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# Distressed Debt Outlook: Fortune May Favor The Brave In 2016

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It was the epoch of incredulity for many a high yield bond and leveraged loan distressed investor as plunging energyprices left even the most seasoned players very badly on the wrong foot.

Distressed trading desks and hedge funds alike suffered multimillion dollar losses in 2015, as annual returns on the S&P U.S. Distressed High Yield Corporate Bond Index were about negative 30%. It was quick, it was brutal, and few came out unscathed.

"There are quite a few people licking their wounds, and it's not yet clear to me that they are emotionally ready to jump in and call it the bottom," says Marshall Huebner co-head of Davis Polk's Insolvency and Restructuring Group. "Because 2015 was such a painful year I think there will be a natural hesitation before people are really comfortable that we have, in fact, hit the bottom."

But the cycle has turned, and fortune will favor the brave in 2016, industry experts say.

"For those who are not seeing a lot of redemptions, or are raising new funds or have extra dry powder, the next distressed cycle is going to be an amazing time to put money to work," says Edwin Tai, senior portfolio manager, distressed credit at Newfleet Asset Management, an investment-management affiliate of Virtus Investment Partners. "In every distressed cycle there is ultimately a buyer, and that ultimate buyer has been disciplined and patient. The returns for those that have been disciplined could be spectacular," Tai says.

And make no mistake; the majority of accounts barely nibbled as they sat on the sidelines awaiting the cycle to turn. Oaktree alone is sitting on $20 billion of dry powder in preparation for what fund managers are describing as the best opportunity in several years.

**Distress doubles**

The number of high-yield bonds trading at distressed levels has more than doubled this year to the highest mark since the 2009 recession as plunging commodity prices caused a considerable widening of spreads in the sector and had a spillover effect on the broader spectrum.

According to Standard & Poor's Global Fixed Income Research (S&P GFIR), the amount of debt trading with composite spreads of 1,000 bps or higher (a widely used threshold as the measure of distressed) increased to about $180 billion from 228 companies as of Nov. 16, from $66.8 billion from 103 issuers in the same period of 2014.

The U.S. distressed debt ratio climbed to its highest level since September 2009, at 20.1%. Not surprisingly, the Oil & Gas sector has the largest proportion of distressed issuers by count, at 113, or 37% of total distressed debt, and the second-highest sector distress ratio, at 50.4%.

The Metals, Mining, and Steel sector has the highest sector distress ratio at 72.4%, and the second-most issues, with 63, while the Retail sector has the third highest distressed ratio, at 21.4%.

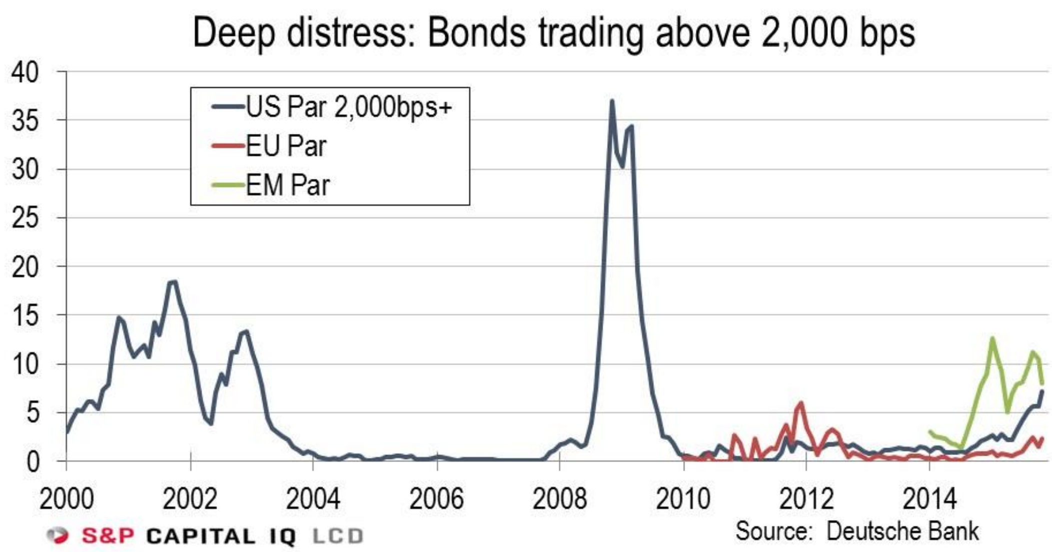
Distressed issuers currently have about $167 billion of outstanding bonds scheduled to mature between 2016–2022, according to Standard & Poor's.

