AMERICAN BANKRUPTCY INSTITUTE

2019 New York City Bankruptcy Conference

PLENARY SESSION

Distressed Market Conditions: The Next Bankruptcy Wave

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2019

2019 Annual Spring Meeting

What Does the Future Hold?

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Discussion Materials

March 2019

Overview

1	2018	▪ Markets sustained similar trends from 2017 into Q1-Q3 '18 before significant market volatility in Q4'18 related to concerns of a near-term recession ▪ Spreads expanded to multi-year highs in Q4'18 led by volatility and credit market outflows ▪ Leveraged finance volumes driven by record M&A / LBO related issuances in 2018 ▪ Yield curve inverted in December 2018 for the first time since 2007
2	Rates and Spreads	▪ FOMC raised interest rates four times in 2018 to 2.25%-2.50% range; projected to raise rates twice in 2019 and once in 2020 to a 3.125% target rate ▪ U.S. interest rates have increased across the board with 3 month US LIBOR at 2.81% while Euribor remains negative creating the largest differential since 2007
3	Default Rates	▪ The current leveraged loan default rate is ~1.63% (vs. 2.05% at this time last year) ▪ Distressed investors expect default rates to trend up to 3.0% by 2020
4	Restructuring Outlook	▪ The U.S. distress ratio(1) has increased to 8.7% which is the highest level in two years ▪ Although issuers were able to push out the maturity wall during 2018, more than \$650 billion of speculative grade debt matures over the next 3-4 years ▪ Largest percentage of credits rated B- or below since the financial crisis should lead to increased distressed activity in 2019

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(1) Number of distressed securities divided by the total number of speculative-grade securities as calculated by S&P.

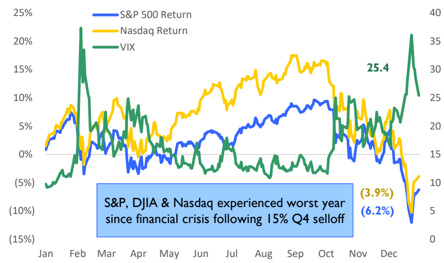
I 2018 Leveraged Finance Markets: A Year Defined in One Quarter

	Part I: More Of The Same In 1Q – 3Q	Part II: A Changing Landscape In 4Q
A Changing Macro Landscape	▪ After a year of historically low volatility, equities ended '17 up ~19% and hit new highs in 2Q and 3Q of '18 ▪ Trade tensions and other geopolitical headlines create pockets of volatility that were short-lived as risk markets rebound quickly	▪ Health of the U.S. economy drove risk sentiment as concerns over the prospect of slower growth and a near-term recession took center stage – GS Economic Research forecasts growth slowing to ~2% in '19 vs.~3% in '18 ▪ Equity markets led the move lower – S&P / DJIA drop (14.5%) / (12%) in 4Q, erasing YTD gains and closing 2018 down (6.2%) / (5.6%)
All Eyes on the Fed as uncertainty Around Forward Policy Grows	▪ To start '18, the market expected LIBOR to continue to march higher with two Fed hikes in 2018, while GS Economic Research called for four – The Fed hiked four times in '18 (Mar, Jun, Sep, Dec) ▪ The yield curve began at its flattest point since 2007 and continued to flatten over the course of '18 ▪ 3m LIBOR rose 70bps to 2.40% at the end of 3Q	▪ After Dec's hike, the Fed lowered '19 guidance to two hikes from three and took a generally dovish tone ▪ GS Economic Research now sees ~1.2 hikes in 2019, while the market is pricing in zero hikes in '19 and cuts in '20 ▪ The yield curve inverted in early Dec for the first time in 10+ years ▪ 10yr UST hit its highest level since 2011 in early Nov, 3.24%, before tightening 55bps to close the year 2.68%
U.S. Loan Volumes Outpace HY Despite Declines in both Markets	▪ Total inst. loan volume YTD ended 3Q down (11%) – Bright spot in M&A / LBO issuance, which ended 3Q YTD +13%, as sponsors and issuers continue to favor the loan market over HY ▪ 3Q YTD HY volume of $146bn, (27%) YoY – Significant decline in M&A and refi led the way at (25%) and (29%), respectively	▪ After 4Q loan volume of $76bn, (15%) QoQ, lowest since 1Q16, total inst. volume of $436bn ended (13%) vs. '17's record high of $503bn – Record high M&A / LBO volume of $275bn, 67% of the year's total ▪ Total HY volume of $162bn, (39%) YoY, lowest year since 2009 – Primary issuance came to a halt in Dec – first month with zero HY deals in 30 years
Loan & HY Technicals Diverge Before Outflows Accelerate at YE	▪ A diverging technical backdrop between loans and HY persisted throughout the year, as CLO dynamics powered the loan market and HY funds saw persistent outflows – Through 3Q, loans enjoyed a $13bn net inflow from mutual funds and $101bn of CLO creation, while $19bn exited HY funds	▪ After a reset in 4Q, both loans and HY saw net outflows on the year, clouding the technical picture heading into '19 ▪ Loan outflows of $3bn overall, of which $13.5bn occurred after Nov. 22, while HY outflows set a new record at $35bn, over double the $15bn record outflow set in '17
Spreads… From Post-Crisis Tights to Multi-Year Wides	▪ Spreads generally absorbed rising rates and grind tighter, although some of the loan / HY bifurcation permeated secondaries – LL100 and HY Index spreads ended 3Q at L+298 (new post-crisis low) and 333bps (1bp above tights seen in Jan), respectively ▪ CCC outperformance in HY remained a consistent theme, with CCCs returning +6.2% through 3Q vs. +3.4% for Bs and +0.7% for BBs	▪ After outperforming all other asset classes throughout the year, loans recorded a marginal positive return on the year of 0.5% ▪ HY ended down (2.1%) overall, while CCC returns fell 10% from the '18 peak to close down (3.8%) ▪ Leveraged finance secondaries ended the year trading at levels not seen since mid-2016

