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Turnaround Topics

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Corporate Restructuring Activity Is Set to Increase

How Much and How Soon Is Debatable

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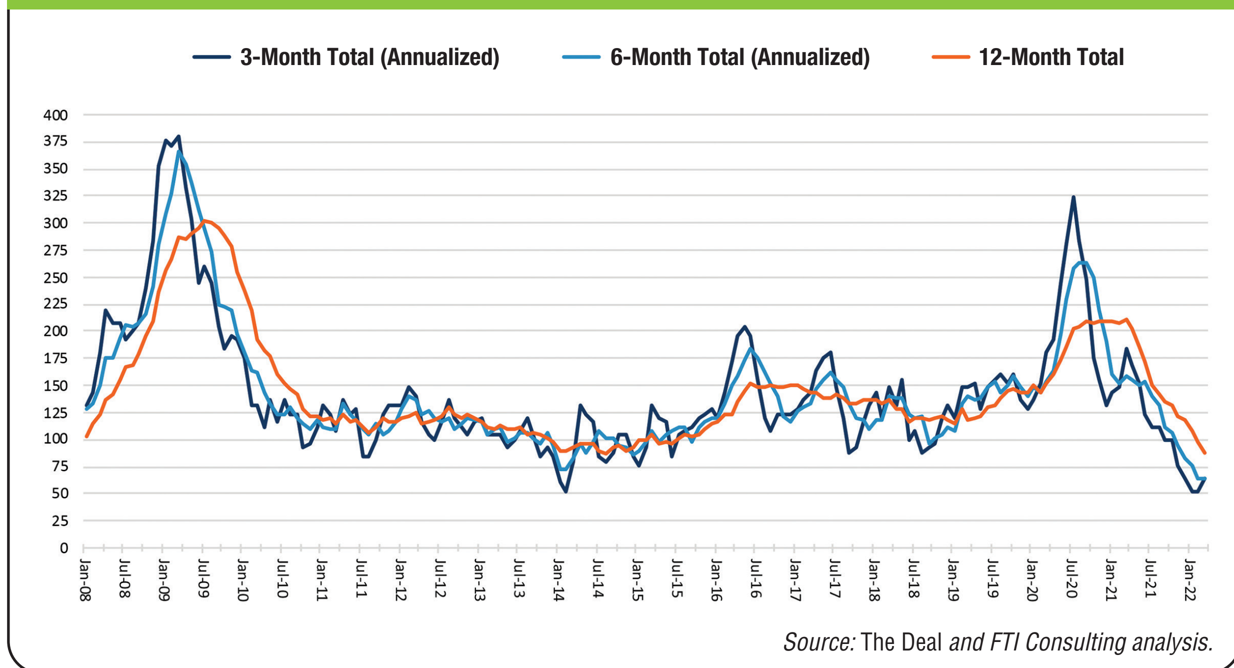
The slump in bankruptcy filings and other restructuring activity for over a year is hardly a secret within the restructuring-advisory profession, but the extent of the falloff tends to be underappreciated. Plummeting bankruptcy filings are a phenomenon across all business enterprises, with commercial filings (regardless of size) falling 43 percent last year compared to 2019 and another 20 percent to date this year. The COVID-related corporate default cycle of 2020 effectively peaked in August 2020, just five months after COVID-19 lockdowns began, after which restructuring activity has consistently subsided, running counter to widespread expectations at the time as well as historical precedent. It was an abrupt end that caught many restructuring professionals by surprise. Nearly two years later, there is nowhere to go but up for restructuring activity, but its trajectory is unclear.

Filings steadily declined throughout 2021, with the number of large corporate bankruptcies (greater than $50 million of liabilities at filing) falling by 45 percent (YOY) last year and ending the year with the lowest annual filing total since 2015, while S&P's speculative-grade default rate fell to a seven-year low of 1.5 percent from 6.7 percent at the end of 2020. Filing activity from the third quarter of 2021 through the first quarter of 2022 was particularly anemic, touching some monthly lows not seen

Exhibit 1: Large Chapter 11 Filings (Greater than $50 Million of Liabilities at Filing)



Source: The Deal *and FTI Consulting analysis.*

since 2013-14, when the U.S. economy finally broke free of the last remnants of the Great Recession. Annualized three- and six-month filing totals still lag the trailing 12-month total, meaning that current filing trends remain depressed (see Exhibit 1). Not only were there many fewer filings in 2021, they were considerably smaller in size, too.

