EVALUESERVE

June 2023

Bankruptcies: On the rise, once again

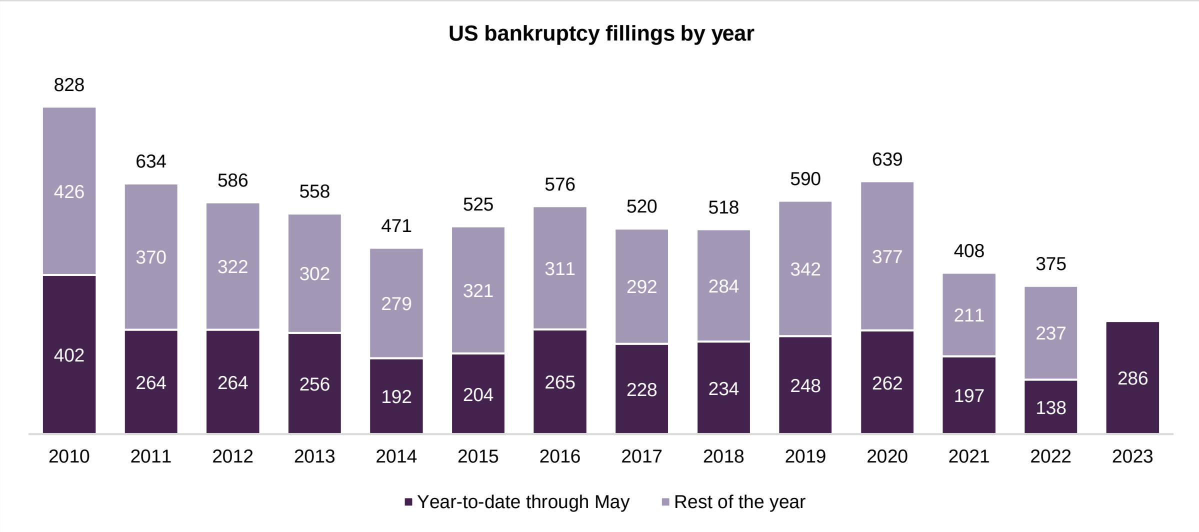
Bankruptcies are a prominent offshoot of any economic crisis. They allow markets to weed out inefficient businesses and reallocate capital to efficient businesses.

In this blog, we look at post-COVID bankruptcies, which unfolded in three stages:

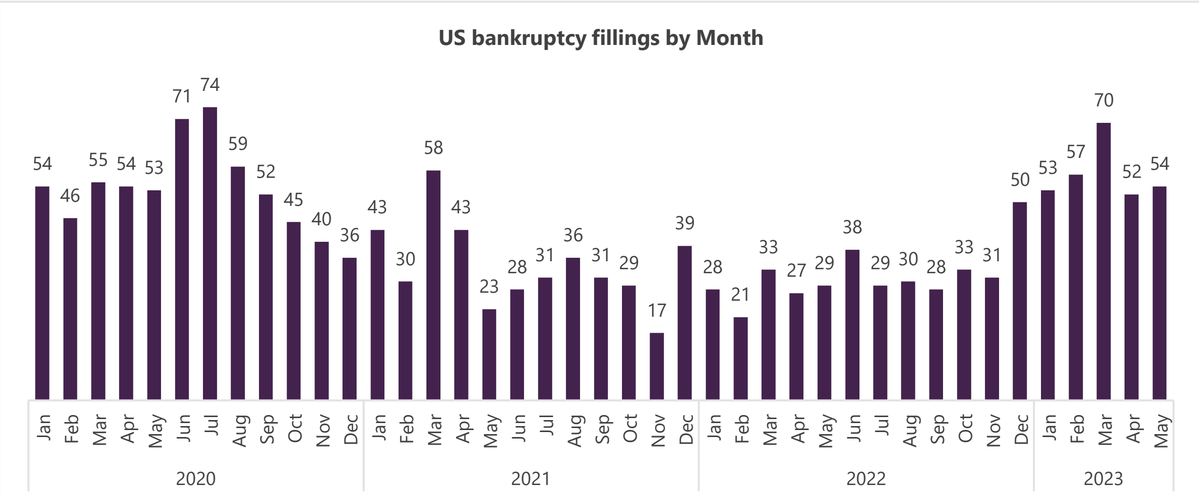
Stage 1: Extinction of the weakest (2020)

The pandemic not only had a profound impact on the humanity, but also on the global economy. The resulting economic uncertainty pushed struggling companies over the edge and led to large-scale bankruptcies.

