The Next Distressed Cycle Is Now!

BY J. SCOTT VICTOR, TMA GLOBAL CHAIRMAN

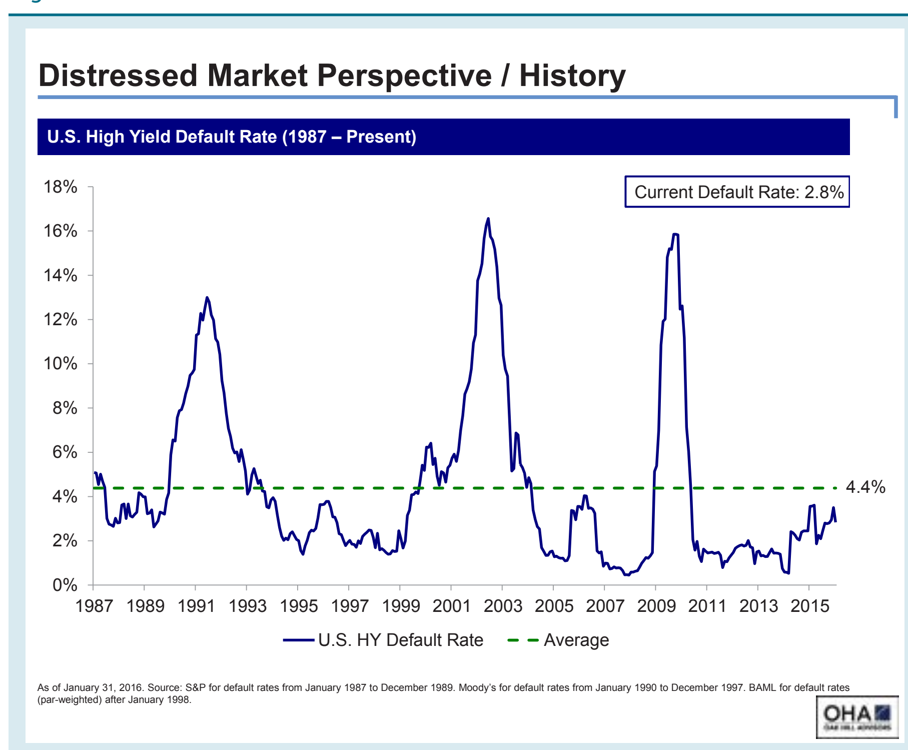
My last Reflections column in the *Journal of Corporate Renewal* was titled "Corporate Restructuring: Will the Force Awaken?" I'm here to tell you now that it has and we're in the early stages of the new cycle.

I write this having just returned from TMA's biggest and best Distressed Investing Conference ever. Over 700 of the top professionals in the restructuring industry attended the annual event in Las Vegas in February. The quality of the educational panels was excellent, and the two keynote speakers were widely regarded as the most outstanding we have had.

First up was Tom Petrie, CEO of Petrie Partners and one of the foremost experts on the oil industry in the world. Petrie addressed the state of the price of oil—where it's been and where he thinks it's going, and why. The summary is that Saudi Arabia and Russia, the two largest low-cost producers of oil in the world, will not cut production to inflate the price per barrel. To the contrary, the stated intent to maintain production at current levels is to drive high-cost producers—namely, those in the U.S. and Canada—out of the markets.

The Saudi cost of production is about $20 per barrel, still well below the current market price of world oil (in the low $30 per barrel range as this is written), while the costs of fracking, deep water, and oil sands production in the U.S. and Canada are multiples

Figure 1



As of January 31, 2016. Source: S&P for default rates from January 1987 to December 1989. Moody's for default rates from January 1990 to December 1997. BAML for default rates (par-weighted) after January 1998.

higher. To make matters worse, Iran, freshly freed from international sanctions, is gearing up to greatly increase its production. The bottom line is that the North American oil industry is in a prolonged downturn that will materially negatively impact production, distribution, field services, manufacturing, and equipment rental for some time. This industry alone is keeping many of us in the restructuring industry very busy.

A second keynote at the Distressed Investing Conference was by Glenn August, founder and CEO of Oak Hill Advisors, a $26 billion firm specializing in credit. August's 73-slide presentation left no doubt in the minds of anyone in the ballroom that a new distressed cycle is here.

To start, there are high default rates in the oil and gas sector, along with climbing default rates in coal, mining, commodities, and shipping. Next, the high yield market, which rewards investors with higher yields for taking on greater risk, has been slammed since third quarter 2015 as a result of growing defaults in those sectors. Those high yield investors are getting a reminder on what a credit crunch looks like.

