OCTOBER 2023

Back to the Future: Are We on the Verge of an Old-Fashioned Distressed Cycle?

KEY TAKEAWAYS

- After years of sporadic opportunities, traditional distressed investing could be entering a far more robust investing environment due to the ramifications of higher rates following a prolonged period of rates near zero.
- Since the Global Financial Crisis ("GFC"), periods of increased defaults have been relatively short-lived. However, given higher base rates and the amount of leverage in the system, an upcoming cycle should last longer – more akin to past distressed cycles prior to 2013.
- The looming maturity wall is expected to be an important catalyst for distressed investors as maturities ramp significantly over the next few years across global markets with base rates remaining elevated.
- Experienced investors who understand structural nuance and advisor-led reorganization processes – and who can leverage their expertise to identify, source, analyze and influence outcomes – should have an advantage in an environment marked by increased restructurings, defaults and bankruptcies. Furthermore, it could require significant expertise to navigate the increased presence of sophisticated and deep-pocketed private equity sponsors.
- While the distressed cycle is likely to feature opportunities across a wide range of industries and asset classes, real estate could be a particularly active asset class given its upcoming maturity profile and liquidity constraints.

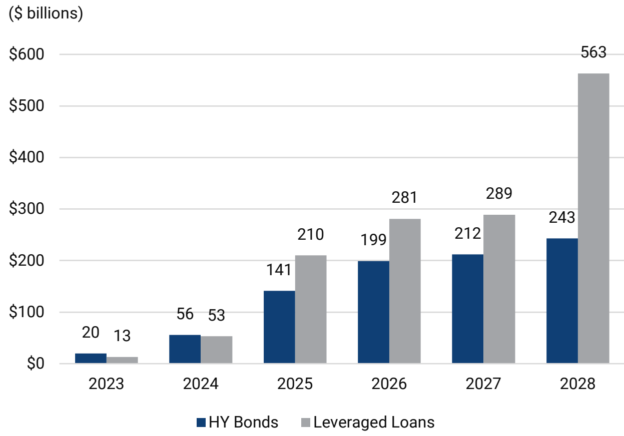
Nobel-prize winning economist Paul Samuelson once joked that the stock market had predicted nine of the past five recessions. Along those lines, since the Global Financial Crisis ("GFC"), many economists have predicted a lengthy default cycle due to distortions caused by the unprecedented actions of global central banks, however these forecasts have largely failed to materialize (yet!). Instead of the five-to-seven-year cycles experienced in 2000-2006 or 2008-2013, more recent cycles in 2015-2016 and in 2020 have been steep but short. These voices have only gotten louder of late, pointing to emerging cracks in the economic system and asserting that "this time is different" than the last decade, a phrase that draws skepticism from most investors. Why is the current environment different? Following a prolonged period of interest rates near zero (referred to as "zero interest rate policy," or "ZIRP"), the emergence of inflation has prompted a sharp rise in interest rates in a short period of time, with the Fed lifting rates from near zero in March 2022 to over 5%, their highest level in 22 years – which, compared to the last 15 years, is *very* different.

UP AGAINST A WALL

We believe that 2024 and the years ahead will be especially active for distressed investors. Higher financing rates will mean that not all borrowers will be able to refinance as easily as in years past and, coupled with sluggish economies in certain parts of the world, may mean that many existing capital structures are unsustainable.

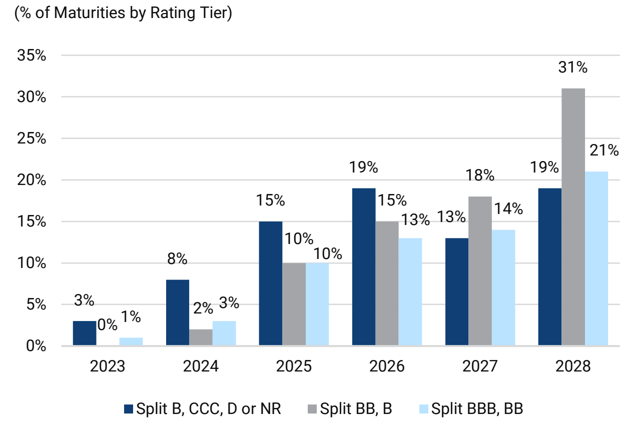
Much attention has been paid to the looming maturity wall that ramps significantly from current levels – and with good reason given its potential to serve as a catalyst for upcoming distressed activity! In the U.S., the value of high yield bonds and leveraged loans that are set to mature rises from $33 billion in 2023 to $351 billion in 2025 and $806 billion in 2028 (see Exhibit 1). The percentage of upcoming maturities from B and CCC issuers, who should have the hardest time refinancing, is also set to rise meaningfully from current levels (see Exhibit 2). This maturity wall is a global concern, as European issuers are confronted with a similar dynamic (see Exhibit 3) and Asian maturities are set to rise over 285% between 2023 and 2025.[1] There has already been a dramatic spike in defaults and restructurings in China, which faced a significant maturity wall in 2021 and 2022.

