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WHITE PAPER

January 2022

Recent Trends in Corporate Debt and Reorganizations: Laying the Groundwork for Future Large Chapter 11 Cases or Just More Runway?

After commercial Chapter 11 filings soared to their highest levels in more than a decade in 2020, the numbers gradually came back to Earth in the latter part of 2020 and, in 2021, fell well below annual averages. The primary driver of this reversal was twofold: swift and robust central bank intervention around the world and readily available and affordable capital from banks, private equity, and hedge funds. Companies were able to amass liquidity by tapping into existing lines of credit, undertaking major capital structure reconfigurations, and leveraging previously unencumbered assets in order to finance existing debt obligations and maintain operations during the pandemic. While this has temporarily abated anticipated increases in restructuring activity, increased interest rates, uncertainty regarding the pandemic's impact on market demand, inflation, and government intervention will all factor into whether restructuring trends return to more "normal" historical ranges or continue their current below-average trajectory.

Future restructuring trends will likely turn on, among other things, whether high-yield issuances remain steady or continue to slow in the coming year and whether liquidity remains readily available and affordable. These macro and micro factors will likely impact the ability of many borrowers to afford existing debt and limit borrowers' optionality in the future, and could prompt an increase in court-supervised restructurings.

EXECUTIVE SUMMARY

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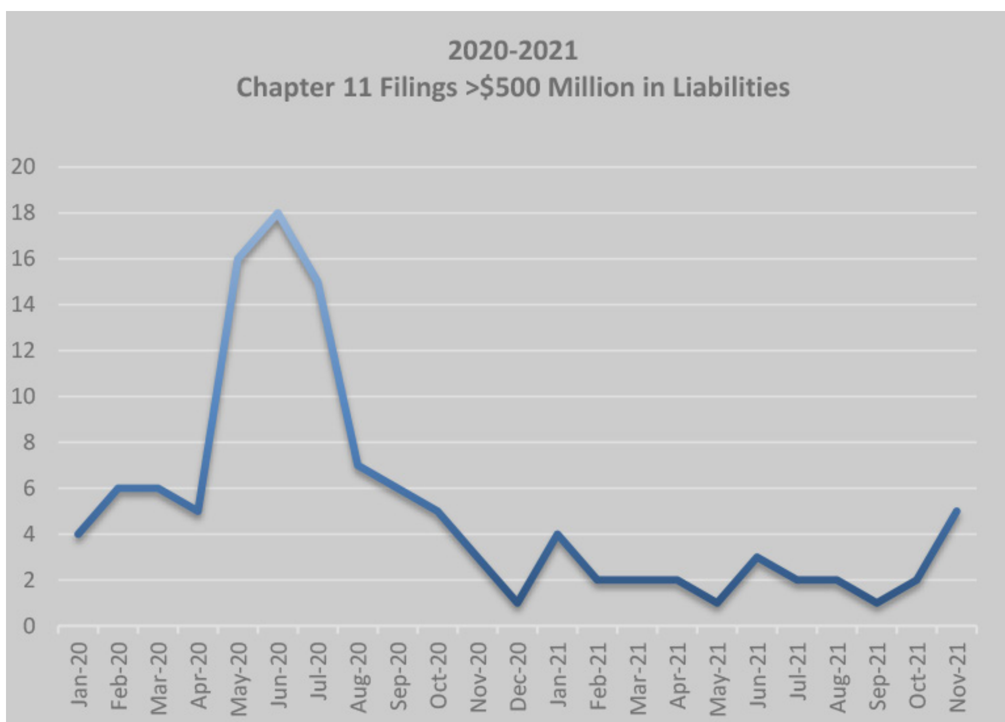
2020: PEAK YEAR OF RESTRUCTURING