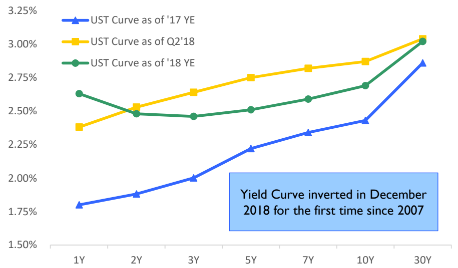
Source: S&P LCD News & Research, AMG Data Services, Dealogic, Bloomberg, Thomson Reuters, GS Economic Research, Lipper FMI.

I 2018 Market in Perspective

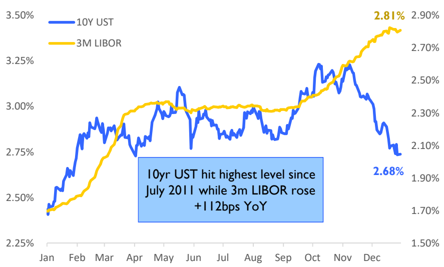
Equity Markets Experienced Losses Amid Volatility…



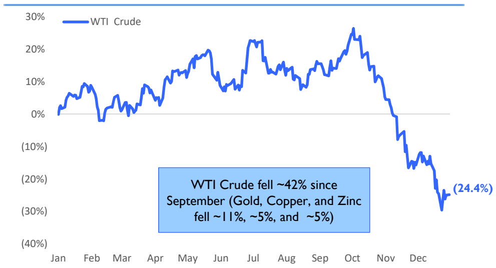
…As Forward Rates Continue To Be in Focus



Flight to Quality Sent 10yr Off Multi-Year Highs…



…As Commodities Fell Heading Into Year-End



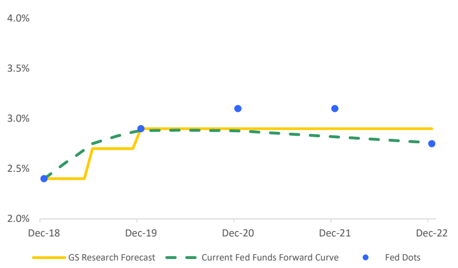
Source: S&P LCD News & Research, Bloomberg, LevFin Insights.

