Volatility. Interest Rates. Case Filings. Is There Rough Weather Ahead?

American College of Bankruptcy
Seventh Circuit Education Seminar
September 21, 2023

ACCORDION AlixPartners GODFREY KAHN GOLDBERG KOHN

Introduction

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Panelist: Randy Klein
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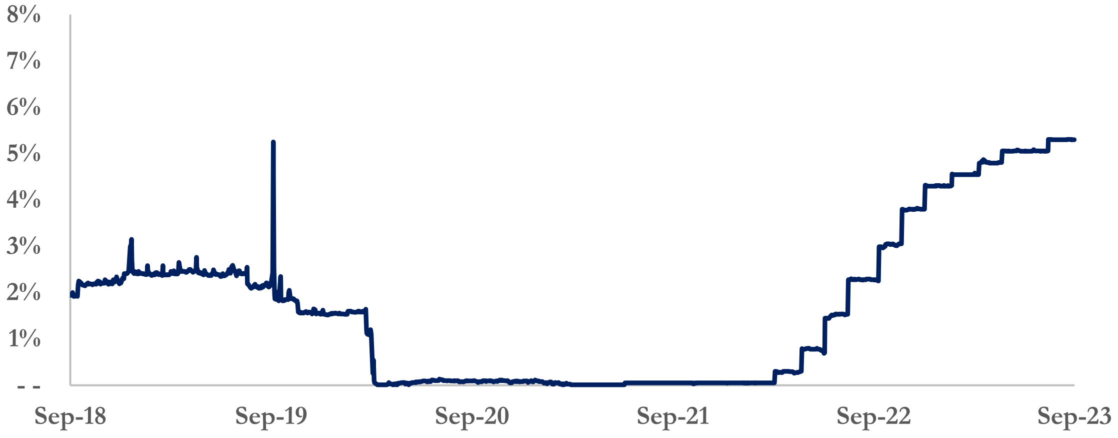
Capital Markets & Cost Of Funds

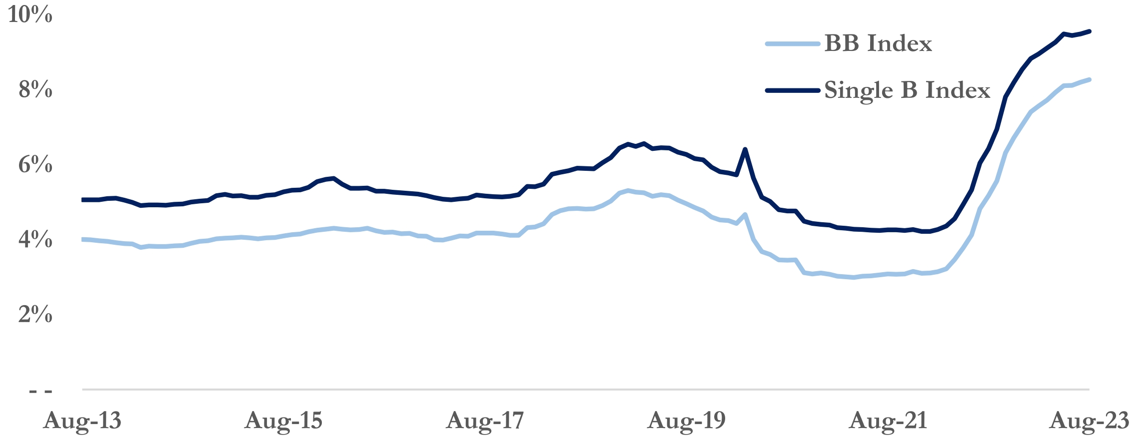
Base Rates & Funding Costs Are On The Rise…

- The end of zero interest rate policy: base rates (SOFR) now sit at 5.3%, up materially versus just a year ago (~2%) and 2020/2021 levels (~0%).
  - This rate cycle represents the quickest increase in rates since 1988/1989 (8.4% to 15% in 6 quarters).
- **Financing costs as a result are materially higher.**
  - Yields on floating-rate leveraged loans are at a 10-year high and approaching levels not seen since the GFC.
  - Effective yields on BBB corporate indices are additionally at 10-year highs.

Secured Overnight Financing Rate (SOFR)