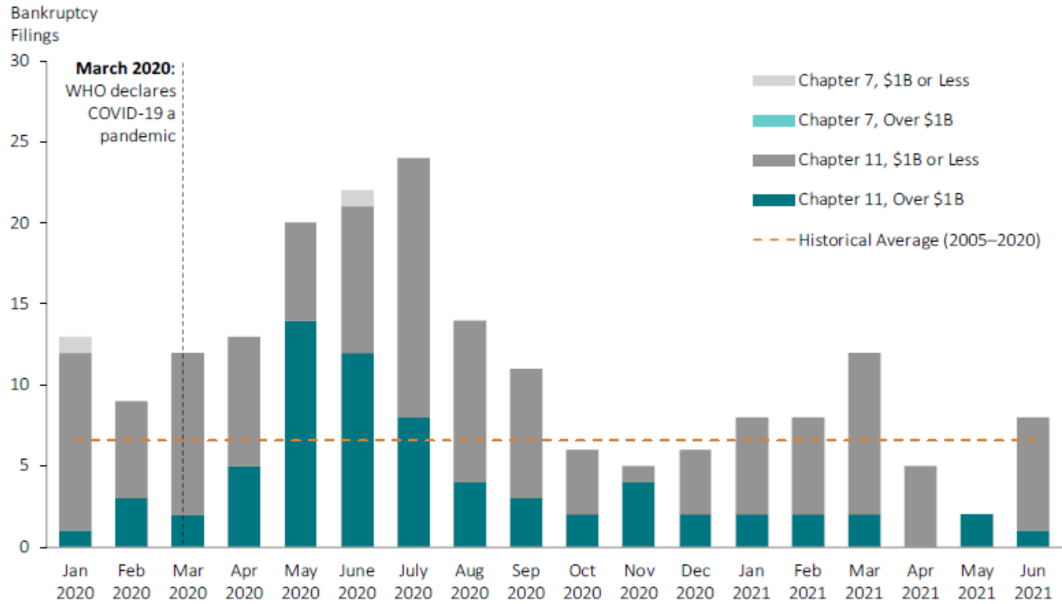
Chapter 11 Filings Reach Historic Highs

During 2020, bankruptcy filings reached their highest levels since the 2009 financial crisis.[1] Ninety-two companies with liabilities in excess of $500 million filed for bankruptcy.[2] This number constituted an 88% increase from 2019, and a 272% increase over the national annual average since 2005.[3] Sixty companies with liabilities exceeding $1 billion filed Chapter 11, representing a 170% increase over the annual average between 2005 and 2020.[4] Chapter 11 filings peaked in July 2020 after three consecutive months of record numbers of filings.[5] Fifty-one companies with liabilities exceeding $1 billion filed from January 1 to June 30, while only nine restructured in the final six months of 2020.[6] For companies with liabilities exceeding $500 million, only 22 filed for Chapter 11 from approximately July 1 to December 31, a substantial drop from the 70 filings in the first half of the year.[7] The second half of 2020 therefore experienced a more rapid recovery than that following the Lehman Brothers filing in 2009.[8] Indeed, by October 2020, monthly bankruptcy filings returned to historical averages.[9]



[10]

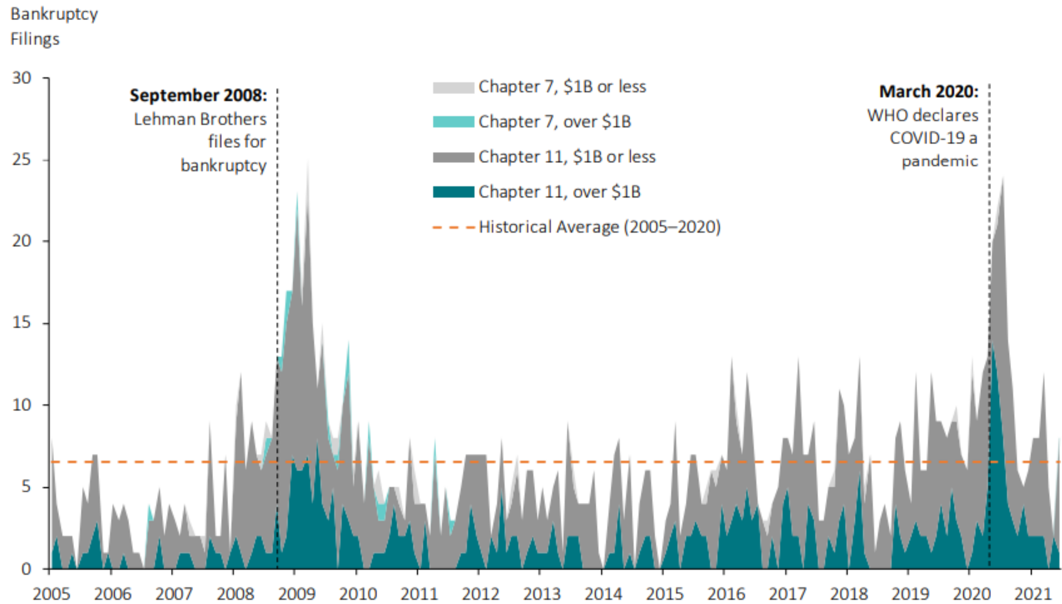
Figure 3: Monthly Chapter 7 and Chapter 11 Bankruptcy Filings (Recent Trends)
2020–1H 2021



