Recession Or Not, Elevated Restructuring Activity Is Coming

By Michael Eisenband (February 2, 2023)

We can’t recall another new year beginning with such negative sentiment and low expectations for the domestic economy as 2023, with the lone exception of 2009 during the global financial crisis.

A mild U.S. recession beginning later in 2023 is now the consensus expectation among most economists and senior executives while inflation remains well above the Federal Reserve System's target despite seven rate hikes to date and the highest interest rates in 15 years.[1]

Michael Eisenband

The housing market is poised for a painful year as ultra-low mortgage rates have become a distant memory. More Fed rate hikes are coming in 2023, though fewer and smaller. The only silver lining is that corporate earnings have held up reasonably well through the third quarter of 2022, though earnings per share estimates for 2023 are coming down. Such widespread pessimism makes it tempting to be contrarian here and assume that the negativity baked into economic expectations is overdone and won't fully materialize.

The January rally in financial markets reflects this sentiment. Perhaps, but don't bet the rent money on that scenario, as there is much that can go wrong in 2023. For the restructuring profession, 2023 is set up to be a strong year for corporate distress and reorganization whether a recession materializes or not, though to what degree is debatable.

The war in Ukraine rages on with little prospect of resolution in sight and has devolved into a proxy war between Russia and NATO nations, primarily the U.S., and the war's wider economic impacts and geopolitical fallout in 2023 remain unknowable. Our nation's debt ceiling showdown remains substantively unresolved. High inflation remains problematic globally, while COVID-19 variants unlikely to kill us continue to linger and impede economic growth in much of the world.

Domestically, the Fed has said repeatedly that quelling inflation remains its top policy priority, and that battle is not done. Its actions to date have probably caused inflation to peak and certainly have helped deflate various market excesses that were prevalent across the economy prior to 2022. For all the bloodletting in financial markets last year, who would argue that such a pullback wasn't overdue?

However, with labor markets and spending still too strong and little sign that the economy has cooled sufficiently, there is more pain to come from the Fed. Many households will find themselves caught in the crossfire this year, with inflation ebbing but still too high just as a slowing economy starts to hit the labor market and unemployment ticking higher. Corporate layoff announcements have picked up in the last month.[2]

Be assured that within a few months the Fed will be under mounting pressure from markets, politicians and other policy shapers to reverse course as inflation eases, but remains unacceptably high while the cumulative effects of tight money policies begin to grind on the economy and hurt corporate performance.

Most advocates of Fed policy easing in 2023 will be arguing on behalf of their investment portfolios.

The greatest determinant of how the year ahead breaks is likely to be whether the Fed stays the course in its inflation fight or yields to market forces clamoring against more tight money and efforts to reduce credit markets' dependence on extraordinary Fed support.

All Eyes Are on the Fed in 2023

The Fed's steady determination to implement aggressive monetary tightening actions to slow economic growth caught markets by surprise in 2022 despite the Fed's clear signaling of what was coming, with large rate hikes and balance sheet reduction continuing uninterrupted since mid-2022.

Short-lived market rallies reflected investors' fleeting hopes that the Fed would ease up a bit, to no avail. How long will it stay the course in 2023?

Ultimately, the Fed doesn't have an entirely free hand in its fight to tame inflation. There is growing recognition that its policy options going forward are handcuffed by the moral hazard effects it encouraged after more than a decade of easy money. In short, cheap and easy money created a barrage of borrowing in recent years by businesses and other private sector entities.

U.S. syndicated institutional leveraged loans outstanding now top $1.4 trillion versus $900 billion in 2017, a nearly 60% increase in just five years, according to Refinitiv LPC,[3] notwithstanding market share taken by private credit platforms.

The ratcheting up of leverage in leveraged buyout deals and other aggressive corporate financing actions since mid-decade are mostly attributable to exceedingly low borrowing rates driven by Fed policy decisions.

As credit markets lose Fed support and migrate toward true market-determined rate levels, it's becoming apparent that large swaths of the leveraged corporate sector cannot tolerate high market rates for long and may be unable to service or refinance debt obligations if market rates revert toward pre-2008 historical averages while economic growth sputters.

This scenario becomes problematic once we move past 2023, when speculative-grade debt maturities start to become onerous. Soon enough, the Fed will feel compelled to ease monetary policy to prevent an ounce of pain from becoming a world of hurt for leveraged borrowers — even if highish inflation persists. This path is fraught with potentially negative outcomes, primarily a resurgence of inflation.

