LEVERAGED FINANCE TRENDS

Distressed Investing Outlook: Players see pockets of opportunity in 2022

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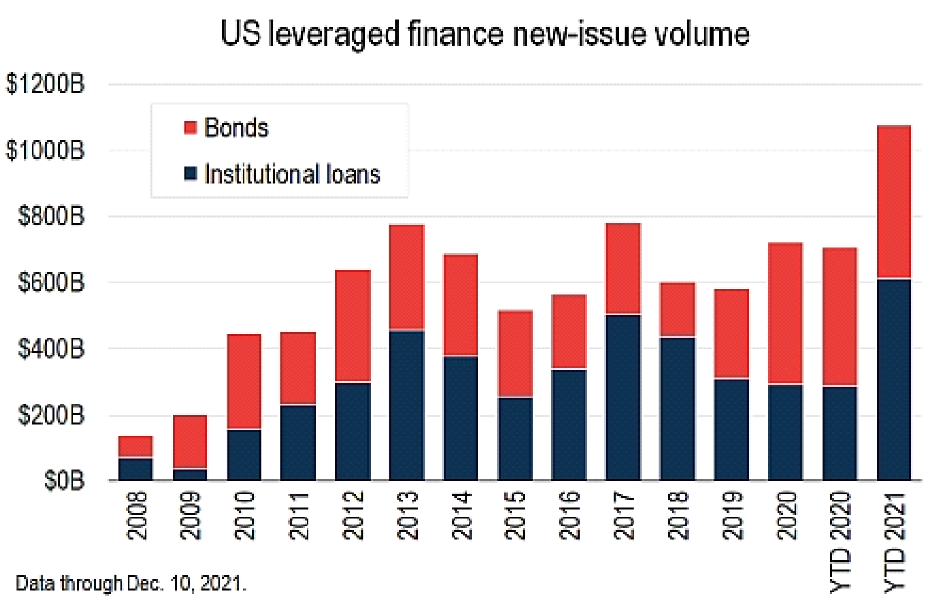
Market Intelligence

While 2021 is fast approaching the finish line as a solid year for investors across most asset classes, distressed players generally expect slim pickings in 2022. But there are already pockets of opportunity for them to put money to work, and a lot can happen next year to expand those pockets.

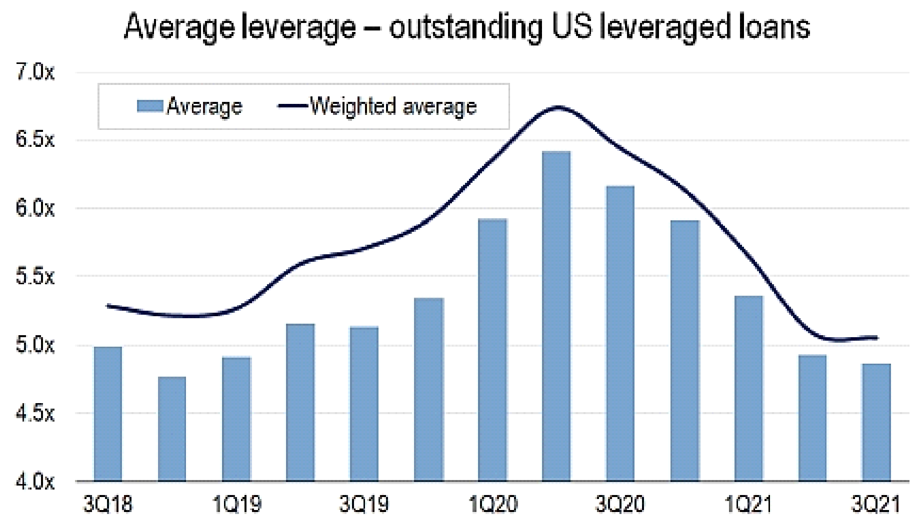
While the pandemic outbreak year 2020 was notable for a remarkably rapid fall and recovery of both debt and equity markets, 2021 offered far less drama. Though it seemed all year as if asset prices just went up and high-yield option-adjusted spreads just came in, there were in reality plenty of bumps along the way. In the end, 2021 was marked by records and near-records in a wide swath of investing categories, including historic highs in equity market indices and near-record tights in high-yield spreads.