Source: BankruptcyData

Note: Only Chapter 7 and Chapter 11 bankruptcy filings by companies (both public and private) with over $100 million in assets are included. For companies where exact asset values are not known, the lower bound of the estimated range is used. Asset values are not adjusted for inflation. The World Health Organization (WHO) declared COVID-19 a pandemic on March 11, 2020. 11

Figure 2: Monthly Chapter 7 and Chapter 11 Bankruptcy Filings
2005–1H 2021



Source: BankruptcyData

Note: Only Chapter 7 and Chapter 11 bankruptcy filings by companies (both public and private) with over $100 million in assets are included. For companies where exact asset values are not known, the lower bound of the estimated range is used. Asset values are not adjusted for inflation. Lehman Brothers filed for bankruptcy on September 15, 2008. The World Health Organization (WHO) declared COVID-19 a pandemic on March 11, 2020. Years are labeled at January 1. 12

The Hardest Hit Industries: Retail and Energy

COVID-19 triggered Chapter 11 filings by distressed companies that otherwise would have eventually restructured, albeit at a later date. In fact, all but one of the top 10 largest companies (by total liabilities) to seek Chapter 11 protection in 2020 were on distressed watch lists before the start of 2020.[13] This trend manifested primarily in the retail and energy industries, with half of the 20 largest bankruptcies filed in 2020 by companies in these sectors.[14] In terms of liabilities, The Hertz Corporation represented the largest restructuring in 2020, with nearly $20 billion in liabilities at the time of the filing.

Top 10 Chapter 11 filings in 2020 by liability size

($ in millions)

Company name	Sector	Liabilities
The Hertz Corporation	Industrials	19,590
Frontier Communications Corporation	Communications	17,513
Intelsat S.A.	Communications	14,717
Chesapeake Energy Corporation	Energy	9,095
McDermott International, Inc.	Energy	7,105
Valaris plc	Energy	7,094
Mallinckrodt plc	Healthcare	5,283
Neiman Marcus Group Ltd LLC	Retail and consumer	5,154
California Resources Corporation	Energy	5,085
J.C. Penney Company Inc.	Retail and consumer	4,917
		95,553

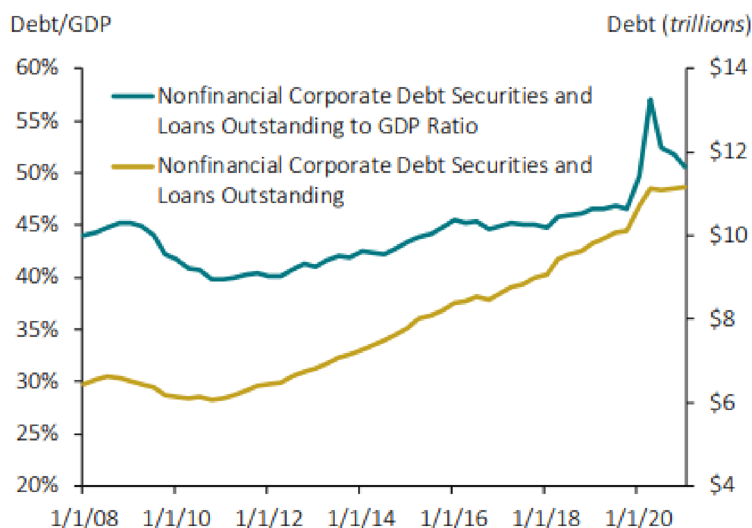
Source: Reorg Research, Debtwire, CapitalIQ

