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Turnaround Topics

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When the Other Shoe Drops: Drivers of the Next Restructuring Cycle



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It is no secret that restructuring activity was down — way down — in 2021. There have been fewer business bankruptcy filings in 2021 than there have been in nearly the past three decades, and global default rates are far lower than they have been in years. In large part, this can be attributed to a glut of cheap credit that has allowed risky borrowers to refinance their debt and avoid the restructuring process. Since 2020, lenders have funded record levels of leveraged loans and high-yield bonds. Despite the broad V-shaped economic recovery that has taken place since mid-2020, the mixture of government stimulus and an uncertain future has created an environment that could give rise to significant restructuring activity, as emerging risks materialize and borrowers no longer find themselves able to refinance their indebtedness on favorable terms.

This article identifies the confluence of factors that may serve as the catalyst for the next restructuring cycle, including the eventual tightening of credit markets and a variety of pre-pandemic and emerging economic headwinds. It also discusses

certain of the legal strategies that might be the most relevant to borrowers in addressing their restructuring goals.

Credit Markets May Tighten, Likely Reducing Borrowers' Ability to Refinance Indebtedness

Most central banks cut interest rates to or near zero following the onset of the COVID-19 pandemic. This prolonged low-interest-rate environment has left institutional investors chasing yield by providing credit to relatively risky borrowers. Borrowers have actively taken advantage of these lenient credit markets to not only refinance their existing indebtedness and push out maturity dates, but also to incur additional debt for general corporate purposes. Corporate balance sheets have ballooned as a result. Although current credit market conditions are benign for even the riskiest borrowers, conditions may change and eventually cause stress. In these conditions, distressed borrowers will find it more difficult to access credit on favorable terms.

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Exhibit 1: Risk Factors Today

Pre-Pandemic Risks



Consumer Spending



Wage Pressures

Post-Pandemic Risks



Long-term COVID Effects



Supply Chain Disruptions



Increased Regulatory Outlook



Energy Price Shocks

The Federal Reserve has announced plans to begin tapering its bond-purchase program before the end of 2021, signaling a beginning to the end of the support that it provided during the pandemic. As of early December 2021, the Federal Open Market Committee (FOMC) was preparing to meet to discuss potentially an even faster schedule of future rate hikes than previewed in its November meeting. Even if some of the factors driving inflation are temporary, such as COVID-related supply chain disruption, many companies are using the current conditions as an opportunity to raise prices, which can affect consumer savings and discretionary income, and ultimately drive down demand. Given the broad inflation that the U.S. has seen in 2021 (as of October, a 6.2 percent annual rise in the consumer price index versus a 2 percent target), the Federal Reserve may need to increase rates higher or faster than markets presently anticipate.

Assuming that FOMC rate hikes occur, riskier borrowers will face both higher costs and a dearth of available credit once institutional investors can achieve their return requirements from safer credits. As a result, restructuring activity may start to increase as borrowers have less liquidity and are unable to refinance, leading to defaults and difficult discussions with lenders. In particular, struggling small-cap sectors such as energy and real estate, which have increased leverage approximately 1-2 times EBITDA since 2019, might find refinancing in the relatively near future to be especially

difficult if borrowers do not successfully execute on growth or margin-improvement plans. Similarly, the relatively risky debt issued during the pandemic could see significant restructuring activity around future maturities if refinancing is not an option.

