

**Andrew Sallway**

Andrew Sallway, partner, business restructuring, at BDO has over 20 years' advisory experience, and is a regular presenter on technical accounting and insolvency topics. He assists financially distressed businesses with operational, restructuring and turnaround issues.

**Shaun McKinnon**

Shaun McKinnon is an advisory partner at BDO, specialising in corporate finance and restructuring services. His experience ranges from business acquisitions, divestments and private capital raisings, to turnaround and restructuring advice, to the agribusiness and food sectors.

The debt cliff

Is your business prepared?

Andrew Sallway and Shaun McKinnon

Fundamental changes to the Australian business environment in a short period as a result of the coronavirus (COVID-19) pandemic are clearly evident, with many business owners asking what's next.

COVID-19 has resulted in a great deal of uncertainty. Depending on geographic location, businesses have had to remain agile in their response. After nationwide lockdowns in March, we saw an easing of restrictions by June, only to see a new and even more rigid lockdown for Victoria in July when a second wave of COVID-19 infections impacted the state.

The situation around the rest of the nation has been mixed, with several localised clusters emerging in New South Wales and Queensland which have so far been contained. Nevertheless, restrictions on free movement and pre-COVID-19 economic and social activity remain in many parts of the country.

Globally, we have seen the situation escalate, with Europe experiencing a third wave in many geographic regions, with France and the UK recently re-entering lockdown situations. While COVID-19 remains active globally and nationally, it is difficult to determine what will happen next. With this, it is evident that for businesses, risk will remain for some time—especially within high-risk industries.

The sudden change to the business environment in March and then again in July for Victoria, does not quite work in reverse. With

restrictions being eased, green shoots began to appear as businesses started reopening. However, as indicated by the disastrous outbreak in Victoria and ongoing uncertainty in New South Wales, a return to normal may be further away than once thought. We will likely see sluggish economic activity as a result of the current recession, coinciding with the concern surrounding the second or even potential third wave of infections.

As many relief packages—both public and private—were originally planned to end in September, there was a growing concern that without a transition plan, many Australian businesses deferring payments would face a 'debt (or fiscal) cliff' and, if unprepared, would not survive.

As a result, on 21 July 2020, the federal government (government) announced the extension of the JobKeeper relief packages until 28 March 2021 for eligible businesses, with JobSeeker also being extended to 31 December 2020. With this extension, eligible businesses will see their 'debt cliff' pushed to March 2021.

However, in light of the worsening situation in Victoria, on 7 August 2020 the Federal Treasurer (Treasurer) announced the easing of the tougher eligibility rules for the second phase of the JobKeeper scheme.

Now, employers will only have to demonstrate a reduction in turnover in the quarters ending in September and December 2020. From 3 August 2020, the test date of employment moved from 1 March 2020 to 1 July 2020.

Further, on 7 September 2020, the Treasurer extended the 'safe harbour' protections for directors from insolvent trading to 31 December 2020 (previously expiring 30 September). At the same time as extending the safe harbour protections, the Treasurer announced radical changes to Australia's insolvency and restructuring laws, due to take effect from 1 January 2021 (the day safe harbour protections expire).

In addition to the above measures, banks initially gave borrowers the ability to take a six-month holiday from repayments. Various legislative provisions passed by the states in accordance with the government's Code of Conduct for Commercial Tenancies gave tenants relief from paying the full value of rent for up to six months or more in some instances.

These support measures began expiring from September, with many borrowers and commercial tenants having started to repay loans and leases again at normal rates as early as October 2020.

Therefore, we now have a three-tiered 'cliff' emerging as follows:

1. October 2020—repayment of loans and leases recommenced and JobKeeper reduced or expired for many businesses
2. January 2021—expiry of the safe harbour protection for directors from insolvent trading (and implementation of new restructuring laws) while JobKeeper payments further reduce
3. April 2021—JobKeeper expiry.

While it is true that directors need to be planning for the here and now, they must also plan to deal with their accrued debts and assess whether they will make it past the tiered debt cliff. As mentioned, although the JobKeeper and JobSeeker schemes and safe harbour protections have been extended, the safe harbour for directors is set to expire on 1 January 2021. Therefore, it is critical that businesses are checking their solvency to prevent directors from being held personally liable in a breach of their duty to prevent insolvent trading.

Over the past few months, many businesses have gone from panic to information overload to an understanding of how they will make it through COVID-19. Yet, while businesses have begun to acclimatise, many are not thinking too far into the future.