The flood of speculative-grade debt issuers rushing through the wide-open bond and loan new-issue windows drove total 2021 leveraged debt issuance to a record. The annual tally topped $1 trillion for the first time ever in November, with plenty of time remaining in the year to add to the deluge.



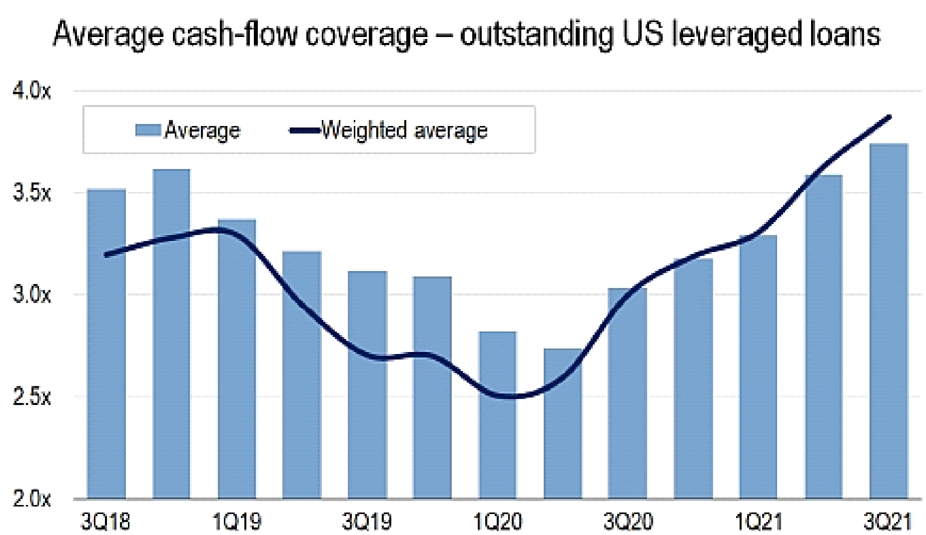
Data through Dec. 10, 2021.
Source: Leveraged Commentary & Data (LCD)

At the same time, leverage levels for companies in both the high-yield and leveraged loan markets declined through 2021, recovering from the initial negative impact of the pandemic. In 2020, high-yield leverage peaked near 6x, while leverage levels for S&P/LSTA Index issuers that file publicly topped out around 6.4x. By the end of 2021's third quarter, those data points had fallen back to 5.3x and 4.9x, respectively, multiples last seen before the pandemic struck, per LCD data on loans and Barclays Research data on high yield.



Data through Sept. 30, 2021.
Source: Leveraged Commentary & Data (LCD)

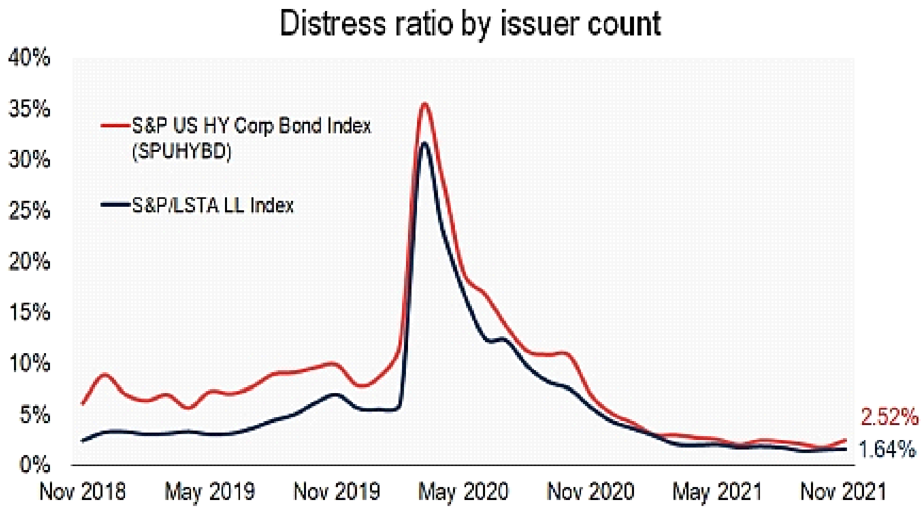
Leveraged loan cash flow coverage for publicly filing issuers also improved in 2021, bottoming in 2020 at around 2.7x as the pandemic took hold, then rising with the economy's recovering health to over 3.7x by this year's third quarter.