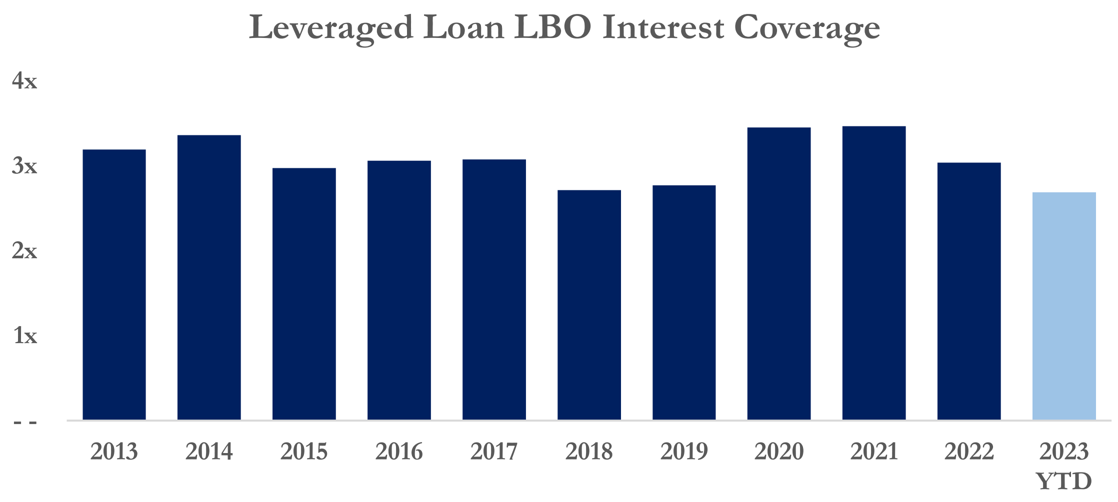
Leveraged Loan Yields

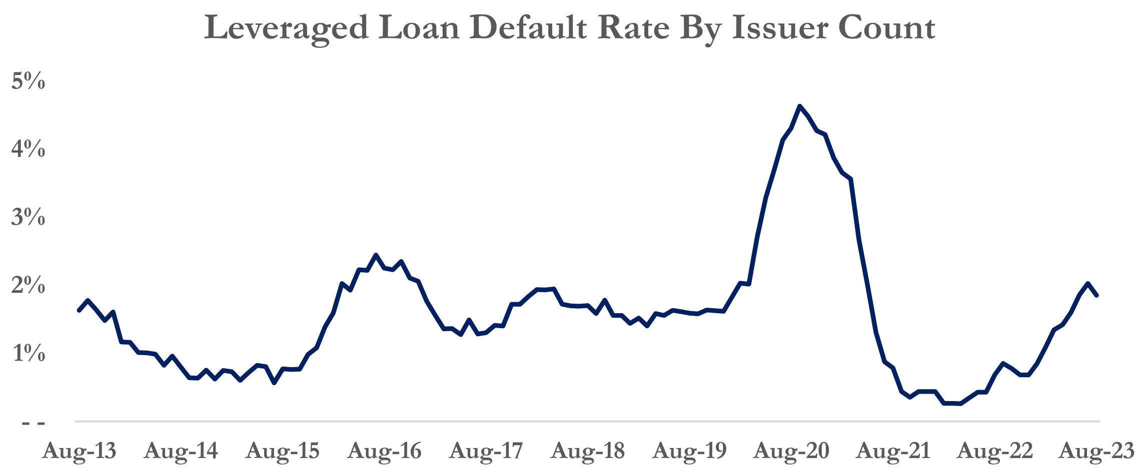


Source: Federal Reserve Bank of New York, Secured Overnight Financing Rate, retrieved from FRED, Federal Reserve Bank of St. Louis and PitchBook LCD.

…Pressuring Cash Flows & Increasing Distress

- Interest coverage on LBOs sits at 2.7x, down from 3.0x a year ago and 3.5x in 2020.
- The top 20 LBOs in 2021 had average interest coverage of 3.5x – when recalculated for base rates today (and all else unchanged), that has dropped to 2x.
- **The LTM leveraged loan default rate has risen to 1.9% (0.7% a year ago), with downgrades and distress materially increasing.**

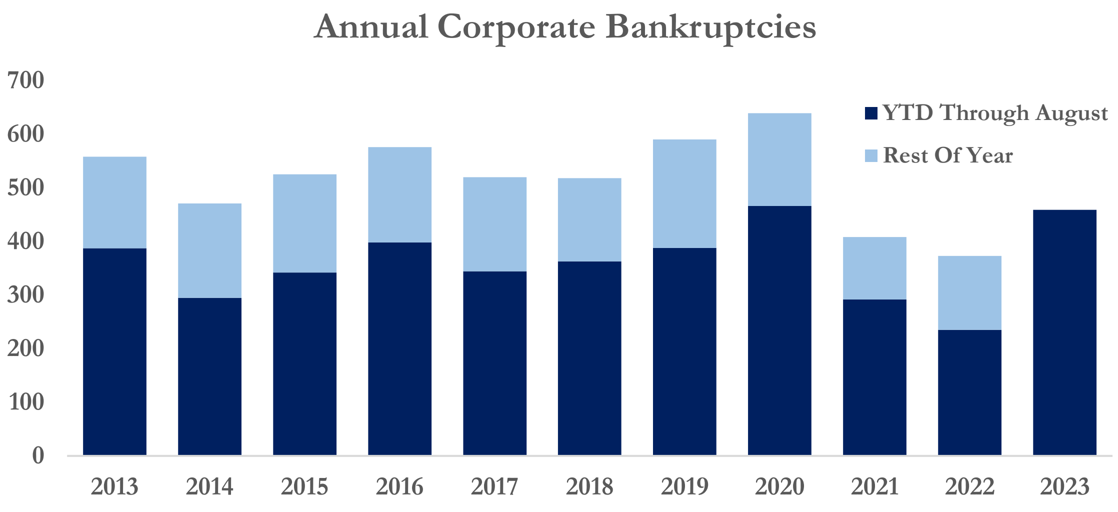


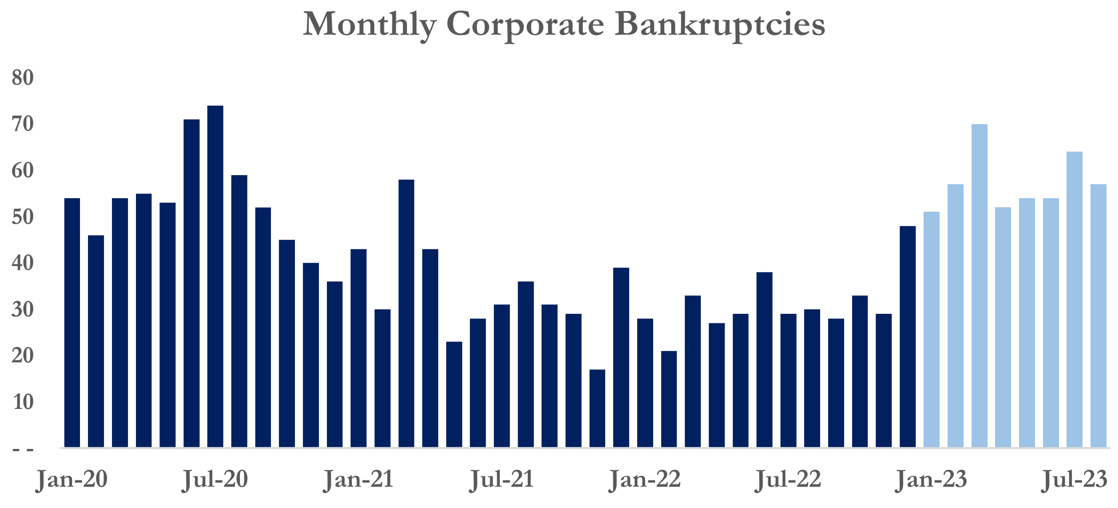


Source: PitchBook LCD. Leveraged Loan LBO Interest Coverage through Q2 2023.

With Filings On The Rise

- **Corporate bankruptcy filings through August have outpaced the 2022 full-year total.**
  - No other year in the past decade has seen higher filings through August except 2020 (COVID).
- August Ch. 11 filings were up 54% vs. the prior year.
  - Small business filings (subchapter V) were up 43%.
- PJT Partners CEO Paul Taubman on 7/25/23: "This restructuring cycle has legs, and we expect our level of [restructuring] activity to remain elevated for some time to come.





