 60-80% for growth capital.
- This means that the pool of equity capital typically invested in UK SME rescue/turnaround (which is most akin to post-Covid SME recapitalisation) is significantly lower than what the headline SME equity investment figure may suggest.

Figure 11: Investments of UK funds, share by stage/focus area, excluding buy-out (%)[24, 25]

Source: BVCA, UK Funds that are BVCA members



[24] Sourced from BVCA; based on the investments of UK funds (noting that some investments may be in overseas businesses and in non-SME businesses); excludes buy-out investment, which may include some investment in SME; Rescue/Turnaround are funds investing equity in companies that are in financial distress with the view to restoring the company to profitability.

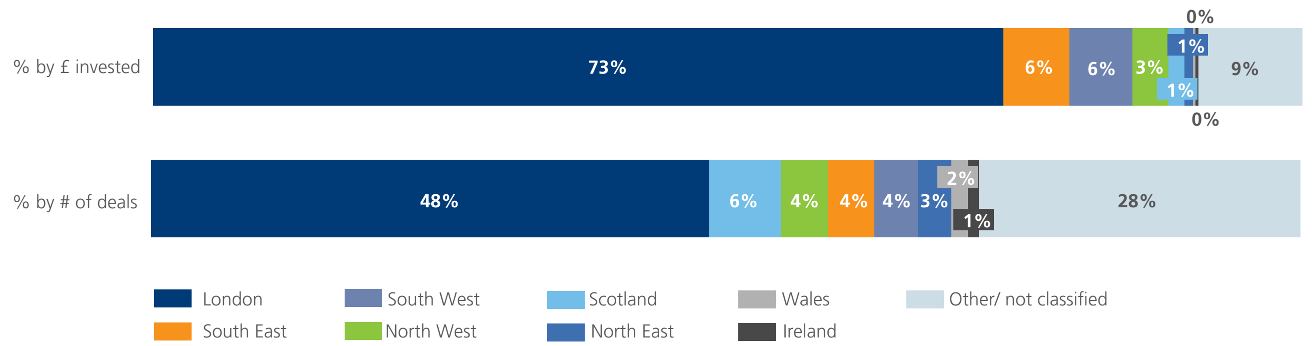
[25] Percentages may not add to 100% due to rounding.

3.8 There is a regional imbalance in the provision of equity finance to UK businesses

- While equity investment into UK SMEs has been growing, large differences in investment levels remain across UK regions.
- London is the largest market by both the amount of equity invested and the number of investments, with circa 70% of all pounds invested and around half of all equity deals. London is followed by the cities of Cambridge and Oxford, together accounting for circa 10% of total equity invested.[26]
- London is a particularly popular destination for global and institutional investors, which are more likely to participate in larger, late-stage deals. In 2019, London accounted for around two-thirds of mega-deals and circa 80% of mega-deals involved participation from one or more foreign investors.

Figure 12: Proportion of UK SME equity investment by region, 2019, (%)

Source: Beauhurst



[26] Sourced from Beauhurst; includes equity investment data for ~20k companies that raised a total £12bn, of which SME accounts for ~19.7k companies and £10.3bn of equity raised.

4. THE POOLS OF AVAILABLE CAPITAL

4.1 There is a broad and interconnected ecosystem of investors in the UK; the ability to (re-)allocate capital to UK SMEs varies and there are significant impediments which would need removing

- The scale of the UK recapitalisation challenge likely necessitates a mix of measures, both equity and longer-term debt, and participation from a broad range of investors. The UK capital landscape comprises a broad and interconnected ecosystem of investors with pools of capital potentially available to meet some of the demand for recapitalisation.
- Capital providers (both institutional and retail) can invest directly into UK corporates through a mix of debt and equity. They can also invest indirectly through a third party investment manager or fund (such as an asset manager or Private Equity fund) which directs and manages capital on their behalf.
- Key investors in the UK landscape are set out below:
  - **PE, VC and Private Debt (PD) markets** raise funds from capital providers such as institutional investors. Undeployed capital exists in these markets including circa £157bn of undeployed capital in PE (inclusive of VC) in 2019 and circa £35bn in PD. PE and PD markets are interconnected – many large PE funds have credit arms and deploy both equity and debt capital. Our analysis to date has focused on PE which accounts for the bulk of existing undeployed capital and could support equity financing to address the UK SME recapitalisation challenge. We recognise that PD could potentially play a role in supporting the provision of loans to UK SMEs, with some of the large PD funds lending in a variety of forms to mid-sized businesses (typically companies with profits in the range of £5m to £50m).
  - **Institutional investors** including insurers, pension funds and sovereign wealth funds invest in equity and debt both directly and indirectly (a significant amount of PE/PD dry powder is from global insurers and pension funds). UK insurers and pension funds together accounted for £3.6tn in assets in 2019.
  - **Retail investors** accounted for £1.2tn in assets in 2019. While there is limited undeployed capital among retail investors (e.g. within existing Unit Trusts and OEICs), new investment products could potentially be issued with appropriate consideration of investor protections and suitability.
- The ability of these investor groups to re-allocate existing assets or allocate undeployed capital varies by capital source.
- Unlocking capital from UK insurers, pension funds and PE could present opportunities to support UK SME recapitalisation and merit further consideration. However, unlocking private capital for this purpose and on this scale has not been done before in the UK market. There are significant challenges (e.g. alignment with investors' risk and return preferences, and regulatory and operational issues) across all investor groups. Therefore substantial changes to the current model and new approaches to overcome existing impediments will be required.
- The size of the UK SME recapitalisation challenge means that any solution to unlock private sector capital into UK SMEs will need to be scalable and may require an aggregator to pool individual investments.
- Unlocking private sector capital may also take time (separate to the time it could take to address operational and regulatory impediments). Since the crisis, some investors (including PE funds) have been focused on supporting existing assets (such as portfolio businesses in the case of PE) which may slow the flow of capital to new investments. In addition, investors may look to delay the deployment of capital until the impacts of Covid-19 on particular sectors and businesses are better understood. Following the last financial crisis for example, PE deal activity and purchase multiples fell noticeably (for example, UK PE deal values fell by circa 90% between 2007 and 2009) and took several years to normalise to pre-crisis levels.
- Individual firms within a particular category of investor are also unlikely to act uniformly; the appetite and ability to deploy capital to UK SMEs is likely to vary by firm.
- Where investors do seek to re-allocate existing capital, this could also mean that some capital is shifted away from financing of other segments of the UK economy, although some of this capital could be sourced from existing overseas investments.

4.2 Attracting PE capital requires significant realignment of risk and return and removal of impediments

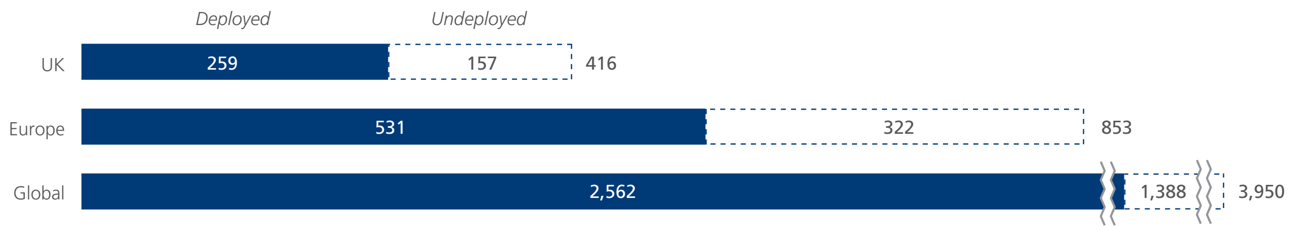
Private Equity

- There are a number of PE funds which allocate capital to UK mid-market businesses and to rescue/distressed assets. While investment in rescue/turnaround situations historically accounts for a small share of PE activity (relative to growth capital), the focus on rescue/distress may increase following the crisis so long as the risk-return dynamics are sufficiently attractive (including the rescue of existing, viable portfolio businesses). Therefore certain segments of the PE market will continue to play a role in supporting the recapitalisation of UK corporates.
- However, deploying PE capital at scale for the purposes of SME recapitalisation presents significant challenges. The vast majority of PE funds focus predominantly on growth investments of +£50m in line with a given investment mandate, run small investment teams, take an active role in management of the business (typically with a controlling stake) and exit after circa five years (commonly through a trade sale, secondary buy-out or IPO). These features, which support a preferred risk-return profile for PE investors, present substantial impediments to unlocking PE capital for potentially distressed SMEs at scale.
- Furthermore, while there is a large pool of existing PE dry powder, this is predominantly focused on the buyout of larger companies and is held in funds with an existing investment mandate and specific requirements (in relation to size of investment, sector etc.) which could prohibit its deployment towards UK SME recapitalisation. This may instead require a new fund raise alongside a new investment mandate.
- The VC market has more of a focus on the start-up and SME segment than the PE market, although it is considerably smaller than the PE market (VCs in the UK had circa £7bn undeployed capital in 2019, whereas PE had £150bn).
- Nonetheless, VC firms face many of the same structural impediments as PE (risk-return preferences, the need to pool assets, exit strategy), the investment mandates of Venture Capital Trusts can be restrictive, and investment for the purposes of rescue/turnaround will be a challenge (given the traditional VC focus on high-growth opportunities). The relative size of the VC market also makes it difficult to deploy capital at the scale required.