2 Interest Rate Market Update

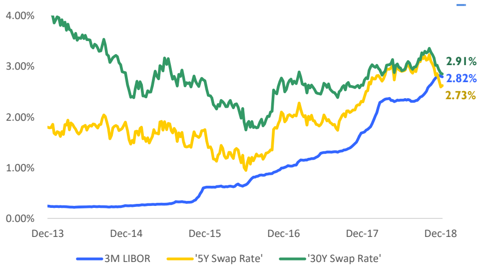
Overview

- As expected, the Fed raised the benchmark funds rate to a range of 2.25%-2.50% in its December meeting
- Central bank officials now forecast two hikes this year, down from three previously projected
  - The median "dots" continue to forecast a hike in 2020, bringing the terminal rate to 3.125%
- However, the Fed continues to include in its statement that further "gradual" rate hikes would be appropriate
- GDP is now expected at 3.0% for the full year of 2018, down one-tenth of a percentage point from September, and 2.3% for 2019, a 0.2 percent point reduction
- Fed Chairman Jerome Powell also rattled markets by saying the Fed was satisfied with its program to shrink its balance sheet and has no plans to change course

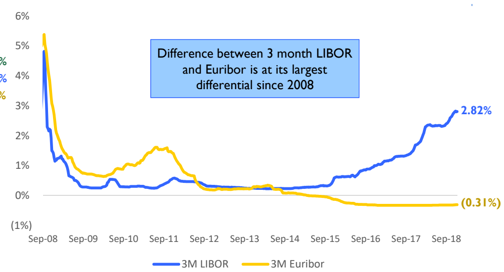
GS Forecasts and Fed Dots Remain Above Forwards[(1)]



Rates Have Increased Materially Across the Curve



LIBOR / Euribor Comparison



Source: Federal Reserve, GS Economic Research and BAML Research.
(1) Fed Dots numbers represent the median of FOMC projections for Fed Funds target rate as of December 2018. December 2022 Fed Dot represents the Fed's Longer Run projection.

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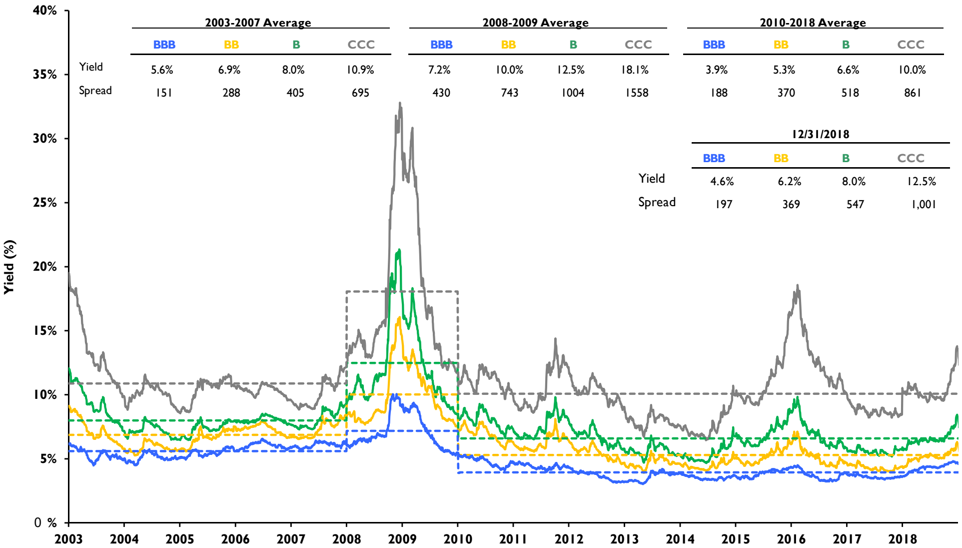
2 Credit Spreads

Credit spreads widen throughout 2018 as the fed raised interest rates and then accelerated in the Q4 as market volatility increased



	2003-2007 Average				2008-2009 Average				2010-2018 Average			
	BBB	BB	B	CCC	BBB	BB	B	CCC	BBB	BB	B	CCC
Yield	5.6%	6.9%	8.0%	10.9%	7.2%	10.0%	12.5%	18.1%	3.9%	5.3%	6.6%	10.0%
Spread	151	288	405	695	430	743	1004	1558	188	370	518	861