Source: S&P Capital IQ. Limited to public companies or private companies with public debt where assets or liabilities at time of filing are $2m+, or private companies where assets or liabilities at time of filing are $10m+; Epiq Bankruptcy

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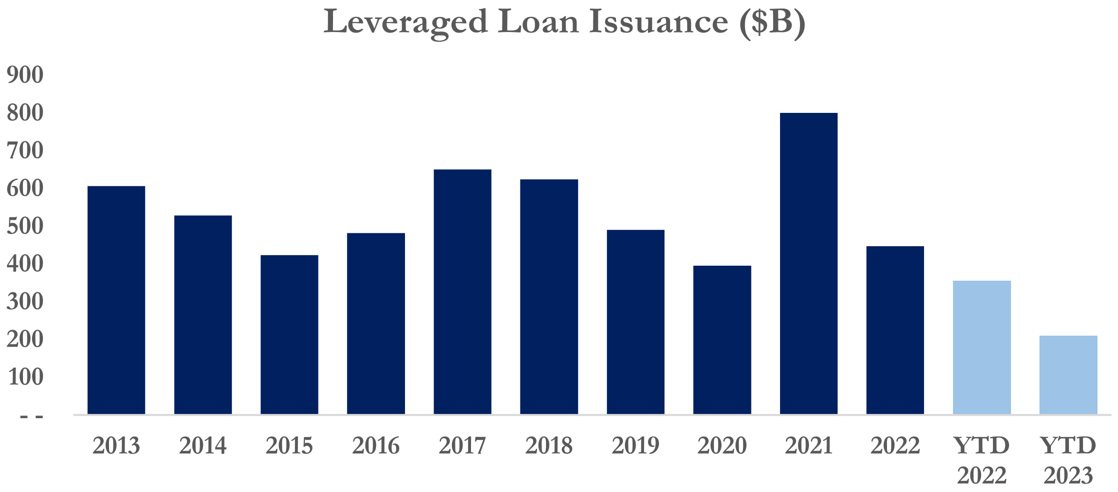
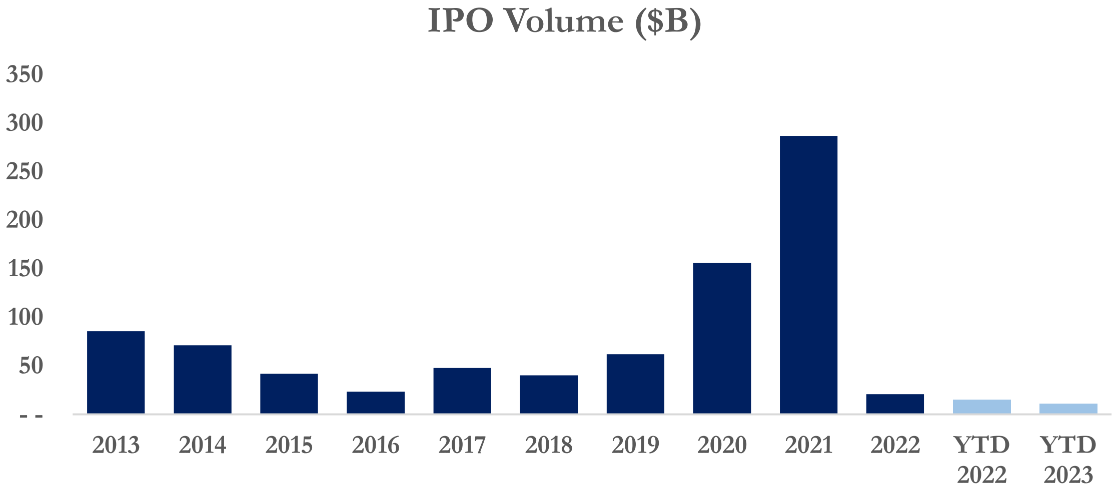
Tighter Financing Markets

- **Debt (leveraged loan and high-yield bond) and equity issuance continues to be sluggish compared to prior years, though activity has modestly picked up in recent months.**
- Private credit has filled some of the void, though this likely comes at a higher spread with tighter covenants.





Source: Pitchbook LCD and S&P Capital IQ. YTD 2023 and YTD 2022 values through Aug 31st of each respective year.

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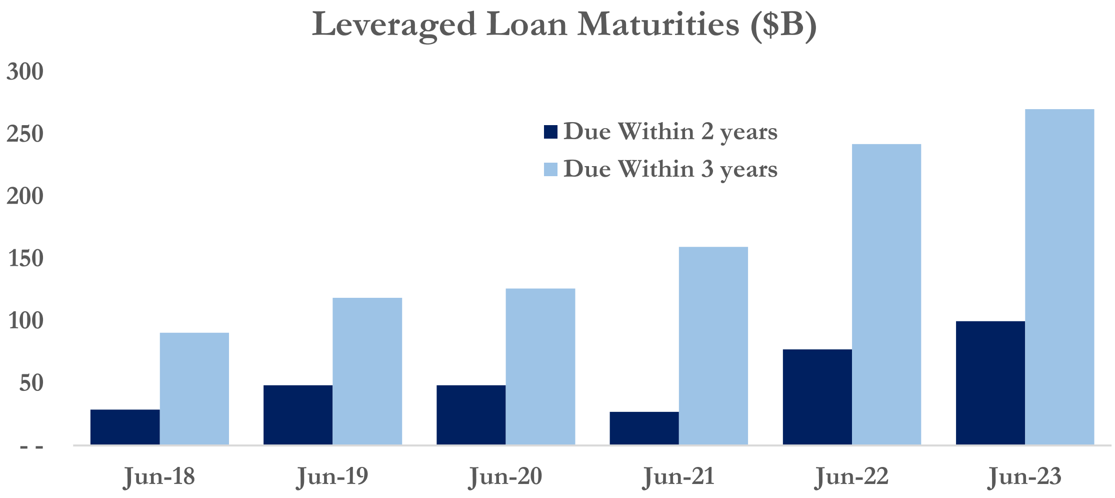
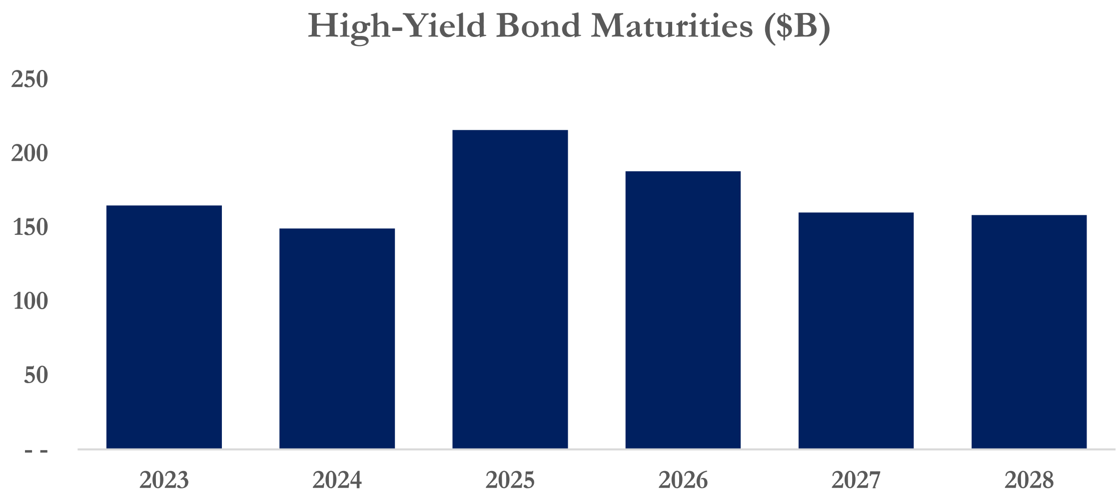
And A Pending Maturity Wall

