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Energy in distress: AlixPartners 2016 North American restructuring experts survey

The long-awaited rise in interest rates suggests that 2016 may see an uptick in restructuring activity. After seven years of near-zero rates, the US Federal Reserve raised rates in mid-December 2015. The action may force the hands of heavily indebted companies in the energy, retail, and healthcare industries, among others, to pursue restructurings or file for bankruptcy.

According to the 2016 AlixPartners North American Restructuring Experts Survey, the number of prenegotiated and prepackaged bankruptcies will continue to grow in 2016, thereby continuing an already pronounced trend, according to 68% of survey respondents.[1]

Respondents had few doubts about the Fed's action: 89% had expected a rate hike. Before the Fed governors announced the quarter-point increase on December 16, few respondents were expecting the hike would be dramatic: 61% of those who said they had expected rates to rise predicted it would be by 0.25 to 0.5%. The increase, effective December 2017, signals the beginning of slightly more expensive capital and could be enough to nudge some companies to a financial reckoning, because their ultra-low-cost financing options may finally have become exhausted. Fully 80% of respondents said low rates and easy

[1] In November 2015, AlixPartners surveyed 185 restructuring experts—such as attorneys, investment bankers, lenders, financial advisors, hedge fund managers, and private equity investors—about the state of the restructuring industry and what to watch for in 2016.

financing have played a "significant" role in forestalling Chapter 11 filings, a situation many observers say may begin to change in 2016.

