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Turnaround Topics

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Restructuring Activity Is Poised to Increase — Recession or Not



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In a year when most major stock market indexes rallied 25 percent or more, and market yields on most junk bonds plunged by 200 basis points, restructuring activity in 2019 had its second-strongest year of the decade. Historically speaking, that is a highly unusual pairing of events. Nobody would say that 2019 was a banner year for restructurings, but it was a surprisingly robust showing considering the stellar performance of global financial markets and aggressive efforts by the Federal Reserve to prolong the economic recovery.

Large bankruptcy filings increased by 21 percent last year, while S&P-rated debt defaults increased by 43 percent over 2018 — with annual totals far exceeding those in a comparable period in the mid-2000s, or in the early post-recession years when

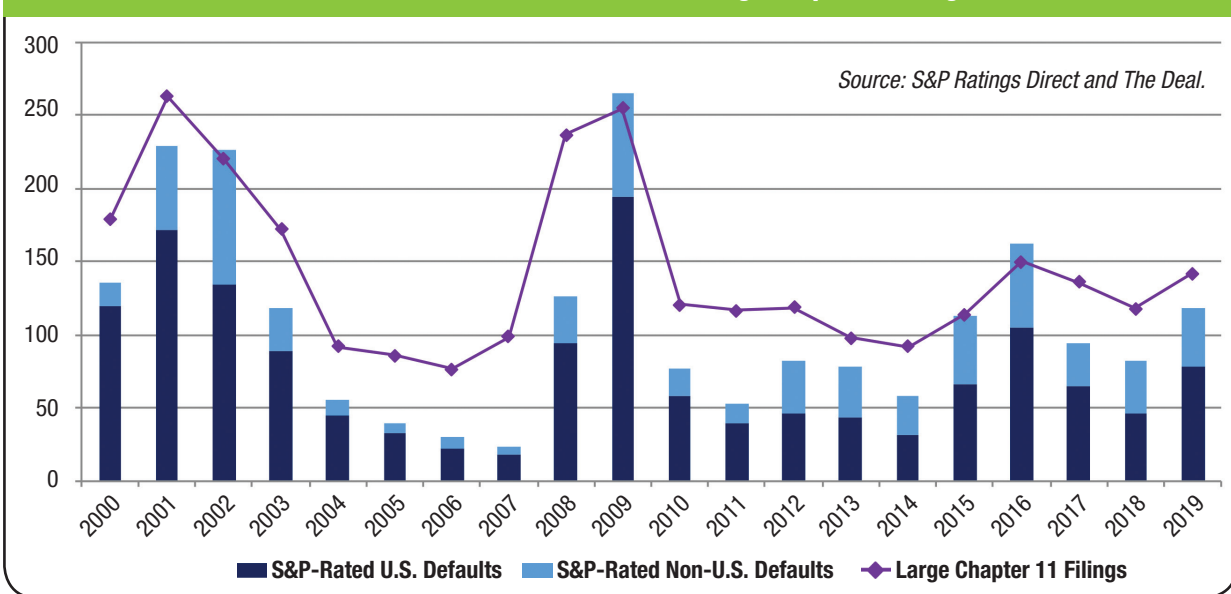
the recovery was still wobbly (see Exhibit 1). This recent uptick is no fluke or anomaly; it is very likely to be the base-case scenario going forward, notwithstanding continued economic growth.

Underlying the strange coupling of elevated restructuring activity with surging markets is a pronounced disconnection between the forces driving financial markets and those impacting “the real economy.” Several trillion dollars of liquidity injected into the financial system by the Fed and other central banks has greatly inflated financial asset prices in recent years, but most measurements of broad economic growth in the post-recession decade have consistently lagged prior recoveries.

For many large companies, profit growth in the last two years has been mostly attributable to the 2017 tax cuts and large stock repurchases, rather than strong organic business growth. This disparity

¹ The views expressed herein are those of the authors and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates or its other professionals.

Exhibit 1: S&P-Rated Debt Defaults and Large Chapter 11 Filings



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widened further in 2019, which arguably was attributable to the Fed’s abrupt reversal on monetary policy, its three subsequent rate cuts, and a reinflation of the Fed’s balance sheet to stabilize the repo market, all of which stoked late-cycle risk-taking activities by investors and lenders but had more muted effects on corporate performance and the consumer economy. It was a liquidity-driven rally in global markets.

Most business leaders today recognize that the U.S. economy and corporate earnings prospects are not nearly as strong as major market indexes would imply. Readings on CEO confidence about the economy and business conditions remain mostly wary, while robust levels of restructuring activity in 2019 support the assertion that this economy is not as strong as advertised. So what is in store for 2020 and beyond? The authors believe that restructuring activity, including out-of-court workouts, will continue to pick up the pace even without a recession.