	12/31/2018			
	BBB	BB	B	CCC
Yield	4.6%	6.2%	8.0%	12.5%
Spread	197	369	547	1,001

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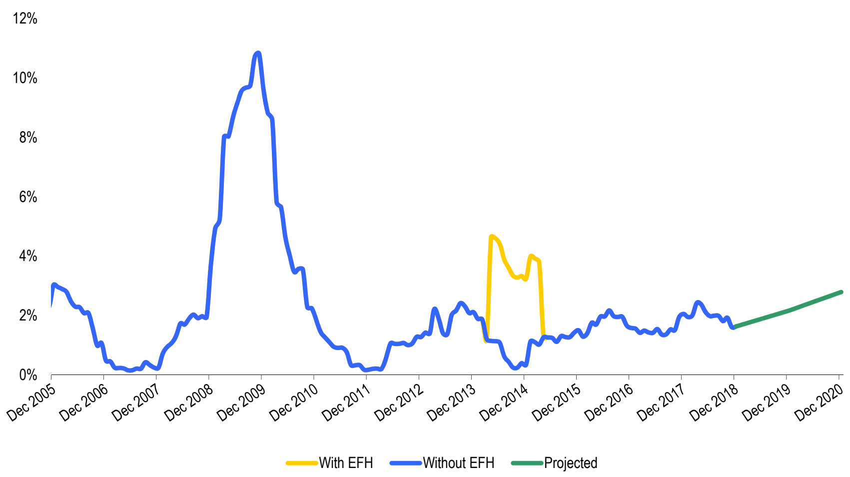
Source: Barclays.

3 Default Rates

Distressed investors expect default rates to return to near 3.0% in 2019

- Current leveraged loan default rate is ~1.63%

U.S. Trailing-12-Month Leveraged Loan Default Rate



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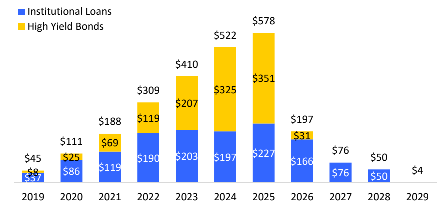
Source: S&P Global Fixed Income Research; S&P CreditPro®.

4 Outlook

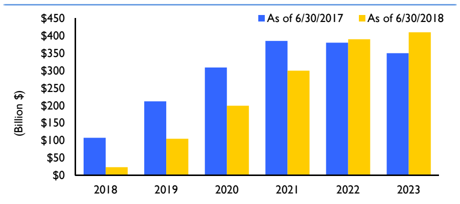
Historical default rates show that a significant percentage of speculative-grade entities default within a 3 year time horizon

- The combination of (i) low cost debt issued to speculative-grade entities in recent years and (ii) the continued rise in interest rates suggest the potential for a steady rise in default rates in coming years

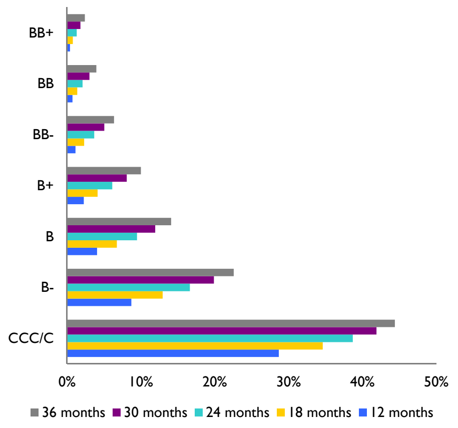
U.S. Non-Investment Grade Maturing By Year(1)



U.S. Non-Investment Grade Maturity By Year(3)



U.S. Average Default Rates by Time Horizon(2)



Source: S&P Global Fixed Income Research.
Note: USD in billions.
(1) Per RBC Capital Markets.
(2) Data compiled between 1981 – 2016.
(3) 2018 maturities are estimated as of June 30, 2017 reflect debt scheduled to mature in the second half of the year. Excludes financial companies.