Quantum of capital available

Figure 13: Amount of capital: PE Market, AUM, 2019, £bn

Source: Preqin; includes venture capital



Investment preferences: The three key components of how PE investors achieve differentiated returns

Typical components	Applicability to UK SME recapitalisation challenge
1. Financial engineering (i.e. management of leverage)	• Very limited potential to manage leverage given existing debt structures.
2. Business improvement / value creation (e.g. buy and build, operational improvement)	• Limited potential to pursue an active strategy given cost of execution to achieve this at scale for SMEs segment.
3. Differentiated view of specific sectors/ cycles (traditionally focused on growth vs rescue/distress)	• Potential to pursue during Covid-19 recovery, with a greater focus on rescue/distress. • Investment into an asset class (e.g. pooled assets from a specific sector) with a preferred return over a multi-year time horizon. • However there are considerable challenges (see next page) and mechanisms for exit would need to be addressed to make this feasible.

Limited applicability Highly applicable

Issues to consider to unlock PE capital	
Risk-return dynamics	• **Active vs passive investment:** PE typically has a relatively high return requirement (IRR of 17-20% over three to five year horizon) achieved through active management of portfolio businesses. Investment in SMEs at scale will involve a more passive investment style (limited control and opportunity for value creation) which compromises the ability to attract a differentiated risk-return profile. Risk-return is more likely to be determined by overall sector performance. • **Visibility of exit mechanism:** Where investment is undertaken on a pooled basis, mechanisms for exit (which would be significantly different to the current approach) are unclear and will affect the risk-return profile.
Operational and governance challenges	• **Investment mandates:** PE investments will need to be made in accordance with investment mandates which may inhibit the deployment of capital into UK SME recapitalisation. There may be restrictions related to minimum ticket size (particularly for larger funds), sector, geographical concentration and Environmental, Social and Governance (ESG) considerations. • **Deployment:** There is considerable time and cost associated with raising funds and deploying capital (including finding potential businesses and conducting due diligence). This means that investment in SMEs at scale is likely to require the pooling of assets. This is more likely to be achieved through the creation of a new fund (or fund of funds) rather than the deployment of capital within existing fund structures.

4.3 UK insurers could play a role in the recapitalisation challenge although a number of challenges would need to be considered

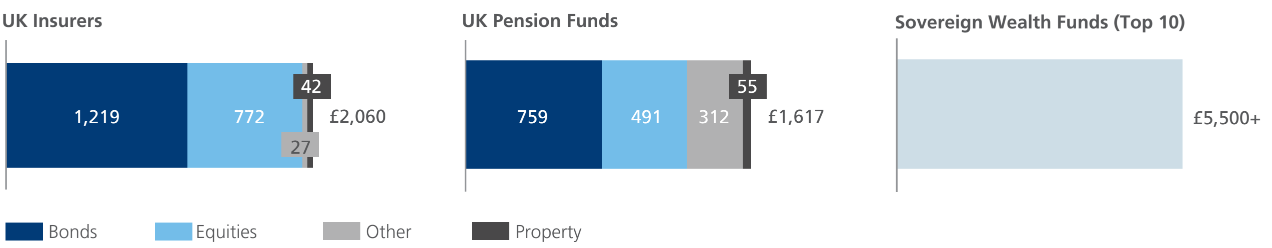
Institutional investors: insurers, pension funds and Sovereign Wealth Funds (SWFs)

- A large proportion of the capital held by various types of institutional investors is already deployed, with the ability and appetite to re-allocate capital varying by investor type.
- Unlocking capital held by UK insurers to a long term debt solution is possible, noting that UK insurers manage £2trn of assets, of which over half are partly or entirely invested at the discretion of management. However, investor appetite would require significant re-alignment of risk and return and there are considerable operational and regulatory challenges which would need to be addressed.
- A workable long term debt solution for insurers would allow companies to underwrite the SME exposures together in a pool. This would likely require:
  - Equity provided by other investors to help underwrite insurers risk, and for the investor's reward to be aligned to the success of the SME business, subordinating debt investment.
  - A large slice of fixed, long term debt, provided by insurance companies, to allow the SMEs to recover over a longer term and repay this debt.
- This would utilise a similar mechanism to the successful sale of UK student loans in allowing insurers to underwrite the investment pool as a whole rather than the individual loans.

Quantum of capital available

Figure 14: Amount of capital: Institutional investors, AUM, 2019, £bn[27, 28]

Source: EIOPA; Pension Protection Fund; SWF Institute



[27] Institutional investors invest in PE funds and represent some of the available capital of PE funds shown on Figure 13.

[28] While equities account for circa 35% of insurers' total capital, the majority of this is held in unit linked funds (which insurers have limited discretion over)

	Investment preferences	Applicability to UK SMEs recapitalisation challenge
Insurers	• Longer term investors • More risk averse • Increasing allocation to bonds and alternatives over equities in recent years (although equities account for a large share of capital)	• While undeployed capital is limited, UK insurers could re-allocate deployed capital to SMEs (to the extent the risk-return profile is sufficiently attractive) as they tend to manage portfolios in-house. Insurers have more discretion over non-unit-linked funds, typically invested in bonds and mortgages (versus equities, typically held in unit-linked funds). • Applicability is therefore limited to a debt solution. • Longer term investment profile is more aligned to SME recapitalisation, however, relative risk aversion is not well aligned to SME recapitalisation.
Pension funds	• Longer term investors • Moderately risk averse • Where pension funds have discretion, they will allocate more to listed equities and bonds	• **DB Pension Funds:** Possible to re-allocate capital albeit more difficult to do so than for insurers as investment decisions outsourced to investment or fiduciary managers. • **DC Pension Funds:** Anticipated growth may create opportunities to support mid cap equity, although many DC funds currently invest in default funds which may limit SME investment due to regulations (including Prudent Person Principles and fee cap restrictions).
SWFs	• Investment preferences highly variable from one fund to another; play in global markets (major debt and equity investments)	• Limited structural barriers to reallocation although applicability is dependent on appetite of each fund to invest in the UK (versus other regions). • Some SWFs take on more active roles and typically do so by setting up funds that operate similarly to PE funds; they may also co-invest with PE funds.

Limited applicability   Highly applicable

Issues to consider to unlock capital from insurers, pension funds and SWFs

Risk-return dynamics

- **Risk:** Insurance and pension funds typically invest in lower risk, investment grade products. If these investors are to deploy capital into UK SMEs requiring recapitalisation, a relatively unfamiliar area, in a short space of time, they will require a new mechanism/framework for managing credit risk. This could be in the form of a credit wrap or credit enhancement for additional protection.
- **Return:** Depending on the framework for managing risk, a debt solution could provide sufficient returns for institutional investors in excess of a corporate bond (e.g. 50 basis points above corporate bond rate).
- **Duration:** SMEs loans can typically be repaid early, whereas institutional investors (particularly insurers) will require greater certainty over duration; this may be partly overcome through longer-term fixed loans or the setting up of a pool of funds to protect investors in the case of early repayment.

Issues to consider to unlock capital from insurers, pension funds and SWFs	
Operational challenges	• **Execution capacity:** Many institutional investors do not have the capability or capacity (e.g. large investment teams) to mass underwrite loans in the case of a debt solution (which is what would be required in the case of insurance) or undertake mass equity investment (including execution of due diligence, valuations etc. for other types of institutional investors). • **Outsourced decision-making:** Where decisions are typically outsourced, there are operational impediments to some investors in asset allocation decisions – for example DB pension funds rely on delegated investment or fiduciary managers, triggering complex approvals and governance processes.
Regulatory considerations	• Regulatory considerations vary by type of investor, and are an important element to ensure investors' protection. Where any adjustments might be considered, investor protection would also need to be considered. Some these protections are not within the UK's gift alone to change, requiring international cooperation and time to address. • Examples include: – **Insurance:** Solvency II Regulations makes en-masse investment into UK SMEs difficult. Examples include the Prudent Personal Principle that requires insurers to only invest in assets where the risks are properly identified, measured and monitored, which would require underwriting or due diligence of every loan/investment, and matching adjustment rules that limit insurers ability to invest directly in SME loans without a securitised vehicle (e.g. some form of Special Purpose Vehicle (SPV) being set up). – **Pensions:** Regulatory fee caps apply to UK DC default pension fund investment which may impede investment in growth and patient capital.

4.4 There are significant regulatory issues to be addressed when unlocking capital from retail investors

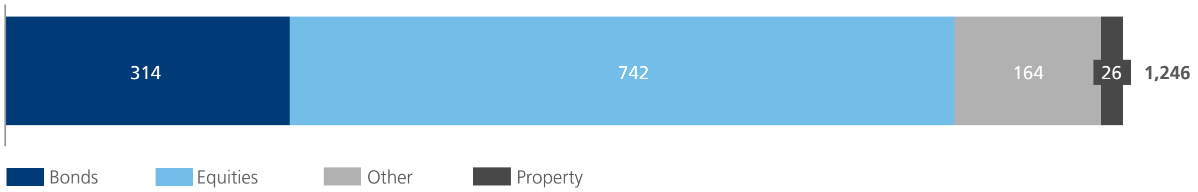
Retail investors:

- There is limited undeployed capital among retail investors (i.e. within existing Unit Trusts and OEICs).
- There is a potential opportunity to capture new investment flows and issue new investment products (with due consideration of suitability) to support the SME recapitalisation challenge. Retail investors have a preference towards current income which SME loans may be well aligned to. However, for products marketed to retail investors, it will be important to carefully consider the risk of mis-selling and the regulatory safeguards (including MiFID I/II) in place to ensure appropriate investor protections.