The average size of a large filer (greater than $50 million of liabilities at filing) fell by more than 50 percent last year, to $325 million from $800 million in 2020. There were just 16 filings of at least $1 billion in 2021 (and just five to date in 2022) compared to 50 filings in 2020. These trends have continued mostly intact through mid-2022; large filings through May 2022 were down nearly 50 percent compared to the same prior-year period, while the U.S. corporate default rate edged lower to 1.3 percent (and lower in Western Europe at 1 percent), even as the war in Ukraine and its economic impacts persisted, inflation raged and the global macroeconomic backdrop deteriorated.

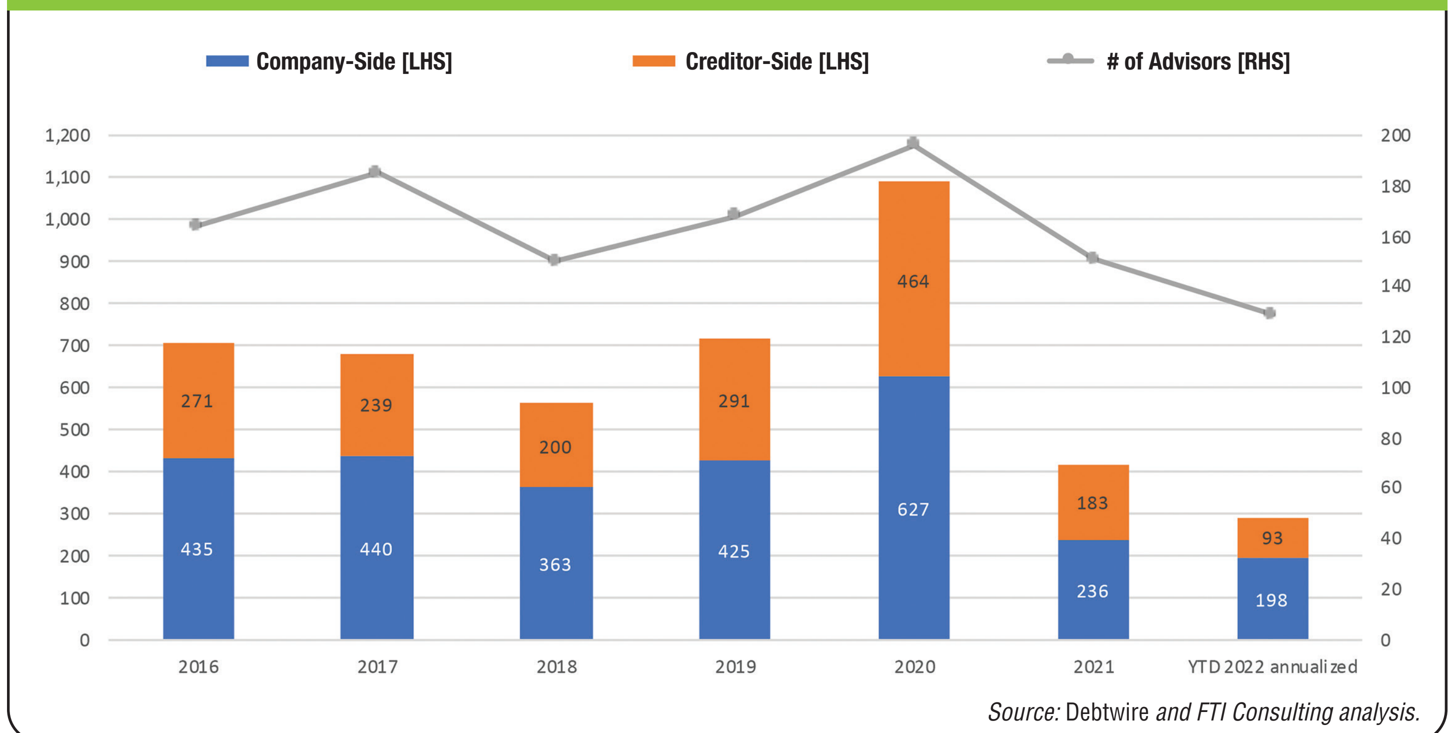
Corporate chapter 11 filings to date are still skewing heavily toward smaller filers (those with liabilities at filing of between $10 million to $50 million). Restructuring activity has ticked higher in recent months but remains well below levels that would be considered average by any historical standard, and it is tracking below 2021's subdued totals. It has been a challenging period for the profession, and this has some impatient observers wondering when a meaningful upturn in restructuring activity can be reasonably expected.