**Deeper in distress**

In its 2016 outlook, Deutsche Bank draws attention to the percentage of names in deep distress, which they define "somewhat arbitrarily as 2,000 bps." They warn that this number, at 7.1%, is materially higher than in October 2011 when it was 2% for U.S. high yield.

"Think about the significance of this number," strategists Oleg Melentyev and Daniel Sorid write. "While some names flirt with modest levels of distress from time to time throughout the normal course of events….many of them stage comebacks and remain current on their obligations."

"It appears that few names ever come back from the deeply distressed levels, and their prevalence in today's environment has to be taken seriously by credit investors."



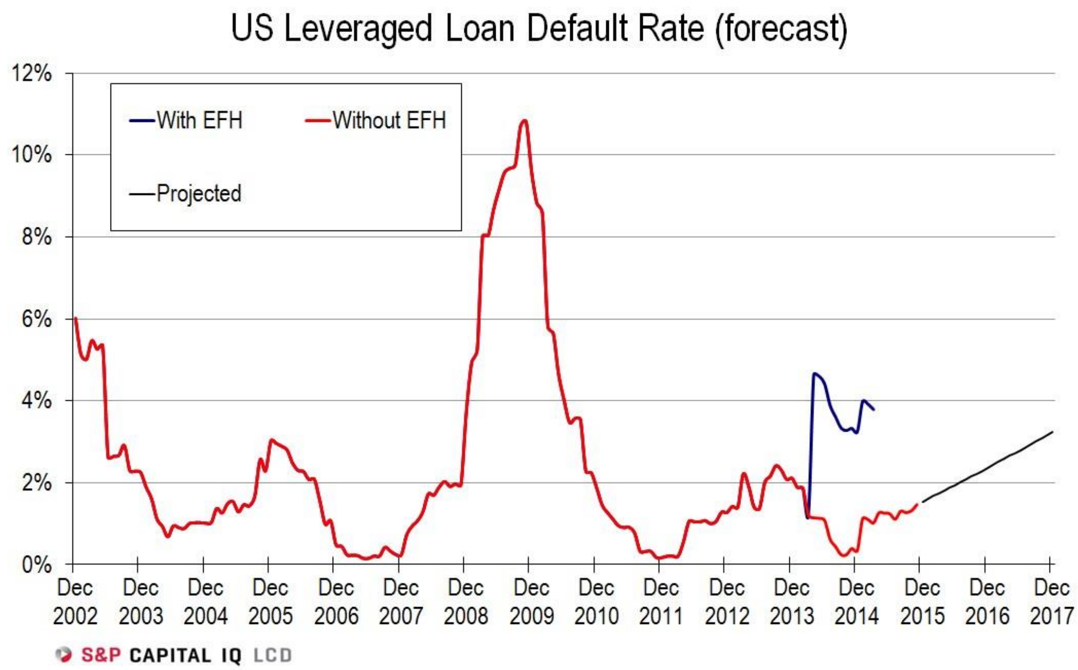

**Defaults on the uptick**

Standard & Poor's Global Fixed Income Research's base-case scenario forecasts that the speculative-grade default rate will rise modestly to 3.3% by September 2016, from 2.5% in September 2015. This forecast remains below the long-term average rate of 4.4%.

In contrast, prominent bank forecasts are mostly higher. J.P. Morgan is under that context on average, at 3%, but then breaks out a 10% standalone default rate for the Energy sector. Credit Suisse is a bit lower, at 2.5–4%, and RBS is modestly higher, at 4.6%.

Barclays is forecasting a 5–5.5% default rate, with a range of 4.4%, if oil prices rise to $60 per barrel or more, to 6.4%, if oil sinks below $40 per barrel.