This paper provides a recap on what has happened, analyses the impending debt cliff, and encourages businesses to rethink a way forward to come out the other side.

A quick recap

It's important to understand what has happened so as to understand what is coming.

1. The panic phase: 12 March to 22 March

As COVID-19 cases started growing, the government responded by enacting social distancing measures, restricting the movement of its citizens and enforcing closures of certain businesses.

As this unfolded, the response from our clients and businesses generally was of concern and even contained a hint of panic. By mid-March, our clients started to see revenues falling and many businesses were forced to close. The rising cases of COVID-19, the rapid slowdown in economic activity and uncertainty of the situation was causing a lot of concern. This was reflected on the Australian Securities Exchange, with the All Ordinaries bottoming in March (after a peak only a month earlier).

At this time, we were advising our partners and clients on the use of the safe harbour, risks of insolvent trading and restructuring options. There was genuine concern for the solvency of many clients and contacts with whom we spoke. Those in tourism, retail, hospitality, sports, entertainment, hotels, accommodation and education were most impacted.

2. The information overload phase: 22 March to 7 April

As COVID-19 cases were rising and the economic impacts were rapidly emerging, the government (and other stakeholders) announced new support measures almost every other day. We were beginning to see the evidence the pandemic was having on trading revenue. Businesses went from panic to a holding stage with cautious optimism as new measures were explained. The discussions we were having around safe harbour and insolvency were no longer critical, with the announcement of the suspension of insolvency laws until September.

During this time, our conversations were around understanding support measures, encouraging clients to build cash flows and understand their runway [the amount of time a business can remain solvent]. As more measures were announced and understood, many businesses came back from the brink—but only in terms of short-term cash flow.

3. The realisation phase: 28 April

As the government announced plans to ease restrictions, and government and other stakeholder support measures now released, some businesses were starting to see revenues stabilise and new norms understood—with the ability to now comprehend and forecast for the immediate future.

This was the first time businesses were able to forecast with some level of confidence since COVID-19 swept Australia. Most businesses were able to trade through on a cash flow basis for six months because of liability deferrals and JobKeeper assistance. However, there were exceptions, with COVID-19 being the impetus for corporate collapses, seeing business failures including Virgin, Tigerlily, Techfront, and Colette, which all went into voluntary administration.

4. Up to mid-year fiscal update: 21 July

The government announced that economic support packages (JobKeeper, JobSeeker) would continue past the originally planned end date of September 28 2020, albeit with newly determined rates and eligibility requirements for applicants.



The quote

Over the past few months, many businesses have gone from panic to information overload to an understanding of how they will make it through COVID-19.

Shortly afterwards on 7 September, the government announced an extension of the safe harbour protections from insolvent trading for directors to 31 December 2020 with the intent that new restructuring laws would commence from 1 January 2021. (These new laws have not yet been finalised.)

A debt cliff coming

5. The next phase: 28 September 2020 to March 2021

With public and private institutions pumping money into businesses and households to reduce the financial impact of COVID-19, many businesses have found they can carry on. However, with the recent extension and adjustments to the economic relief packages currently available to businesses, it is important to stay informed of these changes to avoid unfavourable surprises.

As of 7 August 2020, the eligibility requirements for the JobKeeper payment were as follows:

- From 28 September 2020 to 3 January 2021, employers must reassess their eligibility with reference to actual goods and services tax (GST) turnover in the September quarter 2020 compared with the actual GST in the September quarter in 2019.
- From 4 January 2021 to 28 March 2021, reassessment of eligibility will be in reference to actual GST turnover in the December quarter 2020 compared with the actual GST in the December quarter in 2019.
- Employers no longer need to show a relevant decline in turnover in the June and September 2020 quarters.

In addition to the above, the date of employment has also been expanded. From 3 August 2020, the relevant date of employment will move from 1 March 2020 to 1 July 2020. Other conditions for eligibility have not changed.

Some economists believe that Australia is in a position to be government-supported through a long, slow recovery, stating that a sudden cessation to government support could be detrimental to the economy.

At the same time, business debts are ballooning. Debts such as Australian Taxation Office debt, rent, payroll tax and loan repayments have continued to accrue during 2020, as many businesses were given payment holidays but not permanent debt relief from these liabilities.

There is a security blanket that is slowly being removed (from October to March) as this economic relief ceases—can all businesses trade out to the other side?

What other factors will impact recovery?