In 2020, bankruptcy filings in the US reached 639 [(1)], the highest since 2011. Monthly bankruptcy filings peaked at 74[(1)] in July 2020. Some notable names that filed for bankruptcy in 2020 are contract drilling company Diamond Offshore Drilling, popular fitness chain Gold's Gym, satellite operator Intelsat, more than a century old retailer J.C. Penney, and one of the oldest apparel chains Brooks Brothers.



Includes S&P Global Market Intelligence-covered US companies that announced bankruptcy between 1 January 2020 and 31 May 2023



Data Compiled on 2 June 2023. Includes S&P Global Market Intelligence-covered US companies that announced bankruptcy between 1 January 2020 and 31 May 2023.

(1) *For universe of companies that included public companies and private companies with public debt, where either assets or liabilities at the time of bankruptcy filing were greater than or equal to USD2mn, or private companies where either assets or liabilities at the time of bankruptcy filing were greater than or equal to USD10mn*

Stage 2: Dancing on steroids (2021–22)

Given the unprecedented pressure of the pandemic on the economy, a surge in corporate bankruptcy filings was widely anticipated in early 2021. That surge however never materialized. Instead, US bankruptcy filings plummeted to 408, compared with 639 in 2020. The scenario continued until the last quarter of 2022.

The expected flood of corporate bankruptcies did not occur due to a combination of factors:

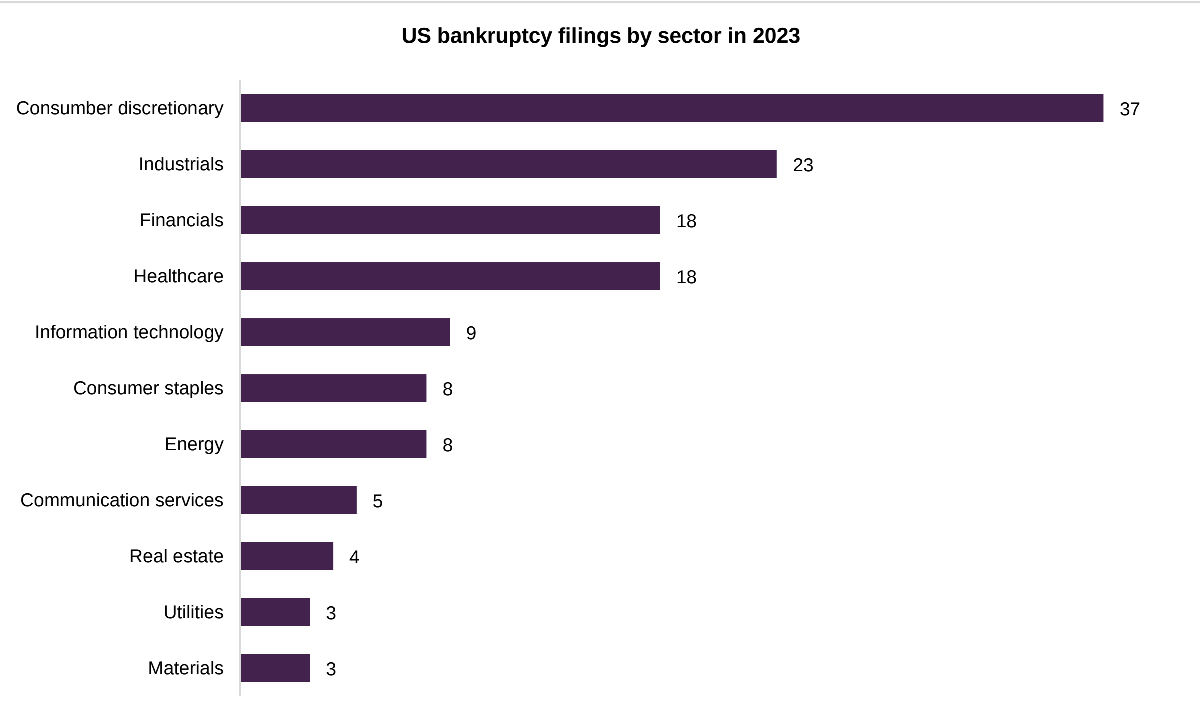
- Legal and regulatory forbearance
- Increased use of out-of-court workouts to resolve business distress
- Trillions of dollars of financial support from governments

While these stimulus measures gave troubled firms some extra time, they also masked deeper vulnerabilities that are now coming to the fore and leading to another spate of bankruptcies.

