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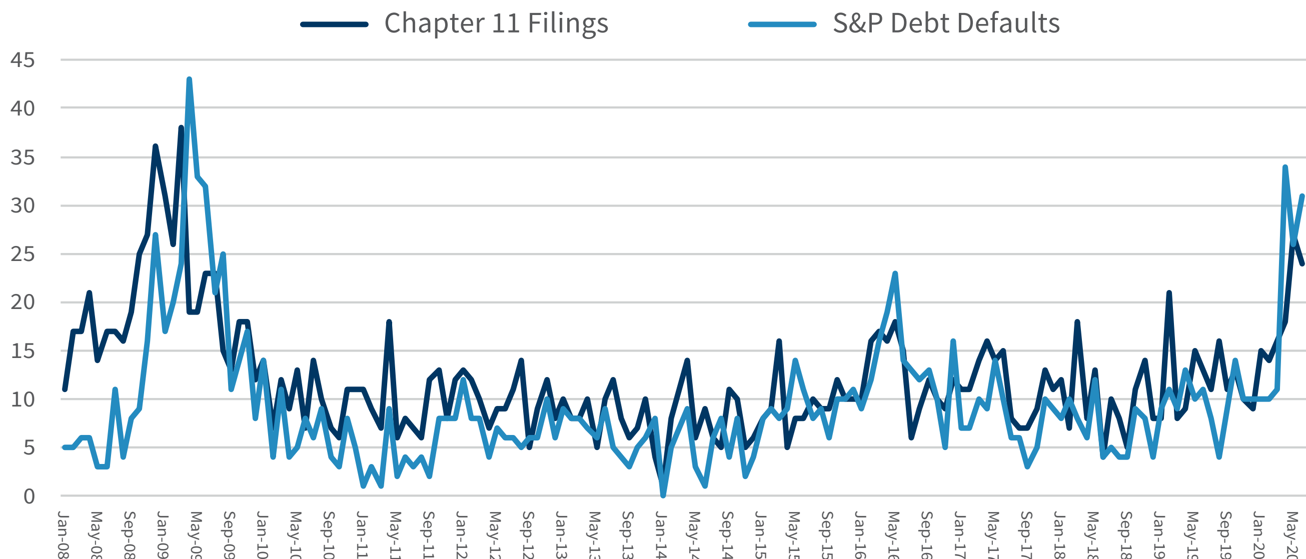
The Halftime Report: High Scoring First Half Suggests More Second-Half Action

Whew! We need a quick breather following a memorable first half for restructuring activity, punctuated in the second quarter by a pile-on of bankruptcy filings and debt defaults that was nearly unrivaled in the record books. How wild was the second-quarter action? It was easily the strongest quarter for restructuring activity in over a decade. Comparisons to 2009 are appropriate (Exhibit 1). However, we'll need to see at least several more months of elevated filings and defaults before that comparison becomes a serious discussion.

Exhibit 1 - Monthly Filings and Debt Defaults



Source: *The Deal* and *S&P Ratings Direct*.

Let's acknowledge that nobody foresaw an economic downturn arriving the way it did, via a global pandemic that shut down much of the national economy for several weeks. In early 2020, even the most ardent bears were expecting restructuring activity to merely grind higher, as it had for many months prior to the outbreak of COVID-19. Those predicting a recession weren't expecting a shock event of this magnitude to trigger the downturn. The wave of debt defaults and large bankruptcies that has ensued since the arrival of COVID-19 is attributable not only to the business interruption resulting from the shutdown, but the financial vulnerability of many large companies whose aggressive capital structures could not withstand deviations from plan, even for a few months.

Now let's take a look at those halftime stats[1]:

- There were 114 large (>$50 million) Chapter 11 filings in 1H20 vs. 74 in 1H19, an increase of 54%.
- Most of the action came in the second quarter: There were 69 large (>$50 million) Chapter 11 filings in 2Q20 vs. 37 in 2Q19, an increase of 86%.
- The 69 filings in 2Q20 were the most in any quarter since the 95 filings in 1Q09 at the height of the Great Recession.
- There were 33 very large (>$1 billion) Chapter 11 filings in 1H20 vs. 12 in 1H19.
- There were more $1 billion-plus Chapter 11 filings in 1H20 (33) than there were in all of 2019 (26).
- Hence, the average size of a filing (liabilities at filing) increased by nearly 85% in 1H20, to $845 million vs. $460 million in 1H19.
- The energy and retail sectors continue to lead all industries in filings, accounting for 20% and 16%, respectively, of all filings in 1H20.
- Private equity-backed companies accounted for 30% of filings in 1H20 vs. 36% in 2019.