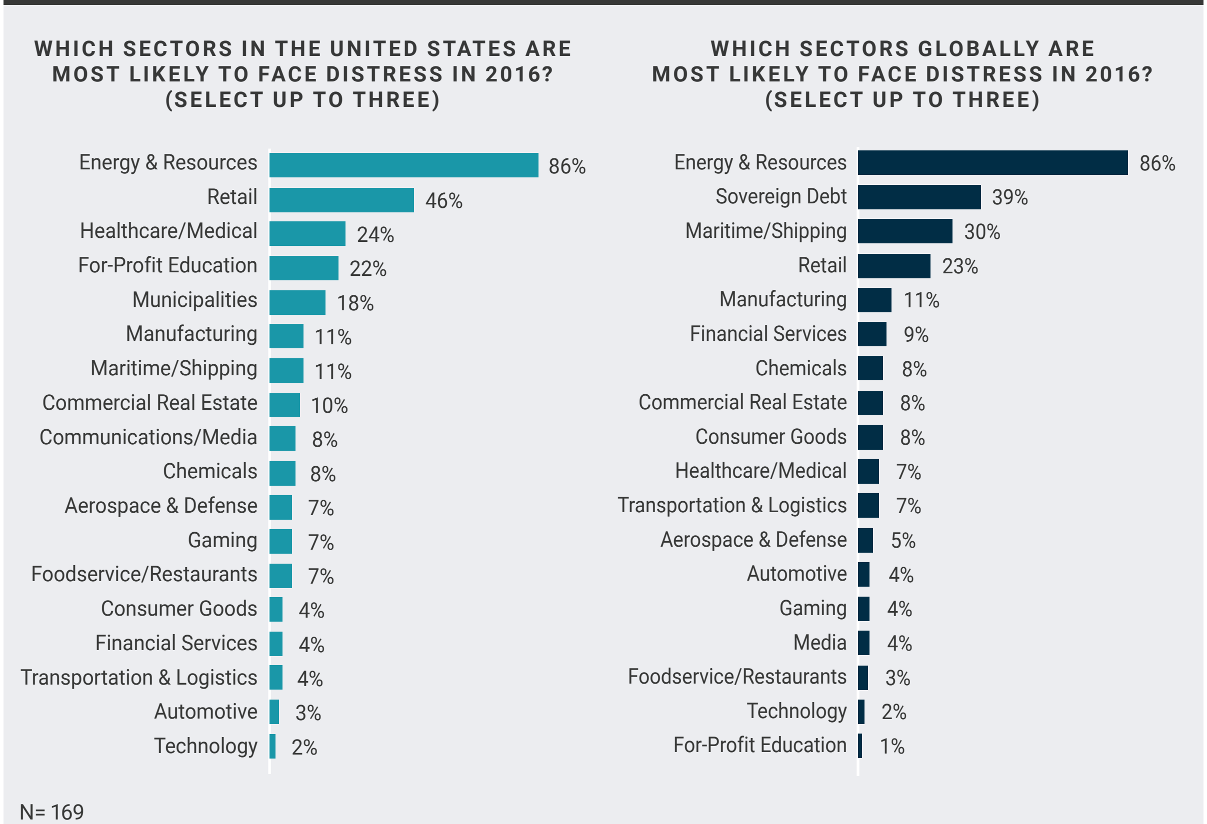
SECTORS IN DISTRESS

Which industries will feel the pinch in 2016? Globally, energy, sovereign debt, shipping, and retail lead the list, with sovereign debt moving up from fourth positon in 2015 to second in 2016 (figure 1). In the United States, energy and retail retain the top two positions. They're followed by healthcare, for-profit education, and municipalities, all of which were seen by respondents as facing greater vulnerability to restructuring and bankruptcy in 2016 versus a year ago.

Globally and in the United States, 86% of respondents said they expect more restructuring activity throughout the energy industry as oil and natural gas prices continue to decline. That expectation will continue to reverberate throughout the energy sector, from exploration and production and oil field service providers to the hard-hit offshore supply vessel sector (figure 2). That forecast is even more pessimistic than in 2015, when 78% of respondents saw energy as the industry most likely to face distress. As US oil prices continue to drop, the expiration of many financial hedge agreements coupled with high leverage may push some companies into restructuring. Just over half of the survey respondents—55%—said exploration and production companies would see the most distress from low oil prices in 2016, thereby increasing the probability of restructurings. The services sector is the next most likely to see severe distress, said 39% of respondents.

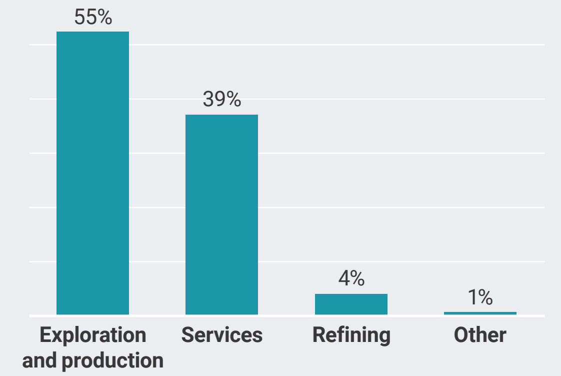
Natural resources are under pressure, because prices for most raw materials commodities are extremely low. The ongoing Chinese economic slowdown plays a major role in those declining global prices.

FIGURE 1: WHICH US AND GLOBAL SECTORS ARE MOST LIKELY TO FACE DISTRESS IN 2016?



Source: AlixPartners
Note: Respondents were asked to select up to three industries; total of responses will exceed 100%.

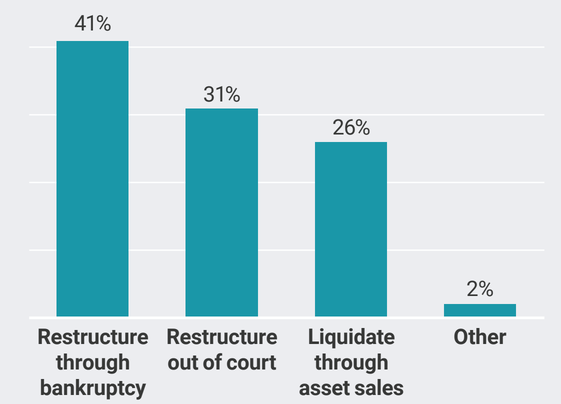
FIGURE 2: WHICH ENERGY SUB-SECTOR IS MOST LIKELY TO FACE DISTRESS IN 2016?



N= 145

Source: AlixPartners

FIGURE 3: WHAT IS THE MOST LIKELY OUTCOME FOR DISTRESSED ENERGY COMPANIES IN 2016?



N= 142

Source: AlixPartners

Many businesses built up capacity based on continued growth of the now contracting Chinese economy. The situation, among other supply-and-demand factors, affects consumers of natural resources, including producers of steel; metal and mining companies (ore, copper, coal, etc.); and companies in the oil and gas industry.

Low natural gas prices are also negatively affecting power and energy, solar, and renewables because the economic choice for clean energy is currently less compelling.

Global oversupply and diminished demand from many of the emerging markets continue to weigh on the US energy industry, making industry-wide restructurings more frequent. Bankruptcy is the most likely path, according to 41% of respondents, whereas 31% suggested out-of-court restructurings would be most common. Twenty-six percent said distressed energy companies would be more likely to liquidate through asset sales than to restructure (figure 3).

