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The Halftime Report: A Dull, Low-Scoring First Half

Like a highly anticipated football game that only produces a few first-half field goals, restructuring activity to date in 2021 has been underwhelming relative to expectations. Though it was clear by the end of 2020 that the default cycle attendant with the COVID-19 pandemic was not going to be the barnburner that many had expected just months earlier, few anticipated the steep falloff in restructuring activity we have seen to date, which is mostly attributable to high vaccination rates, a reopening of the national economy and roaring leveraged credit markets. Commentary on the state of the restructuring market in 2021 has been distinctly downbeat but the numbers need more context than a comparison to 2020.

Indeed, any comparison of filing activity to 2020 is sure to disappoint, given the economic effects of the pandemic last year and the better-than-expected vaccine rollout and reopening scenario that is underway. There were 75 large Chapter 11 filings to date through June, a 35% decline from YTD 2020 when the pandemic was taking its toll on the economy.[1] Such comparisons will worsen during the third quarter, when filings peaked in 2020, and YOY comparisons will likely show a 50% decrease by the end of summer. However, these numbers put 2021 squarely in line with filing activity in 2017-2019 (**Exhibit 1**). In other words, it is an average year, more or less, for restructuring activity. This would translate into approximately 140 large filings for the year versus a decade-high 210 filings in 2020. In that context, 2021 seems “less bad” than the headlines would suggest, given that 2020 was an outlier year. But many legal and restructuring advisory firms geared up for a prolonged default cycle in mid-2020, and that complicates the challenge of navigating this tepid environment and ascertaining whether the moment is merely a pause in restructuring activity or the end of a cycle that never fully materialized.

Where 2021 also falls short is the size of filers — they are decidedly smaller debtors than in recent years. Average filing size (as measured by liabilities at filing) was barely $300 million in 1H21, more than 60% smaller than filings in 2020 and nearly 50% smaller than filings in 2017-2019. Only nine of 75 filings in 1H21 were billion-dollar filings while 28 had liabilities at filing of $50 million to $100 million.[2] Most filings were distinctly middle-market companies, and there were few high-profile filings. Assuming that case length and complexity are positively correlated with the size of a debtor, this suggests faster case outcomes for 2021 filings.

As for rated corporate debt defaults, first-half results fell even more sharply than bankruptcy filings. S&P reported 48 debt defaults in 1H21 versus 124 in 1H20, a 61% decrease. Back in August 2020, S&P's U.S. speculative-grade default rate forecast was 12.5% by June 2021. Today that actual default rate stands at 4.7% and is forecast to fall further, to 4.0% by early 2022, according to S&P.[3] Clearly the baseline default scenario anticipated by S&P (and other rating agencies) amid the pandemic was errant. They were hardly alone. (In fairness, S&P provided a wide range of default rate forecasts under three scenarios given the highly unusual and unpredictable nature of the COVID-19 pandemic, and the default rate forecast under its optimistic scenario was pretty much where we have landed.)

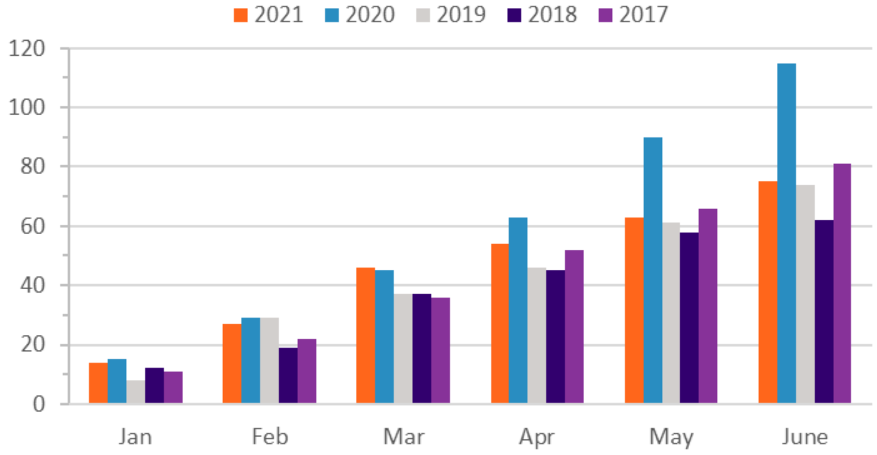
Especially noteworthy in 1H21 was the prevalence of distressed debt exchanges among default events, with distressed exchanges accounting for 58% of first-half defaults (**Exhibit 2**), easily an all-time high.[4] The dominance of distressed exchanges in 1H21 speaks to the willingness of leveraged credit investors to accommodate the aggressive balance sheet management of high-risk borrowers. Historically, a large portion of distressed exchanges later end up as formal restructurings — somewhere between 25% to 33% — so that long list bears watching over the next couple of years as some of these band-aid remedies peel off.