Drilling down into loans, the forecast is less bleak for 2016. According to LCD's latest market survey conducted in early December, the loan default rate is expected to remain below trend in 2016 before creeping up to the historical average of 3.2% by the end of 2017.




LCD's Steve Miller writes that managers on average expect the loan default rate by amount to climb to 2.35% by year-end 2016, from November's reading of 1.47%, and to 3.24% by year-end 2017. For the record, the survey's results were tightly clustered at 1.65–3.00% for 2016 and 2.50–4.00% for 2017.

Given that the Bank of America Merrill Lynch HY Master Index's exposure to Energy—the most troubled of sectors—is far higher than that of the S&P/LSTA Index, at roughly 15%, to 4.4% as of Nov. 30—loans appear to be more insulated from energy woes than high-yield bonds.

But while the loan market is facing little pressure from distressed loans with near-term maturities, the portion of distressed loans maturing in later years has increased recently, Credit Suisse says in its 2016 global outlook.

According to analysts led by Jonathan Blau, $2 billion of loans trading with a discount margin to maturity of greater than 1,000 bps are maturing in 2016 and $7 billion are maturing in 2017. Together, those loans represent 1% of the market. Credit Suisse's default projection for 2016 is 1–3%.

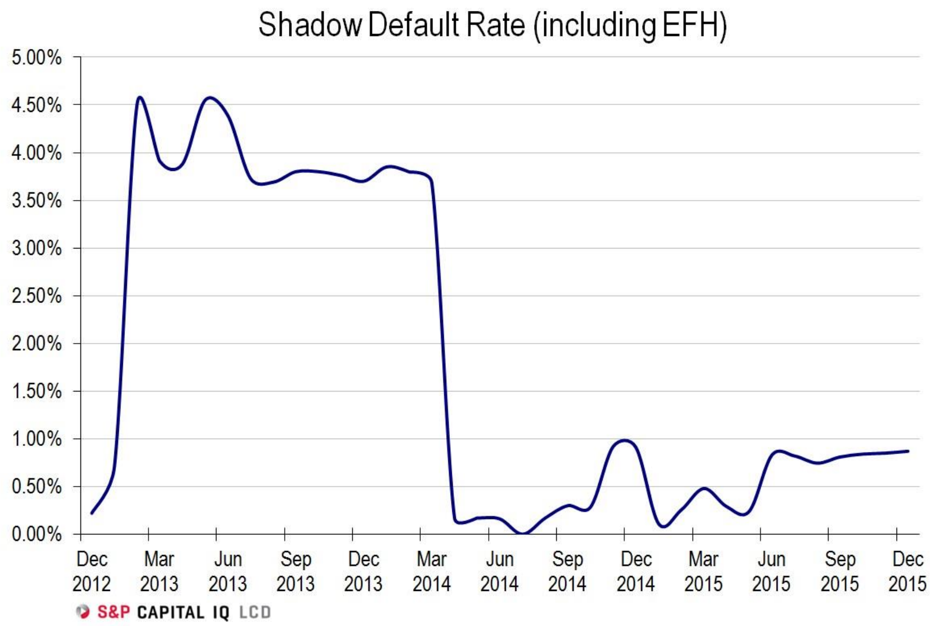
**Stepping out from the shadows**

LCD's shadow default rate—a measure of performing S&P/LSTA Index issuers that have (1) missed a bond payment, (2) entered a forbearance agreement, or (3) hired bankruptcy counsel—ticked up to an 11-month high of 0.85% in November, from 0.84% in October.

October's shadow default rate comprised **Arch Coal**, **Gymboree**, **R.H. Donnelly/SuperMedia/Dex Media**, **Paragon Offshore Finance Company**, **Peabody Energy**, and **NewPage**, whose parent company **Verso Paper** in November warned of a possible Chapter 11 filing as it continues restructuring discussions with creditors.

SuperMedia and R.H. Donnelly are clearly in the hot seat after Dex Media elected to skip an interest payment on its PIK notes on Sept. 30. The company entered into its third forbearance agreement with senior lenders, the deadline to which expires on Jan. 4, 2016. On a pro forma basis, these names would add 0.19 percentage points to the default rate by amount.

