Vital Intelligence for Turnaround Professionals

BY BRIAN J. GRANT, CTP, JUNE GUEST EDITOR

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Since joining TMA Global's *JCR* Editorial Advisory Board at the beginning of this year, I've gained a new appreciation for the *Journal* and the important role it plays in keeping the restructuring community up to date on important trends and developments. Nine times a year, the *Journal* provides readers with unique perspectives and in-depth coverage of the most relevant and timely corporate restructuring topics, intelligence that is vital to practitioners' continued growth and success in their particular field.

I also have a new appreciation for the time and energy that members of the turnaround and restructuring community contribute to make the *Journal* the successful and essential publication that it is. The contributions that authors make to each issue of the *Journal* help to educate other practitioners and strengthen the entire collective restructuring community.

In planning this issue, I was particularly struck by the fact that so many of our colleagues were eager to share ideas and donate their knowledge, time, and effort to this endeavor, and I think you'll see this enthusiasm, along with the authors' hard work and thorough research, come across in each of the following articles:

In "Navigating Burgeoning Private Credit Fund Universe Is Increasingly Complex," James (Jamie) Hadfield and Joseph Weissglass from Guggenheim Securities LLC profile the rise of private capital in the middle market lending space and the potential implications on workouts. This article punctuates some important trends that will likely continue to influence and change middle market lending.

In "Evolving Delaware Law Narrows Lender Option for Recovery from Troubled Borrowers," Mark Maloney and Thad Wilson from King & Spalding LLP examine the evolution of fiduciary duties owed to creditors in Delaware and interpret recent trends that suggest substantial changes for lenders relative to their enforcement of contractual rights.

In "Best Practices for Loan-to-Own Strategies in the New World," Bobby Guy, Bradley Gardner, and Meredith Hoberock from Polsinelli provide a comprehensive overview of loan-to-own strategies. Of particular importance, the group examines recent court rulings and their impact on this popular investment strategy.

Finally, in "How Long Can It Last? Trends and the Economic Cycle," I attempt to provide some perspective on current market conditions by looking at economic trends through the lens of the economic cycle, which suggest that challenges are on the horizon.

How Long Can It Last?

Trends and the Economic Cycle

BY BRIAN J. GRANT, CTP, MANAGING DIRECTOR, CONWAY MACKENZIE INC.

On a daily basis, people are increasingly inundated with more "noise" than ever before. From never-ending coverage of the presidential race to what the stock market did that day and what it means for the future, analysis and commentary are abundant and come from a growing array of media and mediums.

But has all this information made the public more informed or just more desensitized to trends and unable to grasp when trends slip the surly bonds of fundamentals and even common sense? The severity of the asset bubbles during the past 15 years—tech stocks at the beginning of the century, housing during the mid-2000s, and ultimately complex securitized debt instruments—suggests it's the latter. It is still hard to believe that the signs of these crises, so clear in hindsight, were either unrecognized or ignored by all but a select few.

Nowhere was this collective myopia more evident than during the housing bubble. Unlike securitized debt, housing is not a complicated asset, and it had long been known as a safe, albeit relatively slow growing, investment. But when the tech bubble burst in 2000 and the Federal Reserve lowered interest rates, consumers had unprecedented access to cheap financing.

Housing prices, which had historically appreciated just slightly more than inflation, began to surge. Collectively, consumers held to the tenet that home prices could only go up over the long run. They failed to appreciate that median home prices had increased by a staggering 125 percent from 1998 to the peak of the housing bubble in 2006. Equity requirements fell, credit standards all but disappeared, and supply grossly exceeded demand as speculative buying skyrocketed. Looking back, it's staggering that these trends weren't more obvious to more people.

Recognizing that people are prone to group think and unable to see the bigger picture through the fog of the news, the reliance on central banks to guide the economy and the distractions of daily life, it's interesting to think about how people might look back and realize in five years what they can't see today.

The Economic Cycle

Over the long run, increased productivity is the only true driver of economic growth. However, along that upward climb there are repeating patterns, a series of expansions and contractions, known as the economic cycle. Although each cycle is unique in its own way, the fundamentals of the economic cycle have proven reliable and can not only help explain where things stand today but also put the last decade in some perspective. Generally, the economic cycle comprises four stages (**Figure 1**).

In the U.S., most observers use the framework developed by the National Bureau of Economic Research (NBER), which dates business cycles by tracking inflection points in economic activity. According to the NBER, the U.S. has experienced 12 distinct periods of

expansion since 1945, the point at which modern economic data began to be scientifically recorded (**Figure 2**).

Assuming that the U.S. economy is still growing, May would mark the 85th month of the current expansion cycle, the fourth-longest period of expansion since World War II. The question, therefore, particularly for members of the restructuring community, is when will this cycle end? While most economists agree that the end of this cycle is near, opinions vary on just how much longer the economy will continue to grow before a contraction occurs. For some perspective, here is a brief recap on the cycle thus far in the context of longer-term trends.

