

Refinancing in the recession

Briefing

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I. Introduction

The economic conditions of recent years have presented companies in Germany, Austria and Switzerland with unprecedented challenges. The Covid-19 pandemic, geopolitical tensions, rising interest rates, soaring energy costs and a sharp rise in inflation have led to a deterioration in the financial situation of many companies after two years of recession. In light of these circumstances, refinancing is becoming a major challenge for many companies.

Against this backdrop, we will examine the current trends in the financing market and best practices for refinancing in more detail, with the aim of showing ways in which companies can successfully implement their refinancing, thus shoring up their competitiveness and avoiding a financial crisis.

II. Current challenges

German companies will have to refinance debt of almost €450 billion¹ over the next three years. This enormous sum is due for refinancing at a time when companies' turnover and margins are under pressure and growing geopolitical uncertainties are leading to gloomy market assessments. Although competition between lenders remains strong, the rising number of companies in crisis and insolvencies means lenders have become much more reluctant to give companies loans. Stricter regulatory requirements from the banking regulators are also making banks generally more cautious in giving loans. In addition, the market for Schuldschein loans has

declined significantly over the past year. These challenges call for innovative and flexible financing strategies.

III. Current trends in the financing market

The good news is that there is no shortage of potential lenders. Germany is still a highly competitive market. Traditional lenders such as banks have been joined by insurers. Debt funds have now also established themselves as alternative lenders and have sufficient capital reserves to cover the capital requirements of German companies. In addition to other traditional sources of financing such as the bond and Nordic bond market and the aforementioned Schuldschein loans market, companies can also turn to alternative forms of financing such as leasing, factoring and securitisation. Moreover, public development loans and grants also play a role in areas such as research funding, renewable energies, green hydrogen and decarbonisation.

IV. Our recommendations for successful refinancing

1. Proactive planning and communication

Companies should not wait until refinancing is imminent, but instead tackle the refinancing of existing credit lines early on. If companies do not start planning in good time, they risk losing the trust of their lenders and finding themselves in a disadvantageous negotiating position. A lack of transparency in communication with financial backers should also be avoided. Instead, companies should demonstrate transparency towards their lenders and keep them regularly informed about progress in the

¹ <https://www.alixpartners.com/media/fxqfcc10/20241022-dach-debt-report.pdf>

refinancing process. It is essential for companies to speak openly with existing and potential new lenders about any financial challenges and to clearly communicate the strategies being developed to overcome these difficulties.

A particular challenge for companies is to ensure that the necessary transparency does not simultaneously raise doubts about their ability to repay the existing financing. As long as there is an overwhelming probability (over 50%) that refinancing will be successful on time, there is no reason to portray the refinancing as uncertain to the existing lenders. This may not only create more uncertainty on the lenders' side, but also harbours the risk of the existing lenders becoming bad-faith creditors who may have to check whether the repayment of their receivables can be contested under insolvency law or whether leaving the loans outstanding or extending them could lead to creditor liability. This sometimes leads to lenders not extending existing loans without a time-consuming and costly reorganisation opinion on the lack of grounds for insolvency or even not accepting repayment.

2. Diversification of financing sources

Depending on just one source of funding can be harmful. Treasurers should consider several financing components so they can respond more flexibly to market changes. For example, relying on a few large banks can make companies less flexible, especially in a market environment where lending is becoming stricter. Diversified access to capital, including leveraging alternative forms of financing, should therefore be a central component of the financing strategy.

It is also becoming apparent that the existing financing structure in many companies is not optimised. There is often still bilateral financing on the basis of a term set until further notice. Although these can be entered into quickly and cost-effectively, they do not offer the requisite certainty of funds. With regard to the stability of financing, syndicated loan agreements, for example, have advantages because they can only be cancelled by a majority of the lenders (usually two thirds) and are therefore much

more stable in a crisis than bonds, Schuldschein loans or bilateral financing.

In addition to the different financing products, the various financing partners are also a key factor in a resilient financing mix. Debt funds, for instance, are able to act very quickly and provide financing at short notice. Debt funds are typically also prepared to accept a higher level of debt from their borrowers and are generally more open to finding solutions for special issues that affect a borrower's creditworthiness. This can be a decisive factor in refinancing, even though the costs of such financing can be higher. Issuing a Schuldschein loan can also significantly expand the circle of lenders beyond the company's go-to banks, as this financing instrument also addresses insurers, pension funds and large foreign, predominantly Asian banks. While many capital market products are only available to large listed companies as a financing component, privately placed bonds can also be used by German SMEs to expand their financing mix and make it more flexible. Without needing to produce a comprehensive prospectus, medium-sized companies can also secure a further building block for a flexible and thus more resilient financing mix via mostly collateralised bonds under Swedish or Norwegian law (known as Nordic bonds). This financing instrument also helps to make a company fit for the capital market and attracted a lot of attention from German companies in 2024, resulting in a record year for the Nordic bond market².

3. Optimising treasury management and working capital

In a volatile environment in which insolvencies are on the rise and can therefore also affect suppliers, customers or other contractual partners of companies, it is crucial to ensure short-term and long-term solvency. The provisions and cash flow planning/forecast required for this must be robust enough. This is an aspect that lenders also take into account when deciding whether to participate in refinancing. It is particularly important to monitor the (payment) behaviour of important customers. Indications of a worsening of a customer's financial situation must be shared between the relevant departments (sales, finance, accounting) to enable a rapid response to an impending default by a customer. Pre-financing or shorte-

² <https://www.bondguide.de/topnews/nordic-high-yield-hy-bond-markt-mit-rekordjahr/>

ned payment terms, for example, can also increase efficiency in payment transactions and thus cut costs. There are various technical and organisational options for this, including the establishment of a centralised system in a group unit that manages and optimises all group-related payment processes in compliance with financial regulatory restrictions (known as a payment factory).