Stage 3: After the quiet comes the storm (2023)

At the beginning of 2023, the volume of business bankruptcies began to rise again. US corporate bankruptcy filings stood at 286 in the first 5 months of the year, more than double the comparable figure a year ago and the highest in the last 12 years during the same period. In the first four months of 2023, the largest number of bankruptcies were registered in the consumer discretionary sector, followed by industrials, financials, and healthcare.

Bed Bath & Beyond, Serta Simmons Bedding, Kidde-Fenwal and Party City are the largest consumer discretionary companies, with liabilities of over USD1 bn, to have filed for bankruptcy. SVB Financial Group (Financials), Avaya (IT), and Diamond Sports (communication services) were other large corporates with liabilities of over USD1bn that became a victim of the economic environment.



Data Compiled 2 June 2023

What is fuelling the surge in bankruptcies?

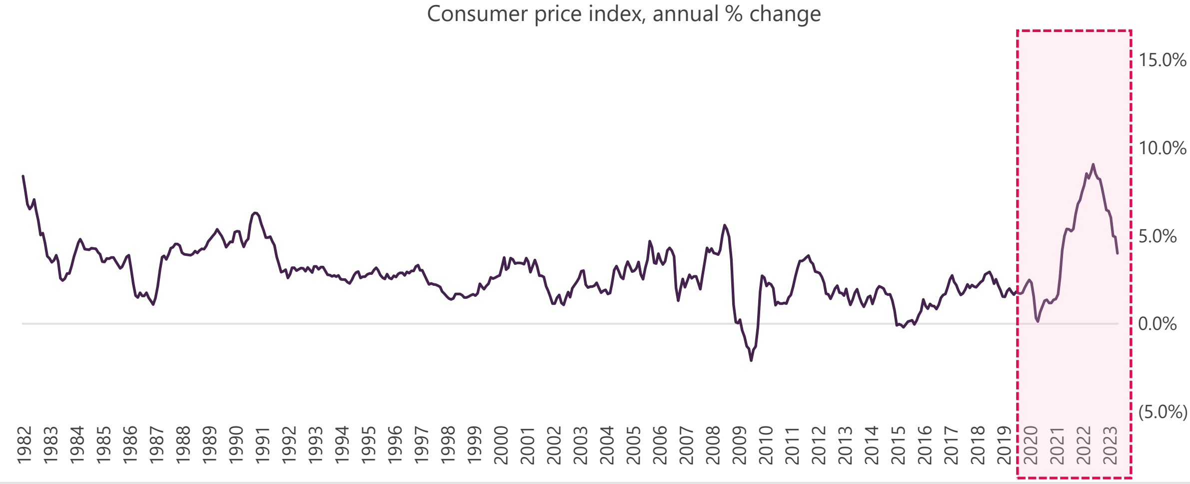
The multitude of factors discussed below are pushing vulnerable companies to the brink of disaster:

Highest inflation in 40 years

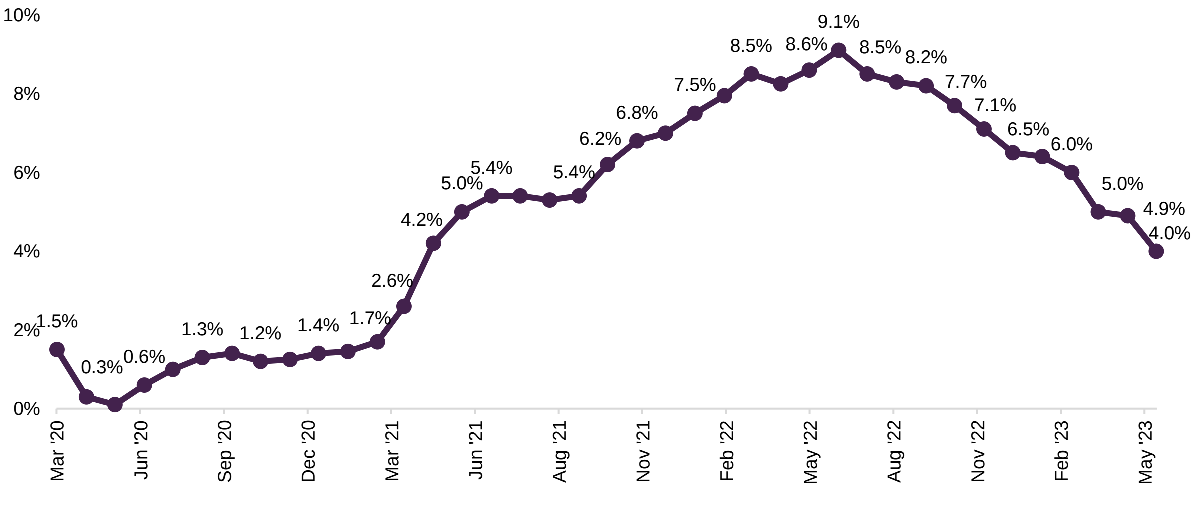
Before the pandemic, inflation in US hovered at around 2%. It dropped sharply at the start of the pandemic in early 2020, as people stayed home and stopped spending money. The lack of spending triggered a deep economic downturn.

US inflation reached at four-decade high in mid 2022

Consumer price index, annual % change



US monthly 12-month inflation rate from March 2020 to April 2023



In response, the US Federal Reserve stepped in to keep credit flowing and implemented a quantitative easing policy, cut Federal Funds rates, and also provided repeated stimulus packages to the public.

By early 2021, the economy started to witness some recovery as households had access to more money after months at home due to stimulus received from the government. At the same time, during pandemic manufacturing activities were affected leading to supply chain disruptions causing shortfall in supply of various goods. As a result, the prices of goods as well as shipping costs saw a jump. By late 2021, services costs began to climb quickly leading to higher inflation.

The gush of excess liquidity caused by Fed's loosening monetary policy, and surging gas and food prices and rent caused US inflation to reach a new four-decade peak of 9.1% in June 2022; it has been falling at a steady pace since and reached 4.0% in May 2023, yet remained well above the Fed's 2% target. Higher inflation has forced customers to curb their spending, thereby impacting sales for many companies, leading to stress in the economy.

Death of cheap money

The Fed's move to increase interest rates (in March 2022), to deal with a four-decade high inflation rate, put an end to the era of cheap financing. Interest rates continued to increase until May 3, 2023, with federal fund rates reaching 5.25%, the highest in 16 years. This lowered lenders' willingness to forbear or extend loan maturities, especially to troubled companies, thereby accentuating their downfall. Though Fed did not raise rates in its recent FOMC meeting on June 14, 2023, however indicated that another sharp increase could be needed before year-end.

Fed rate hikes (2022-23)

FOMC Meeting Date	Rate Change (bps)	Federal Funds Rate
May 3, 2023	+25	5.00% to 5.25%
March 22, 2023	+25	4.75% to 5.00%
February 1, 2023	+25	4.50% to 4.75%
December 14, 2022	+50	4.25% to 4.50%
November 2, 2022	+75	3.75% to 4.00%
September 21, 2022	+75	3.00% to 3.25%
July 27, 2022	+75	2.25% to 2.50%
June 16,2022	+75	1.50% to 1.75%
May 5, 2022	+50	0.75% to 1.00%
March 17, 2022	+25	0.25% to 0.50%

Supply-chain disruptions

Pandemic-led worldwide lockdowns slowed or temporarily stopped the flow of raw materials and finished goods, disrupting manufacturing activity. It also exposed previously unseen vulnerabilities, such as staff shortages and losses due to closure, and magnified problems that already existed in the supply chain.

For example, cosmetics maker Revlon had to file for bankruptcy due to global supply chain disruptions that pushed up raw material costs and prompted vendors to demand upfront payments from the company. Vendors that traditionally offered up to 75 days for payment began demanding cash in advance for new orders. On the other hand, pandemic also lengthened shipping times, pushing up the freight costs.