Exhibit 1: Maturities for U.S. High Yield Bonds and Leveraged Loans, 2023-2028



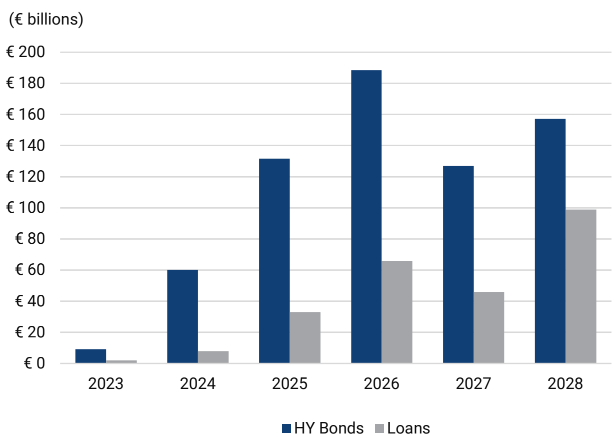
Source: J.P. Morgan. As of May 22, 2023

Exhibit 2: U.S. Maturities by Credit Rating, 2023-2028



Source: J.P. Morgan. As of May 22, 2023

Exhibit 3: Maturities for European High Yield Bonds and Leveraged Loans, 2023-2028



Source: J.P. Morgan. As of June 14, 2023

Since the GFC, default waves, such as those observed in late 2015 or during the peak of the Covid crisis, have lasted for only short periods of time. However, given the rapid rise in base rates and the massive amount of leverage in the global economy, we believe the next cycle will likely last longer and look more like the default waves observed prior to the GFC.

In a hypothetical scenario illustrated in the table below (Exhibit 4), imagine a corporate borrower that incurred debt several years ago in a low-rate environment at a base rate of 1% and a spread of 3.75%, equating to an all-in cost of 4.75%. With an unlevered free cash flow of $35 million, this borrower could have incurred $670 million of debt and still complied with an interest coverage ratio of 1.1x (a common level a borrower could have negotiated under those market conditions).

In the current environment, with base rates around 5.5% and spreads around 4.25%, the all-in rate for this borrower skyrockets to 9.75%. Even if we generously assume that the borrower's EBITDA has risen 25% to $125 million while capital expenditures have increased more modestly, the implied maximum debt capacity this borrower can now incur at the higher all-in rate and a slightly higher interest coverage ratio (reflecting tighter credit markets) is $427 million, or 36% lower than it could have in the low-rate environment! It's just math; except in cases where profitability jumps massively since issuance, a substantial amount of debt will have to come out of the system to make the numbers work.

Considering there was $2.9 trillion of leveraged loan and high yield debt in the U.S. alone at the end of 2022 (up from under $2.4 trillion at the end of 2019)[2], we expect this story to play out again and again in the coming years across geographies and asset classes.

Exhibit 4: Illustrative Impact of Higher Rate Environment ($ millions)

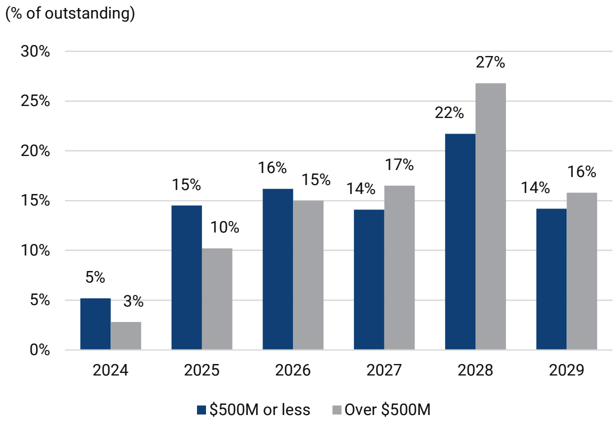
	Low-Rate Environment	Current Environment
Base Rate	1.00%	5.50%
Spread	3.75%	4.25%
All-in Rate	4.75%	9.75%
Assumed EBITDA	$100	$125
Assumed capital expenditures	$65	$75
Unlevered free cash flow	$35	$50
Assumed interest coverage ratio	1.1x	1.2x
Max interest allowed under coverage ratio	$32	$42
Implied max debt capacity at all-in rate	$670	$427

INVESTORS WILL NEED TO SHARPEN THEIR PENCILS

While there is some debate about the quality and long-term viability of corporate borrowers who have defaulted thus far, we expect the upcoming maturity wall will likely include many companies with sound business models but poor capital structures (i.e., the proverbial "good business, bad balance sheet"), which have long been the target hunting ground for distressed investors. In the hypothetical example above, the borrower is growing earnings at a healthy rate, but will still likely need to recapitalize to address future maturities in the current rate environment.

And with the percentage of larger capital structures with maturities set to rise, investors could have the opportunity to build meaningful allocations to higher conviction positions (see Exhibit 5).

