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Rapid financial support to provide urgent liquidity to manufacturing companies via a Debt Equity-Swap option

Jack Harris and Jim McConalogue

This informational briefing proposes that for the purposes of supporting the UK's economic recovery from Covid-19, a Government-backed equity fund should be established to provide manufacturers with the capital required to restructure and grow competitively back into production. In return for a minority stake in the business, a Debt-Equity Swap model, as described using the principles set out below, could inject much-needed patient capital at a time when no other affordable borrowing instruments are available. It would protect critical supply-chain businesses and jobs and would be of immense utility to the high-value manufacturing sector, helping to overcome the challenges faced due to long investment cycles.

1. The challenge: UK economic recovery following the impact of coronavirus

The key concern for all businesses at the moment is the availability of cash, both to support existing operations whilst the economic effects of the coronavirus restrictions are at their most severe, while also remaining in a strong position to return to business as usual and recover some of the lost ground as the restrictions are lifted.[1]

The UK has a total business population of circa 5.9 million (as of 2019) of which the vast majority (circa 99%) compromises SMEs defined as businesses with up to 249 employees. SMEs comprise circa 52% of UK turnover (as of 2019) and circa 60% of UK employment (as of 2019).[2]

The CityUK Recapitalisation Group[3] estimates 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. Moreover, ONS surveys on the business impact of Covid-19 indicate that circa 30% of SMEs are either unsure or not confident with regard to the sufficiency of financial resources to continue operating throughout the coronavirus outbreak.[4] Further surveys of

[1] 'Funding alternatives in difficult time – converting debt to equity', *Farrer & Co*, 18 May 2020. Available at: https://www.farrer.co.uk/news-and-insights/funding-alternatives-in-difficult-times--converting-debt-to-equity/
[2] Department for Business, Energy & Industrial Strategy (BEIS) [Nb. Business segment definitions per BEIS]
[3] The Bank of England earlier in 2020 encouraged TheCityUK to bring together major firms and business leaders to form the Recapitalisation Group (RCG) to help consider the post Covid-19 recapitalisation challenge. See: 'Recapitalisation Group – Interim update', TheCityUK, June 2020. Available at: https://www.thecityuk.com/research/recapitalisation-group-interim-update/
[4] ONS Business Impact of Covid-19 Survey (BICS) results (May 2020)

SMEs indicate that approximately 45% of respondents who have taken out a loan from a government business lending scheme may not repay them.[5]

Economists remain concerned that the loans to business will be a drag on Britain's productivity in the medium term, with executives less willing to invest in capital, skills training and growth because their businesses carry unsustainable debts.

The manufacturing sector is at the heart of economic growth opportunities across the regions of the UK – for example, 90% of aerospace jobs and 65% of defence jobs are reported to be located outside London and the South East.[6] This stands in stark contrast to the large differences in investment levels that remain across UK regions, with London region being the largest market, receiving 73% of all pounds invested and 48% of all equity deals.[7]

2. The supply-chain problem in manufacturing

The overwhelming bulk of manufacturing jobs in the UK are in the supply-chain, which is typically populated by a large and somewhat diffuse network of small and medium-sized enterprises (SMEs) and mid-caps. To be successful post-Covid-19 businesses, these companies have two essential needs: vibrant and vital prime contractors from whom they receive demand, and sufficient liquidity to re-start after an extended lockdown.

UK commentary is devoted to a likely spike in redundancies as the furlough scheme is withdrawn. Currently, this spike will be marked as this national scheme will end for all businesses at the same time, irrespective of sector. More subtle will be a later set of redundancies that would be associated with the gradual restart of different industries and supply-chains – which would therefore be necessarily staggered and consequently less immediately 'visible'. The challenge at the stage of 'restarting' is one of liquidity: companies will have no/reduced revenue at a time when they are having to inject significant cash into purchasing new raw material to 'pump-prime' their manufacturing process. From receipt of raw materials through the manufacturing lead-time, to delivery of finished product to their customers and then the wait for payment terms (the latter being typically 60 – 120 days), there will be no return on the original outlay. For many manufacturers, this 'pump-priming' will occur in 3 – 9 months' time and will be at a point where they may very well find it impossible to sustain greater levels of borrowing. Under this scenario, government is likely to be presented with businesses that survived the pandemic, only to be destroyed by the recovery.

