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THE HALFTIME REPORT:

Restructuring Recap for 1H 2019

Filings Grind Higher But No Surge Yet in Sight

By Michael Eisenband

These are strange times to make sense of for most business folks, including restructuring professionals. Financial markets have been volatile—sometimes schizophrenic but unbreakable as investors grapple with the slowing state of the global economy and the implications of President Trump's risky strategy with respect to trade policy. His unconventional approach to managing the economy and trade, frequent use of his bully pulpit to pressure policymakers and public officials, and his walk-back of some economic threats have been vexing for impacted business leaders who must make critical decisions amid this unsettling environment. The president has certainly ratcheted up the uncertainty factor, and market fatigue is becoming more evident.

Fewer business leaders have any strong conviction about where our economy will be in 2020. That also includes most economists, who now peg the likelihood of a recession within the next year or so at 35%, the highest it has been since 2011. Some prominent market watchers are gloomier than that. However, investors remain more upbeat than the pundits and have kept markets aloft despite these nagging concerns, assuming all along that President Trump will not allow the economy to tank in an election year irrespective of his threats on trade, because that would be an act of political suicide. But one never knows exactly how these things will play out.

For those of us in the restructuring profession, well, let's be honest: we anxiously await the arrival of an overdue downturn—and whenever that is, we're a day closer to it every 24 hours. But let's not allow the anticipation of the inevitable to distract us from the events of the moment or diminish what is happening right now. The ability of many badly underperforming companies to postpone their day of reckoning continues to be a bewildering enigma for those of us waiting on a comeuppance. Nonetheless, it has been a fairly solid showing for restructuring activity so far in 2019 considering the general strength of the U.S. economy and the ongoing support of leveraged credit markets.

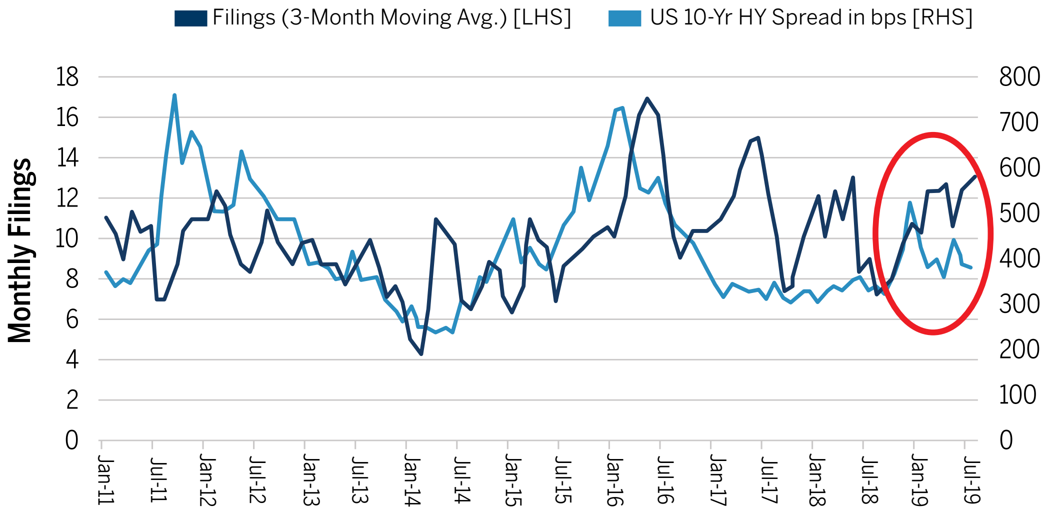
By our scorecard, there were 74 large (liabilities >$50 million) Chapter 11 filings in 1H19 compared to 62 filings in 1H18, a 19% increase. This was largely validated by the number of financial advisor mandates, as tracked by Debtwire, which totaled 347 in 1H19 versus 307 in 1H18, a 13% increase, while company-side advisor mandates increased by 14%. There were 11 filings exceeding $1 billion in liabilities in 1H19 versus 15 filings in 1H18, while the average size of a filing fell to $366 million in 1H19 from $556 million a year earlier. In short, there were more middle-market filings in 1H19, with 61% having liabilities at filing between $50 million-$250 million versus 51% in 1H18. Healthcare accounted for 20% of total filings in 1H19, the most of any industry sector, but these were mostly smaller filings—roughly one-half the size of an average filing, followed by (you guessed it) energy and retail.

None of this sounds very impressive, but it's a respectable showing in a period that included record highs for most major market indexes, nearly record lows for long-term Treasury rates, modest amounts of high-yield debt maturities, and leveraged credit markets that remained open for business to high-risk borrowers despite the market turbulence. Preliminary filing totals for the summer were rather robust as well, and it's highly likely that Chapter 11 filing activity in 2019 will top last year's total of 118, perhaps by a comfortable margin.

The uptick in restructuring activity is evident in **Exhibit 1**, which shows Chapter 11 filings trending higher in 2019 despite a bounce-back in leveraged credit markets from a sharp sell-off in late 2018. In fact, average monthly filings are at their highest level of the post-recession decade except for the period from early 2016 through mid-2017, when energy-related bankruptcies dominated the landscape. Admittedly, this is not much to boast of, as restructurings have been relatively tame this decade outside of the period encapsulating the energy bust, but it does put to rest any notion that recent filing activity is lackluster.