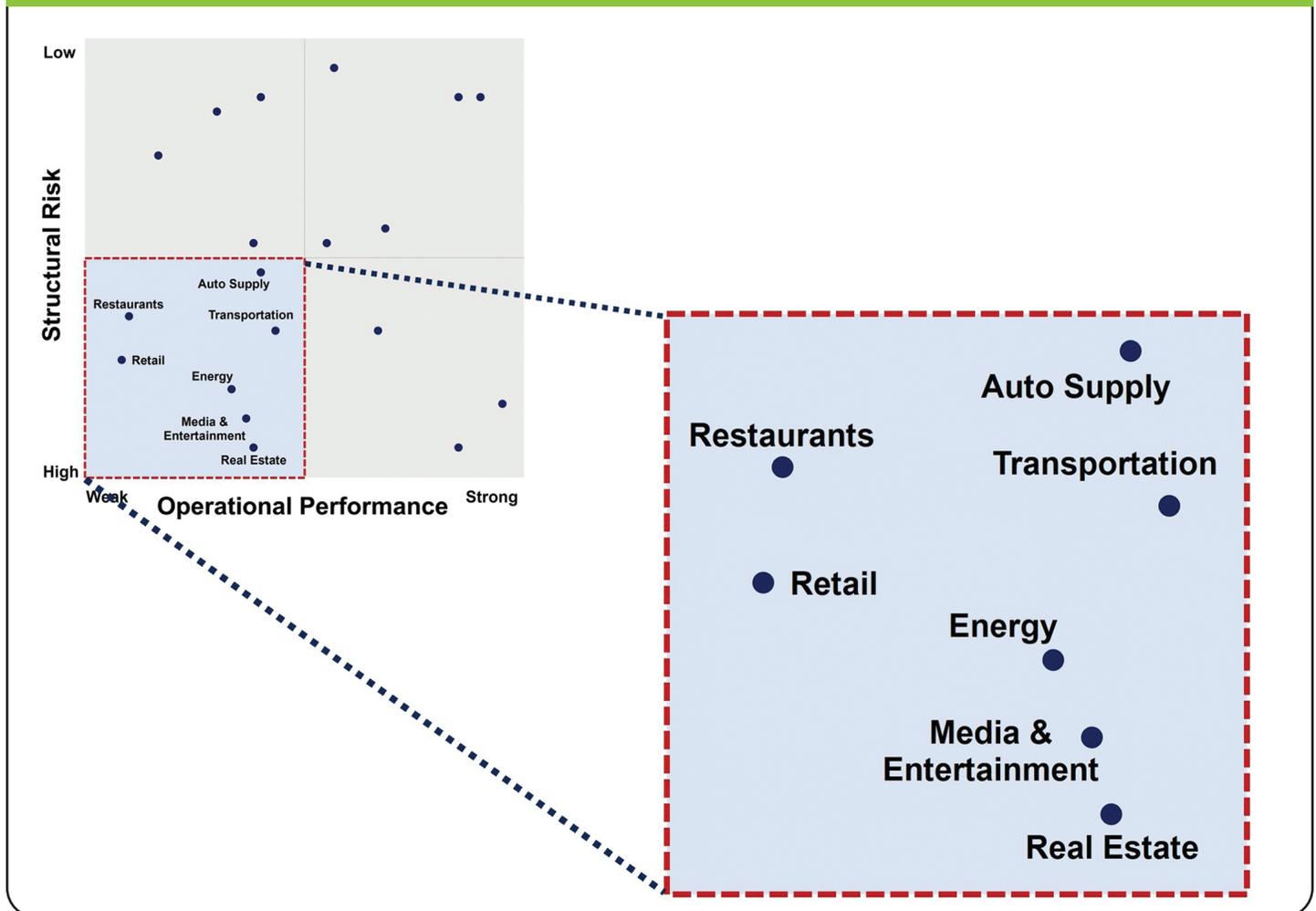
Market Headwinds Could Create Defaults Under Existing Loans

A combination of lingering pre-pandemic and emerging headwinds might trigger defaults by distressed borrowers and pressure companies into restructuring. Exhibit 1 summarizes these headwinds, which are discussed further herein.

Pre-pandemic risks such as wage pressures and changes in consumer spending habits that had previously stressed certain sectors not only remain, but are now rising across the broader macroeconomy. Despite a presently robust economy, these risks can hamper future earnings through operational disruptions such as labor and supply shortages, incremental investment related to changes in (temporary) consumer behavior, and negative investor sentiment.