Ultimately, leveraged credit markets have proven to be more prescient than forecast models in terms of signaling where default activity was headed, with the distressed debt ratio and high-yield bond spreads both falling steadily since mid-2020 even as the pandemic raged, implying lower default rates by early to mid-2021. This development is self-fulfilling to some extent, as the willingness of leveraged credit markets to lend with abandon to high-risk borrowers since mid-2020 has contributed to reduced defaults and filings in subsequent months.

Many seasoned restructuring professionals are befuddled by the euphoric state of financial markets, given how spotty and precarious this recovery has been and the financially vulnerable condition of so many speculative-grade companies. John Maynard Keynes famously cautioned that markets could remain irrational longer than you can remain solvent, so trying to guess when these excesses will unravel is a fool's game.

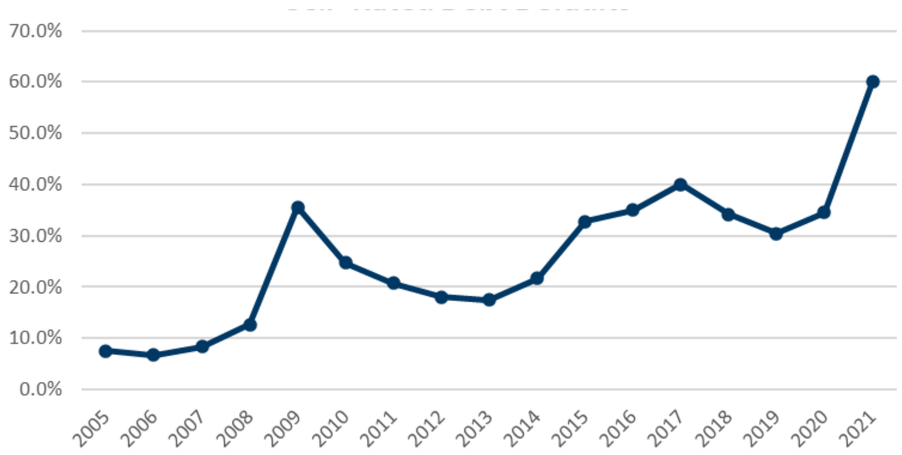
For the moment, it is hard to imagine a disruption to the recovery scenario in place that would cause credit markets to retreat or defaults to spike higher in the second-half of 2021 other than a shock event. Financial markets continue to see the bright side of nearly all events or developments, even seemingly negative ones. Hopeless gridlock in Congress, trillion-dollar annual federal budget deficits for the next decade, unprecedented money creation by the Federal Reserve, ambiguous signals on Fed policy, and the prospect of accelerating inflation appear to be of little concern to markets or investors. Financial markets have become entirely liquidity-driven, and nothing suggests that the forces in place, including a high-yield bond market tracking for $500 billion of new issuance this year, will sputter in the near term provided that an economic recovery, even a bumpy and uneven one, proceeds along in the right direction. Barring a Black Swan event, it seems likely that the giddiness will persist a while longer. Don't count on a high-scoring second half.

Exhibit 1 - YTD Cumulative Chapter 11 Filings (Liabilities at filing >$50 million)



Source: The Deal Pipeline

Exhibit 2 - Distressed Exchanges as a Percentage of S&P Rated Debt Defaults



Source: : S&P Global Ratings Research

Endnotes

1. The Deal Pipeline. Note that we consider large filings as those with liabilities at filing of greater than $50 million. https://pipeline.thedeal.com/login-page
2. Ibid
3. S&P Global Ratings Research https://www.spglobal.com/en/
4. Ibid

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