Financial advisor (FA) mandates[1] are another measure of how busy the profession is, and those readings tell a similarly downbeat story, as one would expect based on recent filing activity. FA mandates fell even more sharply than the decline in large corporate filing activity last year, with the number of total FA mandates plunging 62 percent (YOY) in 2021, far below levels of the four years prior to COVID-19 (see Exhibits 2 and 3). This is also attributable to fewer and smaller filings. FA mandates to date in 2022 through April also trail comparable prior year totals and will set an annual low (since *Debtwire* began tracking mandates in 2014) of approximately 300 mandates if they continue along at this meager pace in the second quarter of 2022, which seems unlikely if corporate distress picks up moderately. There's little debate that the restructuring profession has been experiencing a period of severe drought since mid-2021.

Where do we go from here? History shows that it takes six to nine months from the onset of economic adversity to see a notable upturn in restructuring activity, so it is too soon yet to expect a material upswing in filings. Still, the relative dearth of new filing activity so far in 2022 has caused anxiety for some restructuring professionals over when such a scenario will materialize — if it does at all. Filings have been so depressed since mid-2021 that a modest or moderate upturn in activity will not be enough to reinvigorate advisory work.

However, this is the prevailing expectation, with the two major credit-rating agencies forecasting a U.S. speculative-grade default rate of just 3-3.5 percent by early 2023, well above its current low rate but also below its long-term average of 4.3 percent — hardly the stuff of default cycles. Fitch's U.S. corporate default rate forecast for early 2023 is even lower than that. Moreover, distressed-debt totals have moved higher in recent months from near-record-low levels, but the current distressed-debt ratio of 4.3 percent portends below-average default activity in early 2023. Despite consen-

1 "Mandate" is defined herein as the engagement of a financial advisor or counsel by a distressed or bankrupt company or a related creditor group, either official or *ad hoc*, for purposes pertaining to a restructuring event, either in or out of court. *Debtwire* has tracked financial advisor and legal counsel mandates, both in and out of court, for several years based on court filings, press releases and its journalists' reporting. *Debtwire*'s mandate tallies are not exhaustive, as many out-of-court mandates are kept confidential, but they are substantial and directionally indicative of restructuring activity for larger companies, typically those with liabilities greater than $50 million. All references to advisor mandate totals herein are sourced from *Debtwire* data.



Source: Debtwire *and FTI Consulting analysis.*

sus expectations of aggressive Fed tightening, an economic slowdown in the months ahead, and perhaps a recession in 2023, most industry observers and market indicators are anticipating a moderate upturn in restructuring activity in the months ahead.

