International Insolvency & Restructuring Report 2021/22

capital markets intelligence

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Cyprus: Corporate distress and financial tools in the era of the pandemic; healing the traumas

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The COVID-19 pandemic has undoubtedly caused a severe disruption in global business. Companies worldwide have found themselves facing severe cash flow difficulties as they may be owed and/or owe significant sums. The disruption of supply chains, the various challenges faced by the workforce, and the worsening of credit conditions are all issues that exacerbated the problems already existing as the legacy of the 2008 financial crisis. This article will examine some of the reasons for corporate distress in the Cyprus market, institutional efforts to tackle the problem and some of the less obvious financing options available to assist a business.

Unfortunately, in Cyprus, it is widely observed that due to the fear of stigma and delusional hopes of recovery, company leaders are rarely willing to initiate business rescue proceedings. These kinds of initiatives are often left to creditors with the risk for company management being that proceedings will get out of their control.

There is also the risk that (unless the creditor is reliant on the business for supplies) their main focus is on recovering their money and not on ensuring the long-term survival of the business. These companies are often referred to as "Zombie" companies as immediate and radical turnaround management is necessary, yet insufficient efforts to achieve this are initiated from the inside.

Another quite important aspect that, unfortunately, recently drove many Cyprus companies into distress is the underrepresentation of the finance function at board level. This means that, in many cases, there is an issue of lack of required control on fundamental key-performing indicators such as average creditor days and average debtor days. Insufficient information on accounting issues exemplifies one category of such business failure. As a result of the abovementioned lack of (self) awareness, disproportionate business expansion has also been a critical factor in instances of corporate distress in the Cyprus market.

The above brings the problem of excessive debt exposure in Cyprus into the spotlight. This is often the result of a lack of (intentionally or not) dependable studies/estimations of investment and lending (on behalf of the banks) purpose and any possible excess of investment budget. It has also been found that a common problem for Cyprus SMEs in decline is the inability to compete in price due to high fixed and variable production costs and small profit margins. This creates a vicious circle putting an additional strain on rescue efforts. Of course, the above deficiencies were exacerbated by the adverse effects of the pandemic on the economy.

The Cypriot Government did take action to support the economy in light of the COVID-19 adversities. At the end of May 2020, the Finance Minister of Cyprus announced further economic measures to assist in the economy's recovery. Collectively the current financial packages have a multi-billion euro value. Direct grants have been given to small businesses and, also, interest rate subsidies for corporates with liquidity pressure have been provided. The stimulus provided to Cyprus companies through the European Investment Bank (EIB) by way of loans backed by a state guarantee and the participation in the Pan-European Guarantee Fund collectively appears particularly helpful not only to SMEs but also to mid-cap companies.

Furthermore, the Cypriot Government implemented loan repayments suspensions and also a postponement of foreclosures.

Concerning the institutional restructuring/insolvency proceedings, in June 2020, the "Department of Insolvency and Related Matters" Law 68(I)/2020 entered into force. It established the Department of Insolvency, which is primarily responsible for the restructuring and modernisation of operational procedures. The new framework is expected to enable the department to meet its duties successfully, and to support the effective implementation of insolvency proceedings for individuals and legal entities. This includes the execution of bankruptcy and liquidation orders and the assessment and evaluation of proposals and potential reforms relating to insolvency and restructuring matters.

A fundamentally sound business with cash flow issues resulting from the pandemic might explore obtaining some form of insolvency protection, such as the recently introduced examinership method under the Cyprus Insolvency Law. Such an action would, in a broad sense, offer a moratorium or breathing space for possibly temporarily insolvent companies.

In this procedure, provided there is (imminent) insolvency, and the court assumes a possible restructuring is feasible, an examiner is judicially appointed on request. The examiner's task is to reach a settlement with the creditors under the protection of a moratorium. If the restructuring attempt fails, the examinership goes into formal insolvency proceedings. The management remains in office during this procedure and works together with the examiner.

The Board of Directors of any distressed company must be alert and ready to take action, rescue and recover the business. There are practical options to consider that may seem unpalatable, but sometimes hard times mean hard choices. Corporate management cannot afford to lose grip of reality and it does not have the luxury to waste time on panic. Instead, there must be careful and daring consideration of all available options. These include DIY or private options outside of State-related efforts.

Factoring is one of these options. Factoring, receivables factoring or debtor financing are all different terms describing essentially the same methodology; the case of a company buying a debt or invoice from another company. The core concept of factoring is that a company in need of cash flow liquidity sells its accounts receivable at a discount to its book value. This allows the buyer of the company's receivables' ledger to profit upon the settlement of the debts at their original book value, which is a higher value than the discounted price paid for them. Factoring, therefore, transfers the ownership of some or all of the receivables ledger at a discounted price. The purchaser of the ledger is then legally responsible for the collection of the transferred debts receivable and assumes the associated risk of non-payment.

