As The Economy Stumbles, Where Are All The Bankruptcies?

By **Michael Eisenband** (July 20, 2022)

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Nearly nothing went as expected in the first half of 2022, with most measures of economic activity, corporate performance and financial market returns falling well short of expectations entering the year.

U.S. gross domestic product growth unexpectedly contracted in the first quarter and remains tepid at best, inflation has accelerated globally, leveraged credit issuance has tumbled while yields have soared, and equity markets turned in their worst first-half performance in decades.

There's little reason to believe these forces will moderate in the second half, as the Federal Reserve System's quantitative easing unwinding has just begun and aggressive rate hikes are working their way through the economy, with consumer spending beginning to slow while a housing market downturn has barely started.

The Fed's policy tightening was announced in late 2021, so this year was expected to present some challenges, but nothing like those experienced in the first half, especially with respect to high inflation and commodity shortages.

Today there are growing concerns that aggressive Fed policies to tame inflation could torpedo an economy that is already weakening. The likelihood of a U.S. recession has increased appreciably in recent months, with most economists pegging its chances at no less than a coin toss, and some claiming that a downturn has already begun.

However, to the chagrin of restructuring professionals, the one constant so far in 2022 has been depressed levels of bankruptcy filings and other restructuring activity, which is puzzling considering the many adverse developments in the first half of the year and malign forces still working against the broader economy and corporate sector.

Where Are All the Bankruptcies?

There were only 45 large — $50 million or more in assets and $50 million or more in liabilities — Chapter 11 filings in the first half of the year, compared to 77 filings in the first half of 2021, a decrease of 41%, including just four more than $1 billion filings.

This statistic is somewhat misleading, as the paltry total in the recently ended first half was front-ended by dormant filing activity in the first quarter of 2022, and while elevated totals in the first half of 2021 were attributable to robust filing activity in the first quarter of 2021, that was the last flurry of COVID-19-related filings before restructuring activity downshifted to the subdued levels that have persisted since mid-2021.

Large filings aren't just off compared to lofty COVID-19 period totals — they badly trail comparable totals in the years preceding the pandemic.

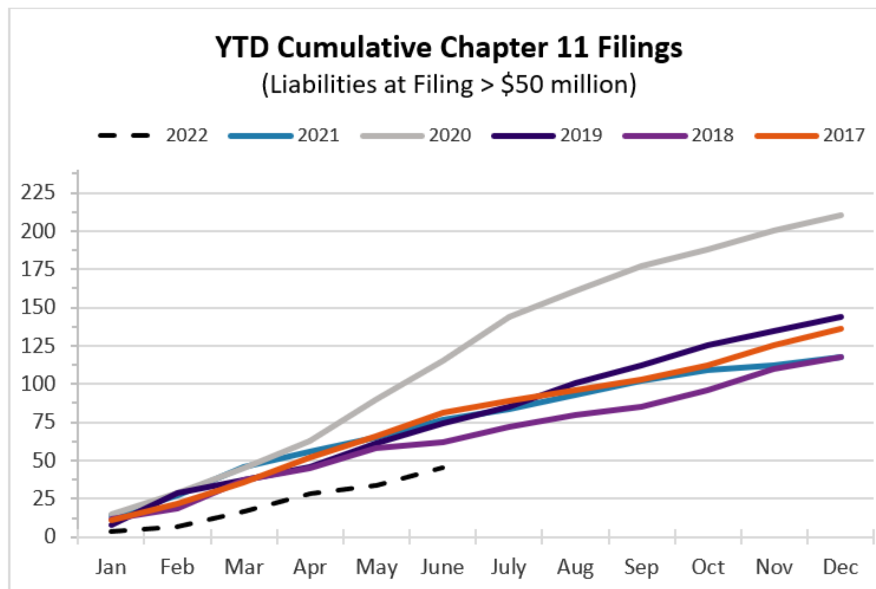

Exhibit 1, Source: The Deal

Similarly, all commercial Chapter 11 filings — regardless of size — were down nearly 30% year-to-date through May before ticking higher in the last two months, but remain well below average pre-pandemic levels.

Four months after the start of the war in Ukraine ushered in a period of mounting global turmoil and geopolitical uncertainties, large corporate restructuring activity has picked up modestly, increasing to levels that can only be considered average at best — around 10 per month — with little to suggest we're on the cusp of a major upswing.