[15]

The Commensurate Rise of Corporate Debt

The nonfinancial corporate debt-to-GDP ratio increased from 46.5% in the fourth quarter of 2019 to 57.1% in the second quarter of 2020.[16] Additionally, high-yield and investment-grade spreads relative to Treasury yields spiked 205% and 297%, respectively, in March 2020 over their levels in January 2020 and then slowly returned to January 2020 spreads by December 2020.[17] Investment-grade and high-yield bond issuance increased following the initial government relief efforts, and by June 2020 were 30% above historical levels.[18] This high rate of bond issuance was likely based on the perception that the rapid spike in demand following the end of the pandemic would offset any risk attendant to providing a lifeline to distressed companies. However, the lower revenues and earnings of these companies forced them to use these proceeds both to fund operating losses and to service existing debt.

Figure 8: Nonfinancial Corporate Debt Securities and Loans Outstanding
January 2008–March 2021



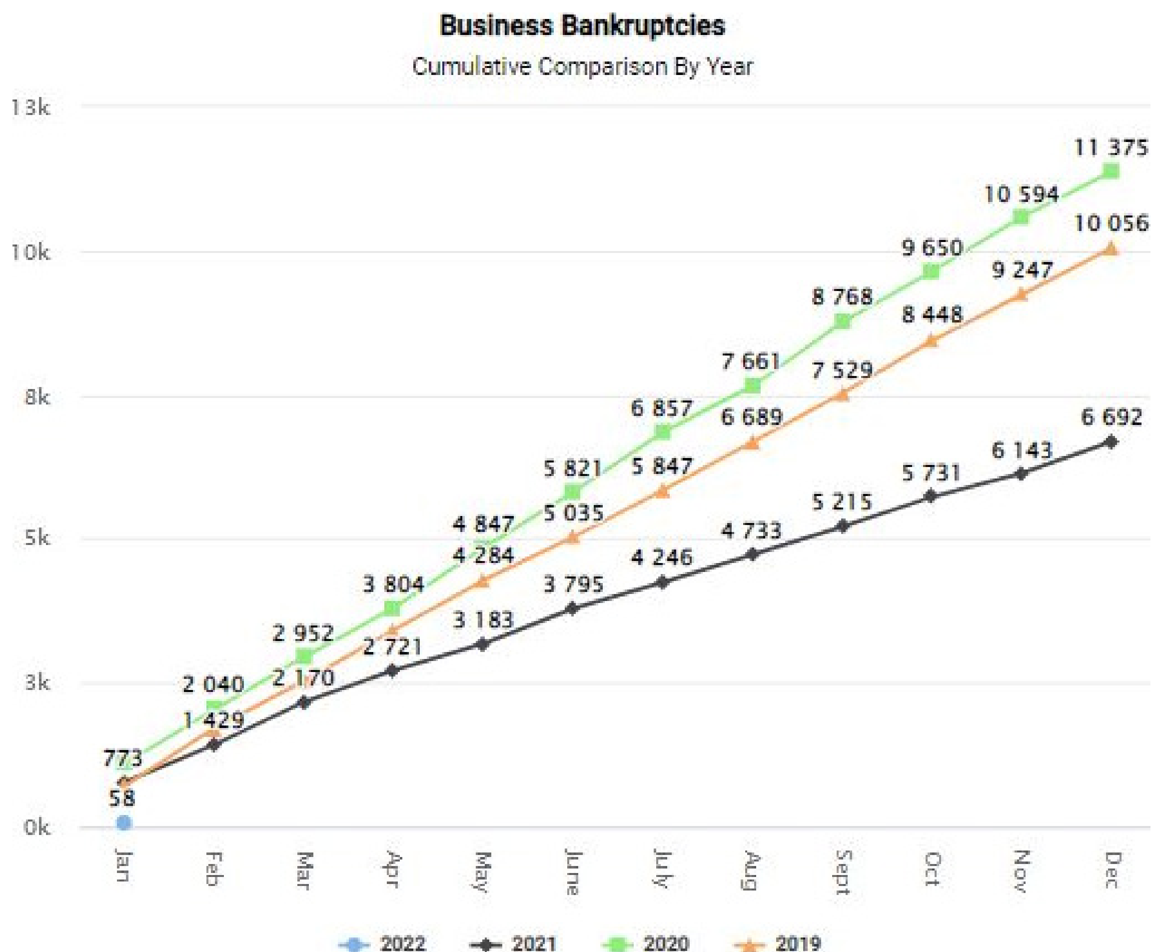
Source: FRED Economic Data

Note: GDP levels and nonfinancial corporate debt securities and loans outstanding are reported on a quarterly basis and are seasonally adjusted. [19]

2021: VALLEY OF RESTRUCTURING

Restructuring Falls Below Historic Averages

In the first half of 2021, nine companies with liabilities exceeding $1 billion filed for Chapter 11, constituting a 50% decrease from 2020 and six fewer filings than the same period in 2019.[20] Similarly, as of December 2021, nearly 30 companies with liabilities in excess of $500 million filed for bankruptcy during 2021, a precipitous drop from the 92 filings in 2020. It is also approximately 50% below the corresponding number of filings in 2019.[21] Private companies constituted nearly 80% of Chapter 11 filings in the first half of 2021, a significant departure from the annual average of 39% between 2005-2020.[22] Conversely, only 12 publicly traded companies filed for bankruptcy in the first half of 2021, the lowest number since 1980.[23]



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The average size of the 20 largest bankruptcies in 2021 was 88% smaller than filings that occurred in 2020.[25] When measured by total assets, 2021 experienced fewer bankruptcy filings compared to 2020, with the top two filings, Seadrill Limited and Washington Prime Group, both occurring in the first half of the year.[26] Only the Seadrill bankruptcy would have made the list of the top 20 largest bankruptcies in 2020.[27]