High-Yield Ratings Distribution Has Deteriorated Badly

Perhaps the most compelling argument that default activity will remain buoyant in 2020 and beyond is the current distribution of speculative-grade corporate credit ratings by letter rating, which has become decidedly “junkier” in recent years. Within the corporate speculative-grade universe (BB+ or lower), of which there are nearly 2,000 rated U.S. issuers, the proportion of issuers rated B- or lower (often referred to as “deep junk”) has steadily increased to unprecedented levels since 2015 (see Exhibit 2).

In each of the last three recessions, the proportion of total high-yield debt considered deep junk began to trend higher in advance of an economic downturn. Today, this trend’s upward drift is off the charts. Consider that approximately 28 percent of speculative-grade issuers are currently rated B- or worse, compared to 13 or 14 in 2005-07 and less than 10 percent in

the late 1990s, which are two comparable periods of late-cycle economic expansion and low default rates. The number of deep junk U.S. issuers now tops 500 and has doubled since 2013.

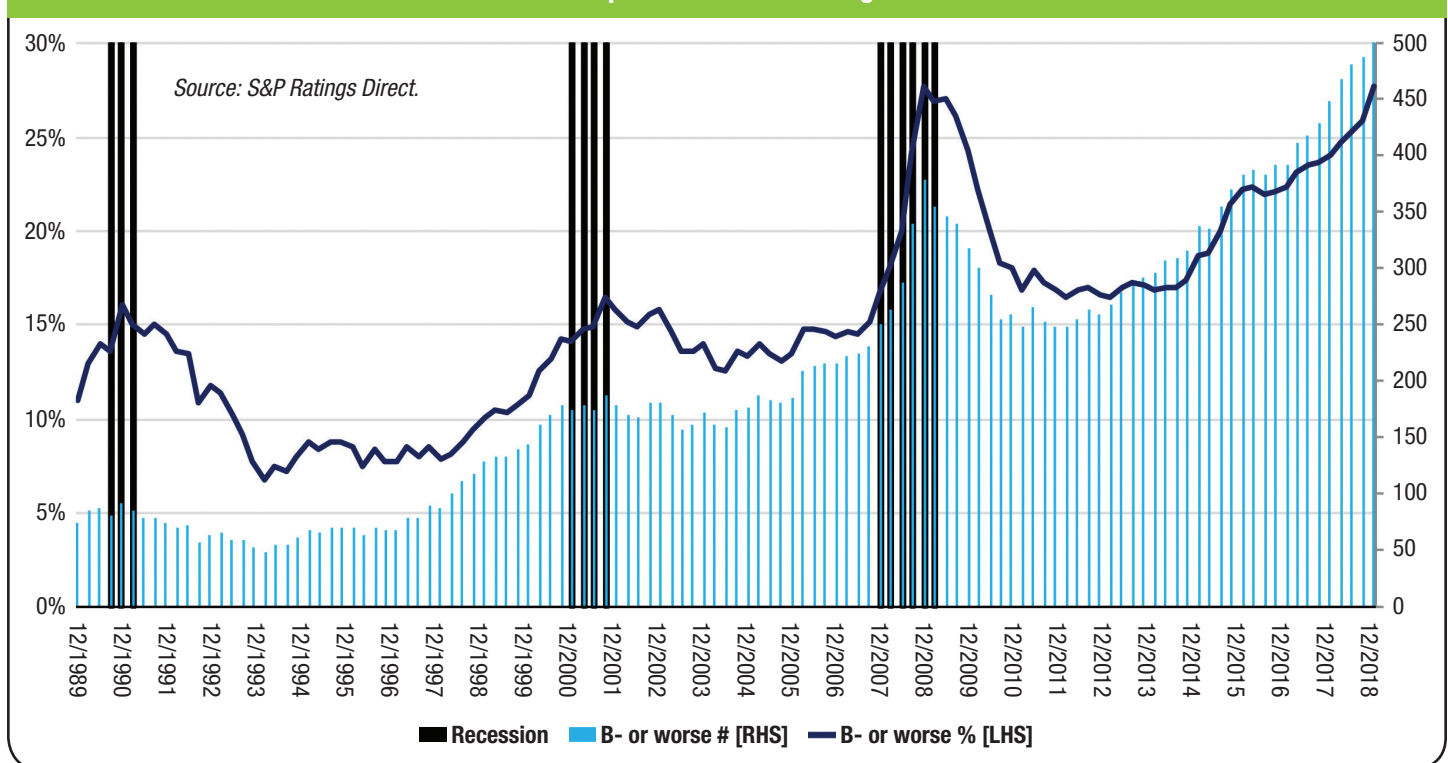
We are very far into uncharted territory with respect to the proportion of deep junk issuers in a non-recession period. To emphasize that point, the proportion of deep junk issuers is higher today than it was in mid-2009 at the height of the Great Recession, when credit downgrades were rampant. At a minimum, the current ratings skewing toward deep junk exposes the vulnerability of these issuers to a business slowdown, economic downturn or shock event.