Exhibit 5: U.S. Maturities by Size of Capital Structure, 2023-2028



Source: J.P. Morgan. As of May 22, 2023

After years of rapidly expanding commercial bank balance sheets, which have increased in the U.S. from under $6 trillion in 2000 to over $22 trillion in 2023,[3] banks may feel pressure to dispose of loans at attractive levels, especially considering pending regulatory reviews of bank capital ratios. If the proposed rules are enacted, banks with balance sheets over $100 billion will be required to hold more capital to support the existing loan portfolios they manage today – *Bloomberg* estimates the shortfall to be $63-75 billion.[4] With many publicly traded banks trading at a discount to book value, management will have to decide whether to sell loan portfolios or create a more structured solution to bridge the anticipated capital gap.

Banks are not the only parties who may feel pressure. Insurance companies, for example, may be forced to dispose of various rated holdings such as broad structured credit and CLOs to comply with their own regulatory requirements. CLOs are particularly vulnerable to credit rating downgrades given standard caps on lowest rated issuers in their structures. Additionally, select mortgage REITs and BDCs have the potential to face liquidity issues if underlying loan quality deteriorates, leverage costs stay elevated, financing availability wanes and their capital structures come under pressure.

Even the almighty U.S. consumer may be affected by rising rates for mortgages, credit cards, auto loans, et al., and this impact could be substantial given the sheer size of aggregate household debt balances, which increased to $17.1 trillion as of June 30, 2023, nearly $3 trillion above the level observed at the end of 2019.[5]

> "Given the rapid rise in base rates and the massive amount of leverage in the global economy, we believe the next cycle will likely last longer and look more like the default waves observed prior to the GFC."

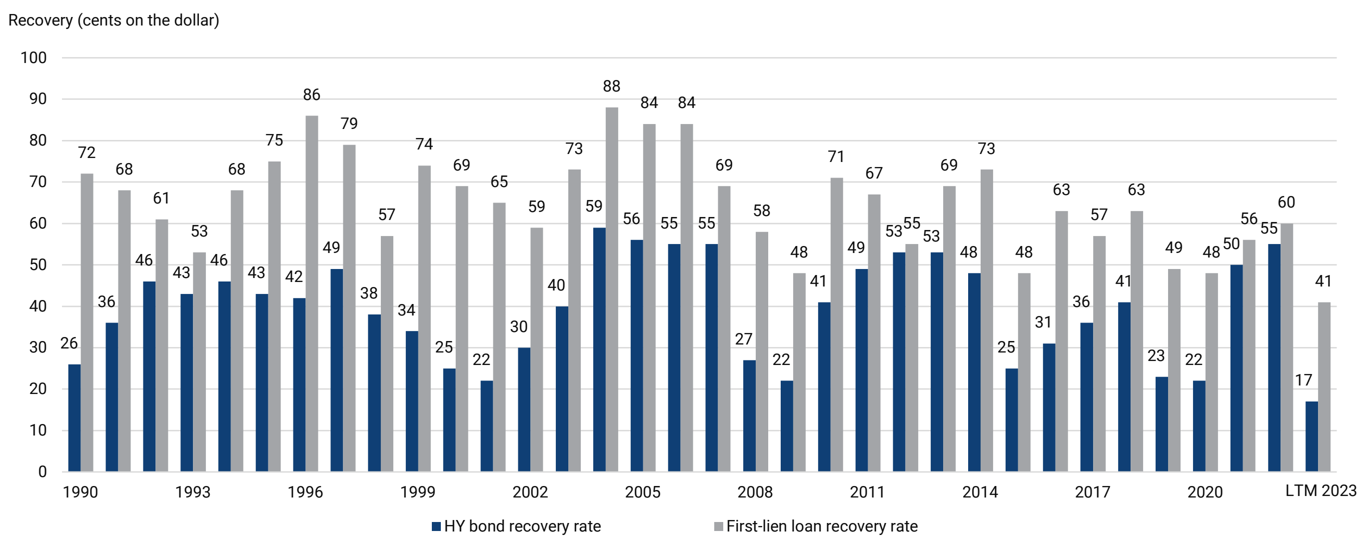
Experienced investors who understand structural nuance, advisor-led reorganization processes and who can leverage their network and expertise to identify, source, analyze and help steer outcomes should have an advantage in an environment with increased restructurings, defaults and bankruptcies. Investors with the capabilities to underwrite a wide range of asset classes may be best positioned to fully capitalize on the opportunity set given the breadth of assets that could be sold, particularly by banks.

For corporate borrowers, the increased ownership by sophisticated private equity sponsors adds an interesting wrinkle. Savvy investors who are able to analyze the quality of sponsor-owned companies, their balance sheets, capital structures, credit documents as well as the strategic importance of these portfolio companies to the sponsor may be able to identify companies that sponsors may seek to defend through additional equity contributions. For example, in August 2023, Vista Equity Partners agreed to inject $1 billion of preferred equity into portfolio company Finastra in order to secure a new $5.3 billion financing package. The presence of private equity also poses significant risks for investors if more aggressive sponsors seek to utilize more coercive tactics, such as stripping assets from issuers or solutions that prime existing creditors.