For example, the UK is a world leader in the supply of aerospace products and services but in recent years is currently losing its share of the global aerospace market, falling from second place after the US to third – behind France and roughly equal to Germany.[8] From technology and exports to apprenticeships and investment, the aerospace, defence, security and space sectors are vital to the UK's growth – generating £79 billion turnover a year in the UK, including £46 billion in exports, and

[5] BBRS (Business Banking Resolution Service): The impact of Covid-19 loan schemes on business banking dispute resolution (May 2020)
[6] 'Industry Facts & Figures 2019, A guide to the UK's aerospace, defence, security & space sectors', https://www.adsgroup.org.uk/wp-content/uploads/sites/21/2019/05/ADS-Industry-Facts-and-Figures-2019.pdf
[7] 'CityUK Recapitalisation Group, Interim update' https://www.thecityuk.com/assets/2020/Reports/0e22eca588/Recapitalisation-group-interim-update.pdf
[8] 'Airbus warns more risk to jobs in UK than in France and Germany', https://www.irishtimes.com/business/manufacturing/airbus-warns-more-risk-to-jobs-in-uk-than-in-france-and-germany-1.4277387

supporting over one million jobs.[9] However, we only need look to one flagship aerospace company, Rolls-Royce, which has experienced a sharp deterioration in its civil aerospace business because of the pandemic. In contrast, French and German aerospace industries – because of significant measures taken by their governments – are now likely to emerge from the crisis more competitive and erode the UK's share.[10]

The UK picture of our high-tech manufacturing is therefore one of losing significantly to deeply entrenched advantages in other countries. France or Germany are also both planning to maintain wage subsidy schemes for up to two years to offset the economic impact of the pandemic. Their aerospace industries further enjoy a package of support measures introduced in Paris and Berlin, that would help accelerate the development of a new generation of aircraft. The UK must act in ways similar to France and Germany to retain the UK's competitive advantage in the high-tech manufacturing sector and protect jobs across the regions. It is notable in this context that the ADS trade organisation in the UK operating in the aerospace, defence, security and space sectors put forward its own proposals for a dedicated equity-based, 'trusted', patient capital fund to re-capitalise UK aerospace supply chain companies in the aftermath of the crisis.

3. Managing the debt hangover

The specific problems with debt are that it operates like tax: [11]

- Debt servicing costs reduce the disposable income of the borrower. Higher debt means a higher debt 'tax' and therefore, a greater drag on activity – meaning lower lending by banks and reduced spending by households and companies.[12]
- Debt and taxes also affect incentives. If set too high, they may put people off from working and investing. If the resulting debt overhang is considered severe, the interest burden weakens the debtor incentives to repay. If both borrowers and lenders find themselves subject to the debt overhang, both are worse off.[13]

If a borrower has a large debt overhang, there is a case for restructuring the claim from debt into equity – a debt-for-equity swap. In some cases, the swap can serve as a recognition that an impaired debt is, in substance, an equity claim. But essentially, debt-for-equity swaps can potentially benefit both lender and borrowers, by airlifting a debtor to the safer position on their debts.[14]

4. What is a debt-equity swap?

A debt-equity swap is a form of transaction in which the obligations or debts of a company or individual are exchanged for something of value – specifically, equity.[15] Equity within a company refers to the money that would be returned to its shareholders if all of the assets were liquidated and on the basis all of the company's debt was paid off. A swap would involve an exchange of bonds

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[9] ADS Group, https://committees.parliament.uk/writtenevidence/12550/pdf/
[10] 'Airbus warns more risk to jobs in UK than in France and Germany', https://www.ft.com/content/a9a55e78-df00-4e7a-9492-b6de87528096
[11] 'The Debt Hangover', speech by Andrew Haldane, 27 January 2010. Available at: https://www.bankofengland.co.uk/-/media/boe/files/speech/2010/the-debt-hangover-speech-by-andrew-haldane.pdf?la=en&hash=5D56C8F06C846CDA60F2487AE65F242225FBBF95
[12] *Ibid.*
[13] *Ibid.*
[14] *Ibid.*
[15] Standard investment definitions, consistent with *Investopedia* (www.investopedia.com) and other financial analysis.

for stock in the case of a publicly-traded company. The value of those stocks and bonds that may be exchanged would typically be determined by the market. The swap is generally pursued to help a struggling company continue to operate.

