IF THIS IS A GREAT ECONOMY, WE'LL TAKE SOME MORE OF IT

Restructuring Activity Nears 2016 Highs While S&P 500 Surges to New Record

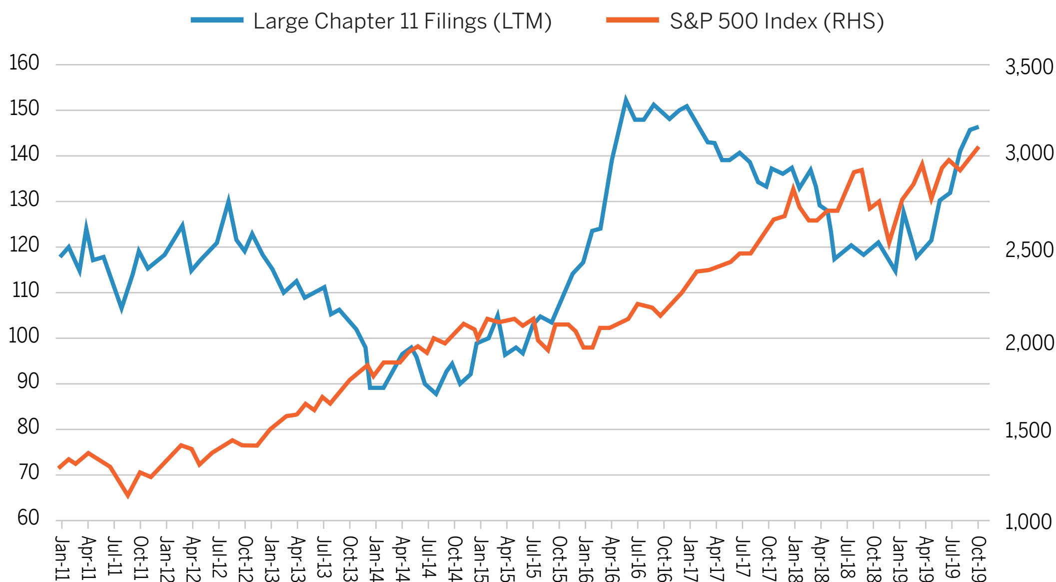
By Michael Eisenband

Once upon a time, restructuring professionals inhabited a feast-or-famine business environment that was highly dependent on the economic cycle, experiencing lean times in periods of robust economic expansion and boom times in and around recessions. Perhaps that is no longer the template. What should have been one of those lean years for our profession has turned out to be a fairly bountiful one for restructuring activity; meanwhile, equity markets continue their relentess march higher despite some lingering economic uncertainties (**Exhibit 1**).

Large Chapter 11 filings through October are tracking 28% higher than a year ago and have a reasonable chance to top the decade-high 150 filings of 2016. Already there have been 23 filings of more than $1 billion (liabilities at filing) through October compared to 19 in all of 2018. Moreover, the proportion of prepackaged filings is down notably this year, while the number of Chapter 22 filings has reached levels not seen since the recession. Similarly, the number of S&P rated debt defaults (which includes distressed debt exchanges) surpassed its 2018 total in early October. All of these totals are not recession-like numbers by any stretch but are solidly above typical levels of restructuring activity in a year of economic expansion. While energy filings dominated restructuring activity in 2016, accounting for one-third of all filings, they account for only 18% of filings in 2019 — meaning that the distribution of bankruptcy filings across industry sectors has begun to broaden.