Furthermore, we believe the importance of navigating the opportunity with experienced managers is magnified by recent trends in recovery rates, which hit record lows for high-yield bonds and are well below historical averages for leveraged loans (see Exhibit 6).

Given the global nature of the current market backdrop, investors with capabilities in markets around the world could have an advantage in sourcing and executing deals.

Exhibit 6: Historical Recovery Rates for High Yield Bonds and First Lien Loans

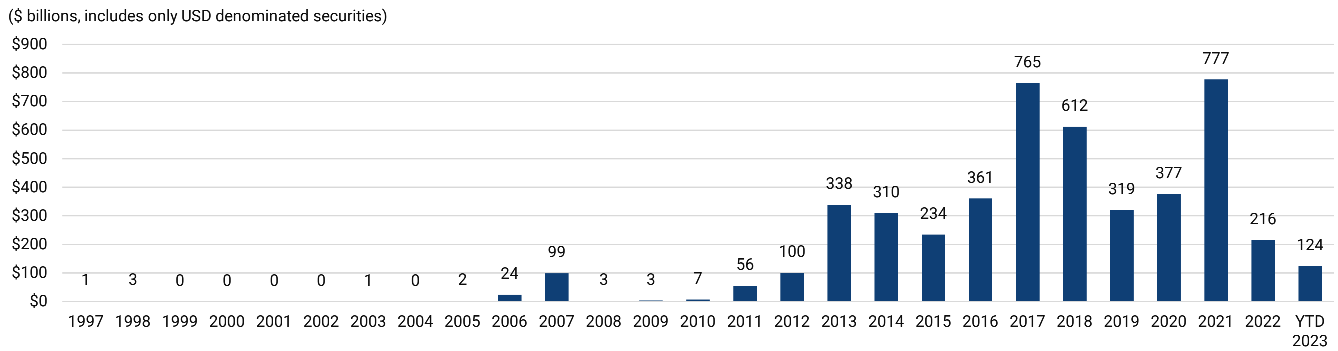


Source: J.P. Morgan. As of July 5, 2023

WAS IT REALLY THE TIME TO LEVER UP?

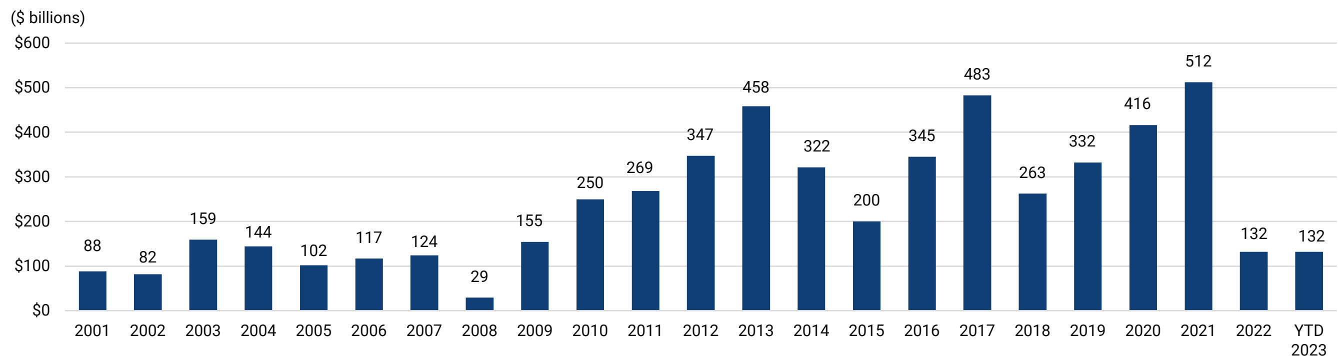
As one would expect, the prolonged period of low interest rates led a massive expansion of leverage globally. In the decade plus since the GFC, lenders competed with each other to deploy capital and borrowers benefitted from extraordinarily cheap financing rates with fewer and fewer covenants on their debt (see Exhibit 7). When debt maturities approached, borrowers simply refinanced at rates that were typically as attractive or more attractive than their maturing debt. As a result, the U.S. leveraged loan market grew from $605 billion in 2008 to $1.5 trillion in 2022, while the high yield bond market grew from $857 billion to $1.4 trillion over the same time period.[6]

Exhibit 7: Covenant-lite Loan New-Issuance Volume – Cov-lite is Largely a Post-GFC Phenomenon