Overall, 2021 experienced a lower level of restructuring activity than anticipated, and that was largely attributable to central bank policies around the world and substantial available liquidity from banks, private equity, and hedge funds. In the United States alone, Congress enacted more than $5 trillion in financial relief measures since the onset of the pandemic, including almost $800 billion in Paycheck Protection Program loans to various businesses. The Federal Reserve, in concert with other central banks around the world, has also utilized powerful monetary policy measures, such as lowering the target federal funds rate to a range of zero to 0.25%, in addition to purchasing corporate bonds and loans. On the market side

of the spectrum, private debt funds raised $88.5 billion in the first half of 2021 after raising $110 billion during the entirety of 2020.[28] Of the $1.4 trillion in capital currently managed by debt funds globally, $1.165 trillion has been invested, while $234.5 billion of capital remains unallocated.[29]

The Corporate Debt Lifeline Continues to Abate Restructuring

Private banks, private equity, and hedge funds were willing to forgo court-supervised restructuring in favor of granting covenant relief, extending maturities, and providing new or additional liquidity to borrowers through debt or equity. In the United States, the nonfinancial corporate debt-to-GDP ratio increased to 50.6% in the first quarter of 2021.[30] Additionally, investment-grade and high-yield spreads declined significantly from their historic levels in June 2020, dropping to 0.86% and 3.03%, respectively.[31] Borrowers were able to seize on available capital at attractive interest rates and delay maturities further into the future, as financing options were available for 70% of high-yield bond issuances.[32]

The corporate debt lifeline enabled some companies to amass liquidity by tapping into existing lines of credit, undertaking major capital structure reconfigurations, and leveraging previously unencumbered assets in order to finance existing debt and sustain operations. One example of this phenomenon began to manifest in December 2020, when AMC Entertainment signaled that it might be on the brink of filing for bankruptcy. Circumstances changed, however, at the beginning of 2021 when AMC was able to raise more than $917 million in new equity and debt. Despite missing earnings expectations in the first quarter of the year, AMC tapped into an additional $587 million in equity issuance in June 2021. Another prominent example is Carnival Corp., which despite facing a notable decline in revenue, amassed approximately $33 billion of total debt by the beginning of 2021, nearly three times more than it had at the end of 2019.[33]