Figure 1 FOUR STAGES OF THE ECONOMIC CYCLE

	STAGE 1 Early Cycle	STAGE 2 Mid-Cycle	STAGE 3 Late Cycle	STAGE 4 Recession
Monetary Policy	Easing policies to stimulate growth	Neutral policy	Contraction in policy	Policy eases to stimulate growth
Credit	Easing credit conditions	Strong credit growth	Credit begins to tighten	Credit dries up
Economic Growth	Sharp recovery following recession	Positive but more moderate growth	Rate of growth declines	Negative (for at least 2 quarters)
Leverage	Starts to increase after deleveraging but mitigated by rising profits	Leverage continues to rise due to credit conditions	Leverage peaks as profits fall	Deleveraging phase
Asset Indicators	Economically sensitive assets grow in value	Asset prices continue to surge	Shift away from economically sensitive assets	Flight to quality

Stage 1: Monetary Policy Kicks Off Post-Crisis Cycle

The seeds of the current economic cycle were sown in the wake of the global financial crisis. In 2008 the Fed and other central banks, facing an unprecedented global economic disaster, initiated perhaps the most aggressive monetary policy response in modern times. The objective was twofold: to encourage spending and to stabilize prices of economically sensitive assets.

By December 2008 the Federal Open Market Committee (FOMC) had reduced the effective federal funds rate—the key short-term interest rate on which all other rates are based—to near zero. Another new and somewhat unconventional tool, quantitative easing (QE), allowed the Fed to bring down long-term interest rates by purchasing mortgage-backed securities and other long-dated debt.

From a short-term perspective, these monetary policies worked. Economically sensitive assets, such as stocks, performed well. After hitting a 13-year low of 676 on March 9, 2009, the Standard & Poor's (S&P) 500 index ended the year at 1,115, making it the second-best year of the decade. Additionally, the U.S. officially came out of the recession in June 2009, and liquidity began to circulate through the economy as credit conditions eased. However, these policies also brought rates at both the front and back ends of the yield curve to unprecedented lows, setting the stage for a debt-fueled recovery.

Stage 2: Recovery, but No Deleveraging

Due to the severity of this last crisis and the fact that it was globally connected unlike any previous crisis, the Fed and other central banks were forced to maintain their stimulative monetary policies for an inordinate amount of time. Interest rates were held at near zero for the next seven years, and in the U.S., the Fed cycled through three iterations of QE. At the high point in late 2014, the Fed was buying $85 billion in bonds per month, and Fed holdings peaked at $4.5 trillion.

From a low point at the end of 2008, corporate profits began to grow rapidly, benefiting from cost cuts made during the downturn, and spending increased, particularly that of U.S. consumers. U.S. nonfinancial corporate profits as a percentage of gross domestic product (GDP) increased from 4.6 percent in Q4 2008 to 10.8 percent in Q1 2012. In real dollars, profits increased from $655 billion to $1.25 trillion. Consistent with previous cycles, equity markets also surged. From the trough in March 2009 to the peak in July 2015 at 2,128, the S&P 500 returned more than 250 percent.

Rising Debt. The defining characteristic of this recovery, however, was that there was no deleveraging on corporations' balance sheets. Unlike U.S. households, which deleveraged following the crisis, corporations continued to borrow; U.S. corporate (nonfinancial) debt increased by almost $3 trillion from 2008 to 2015 (**Figure 3**, page 12). The uses of this borrowing are particularly relevant to the future, as most of this debt was used for stock buybacks, acquisitions, and leveraged buyouts rather than long-term capital investments that would

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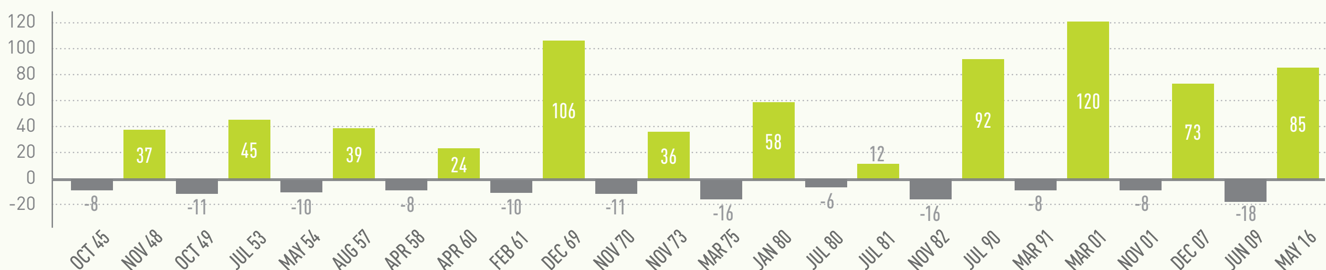
Figure 2 LENGTH OF U.S. EXPANSION AND RECESSION PERIODS (MONTHS)



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produce a future income stream that could service and repay the debt.