Quantum of capital available

Figure 15: Amount of capital: UK Retail Investors, AUM, 2019, £bn

Source: The Investment Association



Investment preferences

- Demand for returns from both equity-like and debt-like solutions
- Simple, streamlined investment products which can be redeemed at will (liquid and easy to value)
- Limited appetite for short-duration debt

Limited applicability

Highly applicable

Applicability to UK SME recapitalisation challenge

- Retail investors already own, on average, 25% of the LSE's Alternative Investment Market (AIM) growth market.
- The ability to re-allocate capital towards SME assets varies by structure – it is more limited for Unit Trusts and OEICs (with less room for management allocation discretion and regulatory requirements around daily redemptions) than for trusts and ISAs.
- Retail customers tend to be more fragmented than institutional investors so it may be more difficult to encourage en-masse re-allocation of retail capital.
- Potentially more applicable if individual assets were pooled and made into a liquid tradeable portfolio (e.g. through an Asset Management Company, (AMC)).

Issues to consider to unlock retail investor capital

Investor protections

- **Prevention of mis-selling:** There is heightened regulatory emphasis on suitability assessments to reduce the risk of mis-selling under MiFID II and supporting regulations (i.e. Prospectus Regulation, FCA Vulnerable Investors). Under MiFID II, restructured SMEs loans are less likely to be classified as non-complex products and may need to be sold to retail investors on an advisory basis only.

Risk-return dynamics

- **Term/structure:** Retail funds, such as Unit Trusts and OEICs, are typically open-ended funds (pooled assets, ongoing new contributions/withdrawals, priced daily) which tend to be more liquid yet post lower returns (than closed-ended funds). As open-ended funds typically invest in more liquid assets, these funds may be less suitable for supporting UK SMEs requiring recapitalisation. This may be mitigated by the use of investment trusts which are closed-ended funds and which many retail investors are familiar with.

5. POTENTIAL INSTRUMENTS FOR RECAPITALISATION

5.1 A broad range of tools are being considered to address recapitalisation needs

In this phase of our work, we have mobilised a number of workstreams to begin developing a range of measures to address the recapitalisation needs of companies.

The workstreams have been seeking to design options which can address the needs of targeted end users. This has involved trying to answer a number of key questions, which include:

– What is the market failure we are seeking to address?

– How can we appropriately segment the market?

– What the design of the recapitalisation instruments should be?

– Consideration of the most appropriate enablement mechanisms for delivering the instrument(s) to businesses?

There are also a number of design principles being considered including scope of application, eligibility, customer assessment methodology and how best to operationalise and fund the recapitalisation scheme(s).

There are a broad range of companies with varying characteristics, notably: levels of debt, company size and whether they hold stimulus and/or non stimulus debt. This led to the initial consideration of a broad range of options to tailor to the differing needs of businesses. A high level summary of these options is presented in this section of the report. The recapitalisation group has since focused on a smaller more targeted range of options.

The design stage of these measures is still ongoing as the RCG continues to work through the design choices and a variety of technical considerations (e.g. tax, accounting, valuations and State Aid rules). Therefore at this stage, the options presented are not a finalised view of our recommendations and should be treated as formative in nature. They will be further refined during the next phase of our work as we take on board feedback from HMT, Bank of England, FCA, trade bodies and businesses, and look to address the broader solution design considerations.

5.2 What is the market failure we are seeking to address?

The RCG is focused on how the private sector can support the recapitalisation challenge. In the development of options a range of considerations have surfaced for both the private and public sector.

Is there a market failure?

While equity markets for large corporates continue to function relatively well, in the mid-market and for smaller companies there is insufficient depth of equity financing to deliver the volume of recapitalisation required. We will undertake further to work to estimate the size of this supply gap.

There are at least two market failure concerns to consider that draw upon issues already outlined in this paper:

– The volume of capital directed at the mid market will be insufficient to meet the recapitalisation need.

– The operational capacity to distribute the capital is currently sub scale.

If these problem statements are correct then significant numbers of business might fail, forcing banks to call on government guarantees and triggering a range of broader adverse economic, fiscal and social consequences.

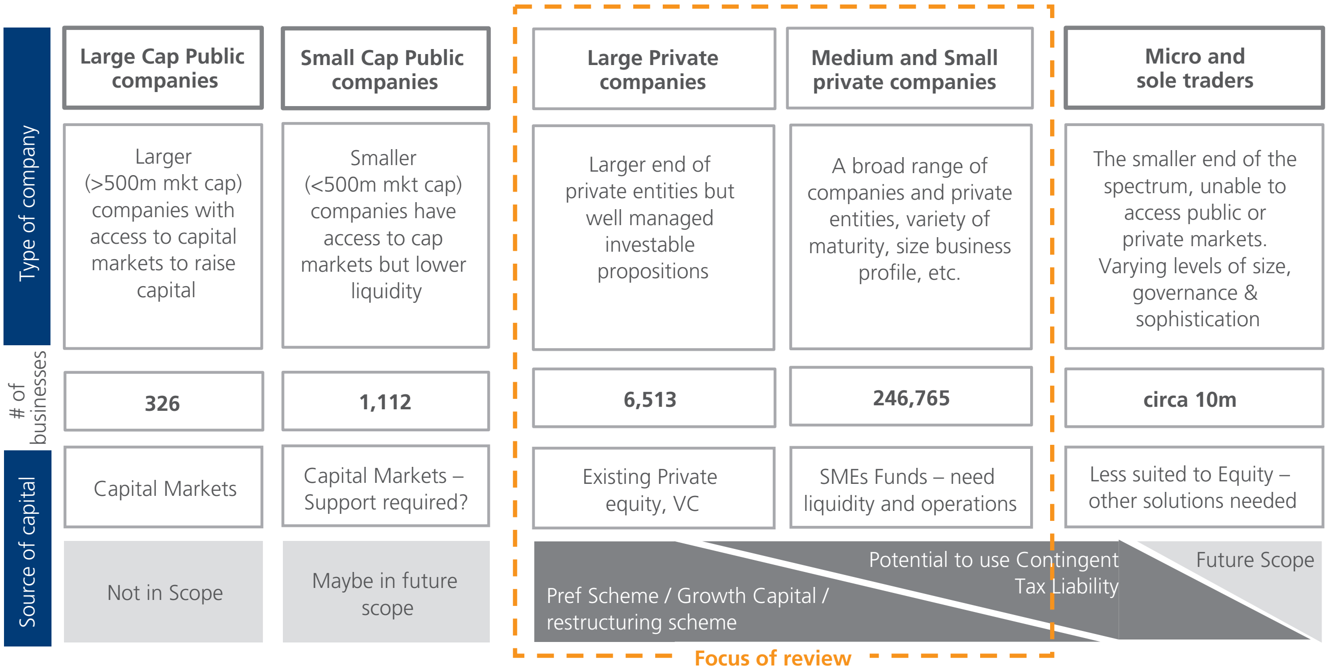
Furthermore companies that are seeking cash resources to invest and grow may not have access to such growth capital other than through debt financing.

5.3 Eligibility criteria requires careful consideration

How can we segment the market?

We consider that the focus of our initial work should be on unquoted SMEs. We will also explore whether there could be potential application of our findings to smaller micro companies:

