OF INTEREST

Changing the Cycle? 2008-2019: Key Differences

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Cycles of stress and distress triggered various defaults and restructurings for European private equity houses and their portfolio companies in the wake of Lehman Brothers and what is considered by some to be the greatest depression in economic history. Despite that context, overall default rates remained low through that period with restructurings taking place relatively quickly. Commentators today seem to be converging on the view that we are at the late part of the cycle but there is no single obvious trigger (macro, political or otherwise) that would bring about the eventualities of 2008, and the abundance of liquidity compared to 2008 means that even a large-scale event wouldn't necessarily lead to a liquidity crisis. We consider here some of the dynamics at play in the finance and restructuring landscapes during the period of 2008 through 2019.

1. 2008

- Many workouts were consensual and preferred to complex, expensive and relatively untested court processes alongside what were then yet-to-be developed intercreditor arrangements (e.g. Wind Hellas, IMO Car Wash).
- Clearing banks subject to their own bailouts were less likely to try to precipitate enforcement proceedings from a reputational risk perspective unless they had to do so.
- The relative absence of cov-lite between 2008 and 2011 made it easier to identify (and resolve) issues earlier in the cycle for covenanted deals.
- An absence of new money deals brought greater focus on maintaining relationships with PE sponsors for access to very limited deal flow.

- A relatively low volume of M&A break-up activity was caused by activist demands. Only 32% of leveraged loans in 2009 were acquisition-related compared with 62% YTD in 2019*.
- Illiquidity in the credit markets forced PE sponsors towards high yield bonds with super senior revolvers to support financing needs. In 2012, over 50% of leverage was effected by way of high yield bonds*.

2. 2019

- Significant macro and eco-political unpredictability aligned with a flattening yield curve and yields being suppressed from quantitative easing are all being touted as likely harbingers of any restructuring wave but no significant market turn has yet occurred.
- Average total leverage levels have been over 5x consecutively for 2017, 2018 and YTD 2019, a pattern last seen in 2005, 2006 and 2007. Leverage for 2018 and YTD 2019 is at its highest level since 2006 and 2007*.
- An increase in European cov-lite volume (c.€10bn in issuance in 2007 vs c.€70bn in 2017 and c.€65bn in 2018)* with an increasing share in institutional debt year-on-year since 2012 (96% in Q1 2019)* will make it difficult for creditors to meaningfully force responses from borrowers prior to maturity or liquidity events. In turn, this means that eventual restructurings will likely see increased value diminution and the associated increase in litigation and contentious restructurings, including formal insolvency. It also means that any restructuring 'wave' would likely be lengthy to resolve such issues across a divergent number of capital structures.
- Convergence of US-style terms and documentation have not been meaningfully tested in English courts. Litigation may be required in both the US and English courts to settle points of contention, particularly where documentation has 'split' governing law clauses where covenants are construed in accordance with laws which are different from those governing the underlying instrument, resulting in what could be lengthy and costly restructuring processes.
- In the UK, there is a well-developed understanding of intercreditors and security documents together with well-heeled use of pre-packs and schemes of arrangements and CVAs owing to retail woes as well as a move towards a US-style legislative framework, but note the changing legislative dynamics across the rest of Europe, e.g. the Benelux move to cram-in processes. There is a growing prevalence of cross-border restructurings involving predictable, if expensive, Chapter 11 proceedings.
- The UK Department for Business, Energy and Industrial Strategy seeks to make holding company directors liable in the event of near-term insolvency, drawing additional scrutiny in respect of directors' duties, particularly around asset sales and dividend recaps.

- Available liquidity – there is sophisticated capital able to provide stressed, distressed and rescue financing at attractive economic rates.
- Permissive incurrence-style documentation allows sponsors to utilise market liquidity and to deploy techniques to buy time or otherwise stifle creditor action during times of stress or distress (using e.g. asset sale provisions, unrestricted subsidiaries, etc.), which is likely to lead to increased litigation, including among hold-outs.
- Continued reluctance for creditors to pick fights with active PE sponsors is heightened by further increased M&A volumes owing to both activist-led break-up activity and attractive equity market pricing.

** Information obtained from S&P Global Market Intelligence.*

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