Data through Sept. 30, 2021.
Source: Leveraged Commentary & Data (LCD)

Default rate futures

The distress ratio of both leveraged loans and high-yield bonds peaked above 30% by issuer count in mid-2020, but as the economy has recovered both data points have plummeted. The leveraged loan distress ratio is now at 1.6% and the high-yield bond ratio is at 2.5%, leaving little for distressed investors to work with.



Data through Nov. 30, 2021.
Distress ratio is the share of loans priced below 80 and the share of bonds trading at a spread above 1000 bps.
Sources: Leveraged Commentary & Data (LCD); S&P/LSTA Leveraged Loan Index; S&P HY US Corp Bond Index

Default rates for both high yield and leveraged loans highlight the difficulties facing distressed investors in 2022. S&P Global Ratings projects that the U.S. trailing-12-month speculative-grade corporate default rate, encompassing all issuers rated BB+ or lower, is likely to rise from October's 2.0% rate, to 2.5% by the end of 2022's third quarter. The rating agency's current best-case scenario projects the rate falling to 1.5% by then.

Projections by Barclays, in a report by Bradley Rogoff, Scott Schachter and Jeff Darfus, were slightly ahead of Ratings' projections, with default rates through 2022 projected at 2.0%-2.5% of high-yield issuers and 1.5%-2.0% of loan issuers. The Barclays team translates that rate into 1.0%-1.5% of the par amount of the high-yield and leveraged loan markets.

The Barclays report cites, among other things, "a supportive macro environment," improving corporate fundamentals that are nearing pre-pandemic levels, excess liquidity and a debt maturity wall that has been pushed out by refinancings, for its positive view of defaults.

Morgan Stanley's 2022 default rate outlook comes in a bit lower than Barclays. In a report authored by Srikanth Sankaran, Vishwas Patkar, Max Blass and Kelvin Pang, the firm projects a 1.75%-2.0% default rate for U.S. and European high yield in 2022, and a "sub-1%" rate in leveraged loans. The report's authors "remain encouraged by corporate balance sheet fundamentals in developed market credit," adding that they don't expect the market disturbances in Asia to take on "a systemic dimension."

Unfriendly trend?

Given current distress ratios and default rate projections, distressed investors could be forgiven for anticipating a quiet year ahead. Restructuring expert and Houlihan Lokey managing director Saul Burian said in a recent interview with LCD that he perceives the distressed community was surprised by how quickly the U.S. corporate operating environment recovered from the pandemic's impact and how wide-open financial markets were in 2021. He added that "there is still a lot of exuberance and a lot of capital that are combining to dampen distressed opportunities."

But despite current strength in the markets and the economy, things can go south. Houlihan Lokey's Burian notes that danger lurks, saying that labor costs are rising, inflation is driving up raw material costs, and those not working are spending less. Burian sees a resultant risk in lower consumer spending exacerbating lower operating margins that are being hurt by higher costs. He notes that these are all ingredients for an economic slowdown and a general decline in corporate earnings, as well as key elements in tightening debt market liquidity.

Recently, both S&P Global Ratings and Goldman Sachs reduced their GDP growth projections for 2022. Ratings' U.S. chief economist Beth Ann Bovino slid her GDP expectation for next year down to 3.9%, from 4.1% previously, while Goldman Sachs reduced its expectation to 3.8%, from 4.2%. Although the adjustments were small and the numbers still represent solid economic growth, the trend is not a friend to the bulls.