Figure 16: Market segments and liquidity

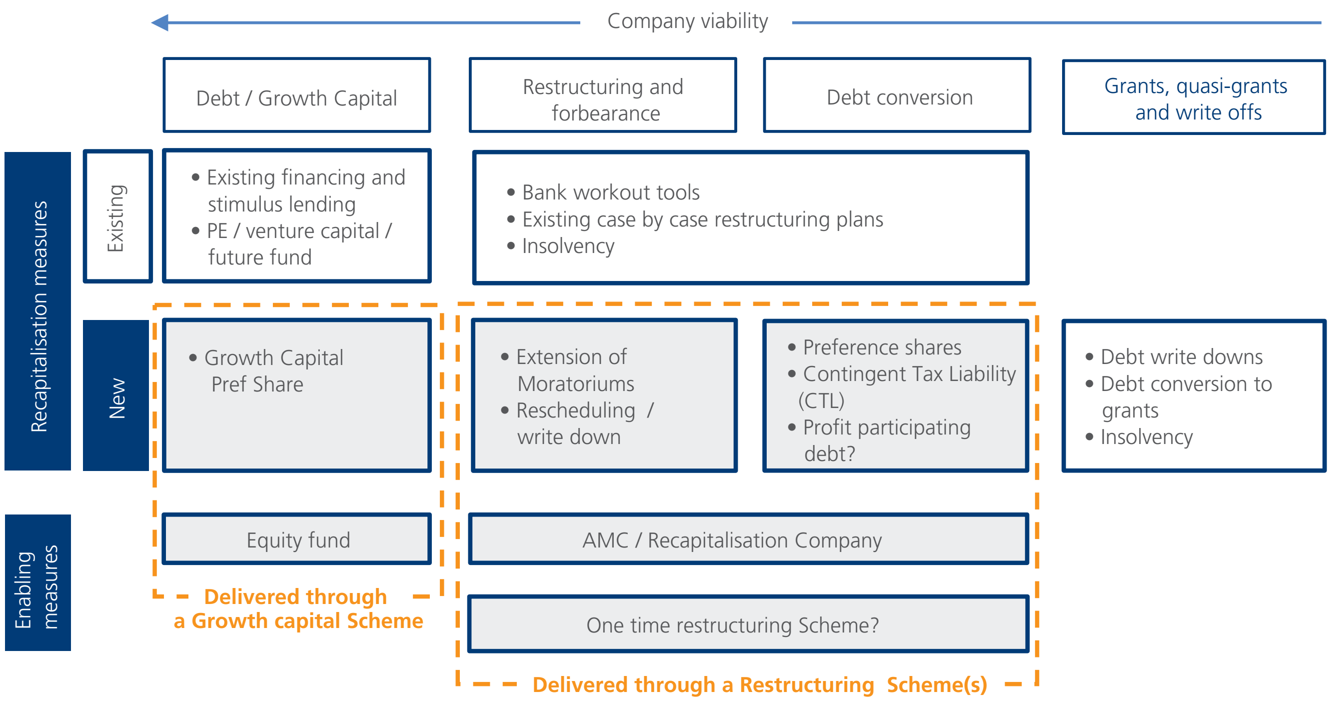


- The options will aim to provide solutions for companies with varying degrees of sophistication, corporate structures and debt levels. Given such variances between entities, the options must consider eligibility criteria carefully.
- Instruments with complexity (or perceived complexity) are unlikely to be suitable for smaller companies – hence not all options may be available to all companies, however the exact scope of application is still being considered.
- Consideration is also being given to whether eligibility for any recapitalisation instrument is linked to the receipt of government backed stimulus lending. Limiting eligibility to the recapitalisation of unsustainable stimulus lending removes a degree of complexity – for example, a single solution could be delivered to as an exchange for each form of stimulus lending, however this would limit the scope of application.

5.4 Company viability

- Company viability is a key consideration when determining the eligibility under each of the proposed options.
- Our focus has been on addressing the need to recapitalise companies with an unsustainable debt burden.
- However, in constructing our work on the development of potential options, we have engaged with a number of stakeholders whose feedback has indicated that in addition to the case for unsustainable debt, there is a need for a scheme to deal with growth capital.
- As such, we have focused on two schemes which cater for 1) growth capital options for viable companies; and 2) restructuring options for companies with unsustainable debt and who require some form of capitalisation (both schemes).
- We acknowledge that the problem-statement and use case for growth capital is different to that of capital for the recapitalisation of unsustainable debt and therefore the design and structure of growth capital solutions needs to reflect those different starting points.

Figure 17: Potential recapitalisation tools



- The expectation is that the toolkit required to meet the recapitalisation challenge will be delivered by a growth capital scheme and one or more restructuring schemes as set out above.

5.5 A broad range of tools are being considered to address recapitalisation needs

- A number of instruments were considered for the recapitalisation task. As we move forward to the evaluation phase, our focus will be on preferred shares (both for restructuring and for growth), a contingent tax instrument and forbearance schemes.

Growth Capital

Recapitalisation of unsustainable debt

Potential recapitalisation options:		Ref. page:
Common Equity and warrants	• Combination of ordinary shares and equity warrants which could provide an incentive for existing shareholders to participate to mitigate dilution. • Warrants provide equity upside and reduce appeal versus other private forms of capital.	43
	Our current focus	
Preferred shares	• Preferred Shares subordinate to all existing debt but ahead of existing shareholder loans and common equity. • Annual dividend payments but means tested with ability of issuer to roll-up dividend if needed reflecting business growth needs /operating requirements etc. • Potential to be used as growth instrument as well as a restructuring instrument.	44 46
Contingent tax liability (CTL)	• A CTL could be used as a restructuring tool as a means tested obligation to the government repayable alongside taxes. • Possibly perpetual, calculated as a set percentage of taxable profits (or other simple calculation) paid after corporate tax charges and NIC etc.	47
Profit participating debt	• Linked to specified profitability metric(s), interest rate ratcheted to reduce in times of reduced profitability. • Provides high incentive from stakeholders to refinance and redeem instrument as well as downside protection that protects the against duration of investment.	49
Forbearance schemes	• Schemes include restructuring tools such as extension of term loan, extension of moratorium and capital holidays. • These can be applied individually or consecutively, with re-assessment of suitability and effectiveness performed periodically, with a view to eventually getting the loan to re-perform.	50
Conversion to grant	• At the extreme end – consideration may need to be given to grants offered by the government to meet solvency or liquidity requirement and maintain operation through the crisis.	51

- It is recognised that existing operational and execution capacity as well as funding appetite for such schemes is insufficient to meet the scale of the recapitalisation need. Delivery mechanisms need to be considered which consider the funding as well as the distribution of any chosen recapitalisation options.
- The ultimate choice and structure of any delivery mechanism will be influenced by some of the design choices that have been mentioned previously, for example a scheme that requires a high degree of bespoke customer assessment, necessarily requires a much higher degree of infrastructure than a more rules-based scheme such as the Future Fund.
- The funding of any scheme will be a critical component of the ultimate design. In the absence of a large enough market for share capital for SMEs to address the need, it will be key to understand how these investments could be made attractive enough to investors without disincentivising the continued running of the businesses by the owners.
- It is likely that, at least in the early stages, government involvement will be required in the funding, with consideration being given to the form that this might take. The under-provision of equity to SMEs is a structural problem which needs to be addressed and so the possible creation of a development fund provides policymakers with an opportunity to create a lasting legacy from the crisis. Subsequently, two possible vehicles are under consideration:

	Potential enablement vehicles:		**Ref. page:**
Enablement Vehicles	Development corporation	• A state or privately owned investment vehicle facilitating minority investments in SMEs and mobilising private capital to (re)capitalise SMEs. • Potential that this vehicle could be aligned to hold any debt or equity delivered by the Project Birch initiative.	52
	Asset management company (AMC)	• An AMC type structure might provide flexibility on the funding options for defaulted COVID-19 schemes guaranteed loans. • Government currently guarantees these loans and options will be investigated as to how best to maintain government's interests potentially through funding of an AMC or alternatively, through some form of Asset Protection Scheme.	53

- There are a number of solutions design considerations which will influence the delivery model of those recapitalisation instruments. In the next section we examine some of the policy and design considerations which we are continuing to examine in relation to the recapitalisation schemes.

6. CONSIDERATIONS FOR SOLUTIONS DEVELOPMENT

6.1 Analysis of Global Schemes

We recognise that the manner of delivery of the instruments set out above give rise to a number of design choices. In order to inform option development, we conducted primary research into almost 30 UK and international SMEs and Mid-Cap support schemes[29] – historic, current and being established – to identify examples with specific features which might inform our options workstream. Relevant schemes will be further analysed in depth where pertinent for option development. Below we have set out our summary findings and themes:

Summary

While there are few direct parallels of schemes being set up to recapitalise businesses across the whole spectrum of an economy directly, schemes have been successful in providing equity support to specific types of businesses or business sectors, either as a post crisis response or as business as usual (BAU) funding. Notably, the Industrial and Commercial Finance Corporation (ICFC) (later renamed 3i) and KfW in Germany both originated as state-owned, post-World War 2 recapitalisation schemes but continued as BAU schemes providing broad economic support but with a focus on financing SMEs across the economy.

Many of the equity-based schemes tend to focus on growth equity and innovation, for example, the British Growth Fund (BGF) in the UK which was established to provide SMEs with financial investment. Also in the UK, the British Business Bank's equity programmes partner with the private sector to finance young and fast growing small companies. Most Covid-19 support schemes, however, have focussed on debt, although schemes such as the UK Future Fund and the US CARES Act, include equity investment, equity for bailout (for example, under the CARES Act certain strategically important companies issue equity to the US government in exchange for the aid or bailout required) or future equity conversion.

Themes

From our analysis, several themes emerge which are valuable to consider in option design:

Sources of funding and risk sharing

There have been a wide range of approaches used to share risk, from public/private collaborations (for example, the ICFC was originally funded by the Bank of England and the major British commercial banks to fill a gap in long-term debt and equity financing for UK SMEs) to private sector funding with the risks of lending underwritten or shared by governments (for example, Enterprise Singapore shares the risks of lending with the participating financial institutions).

Key policy questions might include where risks should fall and how private capital can be incentivised. However, as a general observation, a feature of successful schemes is they often share risk in a balanced way between stakeholders, taking account of an ultimate longer-term goal – usually to support an industry or the wider economy.

