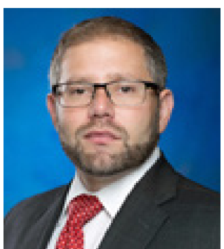
COVID-19: Bracing for Bankruptcies

MILLER BUCKFIRE
A Stifel Company

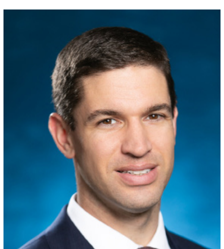
Kenneth Buckfire
President & Managing Director

James Doak
Managing Director

Kevin Haggard
Managing Director



Richard Klein
Managing Director



Matthew Rodrigue
Managing Director

Will we see a rise in bankruptcies as a result of COVID-19?

The COVID-19 crisis will cause a rise in bankruptcies in 2020 and 2021, as companies deal with the loss of revenue and income they are suffering during this global pandemic. The bankruptcy risk is greatest for those companies financed in the non-investment grade leveraged loan and high yield debt markets. Much of this debt was issued in the last decade through non-bank lenders, including business development corporations (BDCs) or is held in complicated collateralized securitization structures. In both scenarios, the debt holders may have limited cash and capacity to work with their borrowers in a crisis situation, which will complicate efforts to avoid bankruptcy.

What challenges will companies seeking to restructure and avoid bankruptcy face?

This crisis is unique because it's driven by a loss of revenue and income, which will make servicing debt more difficult. While business activity may soon resume, companies will need much more time to rebuild their working capital and cash. Companies that need to work with their creditors to avoid defaulting may not have enough time to do so. Borrowers may find themselves working with creditors that don't have more money to lend, or may have limits on the amount of distressed investment they can hold or manage. Some creditors may sell their debt to distressed investors who are more likely to force the company towards restructuring, and sometimes bankruptcy, as a means of gaining control. So there's a risk that a short-term revenue crisis ends up triggering changes in who is in a company's capital structure, and a longer-term period of debt restructuring and bankruptcy.

Will capital be available to companies who are seeking it?

Market dislocation presents both challenges and opportunities for levered companies and their stakeholders. Capital will be available for high-quality companies, but it will come at a higher cost. New investors will seek to invest at the most senior levels of the capital structure and look for out-sized returns and ownership positions normally associated with equity investments at the junior parts of the capital structure. There is so much uncertainty right now, that few investors are willing to make bold investments in the equity of challenged companies.

How will COVID-19 affect the already struggling retail sector?

This will likely serve as a tipping point for many "brick-and-mortar" retailers, many of whom were in serious trouble before COVID-19. Unfortunately, we are expecting potentially dozens of bankruptcy filings over the next few weeks and months. While retailers' liquidity is deteriorating as their stores remain closed and their inventory becomes stale, we do not expect to see many filings until the end of May. Timing is an important part of the bankruptcy filing. Many retailers are waiting to file bankruptcy until stores can reopen so they can liquidate excess inventory. Additionally, the accrued rent that they haven't paid in April and May will become a pre-petition liability, and will be compromised in the bankruptcy process. While it's likely that some retailers ultimately won't survive, others will use the bankruptcy process to reposition their businesses – closing unprofitable stores and rejecting their leases. We don't expect much traditional M&A in the sector, as potential buyers are preoccupied with their own COVID-19 disruptions. We could, however, see more creative transactions, possibly centered on brand managers acquiring valuable retail and consumer brands, or landlords and mall owners taking ownership stakes in retailers to keep them as tenants.

What additional sectors will be particularly affected by bankruptcies?

There will likely be bankruptcies occurring in all sectors where companies and their owners have grown dependent on the availability of inexpensive leverage (cheap debt) over the last decade. That debt will prove difficult to refinance as it comes due over the coming years, even with resumed regular commerce. However, there will also be some industries that will have sustained more lasting damage from the COVID-19 crisis because of changing habits and behaviors, among other factors. Companies highly dependent on business travel are potentially at risk as remote interaction may become more common place. As travel habits and behaviors change, airlines will continue to be adversely affected. Remote working may alter long-term demand for office space. Retail closures and intensifying migration to online shopping will negatively affect regional malls. The unprecedented decline in energy demand will mpact the oil and gas industry for an extended amount of time. We are expecting a wave of bankruptcies in that sector as well.

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