EXHIBIT 1

Large Chapter 11 Filings vs. High-Yield Bond Spreads



Source: The Deal Pipeline, Bloomberg and FTI Consulting, Inc.

Private equity-owned companies accounted for 38% of total filings in 1H19, continuing a trend in recent years that has seen their share of total filings climb to the mid- to high-30% range from about 25% prior to 2017. Sponsor-owned companies are clearly most vulnerable to economic headwinds and the vicissitudes of credit markets.

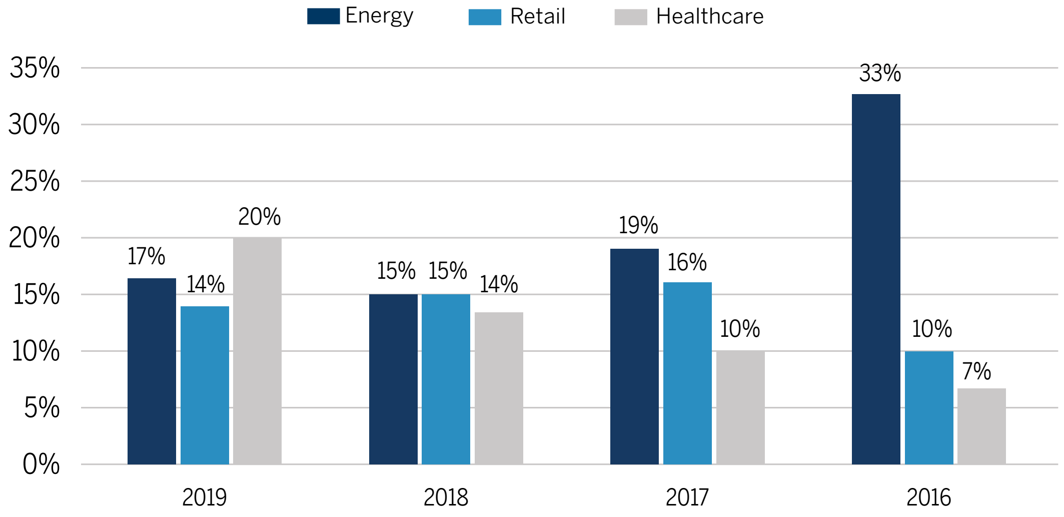
The energy sector is the gift that keeps on giving to the restructuring profession, and now seems to be entering a new phase in its five-year saga, with a rash of independent exploration and production (E&P) companies filing for bankruptcy in 2019, some three years after oil prices bottomed and with WTI oil prices consistently above the mid-$50 per barrel range for most of the last two years. Many of these E&P causalities were still-too-levered companies exploiting various shale plays. It might be time to reconsider whether the lore of the shale boom remains intact, with several prominent E&Ps having recently reported disappointing results from various shale oil projects, and a growing number of stories reporting that well production decline rates have exceeded expectations in several shale basins, including the Permian Basin. As struggling E&Ps increasingly are urged to demonstrate capital discipline and cut back on drilling programs, rig counts in shale basins have begun to decline in 2019 and the fallout for beleaguered oilfield service companies will continue to play out. This wrenching story is far from over, especially if the global economy weakens further. The U.S. energy sector accounts for approximately 5% of the S&P 1500 but has consistently accounted for more than 15% of large corporate bankruptcy filings since 2017, even after the worst of the initial energy downturn passed. As we wrote late last year, the downturn in the U.S. energy sector was never behind us even when oil prices moved back towards $70 in 2018 and rig activity moved well off its 2016 lows.

The retail sector also remains fertile ground for distress and restructuring activity, with Coresight Research reporting the number of announced U.S. store closings to date in 2019 already far exceeding the total for all of 2018. While nationally recognized chains continue to make headlines among distressed and bankrupt retailers, there are many smaller, less-popular chains, such as A'GACI, Charming Charlie, and Things Remembered, that are quietly vanishing from the landscape. There is no reason to believe that the ramp-up in store closings—in or out of court—will abate any time soon, given that online retail sales continue to pick up one percentage point of market share each year. Accelerating store closings can have a spiraling effect on vulnerable shopping venues, as consumers further avoid shopping centers with high vacancy rates.

The energy and retail sectors together have consistently accounted for nearly one-third of all large Chapter 11 filings since 2017—roughly in equal proportions (**Exhibit 2**). Add in healthcare, and we are looking at close to one-half of total filings coming from these three industry sectors since 2016. There is good reason to believe this collective share will not diminish over the remainder of the year, given the challenging fundamentals in those industries. This should provide a solid floor for Chapter 11 filings going forward, but we will need to see substantially more filings outside these sectors before there can be any serious discussion about the next default cycle.

EXHIBIT 2

Percentage of Large Chapter 11 Filings (Liabilities > $50mm at filing)



Source: The Deal Pipeline

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