- As of June 2023, ~$270b in leveraged loans were due within the next three years and another ~$530b in high-yield bonds mature between 2023 and 2025.
- **Companies across the credit quality spectrum that need to refinance do so in a tighter and more expensive debt market, which may be a trigger point for distress.**





Source: Pitchbook LCD.

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PE Activity

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What Are The Public Asset Managers Saying?

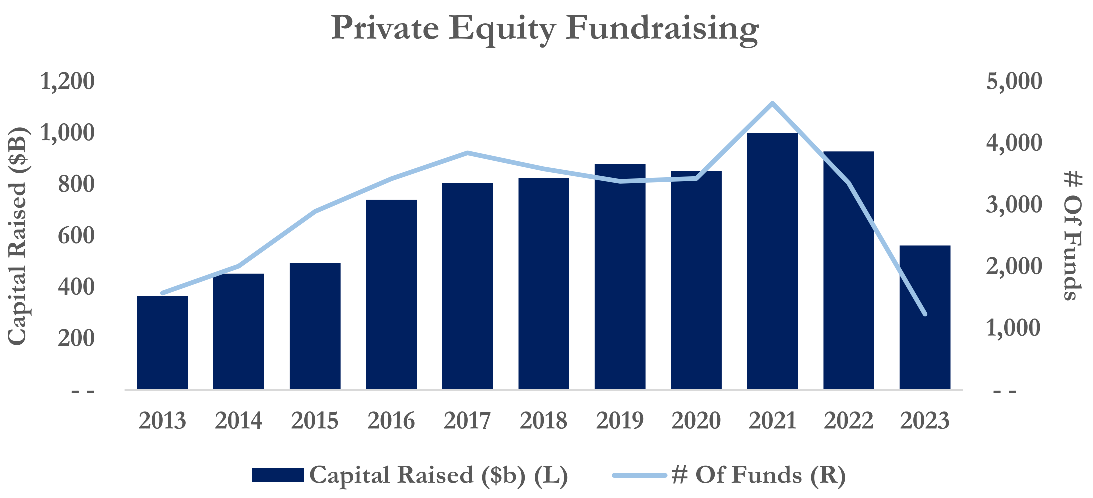
- Underlying portfolio company fundamentals remain healthy, though slower global growth and higher rates may dampen returns.

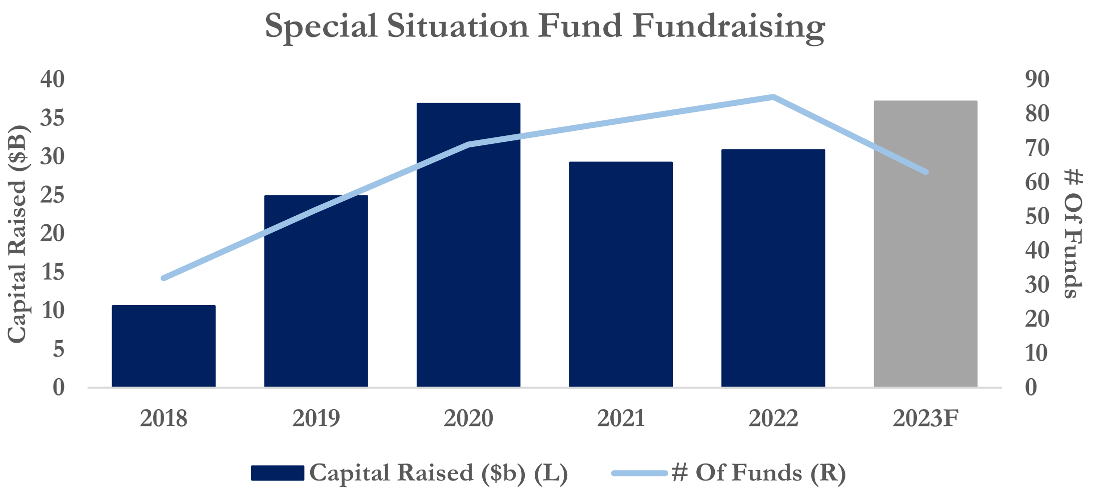
APOLLO	08/03/2023: "There were these incredible tailwinds in the [private] equity business, tailwinds from money printing, pulling forward of demand, fiscal stimulus and certainly from zero rates. **We now find ourselves in an absence of tailwinds.** Rates are higher. Growth is slower. Globalization is in retreat. People will have to go back to investing in the old fashioned way. They'll actually have to be very good investors.
Blackstone	07/20/2023: "Corporate private equity funds appreciated 3.5% with **our operating companies reporting robust revenue growth of 12% year-over-year**, along with expanding margins overall. "
CARLYLE	08/02/2023: "We're starting to see it's more difficult for our portfolio companies to pass through increased cost, reinforcing the view that the inflationary cycle has peaked. **Our portfolio company CEOs remain generally cautious in terms of how they're approaching the operating environment, but broadly, our portfolios have seen accelerating activity with over 10% EBITDA growth**."
KKR	08/07/2023: **"The traditional private equity portfolio was up 5% in the quarter, and over the last 12 months, appreciated 2%.** Importantly here, inception-to-date IRRs for our blended flagship funds remain strong at 22%, which is meaningfully ahead of the corresponding 9% figure for the MSCI World.**"**

Source: S&P Capital IQ. Commentary reflective of 2Q23 earnings calls.

Fundraising Has Been Muted

- 2023 has represented a tough year for PE fundraising, **with Q2 fundraising down 40% vs. the prior year.**
  - The Financial Times reports that PE firms are "increasingly offering sweeteners such as fee discounts to secure backing from deep-pocketed investors", as firms struggle to hit AUM targets.
- **Special situation funds have been a bright spot in fundraising thus far,** as sponsors aim to take advantage of market turmoil.