Future Debtors? Industries Weathering Sustained Distress

Retail & Commercial Real Estate. Notwithstanding the initial wave of pandemic-accelerated bankruptcies in 2020, the retail industry continues to face a variety of structural barriers that may inhibit recovery and lead to another round of in- and out-of-court restructurings in the years to come. The expansion of digital brands into related or core-adjacent product lines has made the market more crowded and competitive. Further, recent calls by investors for retail to separate or spin out e-commerce from brick-and-mortar operations would, if heeded by retailers, isolate profitable e-commerce assets from more structurally challenged brick-and-mortar operations. This, in turn, could precipitate additional (or repeat) in- and out-of-court brick-and-mortar retail restructurings. Unlike the early stages of the pandemic, when retailers benefited from government support and landlord rent concessions or abatements, it is less likely that retailers will be able to negotiate further concessions as landlords face their own financial hurdles, which may limit retailers' abilities to manage liquidity troughs. In fact, based on the challenges facing these landlords, including the potential long-term shift away from brick-and-mortar retail stores, commercial real estate may be among the hardest hit industries during the next round of restructuring activity

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Health Care & Senior Living. In 2021, the average length of hospital stays rose by 12.6% from 2020, while some hospitals with 500 beds or more saw an 18% increase in the median length of stay compared to 2019. [34] Meanwhile, hospitals' cost of care continued to rise, given increased costs associated with inpatient cases, drug prices, labor, and personal protective equipment. These factors resulted in a 15% increase over the pre-pandemic total cost of care per patient.[35] With respect to senior living, occupancy rates recovered to 70% in 2021, but still fell short of the 85-90% pre-COVID levels.[36] Additionally, 84% of nursing homes reported losses in revenue as a result of fewer post-acute patients coming from hospitals.[37] Overall, nursing homes are expected to lose $94 billion over the course of the pandemic.[38] As COVID-19 variants continue to drive this volatility, and near-term debt maturities continue to loom, significant barriers to health care providers' long-term ability to meet the needs of their respective communities will likely remain.

Hospitality & Travel. The airline industry has been forced to adapt continually in response to increasing reports of Omicron variant outbreaks and the attendant increases in flight cancelations. Accordingly, experts have lowered their outlook for global air traffic in 2022. [39] Cruise line operators have likewise reported excess ship capacity, and the dip in cruise bookings following the Delta variant outbreak does not bode well in the wake of Omicron. Furthermore, in an ominous development for other sectors of the hospitality industry, including hotels, business travel is not expected to return to 2019 levels

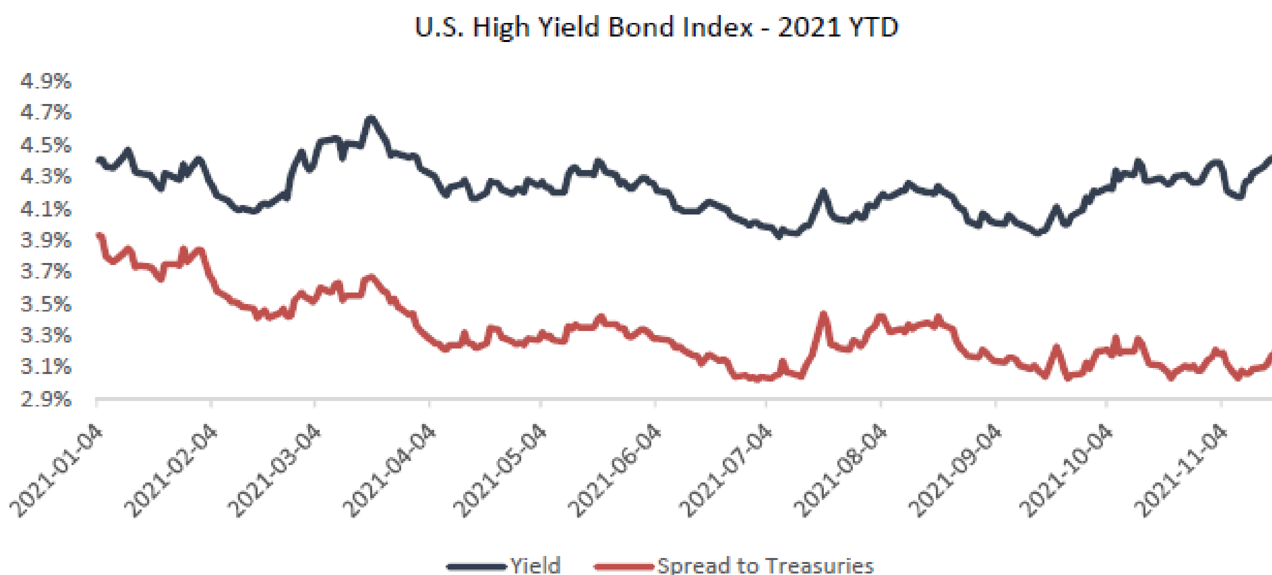
for several years at the earliest. Pronounced volatility is likely to continue plaguing these industries in 2022 and beyond as the population at large navigates the evolving pandemic threat and changes to the way we live and work.