EXHIBIT 1

Chapter 11 Filings vs. S&P 500 Index



Source: The Deal Pipeline and Standard & Poor's

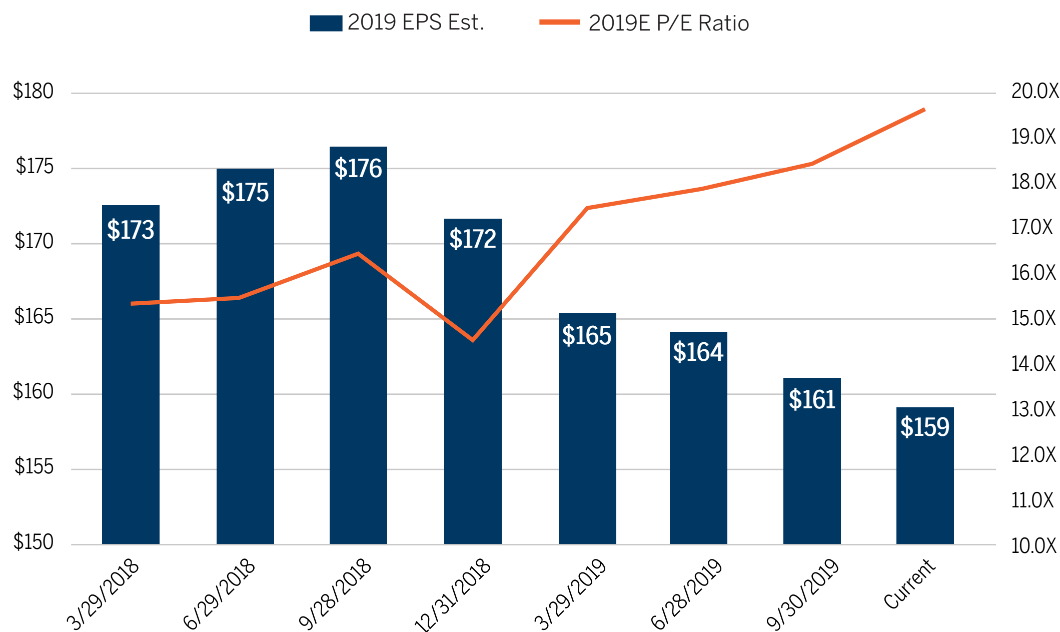
A contributing factor to elevated filings may be the growing number of filings by private equity-owned companies, which have accounted for one-third of Chapter 11 filings so far in 2019 and 30% of filings since 2016 compared to 18% from 2010 to 2015. This might be attributable to the swelling number of leveraged buyout transactions since the end of the recession coupled with aggressive dividend recaps, which could ensure that private equity-owned companies will continue their increased contribution to an elevated number of bankruptcy filings, especially if the economy weakens.

Given President Trump's many tweets extolling the record highs of the U.S. stock market — his shorthand reference for the economy — one might reasonably have assumed that 2019 has been a strong year for economic growth and corporate earnings. But that is not the case. In fact, most broad measures of economic growth have slowed slightly in 2019 while earnings estimates for the S&P 500 in 2019 have steadily declined, from $176 one year ago to $159 currently. Think about that for a moment: the S&P 500 Index has appreciated 24% this year while its 2019 EPS estimate has declined by nearly 10% since late 2018. If the S&P 500 hits its current 2019 EPS target, it would represent a modest 5% increase from 2018 EPS. Make no mistake about it, the market's torrid ascent this year is entirely a story of multiples expansion, that is, investors' willingness to pay more for less, with the S&P 500 now trading at 19.6X earnings compared to 14.6X a year ago (**Exhibit 2**). Whatever the underlying cause, be it FOMO (Fear of Missing Out) or TINA (There Is No Alternative), or monetary accommodation, the 2019 market rally is not earnings driven.

A recent CNBC article quoted one market analyst as saying that the stock market had gone up lately *because* earnings estimates for 2019 had come down; the rationale being that weaker earnings in 2019 were setting up the market for better earnings comparisons in 2020. This is the kind of convoluted logic that prevails when fundamentals cannot explain valuations — and conveniently overlooks the fact that 2020 EPS estimates for the S&P 500 have also started coming down.

EXHIBIT 2

S&P 500 Earnings (EPS) Estimates for 2019 vs. P/E Ratio



Source: Standard & Poor's

The hyped spectacle of earnings beats during earnings season has become something of a transparent charade. Analysts have taken down their 2019 earnings estimates for most large companies throughout the year, and when those companies manage to surpass reduced expectations or lowered guidance, it is interpreted by market pundits and investors as evidence of earnings strength. But when 2019 is in the books, earnings will have come in below expectations at the start of the year for most large companies. No matter — party on.

We emphasize all of this not to opine on the state of equity markets but to dispute the notion that corporate earnings performance — normally the bedrock of market valuations — remains exceptional. In fact, earnings growth since 2017 is largely attributable to reduced taxes resulting from the Tax Cuts and Jobs Act of 2017 and large stock buybacks by major corporations. And this is for the crème de la crème of large multinational corporations. In the lower echelons of Corporate America, where much of our work originates, operating performance appears more challenged.

Talk of recession in 2020 has moved to the backburner, and torrents of central bank-created capital sloshing through global financial markets continue to prop up valuations that have become harder to justify on the basis of traditional metrics. Swelling transaction valuations for leveraged buyout deals and mega IPO offerings are historically indicative of late-cycle market activity. The extraordinary measures taken by central banks to prod economic growth have nudged economic activity but are hardly impressive considering the enormity of the effort. So it has become a fool's errand to guess when the next recession will begin. What is more certain is that monetary policy efforts to forestall recession make it more likely that the next downturn, whenever it occurs, will be worse than a run-of-the-mill recession given the unprecedented amounts of corporate leverage it has unleashed. If restructuring activity remains as robust as it has been in 2019, then it doesn't really matter when the next business downturn begins. If this is a great economy, we'd like some more, please.

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