Source: J.P. Morgan. As of July 5, 2023

Exhibit 8: U.S. Historical Refinancing Volumes

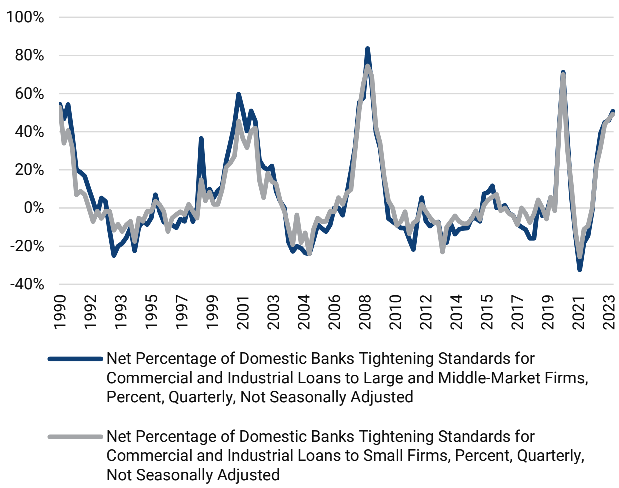


Source: J.P. Morgan. As of May 22, 2023

In the current higher rate environment, however, refinancing activity has dropped significantly from levels observed in recent years (see Exhibit 8). Banks have tightened their lending standards (see Exhibit 9), particularly for borrowers who do not fit their standard criteria, given uncertainty around liquidity requirements and the broader economic trajectory and are poised to tighten further pending the outcome of the aforementioned regulatory review of bank capital ratios. This review comes on the heels of a regional banking crisis marked by two of the three largest bank failures in U.S. history. Regional banks in particular may feel the need to tighten their purse strings due to a) reduced deposits, b) potential changes in regulatory capital requirements and c) elevated exposure to commercial real estate, particularly the office sector, where remote work has challenged the outlook for many properties and the viability of their capital structures. *The Wall Street Journal* estimates that U.S. banks with less than $250 billion in assets hold around 75% of all commercial real estate loans; these banks have $3.6 trillion of exposure to commercial real estate, equivalent to approximately 20% of deposits.[7]

Tighter credit in banks comes on the heels of a steady period of banks shrinking or exiting certain business lines. Private credit managers have stepped in to fill some of this void, with $1.3 trillion of private credit capital raised between 2015-2022, mostly in middle market direct lending.[8] However, given the economic tailwinds during this time period, the due diligence standards of the managers who deployed this capital have not yet been thoroughly tested. It is unclear whether underwriting was lax as managers sought to deploy capital and raise their next funds, particularly in 2019-2021. Furthermore, it is unclear if *all* private credit managers have the resources and expertise to solve issues should borrowers experience difficulty.

Exhibit 9: Net Percentage of U.S. Banks that are Tightening Lending Standards



Source: Board of Governors of the Federal Reserve System. As of July 1, 2023

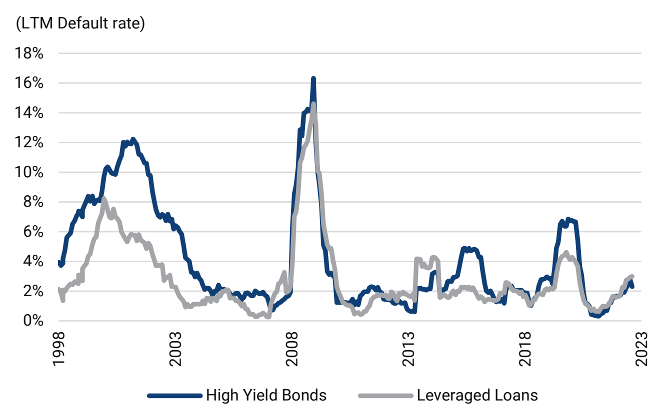
Resigned to a new reality of higher rates, many borrowers have rushed to refinance in September 2023 rather than contend with future uncertainty. This recent activity comes despite the sharp increase in borrowing rates, which reached approximately 5.7% (a 15 year high!) compared to around 1.7% at the end of 2020.[9] However, many of the recent borrowers are investment grade rated, and not all lower-rated prospective borrowers are able to execute in the current environment. Other borrowers are hoping to "wait it out," thinking that inflation data may improve enough that central banks will lower rates by the time their debt matures. Unfortunately for these borrowers, that path may not be simple. While inflation data has cooled of late, it still remains high by recent standards in the U.S. and higher in the E.U. and U.K. Historically, periods of high inflation do not correct themselves quickly.

There could be further pressure on borrowers if the economy fails to improve. Entering the year, many if not most economists believed that the U.S. economy would enter a recession in 2023. While most of these economists have reduced the probability of this recession materializing in light of consumer spending and cooling inflation data, it is not off the table completely. That said, a recession is not a prerequisite for increased defaults considering the dramatic increase in borrowing costs – it would just make a bad situation worse.