The woes of the high yield debt market can be traced to the ongoing commodity price plunge. Those bond/loan prices are trading down dramatically. Many money managers are worried that panic in junk bonds could infect healthier markets, which could lead to liquidity issues throughout the credit spectrum. The third leg of the stool is the increase in credit spreads, with the distress ratio increasing.

Figures 1-4, which are slides from August's presentation, reflect the previous distressed cycles of 1990-1992, 2000-2003, and 2008-2010, and clearly show the current early stages of this new cycle.

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Figure 2

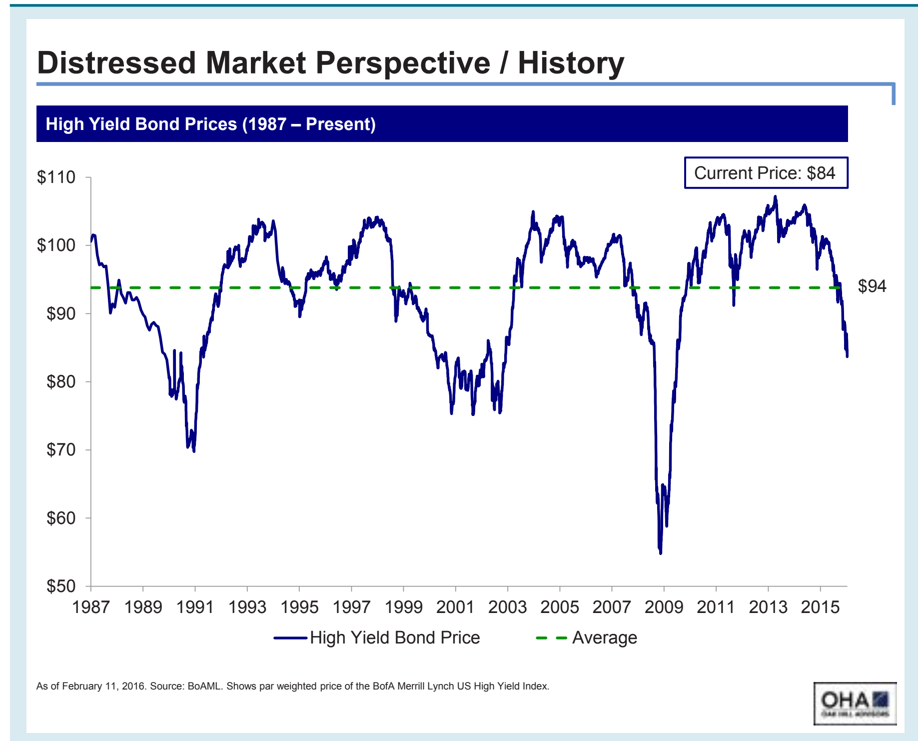
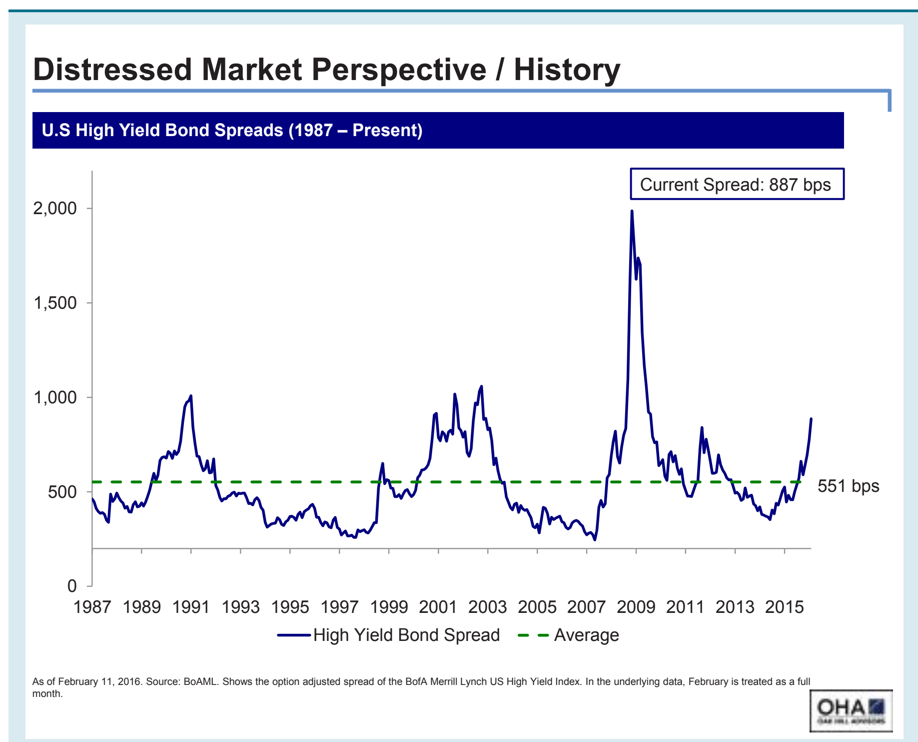