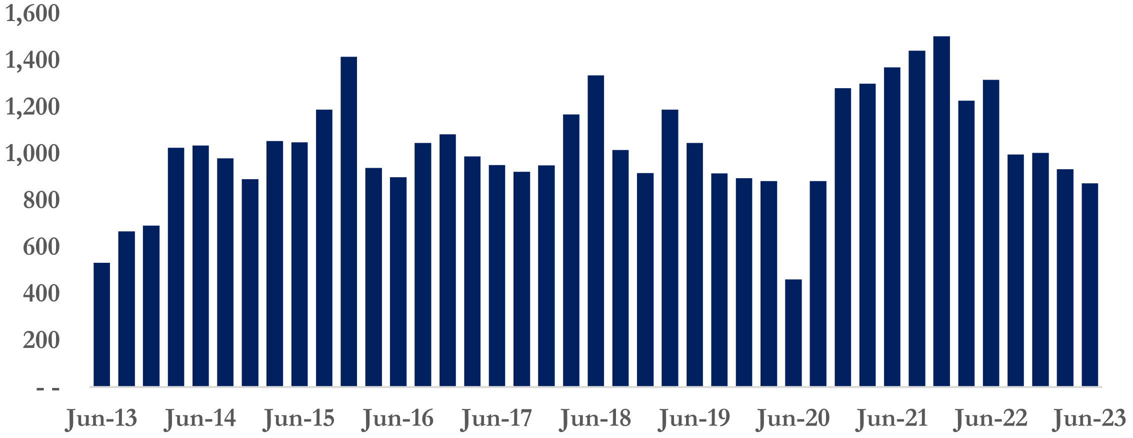


Source: S&P Capital IQ and PitchBook.; PE Fundraising through Sept 2023

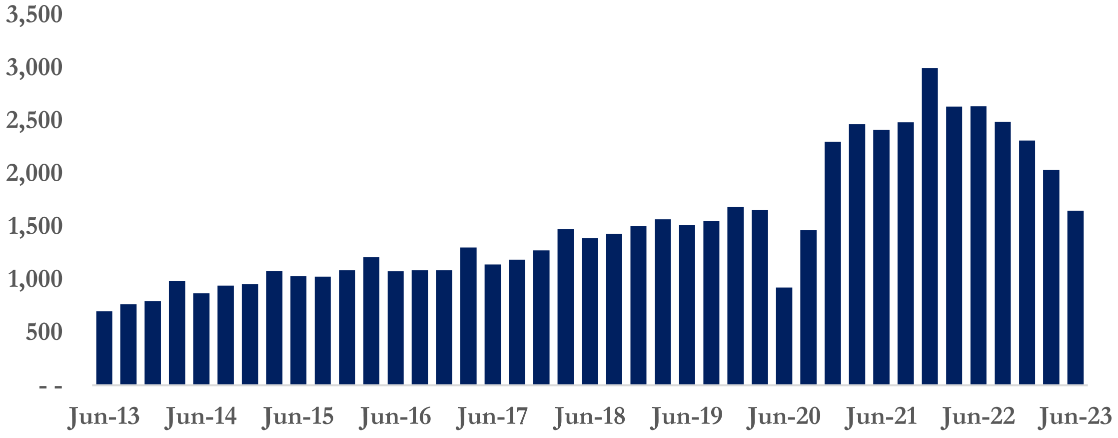
Against A Limited Deal Environment

- **Quarterly M&A volume was the lowest value in the last 10 years excl. COVID (2Q20).**
- Quarterly PE add-ons were similarly down 40% vs. the prior year.
- With fewer high-quality targets and more uncertainty regarding deal close, sponsors have been proactively looking at current portfolio companies for value creation.

Quarterly M&A Volume ($B)



Quarterly PE Add-On Deal Count



Source: Pitchbook LCD.

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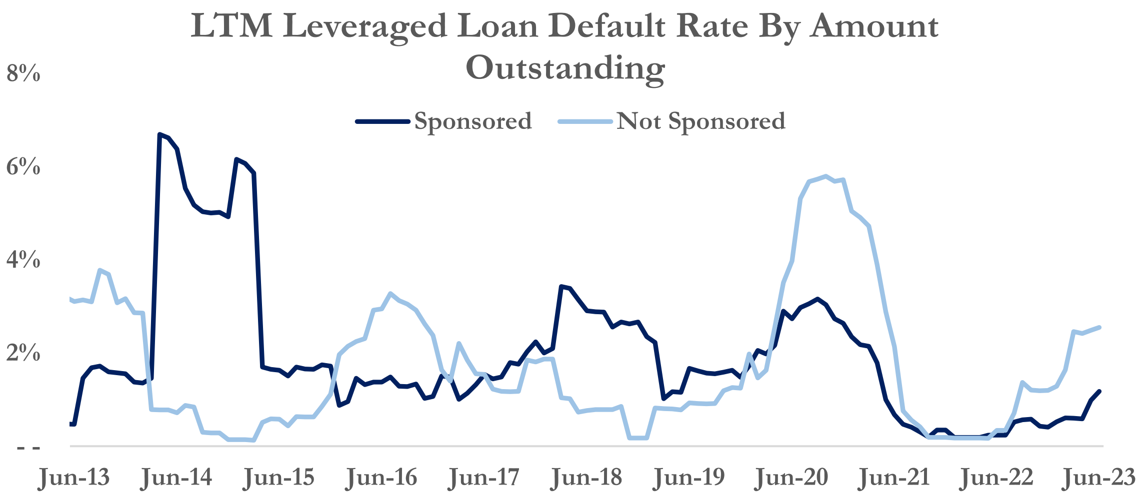
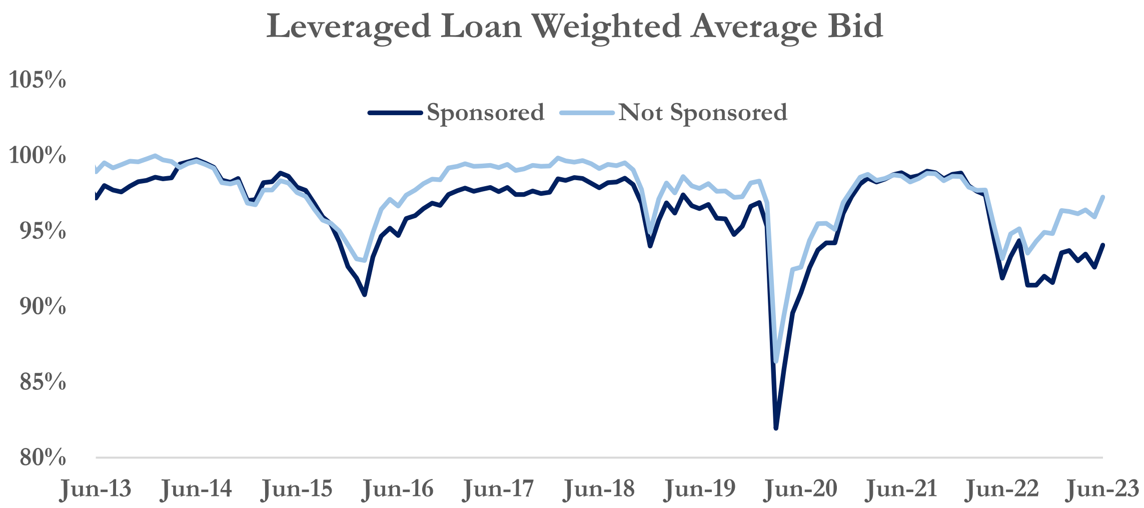
But Credit Issues Have Been Limited To-Date

