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Until The Economy Fully Recovers, Many More Companies Will Face Distress

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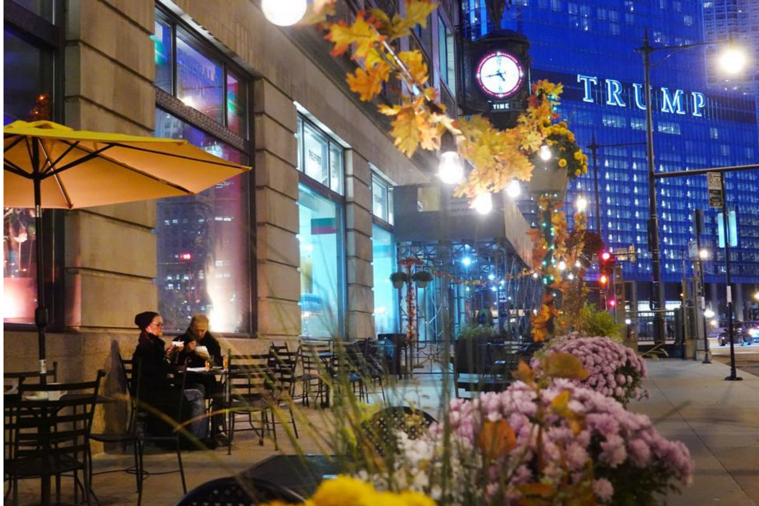
It's been more than nine months since the global outbreak of the COVID-19 pandemic and policy makers continue struggling to balance plans for reopening economies with efforts to contain renewed outbreaks of the virus. On the upside, there are signs that a reliable vaccine may not be too far off and although we have suffered through a major economic slowdown, unprecedented monetary and fiscal relief measures have reduced systemic risk and offered cause for optimism about the future economic outlook.

However, despite all the recent stimulus measures, many companies have been damaged due to the rapidly changing market dynamic and unsustainable leverage has made their situation even more dire. Thus, we have seen default rates climb and a robust supply of new distressed securities across a wide range of issuers and industries.

As the economy charts a continuing recovery, there are bound to be major winners and losers going forward depending on the quality of each company's balance sheet, business plan and strategy for competition. For instance, overleveraged firms will continue to struggle to meet their fixed expenses (despite extremely low interest rates) while more moderately leveraged competitors fight to take market share from overleveraged peers. Similarly, certain industries where social distancing is difficult (such as airlines, theatre chains, or cruise ships) will take longer to recover, if at all, and therefore face heightened risk of distress.

Finally, some industries which were already experiencing secular change – like telecommunications, retailing and oil production – are also subject to heightened bankruptcy risk. With this forecast, we recommend that investors diversify some passive long equity holdings into selective ownership of value stocks with event-driven return potential. Although value stocks have underperformed growth until recently, many have built-in catalysts – like potential special dividends or transformative M&A transactions – which can help generate market uncorrelated returns. We also recommend that investors hedge some market and inflation risk with individual company short positions as well as with long precious-metals holdings. Given the overwhelming amount of new and attractively priced distressed securities, we also advise investors to increase allocations into this alternative asset class.



According to JPMorgan, 92 companies defaulted on $123.4 BN in junk-rated bonds and loans during the first nine months of the year. This YTD level ranks as the second highest annual default total on record and second to only 2009 when $205.0 BN in bonds and loans defaulted.

Defaults have already jumped and will likely continue higher, as highly leveraged borrowers struggle to meet their fixed expenses while facing substantially slower economic demand due to COVID. Of course, some sectors are expected to fare much worse than others in this environment. For example, Fitch expects default rates of over 40% in the leisure and entertainment industries and over 20% for retail and energy.

With regard to the 10 largest junk-rated defaults so far this year, each of these companies was already overleveraged heading into the crisis. Even so, the virus pandemic was the proverbial straw that broke the camel's back. As a result, unprecedented governmental relief measures, like the CARES Act and extremely low interest rates, were unable to further put off the day of reckoning for these big companies. This theme will undoubtably repeat for the rest of this year and into 2021.

Separately, it's interesting to observe that most of the 10 largest YTD defaults were in the energy and retail sectors. On the retail front, high leverage and fixed costs (in the form of retail store leases) make it nearly impossible to compete effectively with online retailers like Amazon. Unfortunately, the outlook for most retailers, even if they restructure through bankruptcy, therefore remains uncertain at best.

In the energy industry, excessive pre-existing leverage combined with dual oil shocks this year to create a lethal combination. The dual oil shocks were caused by: (1) lower demand due to COVID-19 quarantines, and (2) increased supply due to mounting U.S. production and the Russian-Saudi oil price war. By way of history, oil prices had already collapsed in 2014 (from $100/bbl. to only $26/bbl.) However, earlier this year oil prices dropped to below zero for the first time in history.

This caused serious distress up and down the energy patch. From upstream exploration and production firms to downstream refiners and marketers of petroleum products, the amount of energy companies in

distress is high and expected to remain so. Because of this, there are currently some outstanding opportunities for building long positions in distressed energy firms at attractive prices.

While the energy industry suffered from dual supply- and demand-shocks discussed above, other industries (such as: cable/satellite, retail, and telecommunications) also face dramatic secular change which makes it very difficult to compete with less leveraged peers.

The following represent industries and themes where we currently see and/or expect future distress:

• Airlines (coronavirus, distressed debt, governmental bailouts, secular change)
• Auto manufacturers (coronavirus, M&A, overcapacity, secular change, tariffs)
• Casinos (coronavirus, distressed debt, M&A, post-distress equities)
• Coal (coronavirus, deregulation, M&A, post-distress equities, secular change) • Energy (demand- and supply-shocks, distressed debt, volatile commodities)
• Financial Services (BWIC's, coronavirus, distressed loans, liquidations, loss provisions)
• Governments (excessive debt, fiscal stimulus, legacy liabilities, record-low interest rates, QE)
• Industrials (coronavirus, deregulation, distressed debt, legacy liabilities, tariffs, tax reform)
• Litigation (asset stripping, covenant-lite loans, inter-creditor disputes, liquidations, mass torts, priming loans)
• Real estate (distressed debt, low interest rates, opportunity zones, tenant defaults)
• Retailers (coronavirus, distressed debt, lease renegotiations, secular change)
• Shipping (coronavirus, distressed debt, post-distress equities, tariffs, volatile commodities)
• Telecommunications (coronavirus, deregulation, excessive debt, secular change)
• Utilities (distressed debt, post-distress equities, wildfires)

As you can see from the above list, the current supply of distressed investments is robust. For nimble distressed securities managers with a mandate to invest long or short, up and down the capital structure, there are many opportunities, particularly for those able to switch between long and short investing and to invest in various security types, depending on where the best opportunities exist. The current market offers many new chances for short selling companies threatened with default. In addition, the massive new supply of distressed debt bodes well for long distressed debt investments.

The market remains filled with uncertainty and we'll have to wait a while to see what steps the Biden Administration will take to stimulate a faster recovery, but for careful investors who understand the distressed this continuing crisis is a time filled with possibilities and reasons to be optimistic.