Increasing Asset Prices. Capital has been pouring into private equity funds during the past decade. Uninvested global private equity dry powder ended 2015 at a record $1.3 trillion. Private equity capital, supported by leveraged debt, resulted in record investments over the past several years, with total global buyout activity growing from $200 billion in 2011 to almost $300 billion in 2015. In addition to competing with other investors, private equity groups also began to run up against corporations looking to grow through acquisitions, leading to an increase in valuations and multiples. Middle market leveraged buyout purchase price multiples hit record highs in 2015 (**Figure 4**).

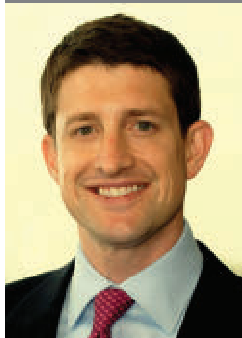
Search for Yield. With interest rates so low, investors also began to look to riskier assets to find yield. High yield issuances, as a percentage of total corporate issuance, grew to approximately 25 percent in 2010 and remained above 20 percent for the following four years, significantly higher than historical periods. Only in 1997 and 1998 did high yield account for more than 20 percent of total issuance during the past two decades.

Stage 3: Recent Trends

In 2015, the strength of the global economy was called into question as commodity prices collapsed, Chinese economic growth decreased, and global trade slowed. For the first time since the European sovereign debt crisis, credit spreads began to widen and low-rated corporate debt and leveraged loans began declining in value. These and other factors suggest that the third stage of the economic cycle is under way.

Contracting Monetary Policy. The Fed has begun to draw the curtain on a seven-year period of zero interest rates, and central bank asset purchases (on a net basis) recently dipped below zero for the first time since the financial crisis.

Profit Margins Under Pressure. Corporate profit, both in terms of real dollars and as a percentage of revenue, began to decline in 2015. Although partially driven by oil and gas and additional commodity-related sectors, other nonfinancial profits have also been impacted.



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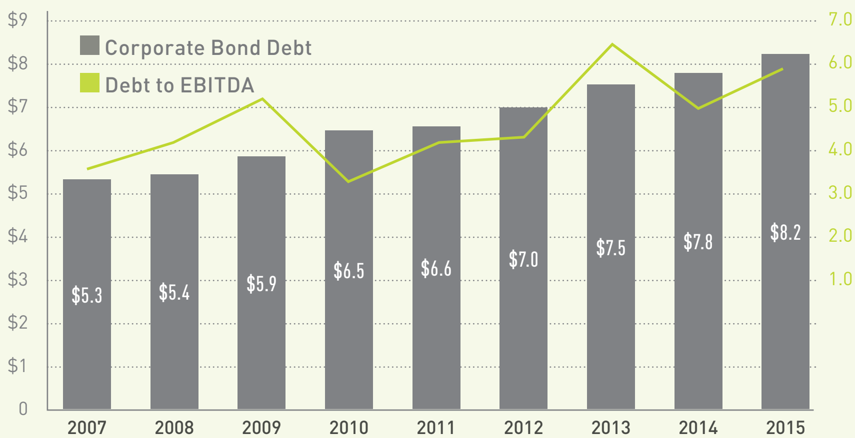
Defaults, Downgrades Rising. S&P downgrades exceeded upgrades in 2015 for the first time since 2009. Overall, S&P made 817 downgrades compared with just 575 upgrades. That trend has accelerated so far this year, with 556 downgrades compared with 265 upgrades, a ratio of 2.1x.

Busy Times Ahead

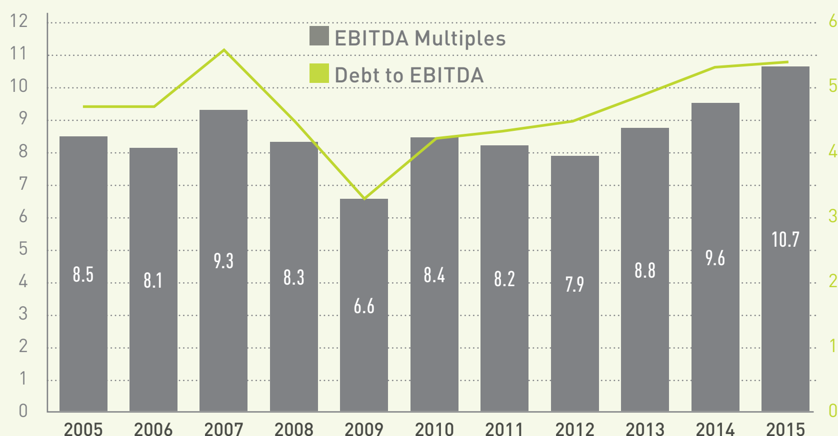
While the economy is by no means simple, it's good to keep the trends mentioned in this article in perspective. During the next five years an average of $800 billion in corporate debt will mature each year, and the economic contraction—whenever it comes—will surely mean that the restructuring community will be busy.

Figure 3 U.S. CORPORATE BOND DEBT AND LEVERAGE



Source: SIFMA, S&P

Figure 4 U.S. MIDDLE MARKET LBO TRENDS



Source: S&P LCD Report, Brown Brothers Harriman