Beyond the names on the shadow list, managers surveyed by an LCD buyside poll say that **Caesars Entertainment** **CZR +0.00%** **Corp**. (CEC), the parent company of bankrupt issuer **Caesars Entertainment Operating Co**. (CEOC), may be headed for bankruptcy in the months ahead, depending on the outcome of pending lawsuits against CEC by bondholders.




**Recovery rates**

The historical recovery rate on senior unsecured debt has typically been around 55% when the default rate is inside 2.5%. Except in this cycle, says Michael Contopoulos, head of U.S high yield and leveraged loan strategy at BofA Merrill Lynch. According to Contopoulos, in this cycle, with default rates inside of 2.5%, recovery rates on senior unsecured has been about 10 percentage points lower.

In forecasting total returns for 2016, Contopoulos factored a recovery rate of 20% for energy and commodity paper, and a 35% recovery rate for non-commodity.

“Historically, one may factor in a blanket 40% recovery. We have adjusted our assumption quite a bit.”

S&P Global Fixed Income Research (S&P GFIR) say that of the distressed issues with available recovery ratings, 36% have the weakest recovery rating of 6, indicating S&P’s expectation for negligible (0–10%) recovery of principal and pre-petition interest in the event of default.

Despite the initial assumption of very low recovery prospects for issues in this asset class, 27% of distressed issues have recovery ratings of 3 or better, indicating recovery prospects of 50% or greater in the event of default.

**About those returns**

By way of returns, an informal survey conducted by LCD suggests distressed accounts are typically pitching a target figure in the mid-to-low teens, with new money invested generally aiming for a 12% return, according to sources. Of course, distressed opportunities often take years, not months, to play out.

At a nearly 12% yield, the ex-commodities part of the CCC market offers good incremental compensation for the risk, analysts at Barclays say in a report led by Bradley Rogoff.

**Sector view: Pick your poison**

Turning to specifics, experts point to several industries that are poised for restructuring activity. Most notably, Oil & Gas and Metals & Mining remain the top picks thanks to plunging commodity prices, followed by Retail.

Global policy divergence, the slowdown in China, yuan devaluation risk, plunging commodity prices, Fed policy normalization, and the significant expansion of the leveraged credit markets are among the factors expected to provide opportunities from increasing defaults and an increase in distressed exchanges.

Highly leveraged B credits and smaller middle-market loans, meanwhile, are encountering resistance. And as banks tighten their lending standards for those looking to raise new debt, loan market participants can also expect that banks may start to become less accommodating in their willingness to amend and extend, and instead see an increased tendency to offload the loans, particularly in the case of smaller issuers.

“Banks are willing to amend and extend. That will always be there, but less so in more volatile times,” says Contopoulos. “In this respect, we can expect significant recognition of losses.”

**Scraping the barrel**

In the Energy sector, fund managers quip that they haven’t seen this kind of quality in the distressed market in years, after bellwether issuers like **Chesapeake** and world-class offshore driller **Transocean** plunged into the distressed trading category for the first time amid September’s brutal sell off.

But in the rest of this heavily distressed space, where companies including **Comstock Energy XXI**, **Linn Energy**, **Murray Energy** and **SandRidge Energy** all have or had debt trading in excess of 3,000 bps over the OAS risk-free rate, managers plan to tread carefully in 2016 after many in 2015 called the entry point too soon and were left badly burnt.

David Miller, a portfolio manager at Elliott Management, says he has probably done more in the past 3–4 months than in three or four years combined, and even then by a multiple. But he remains bearish on the energy and commodity sectors.

“We are going to do some things, but we are extremely selective. And what we are doing has more to do with the specific capital structure or a unique angle rather than a desire to make a unique bet on the underlying commodity.”

Meantime after a number of companies liquidated hedges in 2015 and were able to stave off the impact of free-falling energy prices, Davis Polk’s Huebner is bracing for multiple bankruptcy cases in the sector next year. “2016 is not going to afford them that luxury,” Huebner says.

For E&P companies, lenders’ April 2016 revolving credit facility borrowing base redeterminations bear watching as they could decline meaningfully because hedges are rolling off companies’ books, reserve values will decline, and many issuers are not drilling to replace falling reserves, S&P’s Diane Vazza says.