High energy costs

Energy prices hit an all-time high in 2022, as a consequence of Russia's invasion of Ukraine and the use of gas as a weapon of war. The wholesale price of electricity in the European Union's internal market is linked to the price of gas, which was mostly imported from Russia. It led to an increase in the price of electricity produced in gas-fired power plants and affected overall electricity prices.

Soaring energy costs forced a record number of firms out of business. Even the toilet paper companies could not spare the burn. Hakle, a German household name since 1928, filed for bankruptcy, as its' production processes required large amounts of gas in the drying process.

Persistence of the pandemic

The pandemic kept on resurfacing worldwide, especially in China, where the population had little resistance due to strict lockdown protocols. By virtue of its' sheer economic size, when China sneezes the world economy catches a cold. Since China is a major producer of goods for the world, lockdowns in China impacted supply chains worldwide leading to a shortage of goods and increase in cost. This increased cost pressures and eroded profit margins for many companies.

Current trends and outlook

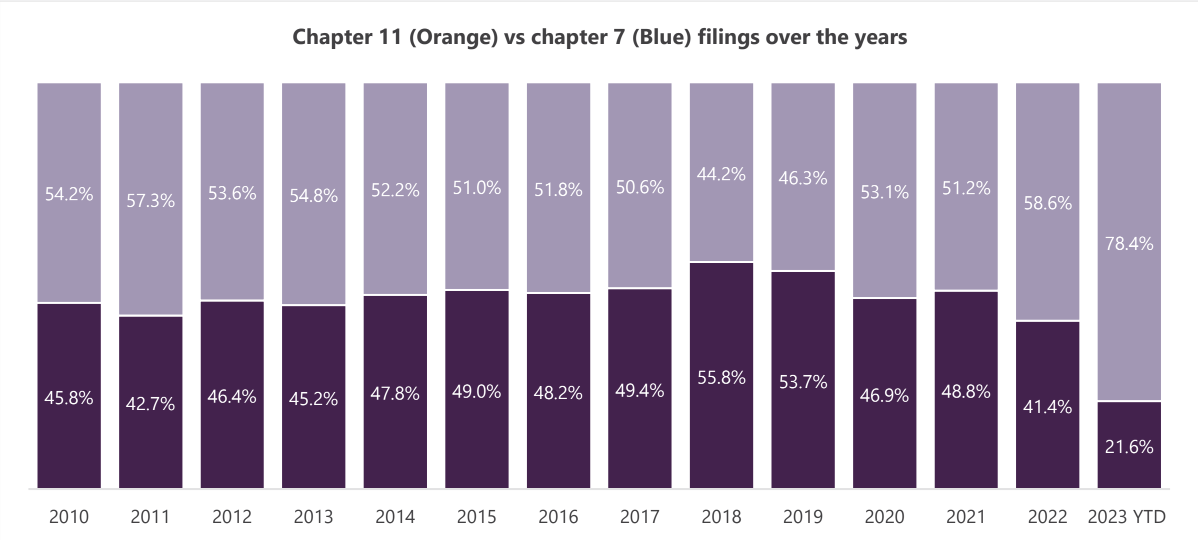
Potential rise in bankruptcies

The likelihood of bankruptcy and resulting restructuring activities remains high, especially in the case of banking and retail companies. According to Allianz Research, the volume of bankruptcies is accelerating and is likely to increase by 21% in 2023 and 4% in 2024.

- In Europe, insolvencies are likely to increase by 41% in France, 16% in the UK, 22% in Germany and 24% in Italy. In the US, insolvency is likely to increase by 49% due to tighter credit conditions and a sharp slowdown. China could see a moderate 4% increase in insolvency, especially because the country's construction sector is still ailing.
- The most susceptible companies are the ones that lack cash buffer, have little pricing power (for example companies operating in specialized retail such as textiles, household appliances and services (like restaurants)) or are more exposed to a higher wage bill (such as retail, transportation, and construction)
- Another set prone to risks are the ones impacted by rising interest repayment costs (such as construction and durable goods companies)

Reorganization over liquidation

There is incremental inclination towards reorganization (Chapter 11 filings) over liquidation (Chapter 7 filings). This shows that distressed companies are optimistic about revival. Chapter 11 allows companies to continue operations while paying creditors while Chapter 7 leads to the cessation of operations and selling of assets.

