Is the end near?

by Matt Miller Posted 09:24 EST, 23, Feb 2007

Loan default rates hang at record lows and threaten to cascade downward. Money is still pouring into high-yield debt. Lending spreads have narrowed. Bankruptcies have slowed to a trickle. And the bankruptcy bar is very quiet. Given all this and the seemingly endless amounts of that magic lubricant called liquidity, it's tempting to hold up a placard that says of corporate distress and the onset of the next big bankruptcy wave: "The end is a long, long way off."

It may be tempting. But it may also be misleading. "If we think that this can go on forever, we're not only deluding ourselves, but making it highly dangerous," says John Jerome, a Philadelphia-based partner at **Saul Ewing LLP** and a veteran restructuring lawyer who for years headed the bankruptcy group at **Milbank, Tweed, Hadley & McCoy LLP**. Jerome traces his first experience with a sudden spike in bankruptcies to 1963.

No one can deny that various indicators of distressed debt show a period of remarkable calm. But those whose memory extends further back than the onset of "American Idol" believe the quiescence is deceiving. If history is a guide, what's happening now could well presage a severe credit storm. "Any number of triggers could really ripple through the system, and then worsen," says Shai Waisman, a restructuring partner at **Weil, Gotshal & Manges LLP**. "If you'll excuse the cliché, we could have a true tsunami."

Excused. We've been here before; we'll be here again. Markets morph, and the forces of greed and fear are continually at war. Deep in every cycle, the signs become, for all their volume, confused. Good could be bad; bad could be good. Market practitioners cast about in the past for models. Two experts, staring at the same metrics, draw opposite conclusions. Everything is timing, and no one can predict the future.

Today, those preaching the onset of the next bankruptcy cycle are definitely feeling the Chicken Little effect. Too many predictions that the sky was about to fall have taken a toll on their credibility. "People have been saying [the next bankruptcy wave] will hit in a year or 18 months now for about two years," quips Karen Ostad, a New York-based restructuring partner at **Morrison & Foerster LLP**.

These days, even the most fearful observers don't see an imminent credit crunch, unless there's some sort of catastrophe, politely known in the trade as an "exogenous event." But they warn that some of the very factors that have combined in recent months to dampen credit woes could return to drive a wave of defaults and bankruptcies bigger and more treacherous than any since the late 1980s. "With today's rating mix, you could see the highest default rates since the Depression," declares Martin Fridson, CEO of high-yield research firm **FridsonVision LLC**. "It's just arithmetic."

Others do the math differently. The optimists maintain that debt markets remain in robust shape, with much to rejoice over and little to fret about. They cite the mind-boggling number and types of derivatives that diffuse risk through vast and very liquid markets. They bring up the explosive growth of hedge funds, with their seemingly bottomless pools of cash. They point to record-high earnings that cushion debt coverage. And they recount the many success stories of the private equity crowd. All of this, they posit, argues for sunny skies for years to come.

The fact is, the optimists have a brisk statistical wind at their tail. According to **Standard & Poor's**, default rates at the end of 2006 stood at 0.79% of total loans, a record low since the ratings agency began compiling such data. That dipped further to 0.78% in January and, barring any last-minute defaults, it looks like it will drop to an amazing 0.46% by the end of February.(see related chart)

The high-yield bond default rate last year was equally small. In terms of percentage of par value outstanding, the 2006 default rate stood at 0.76%, a 25-year low, according to Edward Altman, a longtime authority on the high-yield market and finance professor at New York University's Leonard Stern School of Business.

The number of bankruptcies tumbled as well. According to NYU's Salomon Center Bankruptcy Filings Database, which Altman oversees, the number of Chapter 11 bankruptcies fell to a 26-year low. Ranked by total liabilities, last year's larger bankruptcies — defined as having liabilities of more than $100 million — marked the lowest dollar value in a decade.

At the end of last year, Altman estimates, the total high-yield bonds outstanding stood at $1.05 trillion, a slight increase from 2005. New issues, however, amounted to $144 billion, an almost 50% jump over 2005. Some $61 billion came in the fourth quarter alone. Repurchases amounted to $67 billion, Altman says.

It's the composition of this debt that is especially noteworthy, and, to some, worrisome. According to Altman's reckoning, last year companies issued $20 billion in the bottom tier of high-yield debt, an all-time record. That's the debt most likely to default. According to the J.P. Morgan Global High-Yield Index data, the percentage of this CCC-rated debt stood at 10.46%. That's far greater than it's ever been.