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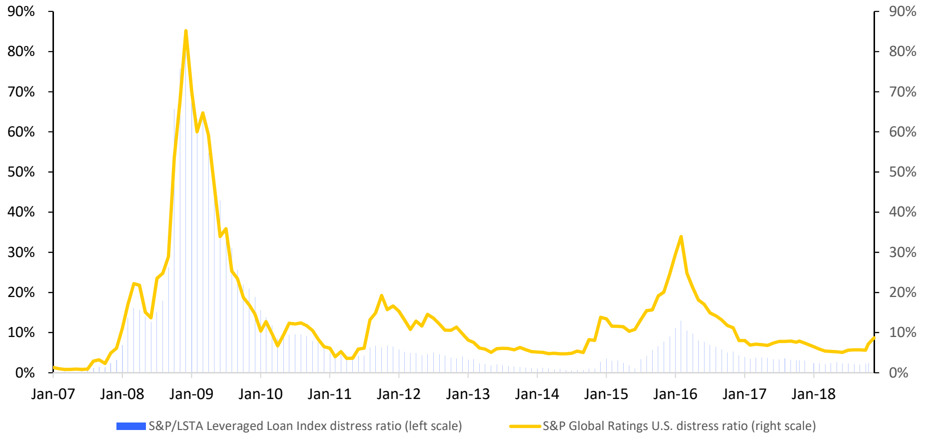
4 U.S. Distress Ratio

The U.S. distress ratio – a barometer for potential defaults – increased to 8.7% at the end of December, down from a high of ~34% in late 2015/early 2016 and 85% during the 2008 crisis

- 25% of U.S. speculative grade corporate issuers are rated B- or lower, up from 16% in 2014 and 15% at the midpoint of 2007
  - This portion of the speculative grade universe is at the highest levels since the 2008 financial crisis

U.S. Speculative Grade Distressed Ratios



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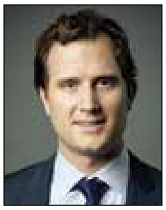
Source: LCD Research and S&P Global Fixed Income Research.

Turnaround Topics

By Mark Laber and John Yozzo[1]

Default Surge on Hold as Leveraged Credit Markets Refuse to Buckle



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It has been nearly a decade since the last default cycle was upon us, and restructuring professionals await the next one with nearly the same eagerness as a child waiting for Santa Claus on Christmas Eve. A decade between default cycles is a good, long time and there is increasing chatter that "we are due." This might be true strictly in terms of calendar time, but default cycles do not spontaneously occur and the ground conditions that have always preceded prior ones are not yet in place. Namely, distressed debt levels are exceedingly low and leveraged credit markets continue to be supportive of high risk borrowers, whose access to capital remains plentiful and affordable.

If you thought that an unexpected stock market correction, the return of volatility to equity markets, creeping interest rates, a hawkish-leaning Federal Reserve, the prospect of trade wars and escalating geopolitical tensions would be enough to rattle leveraged credit markets in the first quarter in 2018, well, you would be quite mistaken. Not only have corporate credit markets withstood these recent adverse developments, but there are new reasons to believe that they will continue to support high-risk credits for the foreseeable future barring a shock event. Despite repeated warnings from highly respected market-watchers regarding deteriorating lending standards, weakening lender protections and distorted risk/return prospects, leveraged credit markets continue to roar. Until this backdrop changes, it is hard to make the case that a substantial uptrend in default activity and bankruptcy filings is in the offing.

How Did We Get Here?

In two letters: QE. In response to the Great Recession, the Federal Reserve implemented an aggressive monetary stimulus initiative commonly known as quantitative easing (QE), which is generally credited with resuscitating U.S. credit markets following a period of near dormancy in the midst of the financial crisis. Since the Lehman Brothers' bankruptcy, assets on the balance sheet of the U.S. central bank have increased nearly fourfold as a result of security purchases under QE. However, we are now embarking on a prolonged period of unwinding as the Fed slowly starts the process of reducing its $4.3 trillion balance sheet, which will entail rising interest rates and a less managed credit environment.