How can that be? Foremost, the measurement of restructuring activity, whatever statistic or metric is used, is starting from exceptionally low levels currently, so it is a long way back to "average" or "normal," and this process tends to occur gradually barring a shock event occurring. Second, a U.S. recession is neither imminent nor inevitable, with most economists putting a 50-50 likelihood on a downturn before the end of 2023. Moreover, even those anticipating a recession expect it to be a mild downturn — nothing like 2008 or 2020 — although such things are nearly impossible to predict with any degree of certainty. In addition, U.S. speculative-grade companies have borrowed a ton of money since late 2020, including an all-time high of $1.2 trillion in 2021 alone, much of it earmarked to refinance scheduled debt maturities through 2023 or to provide extra liquidity to get to the other side of the COVID-19 pandemic. Consequently, speculative-grade debt maturities through next year are modest, and many higher-risk borrowers likely have sufficient financial resources to endure a bout of inflation or spell of business adversity, provided these events do not prevail beyond a few quarters.

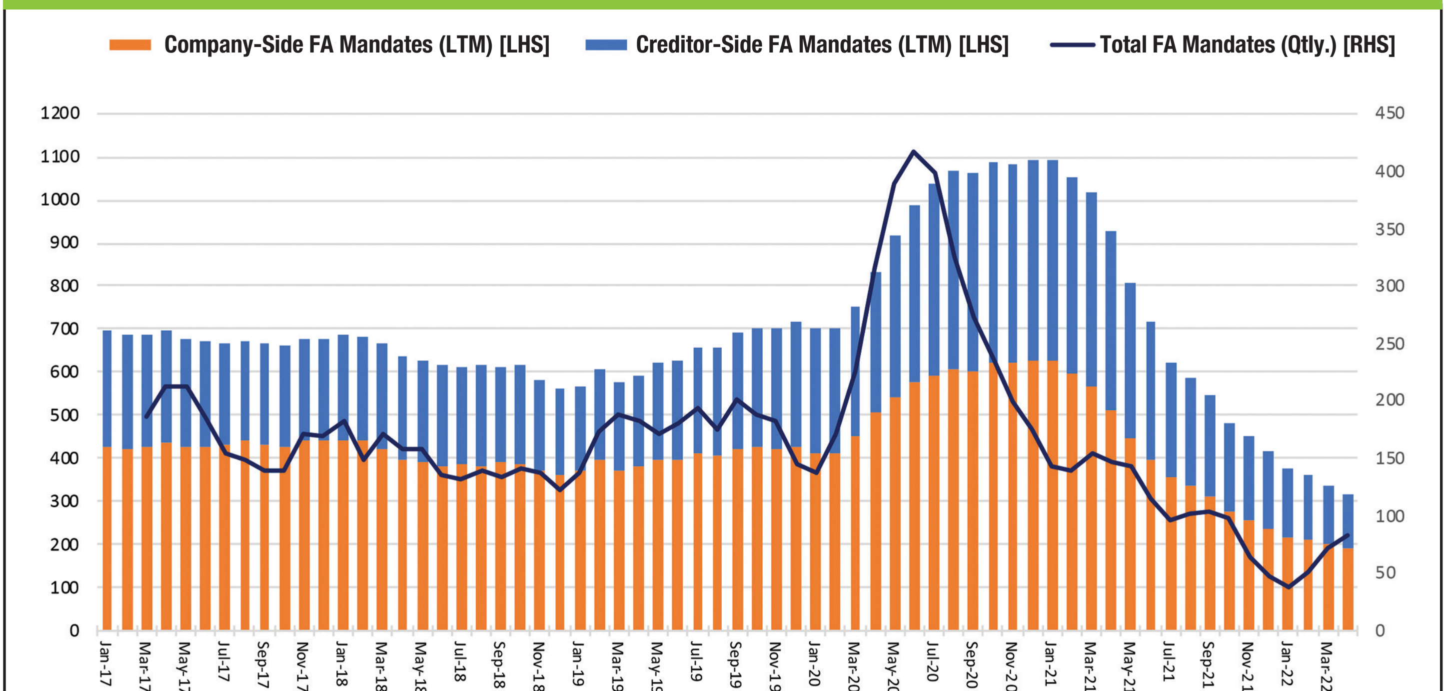
Furthermore, much of this liquidity cushion has come with few strings attached in the way of maintenance covenants or other performance-based testing requirements, and with fewer restrictions on the use of proceeds thanks to looser lending standards in recent years. In short, many higher-risk companies took advantage of wide-open credit markets in 2021 and engaged in liability-management activities to get them beyond COVID-19. Those with any expectations of a surge in filings and defaults in the months ahead must contend with the fact that there is little indication so far that such a scenario is setting up.