Why are distinctions within the single B rating category so critical? Because historical default tendencies among B+, B and B- rated issuers differ significantly — more than in any other letter-rating category. According to historical data from S&P, an issuer with a B- rating is more than twice as likely as a B-rated issuer to default within one year (7.7 percent vs. 3.6 percent) and much more likely to default within three years (21.3 percent vs. 12.6 percent) — a huge difference for just a one-notch rating separation.² Default histories, as measured by cumulative default rates over time, are mostly similar for B+- and B-rated issuers but are starkly higher for B- issuers (see Exhibit 3). While the five-year cumulative default rate is in the mid- to high teens for B+- and B-rating issuers, it jumps to nearly 30 percent for B- issuers and 50 percent for the CCC/C ratings bucket, according to nearly 40 years of S&P corporate default history.

Also noteworthy are distinct differences in ratings-migration tendencies among junk-rated issuers, where the B- rating is uniquely a “point of no return” for many issuers. Within the BB ratings cohort (BB+/BB/BB-), it is almost equally likely that an issuer will be upgraded or downgraded one or two notches within a year. For B+- and B-rated issuers, the

² 2018 Annual U.S. Corporate Default and Rating Transition Study, published in May 2019 by S&P Ratings Direct. The stats cited came from Table 14 on p. 31 of the report.

Exhibit 2: U.S. Speculative-Grade Ratings Distribution



likelihood of a downgrade of one or two notches slightly exceeds that of a corresponding upgrade.

However, for B- issuers, the chance of a one- or two-notch downgrade is nearly twice as likely as a corresponding upgrade. Hence, far more B- rated issuers do not make it back up from this slippery slope. More often than not, the B-rating category ultimately turns out to be a one-way ticket to a courthouse. It is why the B- rating is considered the threshold of deep junk.

We did not arrive at this moment by happenstance; it required a unique confluence of business and market factors to get here. Primarily, high-risk borrowers, including many private-equity (PE) sponsors, have demanded and received ever more favorable terms and conditions from pliant lenders and other creditors — terms that have weakened these credits in the judgment of ratings agencies with respect to default likelihood and recovery rates. Looser loan-underwriting standards and documentation have also been a popular topic with the ratings agencies for several years. PE sponsors have been at the forefront of pushing these boundaries, and the impact of private-credit platforms has pressured many traditional bank lenders to play along. Junk bond markets have also been decidedly borrower-friendly for BB/B issuers and enjoyed a resurgence in issuance last year as borrowers sought to lock in lower fixed rates.

What Lies Ahead?

While default activity since 2016 has been dominated by the energy and retail sectors, these two industries currently account for a much smaller share of deep junk credits compared to other sectors, such as technology, media and health care. This implies that defaults ahead will widen out beyond the usual two industry leaders, which would be a precondition for any default cycle to come.

There is also a seasoning aspect to consider with respect to default tendencies of low-rated credits. It takes time to blow through money and fail, even for the riskiest borrowers. We have entered a period where many of those who have borrowed aggressively since 2015 are “ripe” for default.

Mapping out historical one-year default rates by ratings categories and applying those default rates to the current distribution

of U.S. speculative-grade ratings produces a default estimate that tops last year’s total and exceeds most other default forecasts for 2020. We estimate that there will be 95 U.S. issuer defaults versus 78 in 2019, or a U.S. speculative-grade default rate approaching 5 percent by late 2020, compared to 3.1 percent at the end of 2019. (This expected uptick in restructuring activity also would apply to distressed companies without rated debt.) Again, this is not a rip-roaring expectation, but it would be a sizeable gain if historical default tendencies stay true to form (which might not happen in any given year), with upside potential should the economy weaken or leveraged-credit markets tighten up.

What is most concerning about the extraordinary efforts by central banks to forestall an economic downturn is that these measures very likely will worsen the corporate fallout during the next downturn when it does occur. As central banks’ policy actions continue to help lower borrowing rates for most large corporate borrowers, higher-risk companies have not just refinanced debt — many have stepped up their borrowing. The amount of speculative-grade debt outstanding at large domestic companies has nearly tripled since the end of the recession. Buyout transactions have steadily become more leveraged in recent years, with nearly 40 percent of large leveraged buyouts done in the last two years levered at 7X EBITDA or more, according to Refinitiv LPC. In short, restructuring activity is most likely to escalate in 2020 and beyond simply because the pool of potential default candidates, as approximated by deep junk’s share of total spec-grade credit ratings, has grown so large.

As for the prospect of recession, financial markets have blithely moved past this scenario, but most economists still peg the likelihood of one at 20 percent to 30 percent in the next 12 to 18 months, lower than their expectations in mid-2019, but still elevated. We do not know when that day will arrive, but it has been anticipated for a while. Getting caught up in predicting the precise timing of it is distracting, as it fixates on the length of the fuse instead of the size of the powder keg, which is where the focus should be. **abi**

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Exhibit 3: Cumulative Corporate Default Rates by Ratings Cohort