Yet spreads are narrowing. They now stand at 75 basis points less than historic averages.

Both terms and coverage ratios are also loosening. For example, the amount of so-called covenant-light debt — loans with no maintenance covenants — jumped 10-fold last year, from $2.4 billion in 2005 to $24 billion in 2006. Leveraged buyouts are not only getting bigger, but average leverage ratios are rising. "We're creating a tremendous amount of inventory," says Waisman.

The average age of high-yield debt at the end of 2006 was only 14 months, half the average age of distressed debt during the last bankruptcy cycle. That seems to say to the pessimists that if you give this debt another year, you'd better watch out.

However, what's happened so far, and one reason why default and bankruptcy rates are so low, is that corporations are able to refinance loans before they default. It isn't just the commercial banks and other traditional financial institutions that are doing the bidding. Today, hedge funds are more than willing to shoulder the risk. As a result, demand for distressed paper has remained astonishingly high until the bitter end. According to S&P, the average price of loans going into default since 2004 has been 93 cents on the dollar. Before that, it averaged 60 cents.

That kind of reliance on the greater fool can't last, many restructuring practitioners argue, no matter how much money is sloshing around. "What I see more and more are people walking into the boss' office and saying, 'We were irrationally exuberant on this one and we're going to get away with it, but it's time to cut and run,' " says David Heller, a Chicago-based restructuring partner at **Latham & Watkins LLP**.

Heller says he's seen a change in attitude in recent weeks. "On my desk is $2 to $3 billion in debt that didn't find a quick exit. People have not refinanced their way out of troubled or stressed deals at anywhere near the pace of even last November," he says. "We're starting to get a real backlog of deals that need to be worked out over time, as opposed to being baby-sat until the next refinancing."

Some point to a reeling subprime loan industry as one portent of things to come. "The canary in *that* mineshaft is dead," says Waisman. Big subprime lender **HSBC Holdings plc** was forced to restate earnings earlier this month, and smaller subprime lenders are failing entirely. Three have filed for Chapter 11 in the last two months. The latest: **ResMAE Mortgage Corp.**, based in Brea, Calif., which filed for bankruptcy on Feb. 13. It issued $8 billion in loans last year.

While no one is suggesting that subprime lenders are this decade's version of the failed savings and loans of the late 1980s and early 1990s, the potential knock-on effect is obvious: Consumer defaults, lender bankruptcies, financial intermediary woes, homebuilder and building supplies stress. Some warn that subprime loans, like so many others, have been collateralized and parceled out. That may appear to spread the risk. However, those positions can begin to unwind with unpredictable results. ResMAE, for example, said it was brought to its knees by more than $500 million in repurchase demands from **Merrill Lynch & Co.**, which cited various loan covenants.

One major concern about debt markets in general is that with the preponderance of collateralized loan obligations, no one is quite sure who's going to be left holding the bag. "The notion that somehow structured products take the risk out of the market is poppycock," says **Peter J. Solomon Co.** managing director Anders Maxwell. "Only someone who has never read history believes that." Indeed, critics dismiss the notion that when it comes to debt and restructuring, it's a different scene in 2007 than in times past. "New paradigms, new eras, these kinds of things just don't happen," says Maxwell.

Credit spreads must widen, even the most optimistic agree. Default rates are bound to rise. "Eventually the bills come due," says Steven Miller, who heads S&P's leveraged commentary data group.

How quickly a bankruptcy wave follows a surge in defaults is another matter. Historically, there's a wide variance. As Fridson points out, it took five years in the 1980s to move from default trough to peak. It only took two years in the late 1990s to make the same trip. What's more, adds Miller, even a major economic shock doesn't necessarily mean a bankruptcy wave immediately follows.

The Black Monday stock market crash occurred in October 1987, almost exactly two years before the bankruptcy wave hit. The Mexico crisis, the Asian crisis, the Russian crisis, the collapse of Long-Term Capital Management — all hit years before bankruptcies became the defining road post of the American corporate landscape earlier this decade. "With the exception of a major geopolitical disruption, it isn't a question of watching CNN at night and filing bankruptcy papers in the morning," says Heller.

But sentiment can turn quickly, seemingly inexplicably, and, with it, that money tap can be cranked shut. "When a shock comes, all this business about liquidity goes out the window," says Jerome. "Liquidity is simply a function of perception."