For example, e-commerce and digital engagement have altered consumer spending habits, and it is still unclear how shopping preferences will stabilize and impact sectors such as restaurants, hospitality or real estate. Meanwhile, businesses are investing heavily to meet consumers where they are (*e.g.*, digital channels and suburban markets), and might

Exhibit 2: Sector Dispersion of Vulnerability at the Close of 2021



need to re-pivot as consumers return to historical norms. In addition, increased consumer savings, new competitors, and increases in retirement, and resignations across industries have led to both an ever-tighter labor market and rising employee expectations. A recent survey showed that approximately 41 percent of workers have considered leaving their jobs, meaning that “The Great Resignation” has real implications on operating risk. Turnover and talent shortages in key positions (*e.g.*, CFOs, planning and analysis) place additional burdens on companies needing to adapt to real-time market changes.

Moreover, several new post-pandemic challenges — both directly and indirectly related to COVID-19 — might also create issues for borrowers. Vaccine hesitancy and access, along with evolving COVID variants going into the flu season, increase volatility in both access to in-person activities and supply chains. Vaccine mandates have changed demand in sectors like restaurants, travel and entertainment, while recurring shutdowns or logistical limits have impacted suppliers in certain geographies.

Disruption in supply chains due to the pandemic has continued to limit output, resulting in increased inflation driven by sustained price increases for inputs. These disruptions have strained both the top and bottom lines. For example, U.S. car sales are well below 2019 levels due in part to semiconductor chip and related capital equipment shortages, while average shipping times from Asia to the U.S. have increased from roughly 14 to 70 days. Lack of supply creates additional threats for companies who might lose devoted customers (*e.g.*, buying from a different manufacturer rather than waiting for a particular model to become available). Interestingly, however, up until now, rising prices caused by supply chain disruptions have generally not seemed to limit demand as consumers appear willing to pay higher prices in the near term for goods and services.

In the Next Restructuring Cycle, Certain Sectors Could Be More Affected than Others

Certain segments of the economy may be more affected by these post-pandemic headwinds than others. An analysis of the Russell 2000, an index of small-cap companies, demonstrates a wide dispersion in resiliency to potential headwinds across sectors. Those companies with weaker operating performance (measured by cash flow and operating margins) and higher structural risk (measured by leverage and interest coverage) are left most vulnerable to future distress. As set forth in Exhibit 2, sectors such as auto supply, restaurants, energy, media and entertainment, real estate, retail and transportation have the most exposure.

Next Wave of Distress Will Likely Necessitate Both Financial and Operational Restructurings

Given that the next significant wave of distress will likely be driven by tightening credit markets and a variety of temporary and permanent market forces, we expect to see both operational transformations and purely financial restructurings in the future. Many businesses have faced

structural changes brought on or accelerated by COVID-19. Companies in sectors such as retail, restaurants or energy have large fixed costs and may require chapter 11’s tools to right-size their cost structure and transform into viable business models. For example, the ability to reject unprofitable leases or contracts can help businesses streamline their footprints and renegotiate terms that are more consistent with their go-forward business plans. Businesses may also leverage § 363 sale processes to divest certain assets or brands to attract more buyers and facilitate sales for currently unprofitable assets. These changes will enable businesses to become more nimble and operationally pivot to value-generating capabilities and business lines.

In contrast, other companies might have a sound long-term strategy but could encounter significant, temporary issues affecting liquidity and borrowing ability (*e.g.*, missed holiday shopping windows, volatile commodity prices, etc.). These companies are unlikely to seek to restructure their operations, but will likely seek bridge financing and an extension of existing maturities to weather the economic storm. Whether these financial restructurings will ultimately be executed in or out of court will depend on a number of factors, including the complexity of the capital structure and the level of consensus for the underlying transaction among stakeholders. Lenders may be willing to accept tighter terms in exchange for granted relief (*e.g.*, maintenance covenants requiring the company to de-lever), but this may prove difficult as lenders have become increasingly less accommodating to granting forbearances and waivers.

Conclusion

Although the future is uncertain, significant restructuring activity might start to increase as borrowing costs rise, current levels of government support begin to fall away, and companies feel the full effect of the market headwinds described in this article. Once that occurs, markets can expect to see an uptick in restructuring activity across numerous sectors, whether driven by COVID-era leverage increases, required business and operational transformations, or changes in investor appetite. **abi**

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