Figure 3



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August went on to talk about global macro issues that are contributing to the downturn, including:

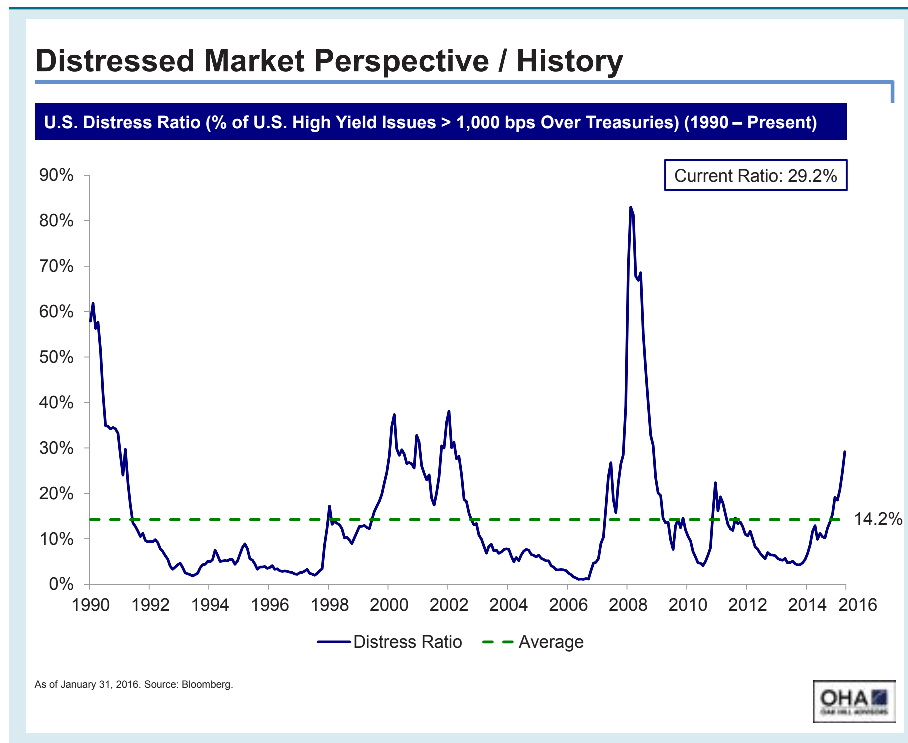
- Slowed growth in China and the resulting damage in world commodity pricing
- Energy issues that encompassed low global oil prices and the coal debacle
- Economic troubles in emerging markets
- Overall reduced liquidity, from the junk bond market to business development companies (BDCs) in the middle market
- Currency markets and the continuing impact of a strong U.S. dollar.

To make matters worse, the first two months of this year have brought a 10 percent decline in global equity markets—a correction. U.S. bank stocks have similarly declined, and fears exist about the health of European banks. Is a U.S. recession in the air? The prevailing thought is no, since job growth is steady and growth in gross domestic product, while still sluggish, continues to be positive. While there may not be a U.S. recession on the horizon, August's conclusion is that the next distressed cycle is here.

I agree with this conclusion, but not solely based on the visual proof from August's slides. I see the current distressed environment from the ground. The past year has been extremely busy for special situations in the mid to lower middle market, resulting from both the macro issues August discussed as well as micro issues. In the past 12 months, I've been involved in distressed M&A deals across a broad array of industries, ranging from coal to consumer goods, defense, distribution, education, electronics, food, manufacturing, media, oil & gas, retail, and others.

Most of the practitioners and investment bankers I know are busier than they've been in years. Even Chapter 11 filings seem to have stopped their multiyear downward trend, and bankruptcy lawyers are busier as well. As liquidity continues to tighten, restructuring professionals will get even busier doing what we do best—maximizing value and preserving jobs.

Figure 4



2016 Distressed Investing Conference Keynote Speaker Glenn August, Founder and CEO, Oak Hill Advisors

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