Outside of the U.S., Europe has been mired in a period of lackluster growth for quite some time, without any signs of relief. Eurozone GDP contracted at the end of 2022, and while it has rebounded somewhat in 2023, recent inflation data has tempered expectations for near-term rate cuts.[10] In the U.K., GDP growth has hovered around zero, and the National Institute of Economic and Social Research does not expect GDP to surpass pre-pandemic levels until the second half of 2024.[11]

It is evident that in today's economic environment, businesses and capital structures that are not equipped for the higher rate environment may experience immense pressure. While default rates have not reached critical levels, they have started to rise, reaching nearly 3% in the U.S. including distressed exchanges as of June 2023, nearly double their levels from the end of 2022 (see Exhibit 10).[12]

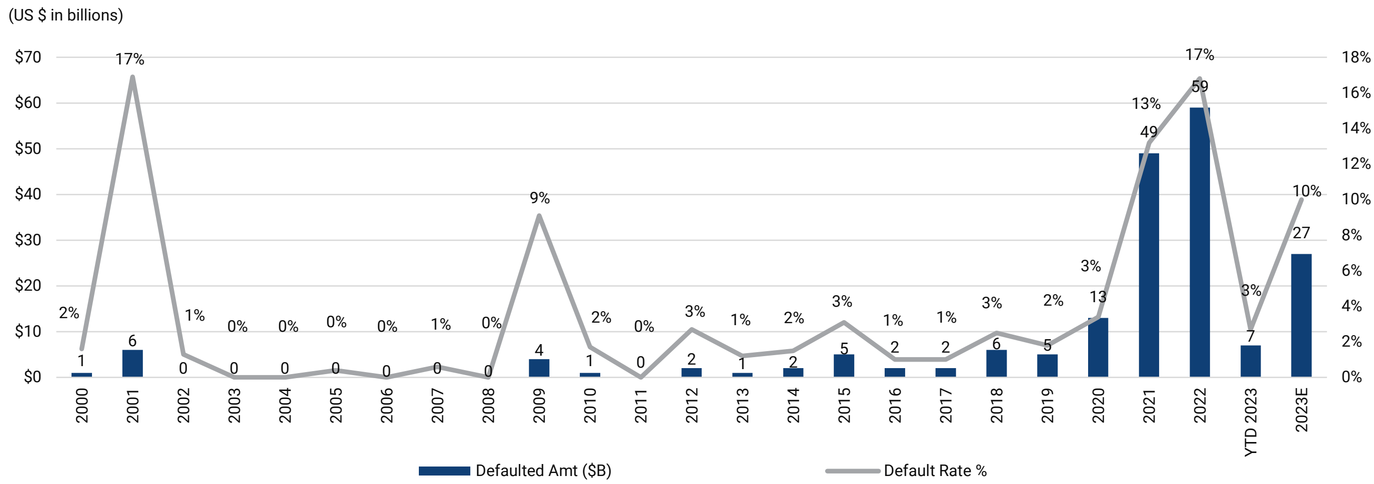
Exhibit 10: U.S. High Yield Bond and Loan Par-Weighted Default Rates



Source: J.P. Morgan. As of July 5, 2023

In Asia, J.P. Morgan is now forecasting a high yield default rate of 10% in 2023 (see Exhibit 11). Thus far, most defaulting borrowers are concentrated in the property sector, but J.P. Morgan points to potential spillover into the wider economy.

Exhibit 11: Asia High Yield Corporate Default Rate



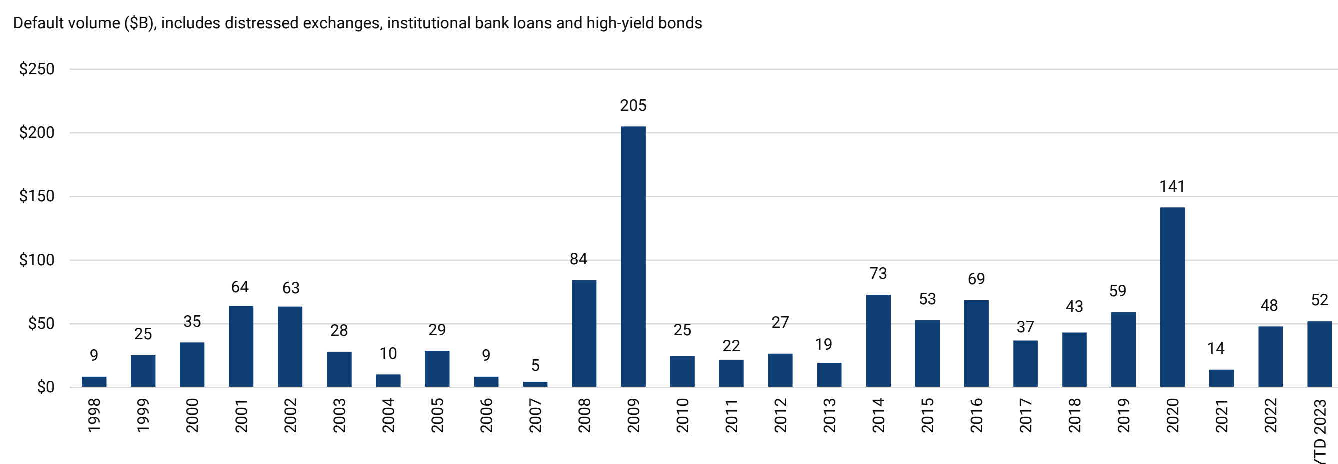
Source: J.P. Morgan. As of August 14, 2023

The market is not expecting this trend to reverse any time soon given that the high yield loan market recently received the highest amount downgrades since the onset of the Covid pandemic in 2020 (as an aside, downgrade activity alone creates technical and fundamental pressure, especially in less liquid markets such as structured products) and the significant amount of outstanding corporate bonds and loans trading at distressed levels – estimated by *Bloomberg* at approximately $590 billion. On the contrary, Moody's Investors Service forecasts that the default rate for sub-investment grade companies globally to increase from 3.8% in the 12 months ending June 2023 to 5.1% in 2024, above the 1983-2022 global average of 4.1%. Under its bear case, the default rate could reach 13.7%, far higher than the default rate witnessed during the GFC.