Incidentally, the well-known phrase “cash is king” applies. Improving cash conversion cycles, minimising stock levels and the targeted management of receivables and payables are important factors. Here, too, it is crucial that various departments, such as purchasing and sales, work closely together towards the targets set for them. The efficient utilisation of liquidity within the group of companies also includes cash pooling once the group has reached a certain size. Cash pools have become tried and tested legal structures. If international group companies are also to participate in a cash pool, this can involve considerable effort to set up, since many national legal provisions have to be observed.

Companies can take the following measures to free up liquidity and relieve the balance sheet:

- sale of non-operating assets;
- use of factoring;
- securitisation for the receivables portfolio.

In addition, hidden reserves can be mobilised through the sale and lease-back of fixed assets.

However, none of these measures should be aimed at specifically optimising debt before testing the financial covenants. Instead, the headroom for compliance with the financial covenants should be increased. Headroom of 20-25% is common for bank financing in order to even out fluctuations during the year. Debt funds typically grant more headroom than other financial backers.

4. Stakeholder management

Another aspect of a successful refinancing is to secure the support of the shareholders (in good time), as lenders will often take the shareholders' situation into account when making their decision on financing. In addition to soft factors such as questions about strategic orientation, lenders may also require financing contributions in the form of shareholder loans, silent partnerships or the contribution of equity. If a shareholder makes such a contribution, it is important to agree on the right time for this so that it is recognised as such by the lenders. Involving shareholders in the refinancing process early on is therefore another success factor.

5. Implementation

Preparing and negotiating a refinancing (in a group of companies) should also be controlled centrally in order to avoid a set of different contract terms at different levels. To avoid complexity, the aim must therefore be to assume the various financing components for the entire group via one company on standardised credit terms and not to assume or maintain any financing, or at most less relevant or special financing, at the level of the various group companies.

As soon as the basic structure of the refinancing is in place, the advantages of different financing components must not be jeopardised during implementation. One important and, in practice, often significant challenge is to harmonise the conditions of the various financing components in the best possible way. This applies not only to obvious aspects such as the term, but also in particular to requirements for compliance with financial covenants and all other restrictions (financial and non-financial covenants).

There are numerous pitfalls here, especially with regard to the differences between various financing instruments. In particular, the requirements for non-financial covenants, such as:

- restrictions on taking on financial liabilities;
- restrictions on the provision of collateral;
- restrictions on the disposing of assets.

Otherwise, the lowest common denominator applies, with the result that the borrower may have to be exempted from complying with the covenant (via a waiver). In the worst case, covenants may contradict each other or multiple waivers (with different content) may be required from different financing partners, which can lead to considerable delays and costs.

The financial covenants and their calculation also regularly play an important role in practice. One or two financial covenants (e.g. debt-equity ratio and equity ratio) are common for investment grade financing. In the crossover segment, there are two or three financial covenants (additionally, the interest coverage ratio or debt service coverage ratio), while companies in the non-investment grade are faced with several requirements (in addition: capex restrictions and minimum liquidity). Details depend greatly on the borrower's industry, company size and the current market environment, among other factors.

Ideally, the duties to provide information under different instruments can also be carried out easily (electronically, via websites for example) and as simultaneously as possible. Harmonising different financing instruments also requires some coordination. For example, subsequently adding factoring to the financing mix typically requires certain clauses to be amended in existing loan and bond financing agreements. The same applies to the use of government-subsidised loans, which are generally only issued on non-negotiable terms. The use of such loans should ideally be considered prior to entering into a financing agreement, in which case one of the

banks involved can take on the necessary coordination with the lender of the subsidised loan in order to save a lot of time and effort.

V. Lessons learned from recent cases

Analysis of successful real-life examples shows that companies that act proactively and strategically are much better able to respond to refinancing challenges. This is in contrast to companies that paid less attention to their financing or underestimated the imminent refinancing and fell into financial difficulties when they tried to find short-term solutions.

Companies should use the insights gained to review their financing strategies and thereby increase their resilience to future financial challenges.

VI. Conclusion and outlook

The challenges of refinancing in a prolonged recession have increased, but also offer opportunities for well-organised companies which are prepared to adapt their strategies. Forward planning, clear communication and the use of alternative sources of funding, as well as a supportive network of shareholders and advisors, can be crucial to successfully navigating an uncertain economic environment and remaining competitive in the years to come.

Authors



Alexander Schilling

Lawyer, Partner
Börsenstraße 1, 60313 Frankfurt
alexander.schilling@noerr.com
T +49 69 971477109



Nikolai Warneke

Lawyer, Partner
Börsenstraße 1, 60313 Frankfurt
nikolai.warneke@noerr.com
T +49 69 971477226



Andreas Naujoks

Lawyer, Partner
Börsenstraße 1, 60313 Frankfurt
andreas.naujoks@noerr.com
T +49 69 971477380



Simone Schönen

Lawyer, Partner
Jungfernstieg 51, 20354 Hamburg
simone.schoenen@noerr.com
T +49 40 300397120