5. Benefits of debt-equity swaps for both borrowers and lenders

A 'swap' of debt for equity presents a number of advantages to a company. The swap can have the effect of improving a company's balance sheet by reducing its debts and increasing its shareholder funds.[16] Interest will no longer be payable, or accrue, on such debt. In the process of converting its existing debt to equity, the company may then find itself able to take on more borrowing, on alternative terms. This will have the consequence of increasing the cash available to the company.[17]

In theory, a debt-equity swap would require the lender to agree to capitalise its debt and become a shareholder instead of a lender. However, the lender may decide to pursue this action if the company is in genuine financial difficulty and the likelihood of the debt being repaid seems remote.[18] The lender might also consider that there is a positive outcome as a shareholder than as a lender, where all it might hope to expect is the repayment of the debt.

By capitalising debt, the lender can even potentially take a controlling shareholding in the company, especially given that the terms of the debt for equity swap may be particularly beneficial to the lender. More directly, the lender may view it as a positive position to acquire shares at a lower price than in normal circumstances, and view their swap as a good investment,[19] particularly given the future of Covid-19 remains uncertain and its ongoing impact on company performance in the current economic climate.

6. Rethinking UK policy: providing urgent liquidity and debt-equity swaps for the high-tech UK manufacturing sector

With further indebtedness being undesirable and/or unachievable and a significant extension to the Coronavirus job retention schemes (JRS/JSS) being unaffordable over the longer term – as it was only designed as a short-term response – a different financial instrument needs to be found. The 'Bailout for Business' paper by the Institute for Government highlights that a potentially longer drawn-out recession could turn a crisis of liquidity into a crisis of solvency, demanding the Treasury explore a more imaginative use of equity and grants.[20]

A Government-backed equity fund should be established to provide manufacturers with the capital required to restructure and grow competitively back into production. In return for a minority stake in the business, a Debt-Equity Swap model, as described using the principles set out above, could inject much-needed patient capital at a time when no other affordable borrowing instruments are available. It would protect critical supply-chain businesses and jobs and would be of immense utility to the high-value manufacturing sector. Such an intervention would help to overcome the challenges faced due to high development costs, lengthy development periods, long time to market, and return

[16] See Farrer & Co, 18 May 2020.
[17] *Ibid*.
[18] *Ibid.*
[19] See Farrer & Co, 18 May 2020.
[20] 'Bailout for business after coronavirus', https://www.instituteforgovernment.org.uk/sites/default/files/publications/bailout-business-after-coronavirus-for-press.pdf

on investment cycles in high-tech manufacturing industry, which inevitably makes it challenging for smaller companies in the supply chain to raise long-term capital from private capital markets.[21]

Unlike the CJRS, a national scheme of this nature would return something of future value to the taxpayer and would also help bridge the significant disparities in capital availability across the regions – thus being in harmony with the 'levelling-up' agenda. It seems likely a Debt-Equity Swap model will be needed immediately if we are to secure the survival and competitiveness of a significant proportion of UK industry.

Research by the Institute for Government emphasises the point at which raising indebtedness for businesses via business loans schemes becomes counterproductive.[22] In that instance, the paper recommends for Treasury that it would be far better to turn to outright equity or grants. To preserve productive capacity and aggregate demand post-lockdown, such alternatives need to be considered. After all, as the Institute research illustrates, unaffordable loans can become the main focus for future company behaviour, rather than bolstering them, and force businesses to focus on paying down the debt rather than expanding. By no longer looking to investing or driving growth, it would thereby hurt the recovery.

There are also multiple legislative and policy adjustments which will likely be needed to accommodate a debt-equity mechanism within the current UK policy context:

- Manufacturers have experienced some difficulties in their access to business loans schemes (such as the Coronavirus Business Interruption Loan Scheme, CBILS) and access to those schemes became problematic due to EU state aid rules.[23]
- A new UK subsidy control system is already being developed – to replace the EU's previous state aid regime – which intends to allow the UK to be more dynamic in providing support to businesses across innovative, R&D-focused industries, to encourage job creation and growth across all parts of the UK.[24] Arguably, this can be tailored neatly to accommodate a debt-equity swap scheme.
- The necessity for a government-backed equity fund to help the recapitalisation of supply chains also raises direct questions for HM Treasury about the availability of 'trusted' patient capital which is sufficient enough to ensure the provision of much needed liquidity for manufacturers to recover, particularly in sensitive industries.
- The recent National Security Investment Bill establishes a welcome new statutory regime for Government scrutiny of, and intervention in, investments for the purposes of protecting national security.[25] The regime must continue to strike an appropriate balance between putting protections in place and continuing to ensure the UK remains an attractive

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[21] The ADS Group have similarly set out such explanations for a dedicated government backed equity-based aerospace patient capital fund. See: https://www.flightglobal.com/aerospace/ads-proposes-1-billion-investment-fund-for-uk-aerospace-to-aid-covid-19-recovery/139752.article

[22] 'Bailout for business after coronavirus', https://www.instituteforgovernment.org.uk/sites/default/files/publications/bailout-business-after-coronavirus-for-press.pdf

[23] ADS Group made similar observations in their proposals for a long-term fund for recapitalising UK aerospace suppliers.