Other risks stemming from the commodity price slide could play out in merger and acquisitions and other deal-making combinations, experts say.

“There are dozens upon dozens of significant reserves that have been, or are going to get equitized,” says Ken Grossman, a managing partner at Juris Advisors said at the 22nd Annual Distressed Investing Conference in December.

The problem, he says, is that those companies are going to be primarily owned by credit groups.

“They are not long-term holdings. In these equalizations the companies go private, they go dark. Don’t be surprised if in the next year or two we are talking about oil or coal companies that have been formed, that are two and three times the size and are going public with new capital structures,” says Grossman.

“And on the way to that happening, these new securities that will be issued in exchange for senior secured debt may well trade at historically low levels often for technical reasons.”

Prior to the so-called OPEC bombshell in late November 2014, no Oil & Gas loans in the S&P/LSTA Leveraged Loan Index were bid below 80. Just one year later, about 70% are bid below the threshold often viewed as a barometer for distress. Some large, liquid performing issues have suffered precipitous losses: the **Ocean Rig** B-1 term loan due 2021 (L+500, 1% LIBOR floor), for example, has tumbled more than 50 points, while among second-liens, the **Fieldwood Energy**term loan due 2020 (L+712.5, 1.25% floor) has dropped to the mid-teens, from the low 90s.

Meantime, among the names on the LCD restructuring watch list is **Paragon Offshore**, which in November announced the hire of Lazard and Weil, Gotshal & Manges LLP to advise the company on strategic alternatives related to its capital structure.

**Burn coal, not cash**

The Metals & Mining sector is expected to lead the charge in the next default wave, with several coal names having already defaulted.

The coal market has been dealt a devastating blow in recent years as historically low coal prices, increased competition from natural gas, environmental regulation, and China’s import tariff has weighed heavily on liquidity-constrained issuers in the sector.

Weak metals prices, meanwhile, will continue to hinder credit quality, S&P says, where the challenges are on multiple fronts: on one hand companies need to rebalance mining portfolios and shut down capacity that is becoming inefficient, while on the other they continue to face slowing revenue growth due to lower prices across metals markets. The ratings agency expect metals prices to remain weak, with its most recent price assumptions seeing flat prices for aluminum, copper, gold, and iron through 2017, with a downside scenario not unrealistic.

With a total debt load in excess of $5.1 billion, the most highly anticipated of restructurings in 2016 will come from America’s second-largest coal-miner, **Arch Coal**, after it failed to make a $90 million interest payment due junior bondholders and instead entered into a customary 30-day grace period through Jan. 15.

The company’s senior unsecured debt has wallowed at a near-worthless one cent on the dollar after it was forced in October to cancel its proposed distressed exchange offer that it said was “the best option” for keeping it out of bankruptcy.

**Foresight Energy** is also in a precarious position after a court ruled that Murray Energy’s purchase of a non-controlling stake in the company triggered a change of control—meaning it could be on the hook to pay 101 percent of the premium on $600 million of bonds issued two years ago. As of the third quarter, Foresight Energy’s liquidity was $191 million, including $25 million of cash.

**Attention to retail**

Retail is an industry that is always seen as ripe for restructuring, with the rise of e-commerce putting increasing pressure on traditional brick-and-mortar retailers. Embattled names mainly fall in the apparel and department stores categories, where Barclays cites several fundamental headwinds that pose challenges

“Management teams have cited a laundry list of concerns, including a sluggish consumer, suggesting that the solid consumption growth numbers for the broader economy have yet to translate to demand for more retail goods through traditional channels,” Barclays’ analysts write.

Retailers **Bon-Ton Department Stores**, **Claire's Stores**, **Gymboree**, **J. Crew**, and **99 Cents Only Stores** are all trading at deeply distressed levels with an option-adjusted spread in excess of 2,000 bps. — Rachelle Kakouris

*This story first appeared on on Dec. 21 on www.lcdcomps.com, LCD's subscription site offering complete news, analysis and data covering the global leveraged loan and high yield bond markets. You can learn more about LCD here.*