Nevertheless, the QE initiative was not without its share of detractors, who contended that it sowed the seeds of the next financial crisis. The primary criticism of this unprecedented monetary stimulus was that it would debase the dollar, discourage saving and ignite inflation due to its massive creation of money. Others were critical that the Fed kept interest rates too low for too long; QE officially ended in October 2014. The U.S. monetary base, which consists of currency in circulation plus reserve balances of U.S. banks with the Fed, has soared to $3.8 trillion currently from $833 billion a decade ago, an astounding annual growth rate of 16.4 percent, due primarily to increases in bank reserves resulting from Fed purchases of securities.

However, the dire predictions of QE critics have utterly failed to materialize nearly a decade later, with inflation remaining very tame and the dollar relatively strong. Were the skeptics entirely wrong? Traditional inflation — too much money chasing too few goods — has not occurred because QE's massive monetary expansion did not flood the consumer economy. Rather, it has largely remained within the institutional community and has sloshed around financial markets, where, arguably, too much money has been chasing high-risk borrowers and leveraged transactions.

Huge capital flows into corporate credit markets via bank loans, institutional lenders and business development companies, as well as the proliferation of private lending platforms, are a manifestation of QE, an unanticipated outcome that continues to encourage high risk tolerance and low pricing spreads and eroding traditional lender safeguards. Much like fluid dynamics, the money must flow somewhere. Fund managers cannot sit on dry powder indefinitely, even if they do not like what they see. This money must be put to work, and fund managers have strong financial incentives to do so.

The enormity of the private-debt asset class today — lending and other credit investing that occurs outside the traditional banking system and is exempt from federal banking regulation — is underappreciated. Preqin, a provider of private capital markets data, reports that assets under management (AUM) in global private debt funds exceed $630 billion, a majority in North America, with dry powder of $236 billion globally at year's end.

1 The views expressed herein are those of the authors and are not necessarily the views of FTI Consulting, Inc. or its management, subsidiaries, affiliates or other professionals.

Direct lending accounts for approximately a third of private debt AUM but accounted for one-half of new capital raised in 2017. Regulated banks have been losing market share in lending to private credit funds in recent years, giving rise to the term "bank replacement debt."

As the expectation of higher interest rates becomes embedded with investors, new money has recently rushed into the loan asset class, which is floating-rate-based, causing spreads to contract since late 2017 and offsetting some of the increase in LIBOR base rates. Even spreads on high-yield bonds, which are overwhelmingly fixed-rate, have remained mostly steady in 2018 as the 10-year Treasury rate hits 3 percent. It has been an impressive showing to date in 2018 amid a period of broader market turbulence.

Private equity sponsors remain a driving force behind leveraged lending volumes, with 2017 being the strongest year for buyouts and sponsor loans since 2007. They are also holding huge amounts of dry powder, with buyout funds sitting on some $600 billion globally in late 2017, per Preqin. Today, sponsors are leaning much more on senior secured loans to finance their deals than they did in 2005-07, when junior lien and unsecured debt tranches accounted for more of the financing mix. The authors' analysis of 950 broadly syndicated leveraged term loans issued in 2017 and the first quarter of 2018 indicates that 65 percent of these loans were made to private equity-owned companies, while less than 15 percent had any financial maintenance covenants.

Why Does It Matter?

Thirty years of credit market history emphatically tells us that access to capital and debt default rates are strongly inversely correlated. When risky borrowers have easy access to financing, it nearly always occurs amid a low default environment (as shown in the exhibit below), while defaults tend to spike when capital markets are restrictive. This is intuitively understood.

Access to capital can be represented by any of three variables: high-yield market spreads, leveraged debt issuance or the distressed debt ratio. These variables begin to deteriorate nine to 12 months in advance of an upswing in defaults. Currently, none of these variables show any indication of weakening, as credit investors continue to pile into leveraged loans. The continued availability of affordable capital has helped many distressed companies stave off bankruptcy and has been a contributing factor to the general downward trend in chapter 11 filings since the end of the Great Recession.

What Has Changed in 2018?

In a word, plenty. As if leveraged credit markets needed any more stoking, several recent developments have increased the likelihood that leveraged lending volumes will remain strong in 2018 and beyond, provided that the economy avoids recession and shock events.

CLOs Are Now Exempt from Risk Retention Rules

Collateralized loan obligations (CLOs) are structured investment vehicles that have become the largest institutional buyer of leveraged loans in recent years. Thomson Reuters LPC recently reported that assets under management by U.S. CLO managers are approaching $520 billion, while new CLO issuance has topped $100 billion annually since 2015.