Another drought year or an arid one for filings in 2022 could have negative implications for the restructuring profession if new mandates continue to languish, perhaps including a culling of the herd. An evaluation of *Debtwire*'s FA mandates data since 2017 makes a few things crystal clear: Large advisory practices consistently account for a highly disproportionate share of total mandates. While there are literally dozens of advisory firms that offer a host of restructuring services and win at least some mandates in any given year, the vast majority of mandates consistently are won by the top 20-30 advisors, typically large advisory shops or practices that are either traditional FAs or investment banks that provide restructuring services. Most others, who account for a large majority of FAs in number, compete for a small slice of the pie, as well as cases too small to be tracked by *Debtwire*.

Between 2017-21, the top 10 advisors, who typically account for about 6 percent of all FAs in number that won at least one mandate per *Debtwire*, took approximately 41 percent of total FA mandates. The top 20 advisors took about 58 percent of total FA mandates, while the top 30 advisors took about 67 percent of total FA mandates. Conversely, the bottom 80 percent or so of advisors in number, typically operating out of smaller advisory practices, win just one-third of total mandates in a typical year, usually three or fewer mandates per advisor, according to *Debtwire* data. These proportions are mostly consistent from year to year irrespective of the total number of FA mandates in any year.

Large advisory practices, whether traditional FAs or investment banks, have several key advantages in such a

Exhibit 3: Financial Advisor Mandates



Source: Debtwire *and FTI Consulting analysis.*

sluggish environment. Mainly, they can move professionals into other related finance practice areas or roles amid the doldrums, much the way large law firms move underutilized lawyers into other corporate practice areas when restructuring activity is slow. For large advisors, an abundance of M&A-related activities since mid-2020 has compensated for the scarcity of restructurings. Second, large FAs typically offer vital ancillary services in restructurings that debtors or creditors have come to expect, such as running or overseeing an M&A process in bankruptcy or leading a capital-raising for a reorganizing debtor, such as a rights offering or other exit financing. Such services increasingly are needed during a reorganization, and key parties to the process strongly prefer that one financial advisor have these various capabilities.[2] Larger advisory practices also have deep benches of industry or subject-matter experts and specific expertise that can be brought to bear in these situations. Smaller financial-advisory shops that are primarily focused on traditional restructuring services for middle-market companies but that lack in financial-markets capabilities or deep-industry expertise are at a disadvantage in this market.

Of course, bountiful times keep all tribes fed, and it remains to be seen what the harvest will be for the restructuring profession in the year ahead. Restructuring activity will pick up over the balance of this year compared to the last six months, given the wavering economic backdrop and the Fed's intention to slow the U.S. economy, and there is an outside chance of surpassing the disappointing activity totals of 2021, but that is no basis for high expectations. Filings, defaults and mandate activity would have to increase by at least 50 percent or more over the pace to date in 2022 before any talk of a potential default cycle can be uttered.

Leveraged credit-market rescues (and COVID-related financial-relief measures for smaller businesses) averted bad outcomes for many higher-risk borrowers once the worst of the pandemic had passed, and consequently, restructuring activity levels today remain a long way from normal. However, the lows of this cycle are almost certainly behind us. A full-on recession would have the potential to usher in a prolonged period of elevated restructuring activity, as extraordinary measures from the Fed seem unlikely next time around, but that outcome remains far from certain given the relative strength of the economy currently. The U.S. economy is approaching uncharted waters, and nobody should have any strong convictions about what lies ahead other than to say generally it will be a busier period for the restructuring profession compared to the depressed activity of recent times. How much busier is the question of the moment. abi

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2 Data from Reorg Research indicates that nearly half of large chapter 11 filers (liabilities greater than $100 million at filing) since 2019 have involved an auction sale or other significant sale process.