- Sponsor-backed leveraged loans generally have higher leverage than non-sponsored deals – but have outperformed on the credit front year-to-date.
  - **The LTM default rate for sponsored loans is approx. 1.2%, vs. the non-sponsored rate of 2.6%.**
  - This also holds in the GFC and COVID, where sponsor-backed debt outperformed non-sponsored.
- Bids on sponsored debt, however, have lagged non-sponsored peers year-to-date – and issuance spreads are additionally wider.





Source: Pitchbook LCD.

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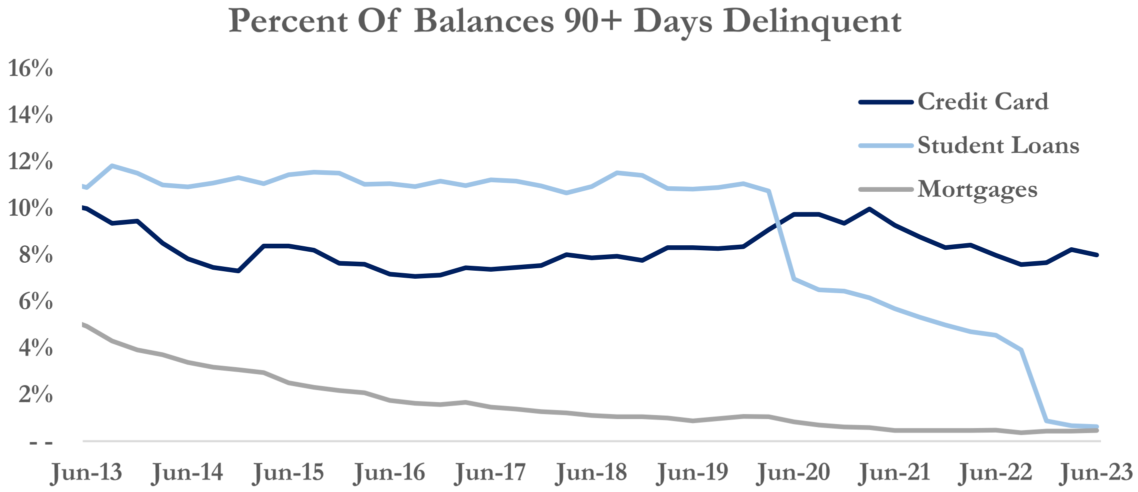
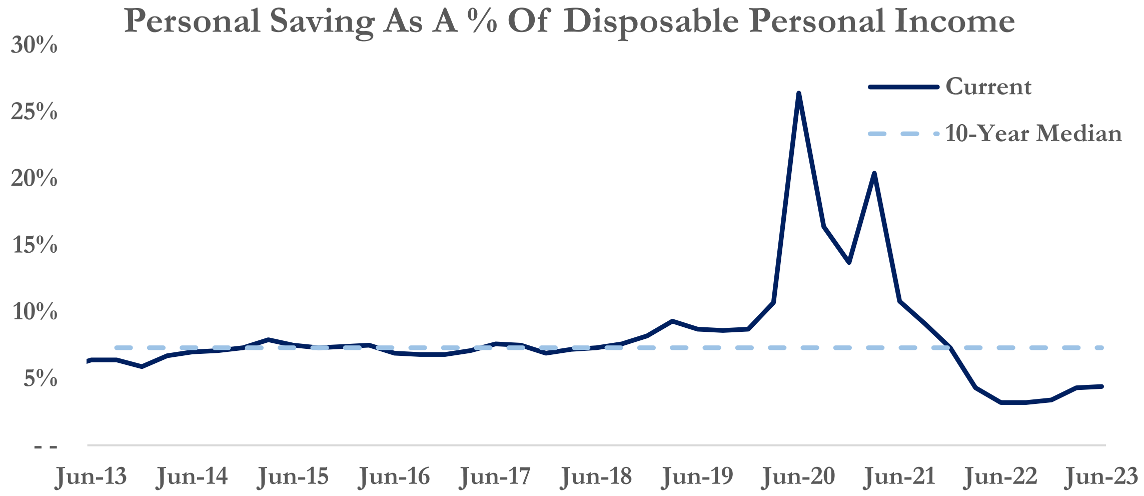
The Crystal Ball… What Items Will Be Pertinent This Time Next Year?