Morgan Stanley, in its 2022 outlook piece, warned that the market “appears to be pricing in record-low default rates for longer,” cautioning that “the bar for negative surprises is very low.” MS expects the surprises, if they come, will be “idiosyncratic” in nature and would most likely appear where financial leverage and operational leverage overlap, such as in smaller C-category-rated companies with limited pricing power, for instance.

At a distressed investing conference held in New York City in November put on by Beard Group, Jeff Aronson, co-founder and managing principal of Centerbridge Partners, said that "one of the biggest concerns in 2022 is if the Fed fell behind the curve,” namely if the U.S. Federal Reserve moved interest rates too slowly or too quickly, either way creating a shock to the U.S. economy.

Things to do

Despite the risks, the U.S. economy and the markets seem to be on a path to continue producing a dearth of distressed situations for investors. But to restructuring expert Burian and others, there will still be things to do. Burian points out that through the depths of the 2020 pandemic many companies raised capital with 2-to-4-year life spans. Those bills are coming due starting in the spring of 2022.

“Some of those businesses have shown improvement,” he said, “but others have not seen growth, whether because of supply chain problems, company-specific issues, or the continued impact of COVID and the new strains.” Burian adds that with the Fed tapering and the beginnings of Fed Funds target increases possibly on the 2022 docket, “it won’t take much of an interest rate rise for refinancings and existing floating rate debt to become more expensive and problematic.”

Burian also notes that supply chain disruptions are being felt throughout the economy, from a broad spectrum of consumer goods, to business-to-business manufacturing, distribution and sales. He noted, for instance, the possible negative impact that shipping delays and increased costs may be having on retail and supplier top and bottom lines.

One experienced distressed sell-side player said that he is seeing troubled-company investors now looking closely at private debt. Long-time distressed asset manager Oaktree Capital may have hinted at its interest in this area when it rebranded its Distressed Debt platform as the Opportunistic Credit platform, broadcasting its wider latitude to invest in assets beyond those troubled or bankrupt. The sell-sider also sees intense focus by distressed investors on rescue financings and debtor-in-possession lending, places they plan to put their capital next year.

Panelists in various sessions during Beard’s recent distressed conference in New York raised numerous areas that should garner attention from distressed analysts in 2022. Real estate was one of them. Among the specifics, hotels were highlighted: limited-service hotels have been recovering nicely but those catering to the business traveler have not kept pace, one panelist said, adding that downtown hotel properties, in particular, have not been doing well.

Other panelists offered that the healthcare space contains an abundance of risks and potential investing opportunities. As an example, hospitals were cited as losing staff through retirement and burnout, and so facing rising replacement costs. Reduced staff is also leading to cutbacks on the number of beds that can be serviced, lowering potential revenue. It is another area that bears watching.

Other investment sectors mentioned at the conference that should be on distressed investor radar screens in 2022 included cruise lines (one panelist said, “I don’t see how they will ever earn themselves out of their liability side”), airlines, movie theaters, and even the long-playing Fannie Mae and Freddie Mac preferred securities.

Stan Manoukian, analyst at Independent Credit Research LLC, said in an interview with LCD that, with the strength in energy prices, oil and gas companies — namely ultra-deepwater offshore exploration issuers — present opportunities.

Manoukian believes emerging markets will offer up investments for distressed investors in 2022. He said that companies in those countries don’t have the pricing power to offset inflation the way developed-market companies may have, and with “muted consumer demand,” he believes trouble may be brewing.

Finally, Manoukian noted that non-ESG complaint sectors, such as prison companies, payday lenders and power companies, might provide fodder to distressed players because ESG investing requirements are causing some investors to shun these. Many of these corporations will need more capital, and potential lenders who may not need to be as focused on ESG compliance may have latitude to charge the sort of yields the distressed market typically extracts from borrowers.

Perhaps the picking for distressed investors won’t be that slim after all.

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