[24] 'Business Secretary sets out new subsidies system that works for the UK', https://www.gov.uk/government/news/business-secretary-sets-out-new-subsidies-system-that-works-for-the-uk

[25] 'National Security and Investment Bill – Explanatory notes', https://publications.parliament.uk/pa/bills/lbill/58-01/165/5801165en.pdf

environment for international investment.[26] In striking that balance, a cautious pathway must be found between tightening of the international investments regime coupled with a lockdown-restricted financial environment – currently operating in the absence of locally available trusted capital – which may have the unfortunate and unintended consequence of denying UK businesses the liquidity required to recover. Without that local capital, British businesses will struggle to re-capitalise out of this crisis.

7. Delivery through a public and transparent body

The CityUK Recapitalisation Group (RCG) has said it is likely that, at least in the early stages, government involvement will be required to recover from Covid-19 and address the under-provision of equity to SMEs. The RCG has argued this could be achieved by establishing a Development Corporation – an 'arm's length'[27] government body or privately owned investment vehicle that could recapitalise SMEs, with the prospect that 'this vehicle could be aligned to hold any debt or equity delivered by the Project Birch Initiative'.[28]

It is evident that some form of arm's length body will need to be appropriately constructed for the delivery of such a policy. One arm's-length solution to the manufacturing challenge in the Covid-recovery environment could be found in a pre-existing business development bank, namely, the British Business Bank.

8. A new era for the British Business Bank

A government-owned business development bank already exists in the form of the British Business Bank – which is dedicated to making finance markets work better for smaller businesses. Notably, during the Covid-19 outbreak, it managed the Coronavirus Business Interruption Loan Scheme (CBILS) by providing financial support to UK SMEs that were losing revenue and seeing cashflow disrupted. It also coordinated the Bounce Back Loan Scheme (BBLS) – which was designed to enable businesses to access finance more quickly. The Bank also managed the Future Fund, which issued convertible loans (of between £125,000 to £5 million)[29] to innovative UK companies with good potential that typically rely on equity investment.

To enable its broader remit, the objective should be to ensure the British Business Bank establishes a subsidiary. It already has two subsidiary companies: British Patient Capital and British Business Investments. A subsidiary of the Bank should be charged with managing an equity fund which would then coordinate resources in order to provide manufacturers with the capital required to restructure. The deals agreed with manufacturers should then enable the company to grow competitively back into production. In return for a minority stake in the business along the principles set out in a Debt-Equity Swap model, the Bank could inject the required capital during the crisis when it has become clear that no other affordable borrowing instruments are available.

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[26] 'National Security and Investment Bill 2020', https://www.adsgroup.org.uk/blog/national-security-and-investment-bill-2020/

[27] The government traditionally defines a non-departmental body (NDPB) as a 'body which has a role in the process of national government, but is not a government department or part of one, and which accordingly operates to a greater or lesser extent at arm's length from ministers'. More information on this can be found on the Public Bodies Handbook, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/686716/The_Approvals_Process_for_the_Creation_of_New_Arm_s-Length_Bodies.pdf

[28] 'Recapitalisation Group – Interim update', TheCityUK, June 2020. Available at: https://www.thecityuk.com/research/recapitalisation-group-interim-update/

[29] 'Apply for the coronavirus Future Fund', https://www.gov.uk/guidance/future-fund

In light of the challenges encountered during the pandemic in implementing the CBILS and BBLS, there have been widespread calls for a review of the British Business Bank. A report by the RSA (Royal Society for the encouragement of Arts, Manufactures and Commerce) has reiterated that call during the crisis by urging the British Business Bank to become a national development. They have also emphasised an enhanced remit to support community stakeholder banking, as is the case in Germany, as well as wider community wealth-building approaches.[30] Since the government is able to explore this new role for the British Business Bank alongside a broader agenda essential to levelling-up Britain through a localised, mutual banking system, the incentives for the British Business Bank in supporting liquidity in this area are manifold.

[30] 'The road to resilience: how community financial services can help level-up Britain', by Asheem Singh, Mark Hall and Eleanor Toner, June 2020, https://www.thersa.org/globalassets/bridges-campaign/invest-in-communites/rsa-road-to-resilience-community-banking.pdf

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