The Health Of The Consumer

- Delinquency rates on mortgages and student loans are at decade lows (the latter impacted by pandemic related payment pauses), while credit card delinquencies remain muted.
- Personal savings rate have additionally dipped after the flush years of 2020 and 2021.
- **After 3 years of forbearance, student loan repayment is set to resume on October 1st – with depleted savings, how will consumers (and the broader economy) fare?**

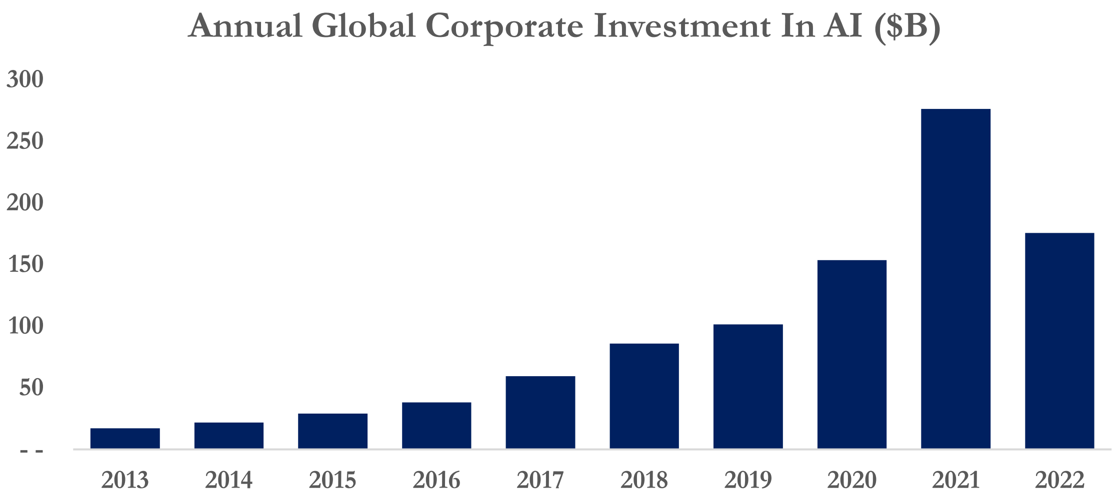


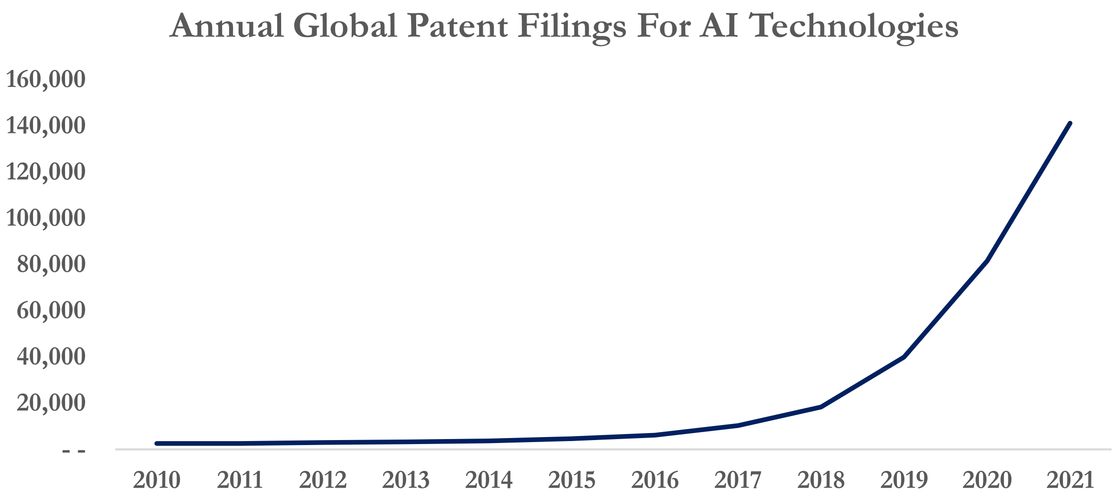


Source: Federal Reserve Bank Of New York Household Debt & Credit Report, and U.S. Bureau of Economic Analysis, Personal Saving Rate, retrieved from FRED, Federal Reserve Bank of St. Louis.

The Rise Of Artificial Intelligence (AI)

- AI is the hot topic of 2023 thus far.
  - Global corporate investment in AI and patent filings are up exponentially over prior years.
  - Expanding media mentions and global adoption of AI and AI-related technologies (i.e. ChatGPT).
- **What industries are at risk from widespread AI adoption? What industries stand to benefit? What are the legal implications?**





Source: Charlie Giattino, Edouard Mathieu, Veronika Samborska, Julia Broden and Max Roser (2022) - "Artificial Intelligence". Published online at OurWorldInData.org.

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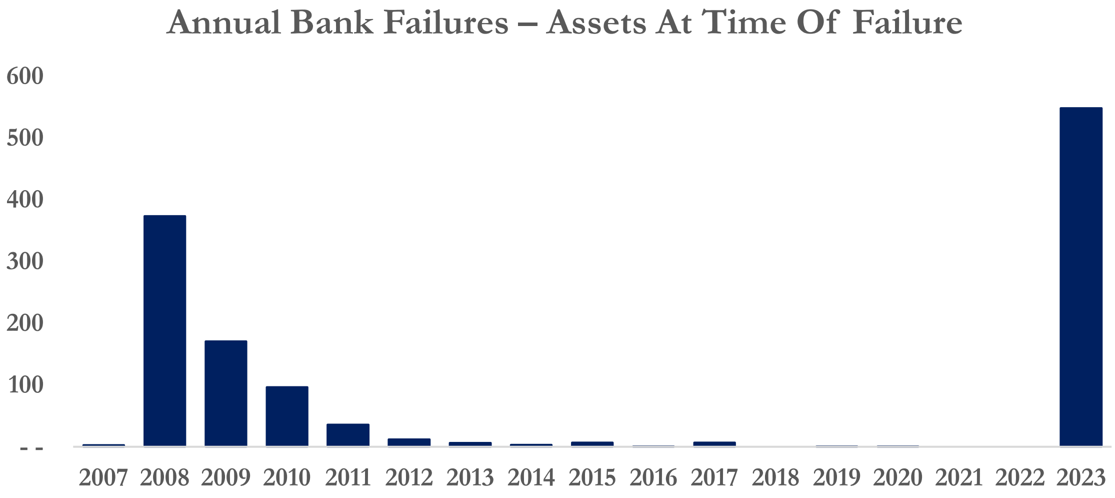
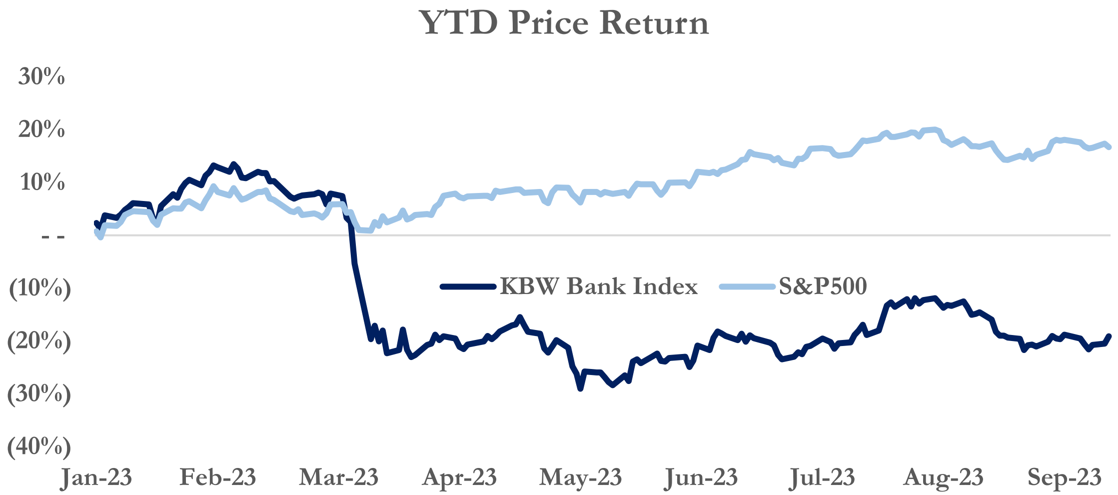
Bank Failures