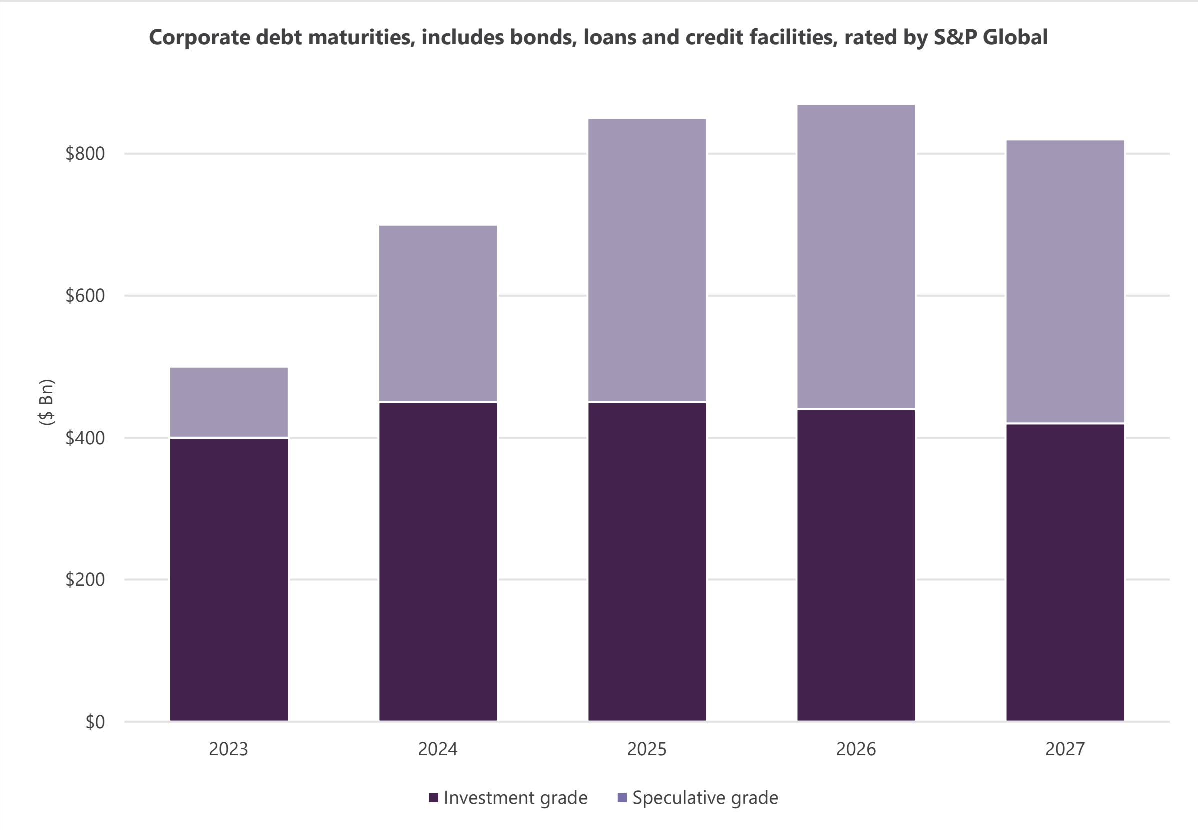


Source: S&P Global Market Intelligence

Refinancing becomes difficult

It is becoming increasingly difficult to refinance and renegotiate debt structures, as economic uncertainty continues to worsen and interest rates continue to increase. As traditional lenders, such as banks, retreat or reduce their commitment, companies are forced to opt for alternative sources of capital at a higher cost and less favourable terms. Private equity and credit funds, who sit on a lot of dry powder, are increasingly participating in the debt market; these charge a higher margin than traditional lenders.

According to the Fed, corporate debt rose from USD16.3 trillion just before the pandemic to about USD19.8 trillion at the end of 2022. Given the on-going environment, near-term profit pressures on US corporates are set to intensify. As per S&P Global Ratings, corporate debt coming for maturity is set to steadily rise through 2026, with speculative-grade debt surpassing investment-grade debt in 2027. Speculative-grade debt carries a higher risk of default than investment-grade debt.