[29] BGF (Business Growth Fund); The British Business Bank; UK Export Finance; Future Fund; Industrial and Commercial Financial Corporation (subsequently 3i); The Green Investment Bank; UK Government Investments; UK Financial Investments China Debt-to-equity swaps programme; Dubai Financial Support Fund; BPI France (Banque Publique d'Investissment); KfW (formerly Kreditanstalt für Wiederaufbau); German Economic Stabilisation Fund (WSF); Treuhandanstalt; Ireland Strategic Investment Fund; Pandemic Stabilisation and Recovery Fund; National Asset Management Agency (NAMA); Japanese SMEs support; European Investment Bank; Finance for Innovators –InnovFin; Equity Facility for Growth; European Investment Fund (EIF); Singapore Enterprise Financing Scheme; SAREB; Securum; Swiss C19 Debt Moratoria / Restructuring; US Capital Purchase Program; US CARES Act;US Small Business Administration

Longevity and objectives

Many of the schemes reviewed were set up in response to specific issues but some of these schemes became part of the longer-term infrastructure of their countries. A notable example, mentioned previously, is KfW. It was set up in 1948, remains part of the German infrastructure and was mobilised to deliver Covid-19 support.

As the fact pattern of a specific crisis may be unlikely to repeat, successful schemes can be designed purely to address immediate issues. However, as a general observation, building and retaining schemes which become part of a country's long-term infrastructure, and are flexible enough to be used as BAU schemes (e.g. as part of an industrial policy) as well as in a crisis, avoid the need to stand up new bodies in the event of any future problems and can facilitate faster response times if economic emergencies arise.

Investment model: direct or through partners

Although there were some hybrid models, the schemes reviewed generally either lent/invested directly or through financial institutions/partners. For example, KfW lends through commercial banks rather than directly and borrowers are also free to choose the lender. Similarly, in the UK, the British Business Bank facilitates lending through participant commercial banks.

By contrast, the ICFC lent directly to companies and made its own investments. While reports suggest that commercial banks may have viewed the ICFC as a competitor, in times of crisis direct lending/investment schemes, such as the US CPP, can be quick to pass funding through to the real economy. However, this will depend on the robustness of their infrastructure and its ability to scale up quickly to deal with volume.

As a general observation, there appears to be a trade-off between schemes that lend/invest directly and can be operationalised quickly versus more cumbersome schemes that work collaboratively with financial institutions but can become part of a wider industry response which can ultimately help to avoid bottle necks in the process.

Regulation: inside or outside the regulatory perimeter

Different approaches have been taken on whether a scheme sits within the regulatory perimeter. For example, while Bpifrance is authorised as a bank and regulated by the ACPR and ECB, Securum, which operated from 1993 to 1997, was set up outside of the Swedish regulatory system.

Short-term, post-crisis schemes set up outside the financial services regulatory system do maximise flexibility and rapid decision making, albeit at a potential cost. Another important question for investors is whether any special regulatory capital treatment will be available for their investments.

Relationships with investee businesses

Relationships have been light and short in some instances, for example, emergency schemes such as the Treuhandanstalt in East Germany in 1990. Longer-term BAU schemes have thought carefully about their levels of engagement. For example, the BGF typically takes minority stakes of between 10 percent and 40 percent in its investee companies and prefers a board seat and an active partnership with the management. The ICFC preferred to be a dormant investor, apart from in special circumstances (e.g. if a company ran into problems, ICFC would use its expertise and knowledge to help turn it around) or for certain reserved subjects, such as director pay or a large investment.

Good stewardship of investee companies has proved important, but the right balance always needs to be struck between active and passive investing appropriate to the number and nature of companies needing support. Longer term investments generally see a greater level of stewardship.

Exiting investments

Successful schemes tend to have clear exit strategies and operational flexibility to make exit decisions that are appropriate for individual investments. For example, Securum returned around half of its funding to the Swedish government in around four years rather than the predicted 15 years. One of the factors behind its success is thought to be the discretion it had to determine when to sell the assets from Nordbanken's commercial borrowers, and its ability to hold on to a large property portfolio until financial recovery made it possible to realise the assets.

Schemes which are fast to support/recapitalise companies, particularly smaller companies, may also have longer activity tails on exit. For example, the US CPP scheme, although fast to recapitalise the banking industry, was left with a tail of small banks which had to be sold by the US Treasury. This may illustrate that exiting from the rapid recapitalisation of smaller entities can be more challenging.

6.2 Wider Considerations for Solutions Development

Wider design considerations

We have sought to apply the lessons of the prior schemes in determining the design criteria for the current recapitalisation scheme:

- Scale and speed – how to deploy recapitalisation of a significant number of companies at speed?
- Economic criteria – how to rapidly identify which companies should receive support on an economic basis?
- Policy criteria – whether to link support to broader public policy or long-term value issues, such as sustainability, industrial strategy, diversity, or employment?
- Publicity – how to engage with businesses on the options available to them?
- Conduct – how to ensure that customers are treated fairly, in accordance with applicable regulatory standards and that existing shareholder interests are appropriately respected?
- Governance – how to ensure the process is transparent, respected and with clear accountability?
- Exit – how to provide an exit route for investors and businesses?

These have led us to several design principles, set out over the following pages that are currently being considered and will influence the form of the eventual recommendations:

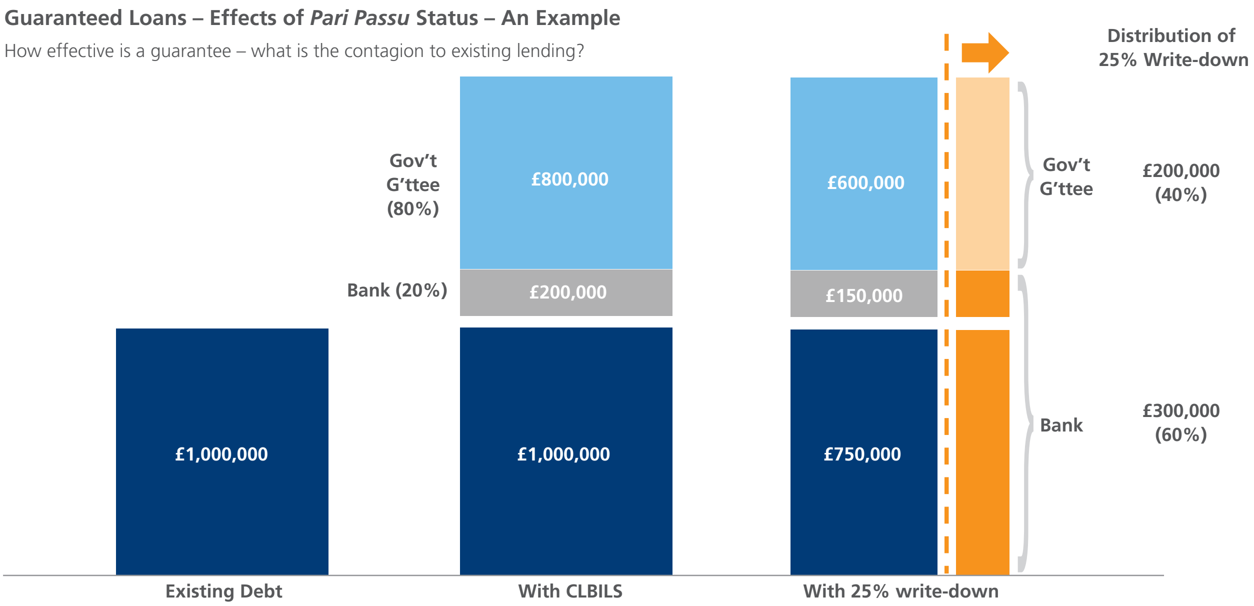
		Ref. page:
1.	The breadth of products being brought into the scheme	37
2.	The trigger point for restructuring scheme eligibility	38
3.	Treatment of government backed loans	38
4.	The degree of optionality provided	38
5.	SME assessment methodology	39
6.	Utilisation of the tax system	39
7.	Management of recapitalisation instruments	39
8.	The funding model of any scheme	39
9.	Enablement and implementation considerations	40

6.3 Consideration of design principles for tools being considered to address recapitalisation needs

1) The breadth of products that are brought into the scheme (applicable to the restructuring scheme):

- Figure 18 illustrates the potential exposure of banks to borrowers who have both stimulus and non stimulus lending.
- Any solution must consider its scope of application – the table below sets out two options with very different scopes and potential impacts.

Figure 18: Exposure illustration



Notes:
1. Outcome dependent on level of existing debt to customers
2. Assumes no receivership to prove guarantee which increases write-down and losses

Table 1: Scheme eligibility options

Focus thus far has been stimulus lending

Our current focus

	Option 1 - Scheme applies to stimulus debt only	Option 2 - Scheme applies to all borrower debt
Pros	• Easier to administer. • Clarity of application. • Fewer inter-creditor considerations.	• Broadest scope of application. • Equitable treatment of similar classes of debt.
Cons	• Potential to leave an eligibility gap between restructuring scheme and growth scheme. • Will only resolve a proportion of unsustainable bank debt.	• Likely to require legislative change to compel certain lenders to participate. • Would likely require an enabling scheme. • Creditor priorities and security would need to be acknowledged within any scheme. • Government guarantees would need consideration.