In the U.S. alone, more than 120 companies have declared bankruptcy in 2023.[13] The dollar value of defaults/distressed exchanges in the first half of 2023 exceeded 2022 levels and quadrupled that amount observed in 2021, reaching the tenth largest annual total record, with half the year remaining (see Exhibit 12).[14]

Aggregate delinquency rates for U.S. consumers are below pre-pandemic level, but recent data has demonstrated an uptick in the share of debt newly transitioning into delinquencies for credit cards and auto loans. Delinquency transition rates for credit cards and auto loans are now above pre-pandemic levels.[15]

Exhibit 12: Historical Default Volumes



Source: J.P. Morgan. As of July 5, 2023

SPONSOR SPOTLIGHT

Much of the distressed debt and defaults are currently in private equity-backed companies, and we expect this trend to continue. Private equity's traditional leveraged buyout strategy generally entails borrowing as much as a sponsor might deem sustainable to acquire a target company, then cutting costs, using cash flows to pay back debt on the levered company and ultimately exiting through a sale or IPO. This strategy worked particularly well during ZIRP, when financing costs were low. However, much of the debt issued to fund sponsor buyouts was in the form of floating rate instruments issued by the aforementioned middle market direct lenders, which as an asset class exploded alongside private equity, expanding nearly 15x between 2010 and 2022.[16]

However, this story may not end well for the private equity-owned borrowers as the interest payments on their debt increases. Facing a more challenging environment – with debt service impacting profits and higher financing rates hindering exits through sale processes, private equity firms themselves are now borrowing in order to send distributions back to their investors. At some point, sponsors may be forced to sell assets at levels below their price targets.

> "Experienced investors who understand structural nuance and advisor-led reorganization processes – and who can leverage their expertise to identify, source, analyze and influence outcomes – should have an advantage in an environment marked by increased restructurings, defaults and bankruptcies."

RECKONING IN REAL ESTATE

Perhaps no leveraged asset class has garnered as much attention of late as real estate. During ZIRP, real estate owners benefited from positive carry as cap rates exceeded financing rates. However, this dynamic is much more challenging in a higher rate environment if cap rates struggle to keep up, particularly in sectors with secular challenges. With an estimated $728 billion of commercial real estate maturities in the U.S. in 2023 alone,[17] stress in the system could increase materially, as rents for many properties may not support higher interest rates and as banks tighten their lending standards.

In the U.S., approximately one-third of all commercial real estate lending is in floating rate instruments,[18] forcing borrowers to pay more as rates increase. To mitigate the impact of rising rates, most lenders require borrowers to hedge their exposure to rising rates. However, once cheaper hedges purchased in a low-rate environment roll off, the cost of acquiring new hedges is expensive. Furthermore, regulators have been pressuring banks to reduce their exposure to commercial real estate since the regional banking crisis in late Q1/early Q2 2023, limiting an important source of credit for property owners. The situation has contributed to a significant decline in activity; commercial property sales totaled approximately $130.5 billion in the first five months of 2023, a decline of over 60% from the previous year.[19] In July, commercial property sales in the U.S. were 74% below the levels of the prior year.[20] In multiple cases, even high-profile, institutional real estate owners have defaulted on loans.

The situation is particularly acute in the office sector, where remote and hybrid work has stifled demand for office space and property values have plummeted (down over 30% since rates started rising).[21] Only $17.6 billion of U.S. office buildings were purchased in the first five months of 2023, down approximately 65% from 2022, while new searches in the office-leasing market in May 2023 were approximately 37% lower than in 2019.[22] Office vacancy rates in San Francisco were over 30% in Q2 2023 and over 15% in Manhattan.[23] Landlords are not the only stakeholders feeling the brunt; the effect is spilling over to many other businesses who rely on office activity, including architects, construction companies, furniture manufacturers, downtown restaurants, et al.