Given the weakened economic backdrop, it seems fair to ask why corporate bankruptcy filings remain so tame halfway through the year. The obvious but unsatisfying answer is that it's just too soon to expect an appreciable upturn in filings.

History says there is normally a time lag of six to nine months between changes in the economic climate and their impact on restructuring activity. We aren't there yet.

However, that explanation is becoming a bit tiresome and perhaps less persuasive with each passing month that shows scant evidence of a notable trend reversal.

As for the argument that filing activity is depressed because many restructurings are getting done via distressed debt exchanges that avoid the courthouse, that assertion doesn't fully explain the dearth of activity.

It's true that distressed exchanges have accounted for an unusually large share of total debt defaults since 2020. A distressed debt exchange is considered an event of default by the rating agencies.

However, the speculative-grade default rate remains abysmally low at around 1.4% — little changed since year-end — meaning that the totality of default activity, both in court and out of court, remains depressed, with rated debt defaults down nearly 30% to date in 2022.

More discouraging, the usually reliable harbingers of restructuring activity also remain subdued.

Distressed debt levels have picked up noticeably from near record lows at the end of 2021 but remain modest, while the S&P Global Ratings' distressed debt ratio remains slightly above its lowest reading since 2014 and far below its long-term average.

Wider speculative-grade bond spreads since year-end imply merely average levels of default activity by early 2023.

Perhaps most concerning, the most recent default rate forecasts from the two preeminent rating agencies expect relatively modest upticks in defaults a year hence, to about 3% to 3.5% by early 2023 — a doubling from near-historic lows but still below the long-term historical average and nothing resembling default cycle activity.

These modest default forecasts are expected to prevail domestically and in Europe, where the continent's proximity to the war and its economic impacts and vulnerability to recession are more acute.

Worst yet, the S&P's pessimistic scenario, which includes a U.S. recession, has a projected default rate of just 6% by March 2023, though Moody's CreditView pessimistic scenario default forecast of 13% is much more consistent with historical default rates during a default cycle.

It's hard to fathom exactly why these base case default rate forecasts are so low given the deteriorating economic backdrop, but it's possible that rating agencies have become gun-shy about making bold default forecasts, given how off the mark they were in anticipating and modeling the pandemic-driven default cycle, which materialized quickly but peaked far lower and fizzled out far sooner than expected.

The most plausible explanation for still-muted restructuring activity is closely tied to leveraged credit market conditions that prevailed in 2020 through 2021.

During this window, higher-risk issuers were able to borrow huge sums at low rates with few strings attached in the way of performance-based maintenance covenants and fewer restrictions on access to and uses of capital — and, often, underlying collateral — giving them financial runway and flexibility to withstand adverse business conditions for an extended period without consequence until liquidity is exhausted, if it comes to that.

Syndicated leveraged credit issuance in 2021 alone was $1.2 trillion, easily a record high, and private credit issuance added materially more.

The list of troubled issuers that likely would have restructured by now were it not for opportunistic credit market rescues or forbearance by lenders is lengthy, and many continue to confront challenges in fixing their businesses.

Borrowers in recent years have had great success in weakening or negotiating away traditional safeguards in credit documents that have given lenders or other debtholders the ability to intervene in a troubled credit long before the money runs out. This trend has been in place for a while but seems to have become a standard practice in leveraged lending circles and has contributed to flagging restructuring activity.

Moreover, in instances when financial covenants have been tripped or events of technical

default have occurred since COVID-19 struck, many lenders have been reluctant to exercise their full rights and remedies and are more inclined to grant a waiver, amend credit documents and collect a fee.

That tendency remains in place even after pandemic-related business impacts have faded. These developments can either postpone or avert a restructuring event, depending on what companies are able to accomplish with this breathing room.

Consequently, the current expectation in credit markets may be that many highly leveraged borrowers have sufficient liquidity to ride out whatever adversity comes their way in the next year.

Of course, that depends on the severity and duration of that adversity, and nobody has a clear read on that currently, with forecasts of recession, earnings and inflation being all over the place. We are in uncharted waters today, and nobody should have strong convictions about where the global economy is headed.

It has been a lean 18 months for the restructuring profession, especially considering how geared up most of us were for a prolonged cycle of intense activity after COVID-19 struck.

Another stretch of depressed activity could begin to take a toll on the profession, which is considerably larger in size than it was five to 10 years ago.

Surely the demand for restructuring services will be picking up in the second half, but we caution against the high expectations of wishful thinking until there's more evidence that this dust bowl is safely behind us.

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