At the peak of the debt cliff are the various economic scenarios that are interdependent to Australia's recovery. These include:

- consumer behaviour
- the recession,
- the health and safety of the population
- the risk of further 'waves' as seen in other countries and the resultant shutdowns to all, or parts of, industry and community.

Such an economic scenario has already occurred in Victoria as positive case numbers increase drastically. Victoria accounts for around 25% of Australia's gross domestic product (GDP) and employment. The lockdown that came into force from midnight 8 July 2020 is estimated to have wiped out \$6 billion in third-quarter national GDP. The lockdown is also likely to cripple consumer spend-

ing and be the final 'nail in the coffin' for many small businesses—both of which will further add to the deterioration of Australia's economic prospects.

With Australia now in its first recession for 29 years, we are seeing higher unemployment rates—it is predicted these figures will increase before sitting at around 7%. We saw house prices initially decrease. This, coupled with COVID-19 concerns, will likely drive lower consumer spending and economic activity.

While the threat of COVID-19 remains in the community, there is also a material risk for individual businesses. For specific businesses that require close person-to-person contact—such as manufacturing, real estate and construction—extra precautions to keep people safe will impact efficiency, but limit the risk of more shutdowns.

For businesses, there may be periodic shutdowns if cases occur among staff, or clusters emerge in the local community. Worse still, if a second or third wave community outbreak were to occur—as seen in Victoria—it is likely to result in a 'w' shaped economy return, rather than a 'v'.

These considerations need to be factored into scenario plans alongside the debt cliff.

An industry perspective

It is expected that while the shutdowns caused widespread pain for many industries, others have fared better. Table 1 looks at industries which have benefited, those which will bounce back and those at most risk of longer-term pain.

Table 1. How various industries have fared

Low risk: industries which have benefited	Medium risk: impacted but expected to bounce back in reasonable time	High risk: longer-term issues expected
<ul style="list-style-type: none"> • Food and essentials: grocery stores, convenience stores, bakeries, bottle shops and newsagents • Stationery and electronics: working from home requirements, home entertainment • Medical supplies: pharmacies and personal protective equipment providers • Outdoors and fitness (i.e. bike shops) • Online service delivery models: food, clothing, etc. • Logistics 	<ul style="list-style-type: none"> • Healthcare: medical, physiotherapy, etc. • Landlords (although some pain will come) • Professional services 	<ul style="list-style-type: none"> • Retail • Hospitality: pubs, clubs, restaurants or businesses that support them • Entertainment: cinemas, concerts, music, and theatre venues • Tourism operators • Hotels and short-term accommodation • Transport: airlines, buses, taxis, etc. • Education • Property and construction

Source: BDO Australia

Rethink: preparing for the debt cliff

Businesses need to be planning now for the debt cliff and looking ahead to profitability or solvency once support measures expire. It is also important to consider the other factors impacting recovery. This will mean a rethink on the way businesses do business.

There are several considerations businesses should be looking at to avoid falling from the debt cliff, including:

- considering if the business will be able to access the JobKeeper program in future periods, with eligibility continually assessed along the extend two quarters
- undertaking cash-flow modelling for the next 8–9 months
- structuring the business for when stimulus packages end
- testing the business for solvency and the implications for directors' duties
- examining availability of other related cash flow stimulus measures
- considering other actions beyond stimulus, such as
 - the rental mandatory code of conduct relief measures
 - banking relief measures.

The top five things that can be done now

Businesses must look at strategies that will see them through, some of which are as follows:

1. **Accept and understand the debt cliff and begin pre-planning.** Some businesses will fail if they are not planning for the repayment of their deferred liabilities.
2. **Engage with stakeholders early and assess options.** Stakeholders are more receptive to early intervention over late intervention and will look more favourably on businesses which take action early.
3. **Constantly review business models.** As we move forward, some businesses will need to restructure to survive.
4. **Continually assess macro and micro impacts.** This aspect is critical, as there is still a high level of uncertainty. This includes the global impact which has the ability to affect local businesses.
5. **Check solvency/directors' duties.** With the cessation of the temporary safe harbour for directors' duties to prevent insolvent trading set to occur on 31 December 2020, it is critical that businesses check their solvency to avoid the risk of directors being held personally liable for breaches of duty.

With the extension of relief measures, there is newfound hope in the business environment. To ensure businesses put themselves in the best position beyond recovery, it is important they plan beyond the debt cliff, be it September 2020, December 2020 or March 2021, depending on eligibility. **FS**