As a result of factoring, the company exchanges debt/debts owed to it for less than the total amount due. While it is understood that this might be painful for the company and the shareholders from an accounting and psychological point of view, it provides the company with vital working capital to survive and continue trading. It also removes the administrative cost and burden related to the collection of debts and, by removing the bad debt risk, offers cashflow certainty. Moreover, the company does not have to provide security in the form of a fixed and/or floating charge over the company assets, which would often be required to obtain a bank-provided working capital facility.

However, as a DIY solution, factoring usually costs more than bank-based financial solutions. Moreover, it often provides only a limited beneficial financial impact to the company and, consequently, it can sometimes be perceived as best used to give a one-off solution to a temporary squeeze on liquidity.

Invoice discounting is another way to generate the much-needed cash flow for the rescue of a distressed company. In many respects it is not significantly different from factoring; the company raising an invoice can quickly access a percentage of the invoice value from a finance company for use as working capital. However, a key difference is that the company maintains the legal responsibility for their sales ledger, payment pursuance and invoice processing in the case of invoice discounting. In this case, the receivables ledger is also used as collateral for a working capital facility and retaining the bad debt risk.

As a result, the company's customers are unlikely to be aware of the relationship with the lender, lacking any direct contact with them. This can be beneficial to the longer-term prospects of a company. The sudden introduction of a factoring arrangement can result in customers assuming that the company is in financial difficulties and as a result they may switch suppliers and push an otherwise viable business into insolvency.

Another variant on the above is forfaiting. Forfaiting involves purchasing an exporter's receivables, i.e. the amount that the importer owes the exporter, at a discount by paying cash. The importer must pay the purchaser of the receivables, or forfaiter, to settle the debt. This is another process often used to accelerate the cash flow cycle and provide risk mitigation for the exporter on, potentially, the totality of the debt value rather than, as in factoring or invoice discounting, a limited percentage of the total.

As the importer's bank usually guarantees the receivables, the forfaiter releases the exporter from the risk of non-payment by the importer. When a forfaiter purchases the exporter's receivables directly from the exporter, it is legally referred to as a primary purchase. The receivables technically become a form of debt instrument that can be sold on the secondary market as bills of exchange or promissory notes. This is known as a secondary purchase. Therefore, this is a tradeable mechanism suitable for receivables of a medium to the long-term maturity date.

On the other hand, a short-term fix, not suitable for medium or long-term finance, can be bridging loans. These are a type of short-term finance usually repayable within less than 12 months, also known as "caveat loans" or "swing loans." The purpose of this type of loan is to 'bridge' the gap between a payment falling due and finance/or funds being received from another source (e.g. the sale of a property). Their relatively high-interest cost is a considerable disadvantage.

However, there is a derivative of this credit type that can be more flexible; development finance. While bridging is a one-off loan that bridges a gap between two credit frameworks, development finance is a loan where the funds are generally released in stages. Generally, this occurs as key pieces of the property development or project infrastructure that they are being used to finance are completed. Development finance can also be arranged for much more significant sums of money than bridging, at lower cost, and for longer timeframes. The exit strategy for a development loan is generally either the sale of the property or a commercial mortgage.

Businesses can also use commercial mortgages to obtain finance for the acquisition of property such as offices or land. Commercial mortgages are offered over shorter timeframes than private mortgages, typically five to ten years, although the premiums are based on much longer terms. For businesses wishing to purchase their own space, rather than paying out significant rent amounts, obtaining a commercial mortgage can be a cost-effective option and offer high flexibility.

Less commonly, property investors may use auction finance to obtain land and buildings at below-market rates. Auction finance is usually used for larger finance amounts whereby the profit gained is how the company will repay the borrowed money. Consequently, it is often deemed an appropriate form of finance for property developers and commercial real estate transactions. The loan is initially offered in cash, transforming into equity, usually after an agreed timeframe between the parties has passed without repayment of the loan. In other words, it is the very own equity of the company that is used as loan security.

Finally, mezzanine loans can be another solution. They are 'subordinated' loans meaning that in the event of the liquidation of the lender, the loan will rank after some other 'senior' debts, such as secured bank loans, in preference for payment but ahead of common equity holders.

Mezzanine finance is usually subordinate to senior debt, i.e. first charge loans, often but not necessarily unsecured. Moreover, it is, in most cases, structured to include part fixed and part variable interest. It can be offered in addition to, or as a 'top up' to, funds provided by a main lender, and the usual repayment periods are one to five years.

Many investors and financial institutions regard mezzanine finance as quasi-equity, from an accounting point of view (meaning lower debt levels are maintained, and therefore, access to additional finance may be possible if necessary). As is the case with bridging finance, mezzanine funding is also more suitable for large, profitable deals which can tolerate the relatively high-interest rates associated with it.

Thus, it can be seen that there are numerous forms of financing other than the "traditional" bank lending facilities. The above are just a few examples. Other options also exist, outside of raising new finance, for businesses adversely impacted by the pandemic to help ensure their survival. Apart from maximising the efforts to maintain and enhance shareholder value and minimise shareholder loss, the management could also look internally at cost-control measures. However, the latter course of action might lead to a need to reduce staff levels and/ or renegotiate certain contracts. In all instances, it would be prudent to take expert legal advice before acting.

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