Huge borrowing needs of municipalities and the U.S. Department of the Treasury will also pressure the Fed to intervene in credit markets to lower key interest rates and support credit flows and market liquidity, despite its still bloated balance sheet and the inflationary potential of such a move.

Prospects for Restructuring Activity in 2023

2022 was hardly a standout year for restructuring activity, but it ended on a high note with 14 large filings in December, the largest monthly total of the year, and continued to be robust in January.

Filings in the second half of 2022 easily topped first-half filings, which were hurt by dismally few filings in the first quarter of 2022. However, the year as a whole was not a strong one for restructurings, going strictly by the numbers, with 103 large filings, down nearly 15% versus 2021, itself a sluggish year.

The bankruptcy leaderboard reshuffled in 2022, with the health care, financial services and real estate/lodging sectors accounting for nearly 40% of all filings, while the energy and retail sectors took a breather.

On average, filings were smaller too, with 36% of large filers having liabilities at filing of $50 to $100 million, slightly higher than 2021 and well above the 24% average in prior years. At the other end of the size spectrum, last year's more than $1 billion filings matched 2021 with 16, most coming in the second half of 2022.

Many restructurings avoided the courthouse, with S&P reporting that 44% of default events in 2022 were distressed debt exchanges, with many unrated names also engaging in aggressive liability-management transactions that probably averted a filing.

This trend will continue in 2023, as sponsor-owned companies face their most challenging environment since 2009, given the ratcheting up of interest rates and oncoming economic headwinds.

Expect to see sponsors pull out all the stops to defend investments, especially more recent ones, and engage in more debt exchanges, distressed debt buybacks, asset dropdown transactions with unrestricted subsidiaries, non-pro rata capital raises, equity cures and negotiated covenant waivers, with a Chapter 11 filing as a last resort.

The ability of sponsors to execute such maneuvers will depend largely on the precise language of the credit documents and the willingness of creditors to push out a maturity, take a haircut or commit more capital to a high-risk enterprise. There is nothing pro forma about any of this.

Markets may be underestimating the impact of high interest rates on many leveraged borrowers, which aren't immediately draining on cash flow but take a cumulative toll over several quarters.

Base rates for most leveraged loans jumped to 4.50% to 4.75% in 2022 — an increase of at least 350 basis points for borrowers with Libor floors and even more for borrowers without Libor floors.

This represents a significant spike in borrowing costs, not only for new issuers but all issuers, with all-in yields for many leveraged loans approaching 10%, in some cases nearly doubling from 2021.

With some $2 trillion in total U.S. leveraged corporate loans outstanding, this will translate into approximately $80 billion or more in additional interest expense for leveraged borrowers in 2023 versus 2021 if base rates remain near current levels.

For all the dire economic concerns for 2023, forecasts for defaults and restructuring activity remain surprisingly moderate in the year ahead. The three major rating agencies expect a U.S. spec-grade default rate over the next year to be in the range of 3.5% to 5.0% — a sizable jump from the currently depressed default rate of 1.8% but far below historical default rates consistent with a recession and/or default cycle.

The tally of annualized bankruptcy filings and debt defaults during a true default cycle typically totals between 200 and 300, which nobody is expecting this year.

Similarly, the distressed debt ratio, a reliable harbinger of future default rates, implies an appreciable uptick in default activity by late 2023 from modest levels but nothing resembling a wave of defaults.

Curiously, credit markets aren't anticipating a surge of restructuring activity in 2023 despite the spike in yields and wide expectation of economic malaise and ground-level sentiment among many advisers and counsel that a sizeable buildup of potential restructuring activity has already begun.

2023 is poised to see a steady uptrend in restructuring activity, but it may not be the blowout year that some professionals are expecting.

Given the generally upbeat prospects for our profession in 2023, that's a disappointment we can live with.

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[1]https://www.forbes.com/sites/siladityaray/2022/11/17/jpmorgan-forecasts-mild-recession-in-2023--heres-what-major-financial-institutions-predicted-this-week/?sh=3aac756f8011.

[2]https://www.reuters.com/markets/us/corporate-america-leans-job-cuts-recession-fears-mount-2022-11-07/.

[3]Refinitiv LPC's Leveraged Loan Monthly, November 2022, slide 47.

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