Automotive. The automotive industry is facing an extraordinary level of productivity disruption due to ongoing supply chain issues. Where OEMs have been able to sustain revenues through fewer discounts and higher prices, tier-1 and below suppliers have struggled to acquire necessary parts and raw materials as a result of supplier shutdowns, excess demands on shipping, and labor shortages. The supplier industry has little bandwidth to endure these ongoing disruptions, which may trigger restructuring events in the first half of 2022. The price tag may be substantial; it is projected that the auto industry will sustain an estimated net loss of $270 billion over the course of the pandemic.[40] With little relief in sight, suppliers may find themselves searching for other ways to correct course or bridge liquidity.

RESTRUCTURING OUTLOOK FOR 2022 AND BEYOND

Price Increases and Rising Interest Rates

In forecasting corporate restructuring in 2022 and the years to follow, a primary indicator of future activity will likely stem from current and prior high-yield borrowers. As of November 2021, high-yield bond issuances exceeded $440 billion, already topping the $431 billion mark set in 2020.[41] Many companies have offered previously unencumbered assets (e.g., cruise ships, frequent flier miles, foreign subsidies, intellectual property) as security for new financing just to keep their heads above water. Prime examples include companies like Boeing and Delta Air Lines, whose total debt doubled between the end of 2019 and beginning of 2021, to $64 billion and $35 billion, respectively.[42] Nevertheless, high-yield issuances have already shown signs of regression. The $30 billion and $29 billion of high-yield issuances in October and November, respectively, mark the second and third slowest months for primary pricings in 2021. Despite the high level of issuances in 2020 and the beginning of 2021, rising consumer and producer prices could depress demand by reducing the purchasing power of fixed bond payments. An uptick in inflation has prompted the Federal Reserve (and other central banks) to accelerate plans to raise interest rates and taper corporate bond and loan purchases. The resulting potential increases in borrowing costs could then lead to greater expenses for borrowers and impact companies' ability to refinance, particularly if they are still in the midst of recovery. But, such plans could change yet again if central banks need to respond to the impact of additional virus variants on the world economy and if inflation becomes less of a relative concern.



Source: ICE BofA US High Yield Index[43]

Inflation

The high-yield market as a whole has exhibited some indications of strain as inflation concerns also remain a factor. Borrowers have prioritized acquiring cash at current rates before yields rise further. The junk-bond index posted a loss for its third straight month in November 2021, while yields rose to their highest levels in eight months at 4.29%.[44] BBs, single Bs, and CCCs all posted negative returns during this period.[45] New issue pricing has also shown signs of instability, while U.S. equity markets have fluctuated on market uncertainty given possible policy changes at the Federal Reserve and open questions regarding Omicron's impact on the return to pre-pandemic norms. Further, central banks may face a quandary between the need to respond to inflation while maintaining the flexibility to respond to additional COVID-19 variants and impacts from lockdowns or economic volatility associated with COVID-19 disruptions.