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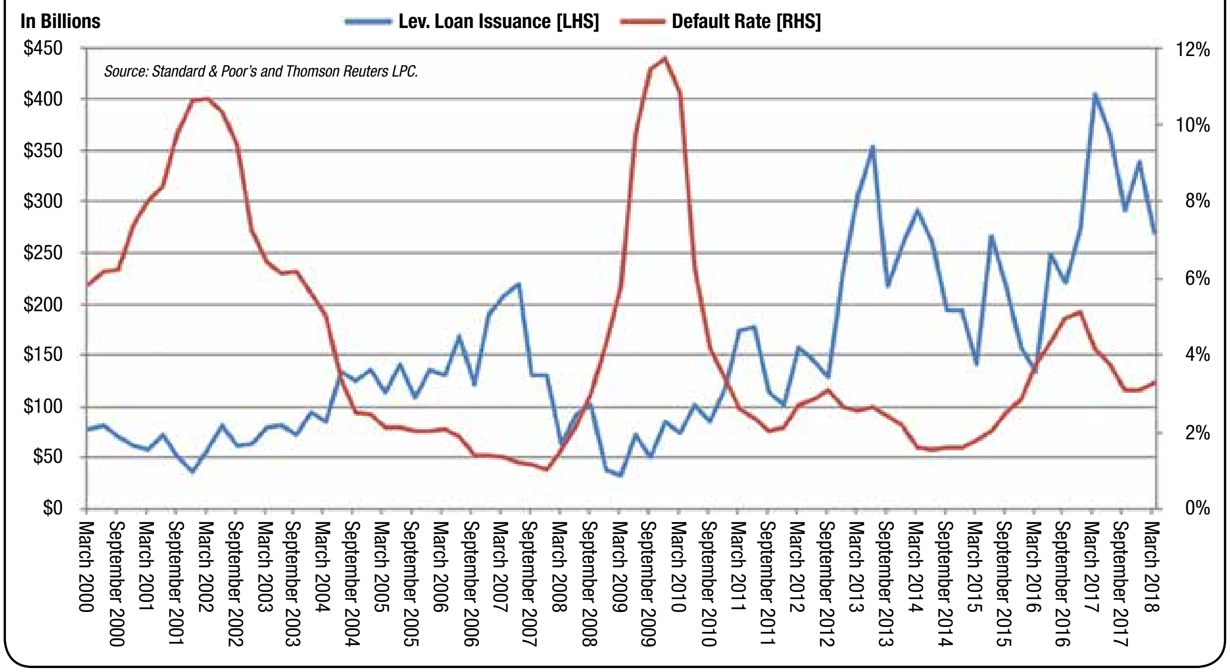
Spec-Grade Default Rate vs. Leveraged-Loan Issuance



Turnaround Topics: Default Surge on Hold as Markets Refuse to Buckle

from page 15

The CLO asset class is well understood by money managers and remains very much in demand.

CLOs were subject to the risk retention rule (also known as the "skin-in-the-game" rule) of the Dodd-Frank Act, which would have required most CLO managers to hold at least 5 percent of their funds. Many smaller-to-mid-sized CLO managers would have been challenged to meet this risk retention requirement, so there was considerable concern that the rule ultimately would depress demand for leveraged loans. The Loan Syndications and Trading Association (LSTA), a trade group representing lenders and CLOs, sued regulators in 2014 to exempt CLO managers who did not originate loans from the risk retention requirement and prevailed in February when a U.S. appeals court overruled a 2016 decision that sided against the exemption for CLOs. This latest ruling, which was not appealed, finally settled the issue by exempting most CLO managers from having to own a portion of their funds.

It is widely believed that this exemption will encourage more issuance for a CLO vehicle that already dominates the leveraged loan market. Market-watchers expect that CLO issuance could approach $140 billion in 2018 — easily a record high — while resets and refinancings will extend the investment lives of older vintage CLOs. Credit rating agencies have already cautioned about looser documentation and loan-selection standards of recent CLOs. Such criticism is met with the same reflexive response from CLO managers: Look how well the asset class has performed for over a decade, which is true — until it isn't.