Narrow — Wide

2) The trigger point for restructuring scheme eligibility (applicable to restructuring scheme):

- A default trigger that limits the application of any recapitalisation scheme to companies that have defaulted on their debt. It has the operational benefit of being an objective, readily identifiable trigger point. This would ensure that SMEs that are able to pay their existing debt continue to do so.
- However, a default trigger would mean that companies have to enter a state of distress prior to being eligible for a recapitalisation scheme.
- An early warning trigger such as a financial metric would extend the scope of the scheme to be much more inclusive and would also have the benefit of supporting SMEs prior to reaching the point of default. It would also benefit banks mitigating the impact on other debt instruments. However, it would give rise to operational complexities around the need for case by case SME assessment to determine eligibility.
- An alternative could be added to a scheme that operates as a pre default conversion of stimulus debt that would improve the businesses/SME's debt servicing commitments and therefore their debt servicing capacity.

3) Treatment of government backed loans (applicable to restructuring scheme):

- Where the government has guaranteed Covid-19 related lending, how should it value its stake and how should we treat hierarchy of stimulus lending in relation to other loans?
- Could stimulus lending be subordinated to provide breathing space to customers?
- We are examining State Aid provisions, including the recent changes to State Aid rules as a result of Covid-19 which might facilitate such treatment.

4) The degree of optionality provided (applicable to restructuring scheme):

- Eligibility is a factor that is still being considered – one route could be to adopt a one product one scheme approach where, for example, CBILS could be exchanged for preference shares and BBLS exchanged for the CTL product.
- However the provision of a degree of choice may have benefits in allowing them to select the most suitable instrument for their needs and it also lessons the potential for conduct issues to arise.
- This may need to placed in a framework whereby both SMEs and lender agree to the exchange – such that SMEs choice is constrained by reference to their business needs.

5) SME assessment methodology (applicable to restructuring and growth schemes):

- A rules based assessment methodology for determining scheme eligibility would be preferable for both schemes to avoid the need for bespoke SME assessment which would likely cause backlogs. In addition – the selection and renumeration of a scheme manager would need to be considered.
- Depending upon the final scheme proposals, a fully rules based system may not be possible as it may restrict eligibility unduly. Consideration will therefore be given to ways of categorising SMEs on a simplified basis, examining the potential use of fintech platforms and other technology tools to enable the schemes and potentially utilising multiple scheme managers.
- The assessment methodology will need to facilitate rebound and growth for viable enterprises rather than recapitalising companies that are unviable.

6) Utilisation of the tax system (applicable to restructuring scheme):

- We are currently examining one product that would result in government backed debt instruments being restructured through long term additional payments via the tax system.
- We are considering as part of our work the legal and fiscal treatment of such an instrument.

7) Management of recapitalisation instruments

Consideration will need to be given as to where and how stakes should be held over the long term:

- Where should the holding sit – within an existing or new entity?
- How should the holding be managed – what would be the constitution and purpose of the entity?
- Should the design be focused purely on Covid-19 related recapitalisation, or set up with a longer-term objective to support capital provision in future crises or other public policy objectives?

8) Funding model of a scheme (Applicable to both schemes):

- The need to determine who the right investors are while managing the interests and rights of existing shareholders will need to be factored into the design of options.
- In the absence of a large enough market for share capital for SMEs to address the need, it will be key to understand how these investments could be made attractive enough to investors without disincentivising the continued running of the business by the owners.
- It is likely that, at least in the early stages, government involvement will be required in the funding, consideration is being given to the form that this might take.
- Consideration is being given to a co-invest model – however this may not adequately incentivise private capital. A preferred return structure will also be considered noting that this may be more difficult to deliver from a State Aid perspective.
- The valuation of any transfer into the restructuring fund would also be a key consideration in analysing any applicable State Aid alongside the terms of the instruments that would be delivered to SMEs.
- Earlier pre default transfer of loans into such a fund would assist with building a case for the fair value of any such transfer being at or around the carrying value.

6.4 Enablement /implementation considerations

9) Enablement and implementation considerations

The existing infrastructure, technology and operational capabilities of current market participants are, in isolation, insufficient to meet the likely nature, scale and timescales of option implementation requirements. Equally, greenfield solutions will also fall short of the delivery timeframes envisaged, necessitating new, innovative implementation models to be developed.

Therefore it is likely that a combination of both the scaling up of existing infrastructure across multiple providers and the development of new operational capabilities will be required. The re-use, integration and build-out of existing and new components offers significant potential to enable rapid deployment and at scale to meet the sustainable industrial strength capabilities necessary.

All deployment solutions are likely to be complex in nature, combining elements from different supply-chains and financial services segments, potentially for the first time. Simplicity of the end to end operation and transparency of proposition to end users will be key design principles. The mitigation of execution risk will also be paramount with the most feasible and credible implementation routes expected to be delivered through time and capability based interim solutions or transition states.

It should be noted that if new organisational vehicles are required there may be a significant time lag for these to be setup and the associated operating model to be in place prior to the start of businesses onboarding.

In this context, a series of design, build, launch, operate and exit challenges require further consideration including the following:

Scale and type of infrastructure build

- What infrastructure to support this solution already exists and how can it be re-purposed?
- Are there existing successful Blueprint/operating models that could be leveraged?
- How significant will IT build/integration and operational setup be, and can this be phased?

Timescales and delivery risk

- What are the envisaged timescales, for launch, operate and exit?
- Can options be implemented in time to support the targeted end user segment or will an interim extension be required to the existing lending schedule and government/bank products?
- What public policy or legal changes, if any, are required to enable the options?
- What level of delivery risk appetite will stakeholders consider acceptable?

Costs to implement and maintain

- What level of indicative build and operate costs are anticipated and considered acceptable? Who funds this?
- What is the envisaged source of funding for the solution option build and ongoing operations?

Operational and end user perspectives

- Is the proposed solution option scalable to meet anticipated demand or dependant on a volume of take up to make it viable?
- What measures need to be taken to ensure this solution option is robust against fraud or financial crime, and what level of monitoring and reporting is required?
- What is the scale of end user support, education and training necessary to implement this option efficiently on-board end users and mitigate conduct risk?

Proposition Design

- What is the overall confidence of delivery for each option and what actions can be taken within the design and development phase to improve the deliverability and mitigate execution risk?

Addressing regional imbalances

- In 2019 London received 79% of all equity invested in the UK SMEs and accounted for 49% of the deals done.[30]
- The recapitalisation supply gap is likely to vary depending on region with greater supply changes outside of London and South East.
- The regional footprint and delivery model should be considered as part of any intervention, given proximity to businesses will be important.
- How will the solution Option help address these regional imbalances?

[30] Beauhurst

7. ENGAGEMENT AND CONSULTATION

Engagement with government and wider stakeholders

Government, Bank of England, Parliamentarians and Regulators

To date, we have engaged with a range of stakeholders across government and regulators to define and test the scope of this work, and our preliminary analysis of the scale on the challenge.

We will be using the content of this interim report to consult further with these stakeholders, and engage with a broader group of parliamentarians, representatives of relevant select committees, and the devolved administrations across the UK, to ensure we have input from a range of stakeholders who represent the interests of the whole of the UK and the end users of any recapitalisation tools.

Business

We have established a workstream dedicated to ensuring the Recapitalisation Group understands the needs of the businesses that will be the end users of any recapitalisation tools we propose. This group comprises the following trade bodies:

- ACCA
- British Chambers of Commerce
- British Retail Consortium
- BVCA
- CBI
- Federation of Small Businesses
- Freight Transport Association
- ICAEW
- IOD
- MakeUK
- PIMFA
- R3
- ScaleUp Institute
- SMMT
- UKBAA

To date, we have shared our preliminary analysis with this group and tested the scope of the work.

On 8 June we will be sharing this interim report with these groups and consulting them for feedback on behalf of their members. We aim to establish how different segments of the end user community have responded to the funding challenge presented by the pandemic to date, their need for future funding, their appetite for and concerns regarding some of the features of the tools being considered, and their preferred sources of information and advice about the options available to them.

Next steps

The feedback received through this consultation process and from our continued engagement with government, parliamentarians and regulators will be shared with our workstreams as they progress their work to recommendations and will be reflected in the final report.

APPENDIX A. RECAPITALISATION MEASURES

THESE ARE WORK IN PROGRESS AND VARIATIONS ON THE DESIGN CONSIDERATIONS ARE STILL BEING CONSIDERED.

A.1 Common equity and warrants

Scheme description

- Combination of ordinary shares and equity warrants.
- Provides an incentive for existing shareholders to participate to mitigate dilution.
- Warrants provide equity upside and reduce appeal versus other private forms of capital.

Target market segments

SIZE	Seed stage start-ups, listed companies accessing CBILS.

Eligibility options

- Business viability analysis would need to be undertaken and assess there are no other funding sources.

Scheme administration options

- Instrument could be packaged into a fund and be spun-off.

Preliminary perspectives and questions

- Lack of incentives to refinance which makes exiting individual investments harder.
- Potential downside is that funding is committed.
- Little downside protection – risk of adverse selection in companies that present themselves.