Market Volatility

Unsurprisingly, the uncertainty regarding ongoing public health concerns remains a significant driver of volatile market activity, and this will likely continue for the foreseeable future. Periodic increases in COVID-19 cases and the advent of new variants have the potential to depress demand within industries whose recovery is contingent on public confidence in a return to normalcy. This, in turn, may impact financing resources for companies like Carnival Corp., which continue bolstering their liquidity through ongoing debt sales. While analysts and investors anticipate a low rate of junk bond defaults in 2022,[46] a continued slowdown of sales may impact some borrowers' ability to service their existing debt while maintaining sufficient operational liquidity. As of November 2021, $283.6 billion of high-yield issuances had been used to refinance existing debt, a 13% increase from the record-setting pace of refinancing in 2020.[47]

Broader Leveraged Market

In August 2021, the U.S. leveraged finance market surpassed $3 trillion for the first time in history. Leveraged loans increased by nearly 130% since the 2008-2009 financial crisis, and below-investment-grade loans have steadily increased over the last two years.[48] In North America, leveraged buyouts and acquisitions have accelerated since the height of the pandemic, with companies announcing $2.2 billion of mergers and acquisitions as of August 2021, a 152% increase during this period.[49] This activity has led to increased sales of short-term loans by lending institutions, indicating that more leveraged buyout lending may be on the horizon in the short term. However, rate increases may lead to a decline in refinancing over the next year given that companies have already maximized favorable market conditions to delay debt maturities.

Looking forward, according to data from Bloomberg L.P., approximately $2.8 trillion of high-yield bonds are set to mature between 2022 and 2030, and these bonds have current yields that are primarily lower than the coupons at which they were issued.[50] The gap between yield and coupons compresses toward the latter end of this timeframe, suggesting that issuers' ability to continue refinancing at lower rates may already be reaching its limit.[51] During this same eight-year time period, according to data from Bloomberg L.P., $130 billion of leveraged loans issued to fund dividend payments will also come due.[52] The attendant deterioration of traditional leveraged buyout and dividend recaptures will undoubtedly yield a blossoming direct lending movement and, possibly, defaults.

Outlook

The retail, commercial real estate, health care, hospitality, travel, and automotive industries will likely face continuing headwinds as payments on high-yield issuances become due. Businesses serving the consumer discretionary retail market will need to address approximately $37 billion worth of high-yield debt maturities through 2030, with nearly $10 billion maturing within the next four years.[53] High-yield issuances within the health care industry appear equally daunting, with more than $32 billion of maturities coming due by 2030.[54] The travel, lodging, and airline industries are facing more than $45 billion of high-yield debt maturities through the end of the decade, $7 billion of which will mature by 2025.[55] With respect to the automotive sector, approximately $32 billion worth of maturities will come due over the course of the next 10 years.[56] While the uptick in refinancing activity may have temporarily abated concerns from investors, these strategies may have only delayed the inevitable. Another economic downturn or increased interest rates could force a debt reckoning on companies that have not yet rebounded from the initial market shock following the outbreak of the pandemic.[57] Likewise, uncertainty regarding the pandemic's impact on market demand, inflation, and government intervention will all factor into whether high-yield issuances remain steady or continue to slow in the coming year. This will likely impact some borrowers' ability to service their existing debt and could prompt

alternative approaches to addressing debt obligations in 2022. As maturities on high-yield debt and leveraged loans become due, private credit will likely continue to expand, possibly as lenders of last resort. In what may amount to a precursor of things to come, private lenders will continue utilizing loan-to-own strategies that anticipate a thawing out of the post-pandemic restructuring freeze.

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Michael G. Fischer, an associate in the Washington Office, assisted in the preparation of this White Paper.

ENDNOTES

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57 These risk factors are not unique to the United States. Companies across Europe, the Middle East, Africa, and Asia will face continuing pressure in 2022 as increases in the price of energy, raw materials, and logistics could push businesses to the edge. The cost and scarcity of labor will only exacerbate this threat to profitability. These inflationary pressures, combined with the uncertainty surrounding future responses to the COVID-19 pandemic, will loom over distressed industries across the globe as they try to recover from the initial outbreak of 2020.

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