LLGs Are Likely to Be Revised, Rescinded or Ignored

Leveraged lending guidelines (LLGs) were implemented by federal bank regulators in 2013 in response to concerns about creeping leverage ratios and looser underwriting standards of many syndicated loans, mostly involving private equity-sponsored companies. LLG laid out some broad metrics and other attributes that regulators could consider in determining whether a loan represented excessive leverage or had adequate repayment capacity. There was always some ambiguity as to whether these guidelines were intended to provide broad guidance or were to be strictly interpreted and adhered to by banks subject to regulatory reviews.

Compliance with LLGs varied among banks, but overall leverage levels of syndicated loans began to moderate within a couple of years of LLGs' introduction. Banks did not take kindly to LLGs, as some highly leveraged deals began to bypass the banking system entirely and were financed by large institutional or private lenders not subject to LLGs or federal bank regulations. Large banks that were losing business to private lenders took those complaints to a new administration intent on reducing the regulatory burden on business.

Their pleas were heard. Joseph Otting, President Trump's nominee for Comptroller of the Currency (the primary overseer of federal banks), has made several public comments since his November 2017 confirmation, signaling his intentions for LLGs, indicating that bankers should not feel bound by them. In this ninth year of economic expansion, with interest rates now on the rise, Otting said that he expects that leverage levels on new loans will trend higher in 2018. Fed Chair Jerome Powell is also on record saying that LLGs are nonbinding guidance.

You can see where this is going. Thomson Reuters LPC has already reported several buyout deals done in 2018 or in the market now with leverage levels at 7.0x EBITDA or higher that got financing considerably above the proscribed leverage limits contained in LLGs. This latest plot twist has the makings of a rush for deals that often compromises lenders' business judgment.

BDCs Can Now Potentially Double Leverage Levels

Business development companies (BDCs) are closed-end investment companies that have become a primary source of loan financing for middle market companies. BDCs can be privately owned or publicly traded companies, and they currently control assets of nearly $100 billion compared to $40 billion in 2012, according to Thomson Reuters LPC.

The $1.3 trillion omnibus spending bill signed by President Trump in March contained a provision called the Small Business Credit Availability Act, which will allow many BDCs to increase their risk profiles by raising permitted leverage to 2:1 debt-to-equity from 1:1 previously, a change for which the industry had been advocating for several years. BDCs are usually characterized as lenders of growth capital to small and middle market companies, but they often finance leveraged buyouts of mid-sized businesses.

The BDC vehicle has shown spotty returns in recent years as it contends with tighter loan spreads and increasing competition from middle market CLOs, private credit funds and other direct-lending platforms. It is hoped that this increase in permitted leverage will help boost returns or give BDCs exposure to less risky loan tranches without lowering total returns. BDCs will remain conservatively capitalized compared to other lending vehicles, but given the fierce competition among middle market lenders, this change will likely encourage more risky lending to speculative-grade borrowers. Middle market companies have never had so many financing options.

Where Is This Going?

However rational the criticism of apparent excesses in leveraged credit markets might be, let's acknowledge that the skeptics and naysayers about the sustainability of these exuberant market conditions have been off the mark so far. Speculation about the next default wave has been slowly building since the end of QE in 2014 and has proven to be premature at best, or just flat-out wrong. Nothing of the sort will materialize until credit markets first cool off, then retrench. Even then, history tells us there will be a notable time lag until bankruptcies and defaults meaningfully accelerate. Given the recent developments that will likely encourage more risky lending and forestall debt defaults, and the overall resilience of corporate credit markets, we cannot see that happening before 2020 as things now stand. However, there is an unmistakable sense of top-of-the-market euphoria in the air with respect to aggressive risk-taking by capital providers that is reminiscent of 2007. That is not to suggest that a 2008-like crisis is lurking with respect to timing, rapidity or global repercussions.

Given the high leverage and business vulnerability of so many speculative-grade companies today, it would only take a mild business downturn or run-of-the-mill recession to unleash the next big wave of corporate defaults. It will happen eventually, as it is already baked into the cake, but it could take longer to get going than many restructuring professionals now anticipate. abi