- **After the banking crisis of March 2023, is there more trouble to come?**
  - First Republic, Silicon Valley Bank, and Signature Bank represent the second, third, and fourth largest bank failures in U.S. history (~$550b in assets at time of failure)
  - KBW Bank Index down 19% year-to-date vs. the S&P500 up 17%.
- Moody's recently downgraded several small to mid-sized US banks.
  - Exposure to commercial real estate to be impacted by high interest rates and declines in office demand.
  - Tighter credit standards and weaker loan demand from businesses and consumers in 2Q23.





Source: FDIC & Yahoo Finance

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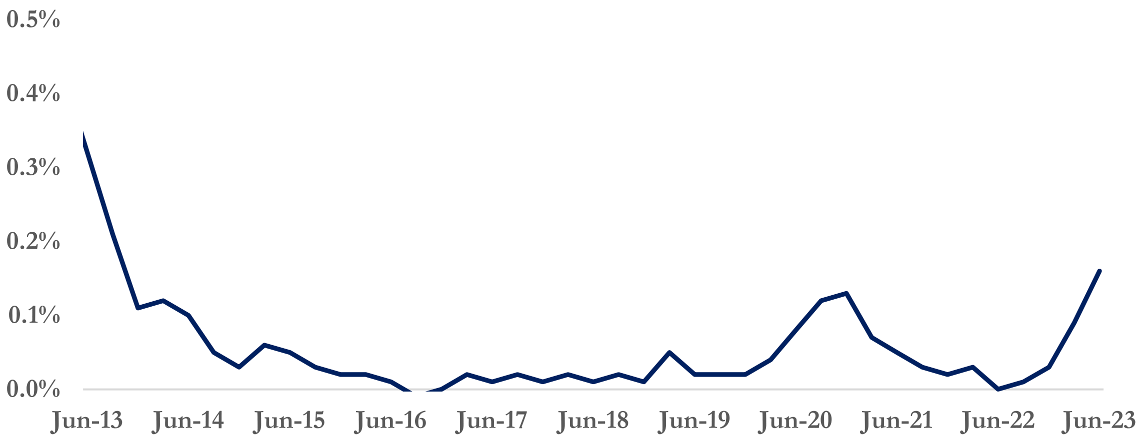
Commercial Real Estate

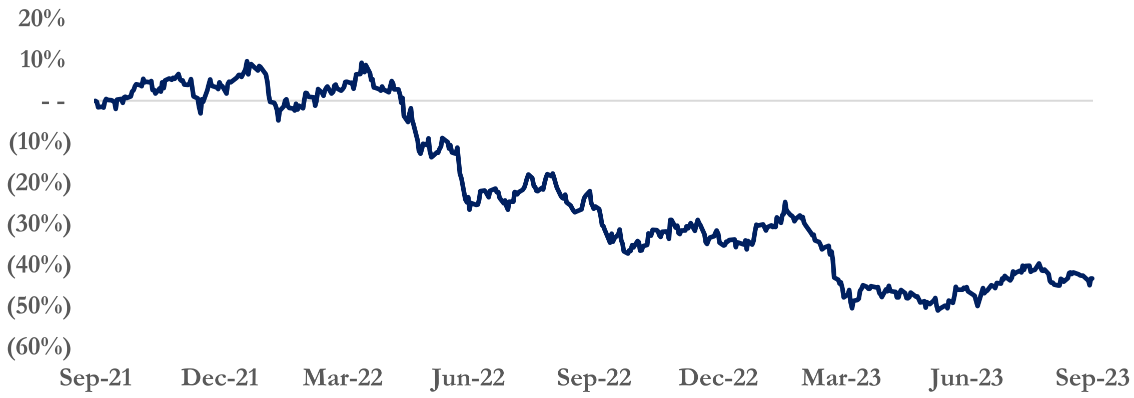
- With a surge in interest rates and the rise in hybrid work, what is the future for commercial real estate?
  - CRE loan charge-offs are at 0.2%, above COVID levels but still well below the GFC peak of 3.1%.
  - The Dow Jones Real Estate Office Index is down 43% over the last two years, indicative of investor pessimism towards the space.
  - Community/regional banks are estimated to have the greatest exposure to CRE

- **Who is buying? Who is financing? How do you value it?**

CRE Loan Charge-Off Rate, All Commercial Banks



DJ U.S. Real Estate Office Index: 2-Year Price Change



Source: Charge-Off Rate on Commercial Real Estate Loans (Excluding Farmland), Booked in Domestic Offices, All Commercial Banks, retrieved from FRED, Federal Reserve Bank of St. Louis and S&P Capital IQ.

Chapter 11 In Future

- **A World Of Newbies:** As with prior cycles, there are not as many portfolio managers with workout experience among new entrants in the private debt market – how will these funds act in a period of distress?
- **Unsecured Creditors' Committees – Friend or Foe:** In an upside-down secured debt structure with little to no value for unsecured claims, how do you get to a sale process or plan confirmation if the UCC is adverse?
- **Lender Protections Turned on Their Heads:** When so many senior secured lenders are under water, what does adequate protection mean, and what is the hurdle to be cleared for priming? How will feasibility be affected by the increase in cram-down interest rates?
- **Capital Stack Overlap:** Private equity funds with their own debt funds can invest debt capital to hedge positions and potentially enhance recoveries – how will other stakeholders protect their positions?
- **Over Before it Started**: Restructuring Support Agreements and Debtor-in-Possession Financing have more built-in plan control features. Do they distort priorities? Do practitioners care, and if so when?
- **Litigation:** Will recent leveraged dividend recaps lead to more avoidable transfer litigation? Will increased availability of litigation funding affect Chapter 11?