DRAFT FOR DISCUSSION

A.2 Growth scheme - preference shares

Scheme description

- Key principle is to lower the cost of capital of the private sector deploying new investment aimed at the UK economy. Acts as a form of leverage to the equity investors thereby increasing their returns on equity making them more incentivised to deploy capital.
- Preferred share subordinated to all existing debt including shareholder loans but ahead of the common shares.
- The stated use of proceeds to fund investment should be linked to a direct benefit to the UK economy. This could take many forms for example: Funding research and development.

Target market segments

Type of need	Applicable to all companies that have an investment need as defined in use of proceeds that is being matched 50% with equity.

Eligibility options

- Company needs to demonstrate that prior and even during Covid-19 that the company was profitable and would be able to pay.
- Some sort of pre-qualifying criteria such as leverage caps might be needed to avoid this being politically charged.

Scheme administration options

- Aligning the private sector through a co-investment scheme removes the need for government to be the primary underwriter of investment projects.

Preliminary perspectives and questions

- Potential to have some rating agency equity credit or improve internal commercial bank ratings.
- Question as whether this could well be seen as a bail out of the private equity industry?
- Shareholders and directors would have ability to subscribe to a portion of the preference share.

DRAFT FOR DISCUSSION

A.3 Restructuring scheme - preferred shares

Scheme description

- Preferred Shares subordinate to all existing debt but ahead of existing shareholder loans and common equity. Perpetual, but with built-in incentives /triggers for redemption and /or refinancing as conditions normalise.
- Annual dividend payments but means tested with ability of issuer to roll-up dividend if needed reflecting business growth needs /operating requirements etc.

Target market segments

Size	• Applicable to: – CBILs and CLBILs borrowings – companies with non-scheme unsustainable debt.

Eligibility options

- Triggered by:
  - default, called by the relevant bank
  - existence of specified circumstances (to be identified) at a point-in-time ahead of default, notified by the relevant bank
  - application by the borrower.

Scheme administration options

- Complexity in mechanics for debt to equity swap; current preference for relatively standardised and formulaic approach.
- Consider minimum company size for which instrument is applicable.

Preliminary perspectives and questions

- Consideration to be given to bank loan monitoring standards ahead of default.
- Develop framework and assess timing for common equity convertibility.
- Dividend rate will need to balance impact on a) cashflow recovery /affordability; b) appropriate incentive to repay quickly relative to capital charge to service existing debt; and c) private market commercial expectations if Private Equity exit target outcome.
- Valuation methodologies will have to be clearly articulated and accepted by beneficiaries.
- Consider incentives to repay pref shares e.g. dividend blocker, remuneration caps etc.
- Significant capital weighting for banks. Consider repackaging via government.

DRAFT FOR DISCUSSION

A.4 Preferred shares – indicative term sheet

These are Work in Progress and variations on the design considerations are still being considered.

	Details	Alternatives
Applicable circumstances	• UK companies limited by shares only. • Applicable to: CBILs and CLBILs borrowings only • Triggered by either default, called by the relevant bank, or existence of specified circumstances (to be identified) at a point-in-time ahead of default, notified by the relevant bank. • Application by the borrower.	• Consideration to be given to Bank loan monitoring standards ahead of default. • A conversion into this instrument could also be deemed a trigger event for the purposes of the guarantee under government schemes. • Non-scheme unsustainable debt to be addressed, if required, through variations to this term sheet.
Legal status	• Preferred Shares subordinate to all existing debt but ahead of existing shareholder loans and common equity. • No voting rights. • Could be capable of conversion into common equity upon [material] breach of the terms of restructuring.	• Preferred Shares also subordinate to shareholder loans.
Duration	• Perpetual, but with built-in incentives /triggers for redemption and /or refinancing as conditions normalise. • Potential for exit via: – listing – transfer to public /private sector Covid-19 fund /other 3rd party investors – put back to company at pre-agreed trigger points, e.g. cashflow, profitability – issuer call option at any time at accreted value – requirement to re-finance based on pre-agreed trigger points (e.g. market normalisation).	• Could be a target term of [five to seven years, with a mandatory redemption if distributable reserves become available]/ include redemption date, although need to consider outcome where company is unable to redeem at that point.
Dividend payment	• Stepped to incentivise redemption: [0%] for first six months rising to [2.5%+] in year two and [5%-10%] thereafter. • As an alternative variant, coupon could be the higher of the above or a participating redemption, as a potential incentive to repay, and also it may possibly benefit the State aid approval to have an equity share return to consider.	• Dividend rate to be adjusted for all issuers to reflect external factors/ economic conditions (in addition to company-specific ability to pay). • Automatic dividend repayment/ prepayment of principal amounting to [25%] of distributable reserves.
Conditions on the beneficiary	• No dividends, shareholder loan payments, buybacks or other capital distributions permitted until redemption. • Salary restrictions for existing equity owners and for certain executives / senior staff members and their connected persons. • Anti-avoidance / fraud protection measures. • Voting rights could arise in case of value leakage to shareholders (including shareholder loan repayment, bonuses to owners in default, and default on Preferred Share dividend after certain periods) with statutory power to recover value. • Veto / control rights.	• Introduction of ESG policies, HM Treasury's Investing in Women Code or other similar policy objectives.

DRAFT FOR DISCUSSION

A.5 Restructuring scheme - Contingent Tax Liability

Scheme description

- The Contingent Tax Liability (CTL) is a means tested obligation to the government repayable alongside taxes, charged as a surcharge on taxable profits. The instrument is perpetual i.e. the liability continues until it is paid off or the company / business is liquidated / dissolved.
- The CTL payment is calculated as a set percentage of taxable profits (or other simple calculation that is difficult to arbitrage, but a better proxy for free cashflow) over and above normal corporate tax charges and NIC etc.
- A business that never makes a profit never repays, but accrues an increasing liability. A business that has a difficult period but returns to healthy profit will pay down the CLT rapidly and return to normal course.

Target market segments

Type of need	• Alternatives being considered: i) applicable to CBILS borrowers who experience difficulties ii) BBLS borrowers, requiring bank exposure to be addressed too iii) non-indebted businesses, and eligible for BBLS or CBILS but choosing not to take on debt.

Eligibility options

- Dual trigger of [default] and voluntary application.
- Consider any other eligibility tests, such as, solvency ratios/current loss ratios, etc?
- Borrower is able to elect to convert [all or some] of their scheme borrowings into a CTL.

Scheme administration options

- Application window to be specified.
- Collection of repayments by HMRC through the tax system.
- Calculation of balances and interest to be performed by newly established entity similar to the Student Loans Company.
- Novel, deep and potentially complex integration with HMRC systems required.

Preliminary perspectives and questions

- Consider whether there are any other triggers than default.
- Depending on tax advice, may need to be a capital instrument labelled as a tax liability.
- Potential to apply a surcharge to another metric other than Taxable Profits that better reflects free cash flow.

DRAFT FOR DISCUSSION

A.6 Contingent Tax Liability – indicative term sheet

	Details	Alternatives
Applicable circumstances	• Applicable to BBLS borrowers [entering a state of default] • Borrower is able to elect to convert [all or some] of their scheme borrowings into a CTL. • Dual trigger of [default] and voluntary application. • Application window to be specified.	• CBILS borrowers, requiring bank exposure to be addressed too. • Apply to all debts subject to a maximum proportion of debts? • Consider any other eligibility tests, such as, solvency ratios/current loss ratios, etc.
Legal status	• CTL is a tax obligation – specifically not a capital instrument on the beneficiary's balance sheet. • The CLT ranks pari-passu with other tax liabilities – i.e. super senior.	• Depending on tax advice, may need to be a capital instrument labelled as a tax liability.
Duration	• Perpetual – liability continues until it is paid off or the business is liquidated / dissolved.	• Events of write off may be considered depending on policy objectives.
Interest rate	• Rate [TBD]. • Interest applied to the balance and rolls up irrespective of cash repayments.	n/a
Repayment	• Repayable alongside tax – calculated as a tax surcharge or levy on taxable profit. • If no profit is made, no repayment is due. • Surcharge percentage [TBD]. • Failure to pay repayments when due ranks alongside failure to pay corporate taxes as a criminal offence.	• May be desirable to apply surcharge to a metric other than Taxable Profits that better reflects free cash flow. • Consider early repayment incentives. • Consider early repayment on disposal of the company for value.
Transferability	• Economic benefit of CTL can be assigned / transferred to third parties by HMG as required.	n/a
Conditions on the beneficiary	• No dividends, buybacks or other capital distributions permitted until the CLT is repaid in full.	• Potential to introduce other restrictions e.g. executive pay restrictions on disposal by owners, on value extraction, pre-existing shareholder loan repayments, etc.
CTL servicing	• Collection of repayments by HMRC through the tax system. • Calculation of balances and interest to be performed by newly established quango similar to the Student Loans Company.	n/a
Lender exposures	• N/A for BBLS (full loan converted to CTL). • For CBILS, 80% HMG exposure and 20% lender exposure converted to CTL. • Separate contractual obligation on HMG to pay out 20% of CTL cash flows to the lender.	• Potential for Lender to be bought out through conversion – @100% face value? or, potential for 20% to remain outstanding as unguaranteed loan.
Anti-avoidance	• Consider loss of eligibility if dividends/bonuses/shareholder loans repaid post Covid-19 crisis but pre-conversion to CTLs.	