Office is not the only challenged real estate sector – rising interest rates are also impacting multi-family properties. Apartment building values declined 14% in the twelve months ending June 2023.[24] While vacancies in the category are low, rental growth is slowing, mortgage delinquencies are increasing, as are expenses. As in the office sector, property owners (including large, institutional managers) have started to default on debt. And the situation could get worse, with $981 billion of debt maturing between 2023 and 2027.[25]

In Europe, the amount of maturing public debt in the real estate sector more than doubles from 2023 to 2024, and then increases again in 2025.[26] While real estate borrowers could monetize assets to help address their debt load, the wide discrepancy between valuations among buyers and sellers has contributed to limited deal activity in Europe, which declined over 80% in the first half of 2023 (we note this phenomenon is transpiring globally, not just in Europe).[27]

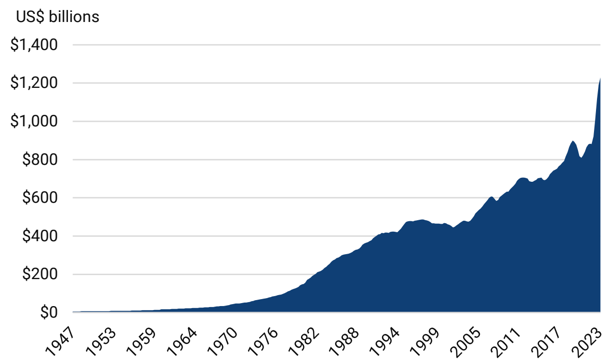
BACK TO THE FUTURE: WHY THE NEXT DISTRESSED CYCLE SHOULD LOOK DIFFERENT

Re-framing the opening question, perhaps investors should not ask whether the current economic backdrop is different, but, rather, whether the prolonged period of ZIRP was the anomaly. Historically, rates have rarely touched zero, let alone stayed there for over a decade. The simple math suggests there will need to be an adjustment period as the world re-acclimates to a new rate paradigm, and given the sheer magnitude of global leverage, it is reasonable to expect this adjustment period to last longer than the periods of volatility experienced since the GFC.

> "We may be on the precipice of a lengthy distressed opportunity that has been a long time in the making, and investors should position themselves according."

For distressed investors, opportunity may arise as the excesses and distortions caused by ZIRP are undone. And unlike recent history, it is questionable whether governments can come to the rescue yet again given their ever-increasing obligations, including rising interest payments to service their own debt (see Exhibit 13) – look no further than Fitch's August 2023 downgrade of the U.S. credit rating. As a result, we believe lenders and borrowers across the entire global economic system stand to be impacted due to the evolving landscape, with certain sectors (such as real estate) or themes (such as sponsor-backed companies) offering the potential for robust activity given their large amount of leverage and/or changing fundamentals. Market participants may not have to wait long for action given the massive, looming maturity wall, which could serve as a major catalyst. In sum, we may be on the precipice of a lengthy distressed opportunity that has been a long time in the making, and investors should position themselves accordingly.

Exhibit 13: U.S. Federal Government Interest Payments



Source: Bloomberg. As of June 30, 2023

ABOUT DAVIDSON KEMPNER

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[1] Source: Citibank.
[2] Source: J.P. Morgan.
[3] Source: Board of Governors of the Federal Reserve System.
[4] Source: Bloomberg, "Regional Banks May Need to Sell $63 Billion In Bonds Under Rule," September 6, 2023.
[5] Source: Federal Reserve Bank of New York.
[6] Source: J.P. Morgan.
[7] Source: Wall Street Journal, "Real-Estate Doom Loop Threatens America's Banks," September 6, 2023.
[8] Source: Preqin Ltd. Data set includes assets under management across private debt strategies including direct lending, mezzanine, special situations, distressed debt and venture debt. Excludes fund of funds.
[9] Source: Wall Street Journal, "Companies Pay More to Borrow in Record Bond Rush," September 8, 2023.
[10] Source: Financial Times, "Eurozone economy returns to growth in second quarter as inflation falls," July 31, 2023.
[11] Source: National Institute of Economic and Social Research, "UK Heading Towards Five Years of Lost Economic Growth," August 9, 2023.
[12] Source: J.P. Morgan.
[13] Source: Bloomberg, "A $500 Billion Corporate-Debt Storm Builds Over Global Economy," July 18, 2023.
[14] Source: J.P. Morgan.
[15] Source: Federal Reserve Bank of New York.
[16] Source: Preqin Ltd.
[17] Source: Bloomberg, "Commercial Real Estate Risks Has Investors Holding Back on Lending," August 15, 2023.
[18] Source: Wall Street Journal, "Top Property Owners are Creditworthy – They Might Default Anyway," May 22, 2023.
[19] Source: Wall Street Journal, "Bank Regulators Urge Flexibility in Commercial Real-Estate Loan Workouts as Defaults Grow," July 24, 2023.
[20] Source: Wall Street Journal, "Real-Estate Doom Loop Threatens America's Banks," September 6, 2023.
[21] Source: Wall Street Journal, "How to Play the Property Meltdown in Five Charts," August 30, 2023.
[22] Source: Wall Street Journal, "Industries Reliant on Thriving Downtowns Suffer from Remote Work," July 3, 2023.
[23] Source: Wall Street Journal, "Real-Estate Investors Flee the U.S. for a Land of Fuller Offices," July 25, 2023.
[24] Source: Wall Street Journal, "A Real-Estate Haven Turns Perilous with Roughly $1 Trillion Coming Due," August 7, 2023.
[25] Source: Wall Street Journal, "A Real-Estate Haven Turns Perilous with Roughly $1 Trillion Coming Due," August 7, 2023.
[26] Source: Bloomberg.
[27] Source: Evercore.