Source: S&P Global Rating

S&P Global Ratings also forecasts that the 12-month trailing default rate for speculative-grade securities will jump from the current 2.5% to 4.5% by early 2024. These default rates had fallen to about 1% in 2021.

Similarly, yields on speculative-grade bonds, as measured by BofA US High Yield Index, which were less than 4% in mid-2021, have now more than doubled, giving an indication of how the capital has become more expensive for the borrowers.

Many companies, particularly with speculative grade debt are likely to find it difficult to refinance their debt, thereby increasing their chances of bankruptcy.

A ticking time bomb

The banking sector has grabbed the highest attention in recent times. Q1 2023 was a tumultuous period for US banking, as it saw the collapse of Silicon Valley Bank (in March 2023), Signature Bank (known to cater to law, real estate, and cryptocurrency firms), and SVB and SB (second and third largest bank collapses in US history), and First Republic.

In Europe, Switzerland based Credit Suisse, which was already facing problems on multiple fronts, was hit by deposit withdrawals; the largest Swiss bank, UBS, was almost forced by the government and regulators to acquire Credit Suisse.

The rout, especially in US mid-size regional banks, continues; PacWest Bancorp, Western Alliance, First Horizon, and many others are still vulnerable and may be the next in line. If that happens, it will only be a matter of time before other weak financial institutions witness a domino effect.

Commercial real estate at risk

Another sector in the US that is creating a concern is commercial real estate. Work from home, layoffs, rising interest rates and mortgage refinancing are taking their toll and bankruptcies are expected to increase.

Aviation to witness consolidation

In the aviation sector, bankruptcies or restructuring is the norm rather than the exception. Globally, the industry lost USD140 bn in 2020, USD42 bn in 2021, and USD6.9 bn in 2022. As per IATA data, more than 160 airlines have gone belly up since 2019 after the start of the pandemic. Aviation witnessed 59 bankruptcies in the pre-covid period, 53 in 2020, 35 in 2021, and 15 in 2022.

Rising interest rates have impacted all aviation companies pushing up borrowing costs as well as purchasing costs, which has added to the inflationary pressures. While economy class fares have increased by an average of 36% for 2023, overall, bookings were still down by 22% globally for the first quarter of 2023. The global airline industry seems to be following the same path as the US, which has only the “big four” airline companies (American, Delta, Southwest and United). For example, in Europe, companies such as Aer Lingus, British Airways, Iberia, Level and Vueling are already owned by a single entity, i.e., IAG.

Retail

The fall in US retail sales in March 2023 was more than expected, as consumers cut back on purchases. Overall sales dropped 1.0%, as most segments, including auto, furniture, electronics, appliances, building material, garden equipment, and even clothing were impacted.

As high borrowing costs, shrinking savings accounts and inflation put a check on discretionary purchases, the industry's long-entrenched problems, such as shifting consumer habits, presence of many physical stores, and too much debt, are resurfacing. On the other hand, severe impediments in the supply chain (inability to source products, cost increases and delay in receiving goods) are putting pressure on retailers.

Given the challenging scenario, more retailers are likely to be pushed to the brink in the coming months. Fitch estimates that the default rate among junk-rated US retailers could reach 12% in 2023, compared with the rock-bottom low of 0.2% in 2022.

Conclusion

Extraordinary times call for extraordinary measures. The US Fed took extraordinary measures during the pandemic to prevent the economy from coming to a halt. It implemented quantitative easing measures to provide the desired liquidity. As a result, equity markets rallied, credit conditions became benign, and commodities prices surged.

However, the party continued too long. The Fed made a poor judgement and delayed the roll back of its accommodative stance. Too much money chased too few goods, inflation surged, and forced the Fed to tighten policy at an unprecedented rate. As not all corporates could adjust to the change at an equal pace, unpleasant consequences such as rise in restructuring or bankruptcies became commonplace and are expected to continue in the near term.

About the Authors

VIBHOR RASTOGI

Senior Manager

Corporate and Investment Banking LoB

Vibhor has 12 years of experience in working as part of an investment banking team with focus on various industries

Vibhor.Rastogi@evalueserve.com

RAGHAV AGGARWAL

Associate Director

Corporate and Investment Banking LoB

Raghav has over 17 years of experience in managing offshore investment banking delivery teams

Raghav.Aggarwal1@evalueserve.com