DRAFT FOR DISCUSSION

A.7 Profit participating debt

Scheme description

- Participating loan notes as alternative to CTL.
- Linked to specified profitability metric(s), interest rate ratcheted to reduce in times of reduced profitability.
- Provides high incentive from stakeholders to refinance and redeem instrument as well as downside protection that protects the against duration of investment.

Target market segments

Type of need	• Growth companies - Provide an equity bridge to a next funding round through debt convertible into preference shares. • Smaller companies less suited to equity participation.

Eligibility options

- Are only CBILS to be refinanced? Could include other pari passu debts.
- Size of debt? Could be £250k-£5m.

Scheme administration options

- Undertaken by lending banks on formulaic basis (to be determined).
- Repayment holiday – circa two to three years?
- Early repayment allowed with premium?

Preliminary perspectives and questions

- Consideration needs to be given to the fact that this could be perceived as expensive equity.
- Can be timely to execute such a structured investment.
- There is also a potential mis-selling risk for less sophisticated companies.
- Potential downside is that funding is committed.
- Politically, a payment-by-results scheme may avoid wider allegations of not giving businesses a chance.
- Spreads the financial burden over a number of years – better for banks and government.
- Proposed repayments: initial holiday [two to three years?] followed 25% x principal per year where principal is adjusted on a LTM basis compared to LTM before Covid-19 (no catch-up, i.e. principal reductions each year are permanent).

DRAFT FOR DISCUSSION

A.8 Restructuring scheme – forbearance measures

Scheme description

- The restructuring scheme is centred around using traditional restructuring tools such as the extension of term loans, moratorium and capital holidays.
- A combination of these tools can be applied. Reassessment would be performed periodically with a view to eventually rehabilitating the loan to performing status.

Target market segments	
Existing finance	• All companies that have received CBILs / CLBILs; could also be applicable to other forms of lending through direction to banks / lenders.
Type of need	• Companies that do not require further injection of funds growth capital, but rather are facing short-mid term liquidity issues and are expected to recover once the crisis eases.
Size	• Companies too small to pay for bespoke restructuring.

Eligibility options

- Government lending only or includes pre-existing debt? Would government provide incentive?
- Cashflow forecast with director statement.

Scheme administration options

- Eligibility assessed by the associated lender?
- For non-gov lending, coordinated response across debt holders? Who bears losses?

Preliminary perspectives and questions

- Does not resolve underlying debt burden on the business. Unlikely to be successful in cases of deeper distress. At what point is it not worth trying?
- Will secured creditors be involved? They will be harder to incentivise.
- Current insolvency framework does not readily facilitate restructuring plans.
- Director remuneration % increases plus dividend payments limited to [2x] % increase in tax paid?
- TPFC – Pro rata extension of TPFC unsecured debt OR CIBLS converts to preferential status? Prohibition on voluntary repayments of TPFC debt?
- Conversion to preference shares as an alternative. Similar criteria, need to consider how to make sure businesses don't go straight for pref shares e.g. slower remuneration increase.

DRAFT FOR DISCUSSION

A.9 Restructuring scheme - conversion to grant

Scheme description

- Partial or full forgiveness of the debt outstanding as part of a restructuring in cases where debt is considered to be unsustainable and viability of outlook is uncertain.
- Likely only to operate in the case of very small exposures where a public policy decision is being made not to enforce on debt.

Target market segments

Size	• Smaller end – Only efficient where amount of debt to be written off is less than the cost of employing other strategies.
Viability	• Less viable end – will be a last resort after considering restructure to save businesses that wouldn't otherwise survive.
Industry	• Most likely to be used in cases where public policy / industrial policy requires that companies / Industries are supported.

Eligibility options

- Consider imposing an eligibility cap.
- Criteria need to be relatively simple such that approvals process can be streamlined.
- Prove the amount of debt they have that has become unserviceable / the amount of revenue they've lost due to the crisis?

Scheme administration options

- Potentially administered by lenders (in line with centralised guidelines?) but could be administered by AMC.
- In case of a claw back clause, ongoing monitoring requirement.

Preliminary perspectives and questions

- Injecting finds at the bottom of the chain will help prevent the problem becoming systematic e.g. suppliers also finding themselves in trouble and so on.
- Will be a challenge to get criteria simple enough to approve at scale, but not so simple as for businesses to easily manipulate their books to get approved – Significant moral hazard risk if potential is signalled too early.
- Do you need to have an anti embarrassment / claw back clause?

DRAFT FOR DISCUSSION

A.10 Delivery mechanism for growth fund: development corporation

Description

- A state or privately owned investment vehicle facilitating minority investments in SMEs and mobilising private capital to (re) capitalise SMEs.

Key design choices

- Build or repurpose an existing inv. vehicle.
- Use both public and private capital.
- Include guarantee support from the government for part of the private investments.
- Leverage prior national experience from 3i (Industrial and Commercial Finance Corporation) and / or international (e.g. KfW, BPI France).
- Scale up existing capacity such as BGF, BBB, Future Fund.

Conditions for success

- Should combine transparent, efficient, and accountable governance with decision-making autonomy.
- Must have sufficient scale, which may require governments to provide additional capital.
- These institutions need appropriate instruments to enable them to mobilise sufficient private finance while channelling their own funding to meet development objectives.

Preliminary perspectives and questions

- Strategy: focus on specific industry, size, type of investment, control strategy, exit strategy.
- Governance: decide on industry participation in the board.
- Independence: operated on mandate, independent from state intervention.
- Legal and regulatory: amend existing legal and regulatory framework if need.
- State Aid considerations: design principles to consider state aid support limitations.
- Funding: government capital and market funding on quasi sovereign risk.
- Operating model: lean yet robust operating model with simplified processes.

DRAFT FOR DISCUSSION

A.11 Delivery mechanism for restructuring: asset management company

Description

- An AMC type structure could help to facilitate the resolution of defaulted COVID-19 schemes guaranteed loans.
- Consideration could be given to government providing a level of funding or alternatively, Asset Protection Schemes may also play a similar role.

Key design choices

- An AMC is incorporated responsible for financing defaulted loans.
- The management and servicing of exposures could be performed by the banks or externalised.
- Initial capital is paid, with potential Government participation in funding or equity.
- Other equity holders might include banks, private equity and hedge funds and domestic and international financial institutions.

Conditions for success

- Potential changes in restructuring framework to allow for the acceleration of converting the loans into some other instrument.
- Insights from professional servicers in devising the target operating model.
- Clear independence of the AMC's operations.
- Ensuring the AMC balances the need for social responsibility vs. a proportionate approach that ensures good value for money for the tax payer.

Preliminary perspectives and questions

- In the current situation the AMC may need to be different than historic AMCs that have primarily focused on real estate as underlying asset.
- The type of AMC needed in this case is likely to cover classes of operating businesses, requiring specific operating model, governance and funding.
- The application of State Aid rules would require consideration.
- With regards to the assets received from banks, specific valuation methods would be required to determine the transfer price – potentially using Long Term Economic Value rather than market value which will be depressed in times of stress.

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APPENDIX B. ECONOMIC ASSUMPTIONS

EY ITEM Club Forecasts (June 2020)

Projections for macroeconomic aggregates					
	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1
GDP (2019 Q4 =100) used f or Revenue Shock	98.0	80.0	82.6	87.0	90.4
Unemployment rate (ILO)	3.9%	7.0%	7.7%	6.8%	6.1%
Bank rate (period average)	0.6%	0.1%	0.1%	0.1%	0.2%

Projections for sector groups, GVA at 2021 Q1 (where Q4 2019 =100)			
Agriculture, Forestry and Fishing	99.5	Financial and Insurance Activities	96.7
Mining and Quarrying	85.9	Real Estate Activities	93.3
Manufacturing	91.9	Professional, Scientific and Technical Activities	98.8
Electricity, Gas, Steam and Air Conditioning Supply	91.9	Administrative and Support Service Activities	89.7
Water Supply; Sewerage, Waste Management and Remediation Activities	94.0	Public Administration and Defence; Compulsory Social Security	96.3
Construction	87.4	Education	84.5
Wholesale and Retail Trade; Repair of Motor Vehicles and Motorcycles	89.3	Human Health and Social Work Activities	94.3
Transportation and Storage	80.3	Arts, Entertainment and Recreation	88.6
Accommodation and Food Service Activities	63.7	Other Service Activities	80.1
Information and Communication	98.2		

Notes:

The above macroeconomic assumptions are representative of EY ITEM Club Forecasts (June 2020) and the following significant assumptions:

The lockdown measures put in place to supress transmission of coronavirus will be fully lifted by the end of Q3 2020 and that a second wave of Covid-19 cases will not lead to a reintroduction of such measures.

The UK and the EU agree a trade agreement to take effect from 1 January 2021.

The GDP estimates in the EY ITEM Club forecasts have been adjusted to reflect EY's analysis of sector supply and demand conditions to provide the basis for the revenue shock estimates used in this report.

Further publications of this report will take into account revised economic assumptions at the time of writing.

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