As for S&P-rated debt defaults:

- There were 122 S&P-rated debt defaults in 1H20 vs. 63 in 1H19, an increase of 94%.
- The 122 defaults in 1H20 exceeded the total of 118 defaults for all of 2019.
- There were 91 S&P-rated debt defaults in 2Q20 vs. 34 in 2Q19, an increase of 167%.
- The 91 defaults in 2Q20 were the most in any quarter since the 108 defaults in 2Q09 at the height of the Great Recession.
- Approximately 70% of rated debt defaults in 2020 and 2019 were U.S.-based companies.
- Missed interest or principal payments were the leading cause of defaults in 1H20, accounting for 40% of all events of default, followed by distressed debt exchanges at 27% and bankruptcy filings at 24%. This suggests more bankruptcy filings to come in the second half, as missed payments, most of which occurred in 2Q20, often are a prelude to a bankruptcy filing.
- The S&P U.S. speculative-grade default rate, which is measured on an LTM basis, surged to 5.3% in June compared to 3.1% at the end of 2019 — a significant movement in just six months, considering the lagging nature of the metric.
- While the retail/restaurants and energy sectors led all industries in defaults, the consumer products and media & entertainment sectors were also near the top of the leaderboard.

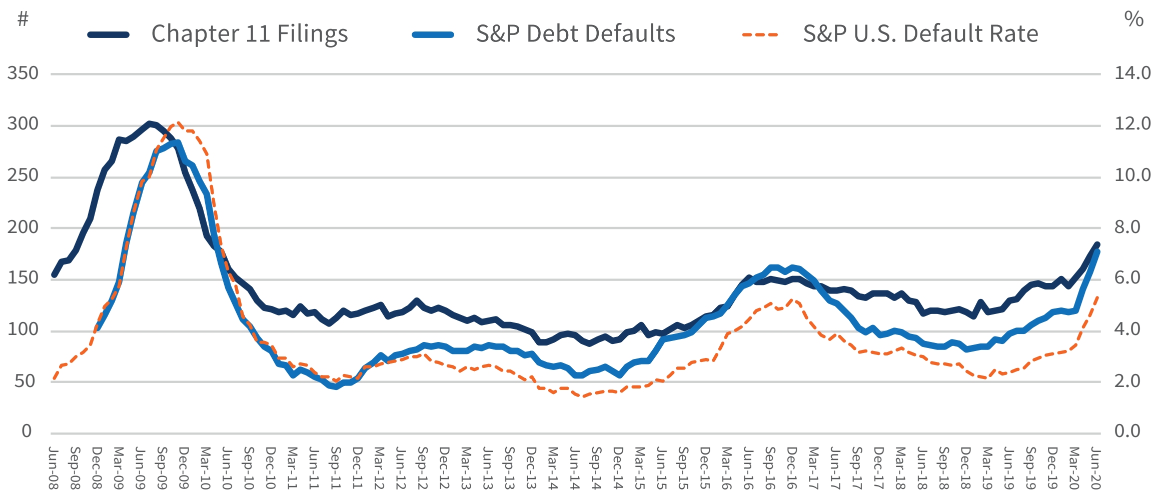
Before anyone gets too animated about restructuring activity in 2020, it's worth noting that while a U.S. recession call already has been made by the National Bureau of Economic Research (NBER), it is still a bit too soon to say that a bona fide default cycle is underway. The NBER's quick recession call was based on the severity of the economic contraction that occurred in March through May, but it is the duration of elevated restructuring activity that largely will determine if a default cycle is happening or has occurred. For instance, a wave of energy-related defaults in early to mid-2016 caused filings and defaults to spike that year, yet that heightened activity was neither intense enough nor long enough to constitute a default cycle (Exhibit 2).

Certainly, it appears we are well on our way to what will be a legitimate default cycle, with S&P and Moody's both expecting the speculative-grade default rate to exceed 12% by early 2021 under a base-case scenario. There has been little letup in restructuring activity so far in July, and the reopening of the economy, along with surging financial markets, has done little to quell filings and defaults in the last two months. Moreover, many sectors

[1] All Chapter 11 statistics cited sourced from *The Deal*; all debt defaults statistics taken from *S&P Ratings Direct*.

of the economy are not expected to recover meaningfully any earlier than 2021. However, keep in mind that running 12-month default and filing totals peaked in the range of 275-300 at the height of the Great Recession while they currently are running below 200 (Exhibit 2)—though it is still early in the game. We estimate it will require an average of at least 20 filings and/or defaults monthly for the balance of the year to confirm that we are solidly in default cycle terrain. Working against this scenario are buoyant leveraged credit markets that are once again open to all but the riskiest issuers, a pliant Fed that has indicated it will do almost anything to avoid a stall-out of the recovery, and overall market sentiment that continues to overlook the lingering economic effects of the COVID-19 pandemic. Can a default cycle persist indefinitely alongside roaring financial markets? It hasn't happened before. We'll find out soon enough.

Exhibit 2 - Chapter 11 Filings and S&P Debt Defaults 12-Month Rolling Totals



Source: *The Deal* and *S&P Ratings Direct*.

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