US INDUSTRIES IN DISTRESS IN 2016

Restructuring experts predict that after energy, retail is the next-most-likely US industry to face distress, though only 46% of respondents named retail among the three industries most likely to see distress—down from 52% a year ago. Prepackaged and prenegotiated bankruptcies continue to play very significant roles in retail restructurings, driven by the 2005 changes to the federal bankruptcy code that effectively give most retailers only 210 days to file a bankruptcy plan of reorganization (see AlixPartners Retail Bankruptcy Insight).

Restructuring professionals also expect healthcare, for-profit education, and municipalities in the United States to face distress in 2016.

Healthcare: A blend of regulatory considerations, many of them stemming from the effects of the Affordable Care Act, combined with ongoing operational pressures at underperforming hospital chains, may drive a greater number of healthcare restructurings in 2016.

For-profit education: Sharp drops in student enrollment at leading for-profit colleges, which represent 13% of the total US higher education market,[2] may compound the effects of a recent regulatory crackdown. The higher education industry saw a 13.7% drop in enrollment from the fall term of 2014 to the fall term of 2015,[3] and federal rules concerning the availability of loans and the requirement that for-profit schools demonstrate that their graduates have gainful employment are increasing the pressure on this sector. Those facts prompted 68% of respondents to say they predict a moderate-to-significant jump in restructuring activity in the for-profit education sector in 2016.

[2] "Reshaping the For-Profit", Inside Higher Ed, July 15, 2015, accessed Dec. 23, 2015. https://www.insidehighered.com news/2015/07/15/profit-industry-struggling-has-not-reached-end-road.

[3] "REPORT: Current Term Enrollment Estimates – Fall 2015," last modified December 15, https://nscresearchcenter.org/tag/enrollment-trends/.

Municipalities: A number of US municipalities remain distressed, burdened by legacy pension and healthcare obligations and costly infrastructure needs. As a result, 18% of survey respondents said municipalities are among the top sectors in the United States likely to face distress in 2016. Among troubled states, 64% of respondents singled out Illinois as the one most likely to face financial distress, reflecting well-documented struggles to meet pension obligations and to solve other problems related to existing debt payments.

GLOBAL DISTRESS CENTERS ON BRAZIL

Financial woes worldwide—including a European recession, the mounting effect of China's economic slowdown, and a regional lag in the Middle East due to lower oil prices—prompted respondents to express concern about sovereign debt generally and the Brazilian economy's prospects specifically. Sovereign debt will be among the sectors most likely to face distress in 2016, according to 39% of respondents. The emergence of the sovereign debt sector came about after Greece spent much of the past year struggling to address its debt crisis.

Brazil was named by 37% of survey respondents as the country outside the United States that is most likely to have restructuring opportunities in 2016. It was followed by the United Kingdom and Europe, named by 22% of restructuring professionals. Latin America, excluding Brazil, and China were virtually tied for third, at 14% and 13% of respondents, respectively.

Brazil's postelection economy will offer many restructuring opportunities as the effects of its dramatic 2015 decline get sorted out. The decline was marked by plunging prices for Brazil's principal commodity exports, including oil, metals, and sugar. Coupled with a sharp drop in the value of the real against the US dollar, which effectively doubled the cost of servicing any US-dollar-denominated debt, bright spots are scarce; and restructurings will likely increase in every sector of the economy.

Restructuring professionals also considered the effect of China's economic slowdown on the US market. Three out of four survey respondents said China's slowdown will have a "significant" or "moderate" effect on the number of US restructurings this year, pointing to the potential ripple effect the Chinese economy has on other economies around the globe.

RESTRUCTURING'S RETURN?

After seven years, during which bankruptcy filings were scarce, 2016 seems to offer better prospects for the restructuring industry. The postrecession economy is not as robust as it was before 2008, yet when asked whether a strong economy has helped sustain companies, 62% of experts said the economy had a "moderate" or "strong" influence on keeping companies out of Chapter 11. About one-third of respondents (36%) said it had "little" influence on keeping the number of bankruptcy filings low. Cost may be a factor in the declining number of bankruptcy filings, as many respondents said companies' managements and boards of directors feel that bankruptcies have become too expensive and litigious, prompting a turn to out-of-court restructurings. Among the respondents, 68% said cost had either a "moderate" or "strong" influence on the drop in Chapter 11 filings. As economic conditions shift—within particular industries and on both global and domestic scales—2016 seems poised to be the year restructuring reasserts its role. A

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