What's more, economists point out, the onset of a bankruptcy wave tends to precede, not follow, a recession. So, is the sky about to fall?

Again, all we can do is look at the numbers. S&P predicts a small spike in the default rate, to 2.83% in May, bumping along for the rest of the year in the 2%-plus range. Fridson projects "a modest escalation this year and an acceleration in 2008 [in terms of defaults]."

Altman forecasts a 2.5% default rate in high-yield bonds this year and a 3.72% default rate in 2008. Even those rates, however, are relatively benign.

"The stars really aligned to have default rates so low," says Miller. "There's a long way to go to just get back to historic averages."

To provide a sense of contrast, during the last down years, loan default rates topped out at more than 8% at the end of 2000, according to the S&P data. The high-yield bond default rate hit 12.8% in 2002, Altman's data shows.

With its huge scandals, its dot-com excesses and its telecom meltdown, the most recent cycle of corporate busts is not only freshest in the minds of most, but provides a convenient model — perhaps too convenient.

Bankruptcy professionals warn that while it had some spectacular cases, the bankruptcy wave of 2001 to 2004 was contained to a few sectors and not marked by a more general credit crunch.

Instead, they cite the late 1980s wave as a model for what might follow. The conditions now being faced are "very similar to the late '80s, not what we saw in the '90s," says Maxwell. "We're seeing the same structural dynamics of the late '80s, when mortgage products became collateralized bond products. What happened? Most intermediaries pulled out of the market and took the liquidity out of the market."(see related chart)

Maxwell remembers well. He was on the trading desk of Salomon Smith Barney in October 1989 when a proposed LBO of **United Air Lines Inc.** collapsed. "There was an electrifying effect on the market," he recalls. "I can't tell you why. But everyone ran for the exit."

Within days, the LBO market, which had been on its heels, was pretty much knocked out. Defaults littered the corporate landscape. The savings and loan industry collapsed. High-profile bankruptcies followed. For example, **Federated Department Stores Inc.**, which financed its takeover of Allied Stores Corp. with $7.5 billion in junk bonds, held on until January and then filed for Chapter 11. One money manager in 1989 called that time a "period of speculative insanity." Are there parallels to the current situation?

"Essentially, many companies have been able to stave off filing Chapter 11 by accessing low-cost capital instead of addressing problems inherent in their business or balance sheet," wrote **Piper Jaffray & Co.** in a report earlier this month. "Some of these companies even underwent multiple refinancing within a relatively short period of time, essentially a strategy of replacing a Band-Aid with a more expensive Band-Aid."

In a recent analysis, Fridson looked at the universe of high-yield debt in 2005 and compared it to default rates experienced in the first years of the past two bankruptcy cycles. In the 2000-2001 "soft landing," the default rate of the lowest-rated high-yield debt was 27%.

But in the "hard landing" of 1990-1991, the default rate hit almost 48%, with the next level up at a 15% default rate. That translates, Fridson believes, to a default rate of 2005-level debt of 17% a year.

Not that anyone is predicting the next bankruptcy wave would mimic completely what has happened in the past. "History tell us it will come, and it will be different," Waisman asserts.

Again, the role of hedge funds could be key. The hedge funds have set up billions of dollars of distressed-debt funds and now own perhaps a quarter of all high-yield paper. What they do with it remains unclear. Some hedge funds may want to force bankruptcies, hoping to own companies after they emerge from Chapter 11. Others may want companies to restructure out of court. Miller, for one, envisions the possibility of a kind of two-step cycle. Hedge funds could effectively ease the rate that distressed-debt prices fall by providing ready demand for defaulted paper.

But that doesn't mean they can delay materially the day of reckoning. According to Altman, the majority of bankruptcy filings are pretty much simultaneous with defaults. Any lag time tends to be relatively short, less than six months.

The change in bankruptcy regulations that took effect at the end of 2005 could also affect the nature of a bankruptcy wave. Bankruptcies may well be shorter. There could also be far more liquidations than in the past, tossing more folks out of work. They may also be more complicated and more contentious. Companies these days have loaded up, not just on more debt, but on different kinds: multiple liens, multiple subordinations. Those, in turn, have been parceled out, repackaged and combined. That creates more creditor classes and the potential for messy, if not dysfunctional, bankruptcy workouts. "They're going to be nastier," predicts Waisman.

So, where are we now?

"The beginning of the end or the end of the beginning," says Maxwell. "All the telltale signs say we're at an inflection point." If only that inflection point would give us a few more details.

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