

The Rising COVID-19 Bankruptcy Risks

By Julia Zhu (March 19, 2020)

On March 11, the World Health Organization declared COVID-19 a pandemic, as its spread and severity escalated around the globe.[1] The COVID-19 pandemic is first and foremost a human tragedy.[2] At the same time, with increasing travel bans, business closures, cancellations of major events, restrictions on a wide range of activities, and turmoil across global stock markets, the business world is bracing for the economic impact of the outbreak. For the restructuring and bankruptcy industry, the pandemic is likely to bring heightened distress and bankruptcy risks.



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Certain industries are already taking a hit due to decreases in economic activity and supply chain disruptions. There is likely more to come from less expected industries.

The travel and hospitality industry has been the first to face drastic declines in demand and revenue. International travel has fallen sharply, as countries and carriers institute restrictions on flights to countries and regions affected by COVID-19. The International Air Transport Association estimates that airlines could lose \$63 to \$113 billion in global revenues in 2020.[3] Hotels, cruise operators, car rental agencies and restaurants are also feeling the pressure.

As its impact continues to expand, the COVID-19 outbreak is likely to threaten a wide range of industries, some of which may be less expected, given the complexity and intricacy of the economy. For U.S. businesses, risks are shifting from exposure in China to a potential domestic and global slowdown. The shock to the ecosystem is likely to come from at least four areas:

- **Supply chain disruptions:** Over 50,000 companies around the world have one or more of their Tier-1 suppliers located in the impacted regions of China.[4] A survey conducted by the Institute for Supply Management between Feb. 22 and March 5 revealed that 75% of U.S. manufacturing and non-manufacturing companies experienced COVID-19-related supply chain disruptions, largely from China.[5] It is also worth noting that, for companies with longer inventory cycles, the peak disruptions resulted from their China exposure can be lagging and still yet to come.
- **Dropping demand:** Adding to the declines in international travel and exports to China, as COVID-19 spreads in the U.S., domestic demand also begins to decline. Entertainment (movie theaters, theme parks, casinos), retail (malls, restaurants), services (ride hailing, fitness, beauty), and other businesses that rely on foot traffic are already experiencing material revenue decreases.
- **Operational challenges:** While certain industries, such as segments of professional services, have the ability to conduct business via telecommuting, the vast majority of industries do not. If the situation escalates, many more industries will face logistical

and labor challenges as goods cannot be transported efficiently, business activity becomes suspended, and employees are unable or unwilling to go to work. This could affect the construction, manufacturing, energy, and biotech industries, among others.

- Financial markets turmoil: In addition to disruptions in the real economy, COVID-19 has sent financial markets into sharp declines, spiked volatility and panic selling. Balance sheet exposure could become a concern for financial institutions. Insurance companies may get double dinged because of rising claims and negative returns on assets for years to come. Liquidity is likely to decline as investors withdraw from risky asset classes to treasuries and gold in an attempt to protect against downside risk. New debt issuances, initial public offerings and M&A transactions will be challenging due to heightened uncertainty.

The magnitude of the potential impact depends on the duration and severity of the pandemic, and the timing and magnitude of the economic activity rebound.

Some market disruptions last longer than others. While it is clear that COVID-19 will cause a global economic slowdown in 2020, its longer term impact remains highly uncertain. Potential outcomes range from a relatively quick recovery to a global recession, with market participants increasingly concerned about the latter.[6] Government interventions to control the disease and inject liquidity into the market will play a significant role.

The Federal Reserve has cut its benchmark interest rate to 0-0.25% and launched a \$700 billion quantitative easing program of U.S. Department of the Treasury securities and mortgage-backed securities purchases.[7] A legislative response to COVID-19, a relief package including free testing and paid sick leave, was signed into law on March 18.[8] Another emergency stimulus package is also being contemplated and negotiated.[9] Meanwhile, existing geopolitical tensions among the world's major economies may be further fueled by COVID-19 and take a toll on already disrupted international trade. The situation is evolving every day.

Lower revenue and earnings in one or two quarters do not necessarily push companies into distress or bankruptcy. However, persistent cash flow problems can result in payment default and/or covenant default on debt securities, either because the company is unable to make timely payments towards its debt obligations, or because coverage ratios, such as the debt/EBITDA ratio, fall below required levels.

In addition, living through the outbreak may result in shifting consumer behavior, such as increased penetration of e-commerce, lower consumer confidence, and reallocation between saving and spending. Businesses, especially brick-and-mortar businesses, may continue to face pressure in the aftermath.

Companies with existing operational and financial challenges are likely the first ones to fail.

The market has started to see signs of heightened distress and bankruptcy risks. Market participants are increasingly concerned about the turn of the tide in the credit and economic cycle.

In January and February, corporate bankruptcy continued at a slow pace, with 16 new cases each month.[10] In March, the number of companies on Debtwire's Distressed Watchlist, which tracks borrowers engaged in financial restructuring and/or face imminent pressure of restructuring, rose to 316 borrowers, a 12% increase from February.[11] Option-adjusted high yield spread over Treasury more than doubled year-to-date, up from 3.56% (Jan. 2) and 5.06% (Feb. 29) to 8.38% (March 16).[12] The yield curve has flattened and, on certain days, inverted.[13]

There have already been several COVID-19-related bankruptcies. As early as Feb. 9, medical device maker Valeritas Holdings Inc. filed for Chapter 11, citing supply chain disruptions due to the then "coronavirus epidemic in China," which exacerbated existing operational issues.[14] On March 2, Japanese cruise operator, Luminous Cruise Co. Ltd., went bankrupt, citing cancellations due to COVID-19 and struggles with rising fuel costs and typhoons impact before the outbreak.[15] Coal mining company Foresight Energy LP also filed for bankruptcy on March 10, stating that the economic slowdown caused by COVID-19 had pushed it over the edge, after having defaulted on its debt last year.[16] Laura Ashley, a U.K. fashion and homeware retailer, has collapsed into insolvency administration as of March 17, as it was unable to secure financing amid the bleak outlook under the impact of COVID-19, after having struggled with declining sales and working capital issues for some time.[17]

One common observation from these filings is that the companies all had preexisting operational or financial problems that were exacerbated by the impact of COVID-19, ranging from supply chain issues to overall economic slowdown. Some of the underlying conditions are company-specific; others reflect the challenging business environment for certain industries. It is more difficult for companies with higher fixed costs and/or higher leverage to flatten the curve of depressed earnings caused by COVID-19. These companies are more likely to become distressed with COVID-19 being the last straw.

Over the past decade, businesses have enjoyed abundant credit with low interest rates. The extended credit cycle and benign credit environment can change quickly in the face of the pandemic. U.S. corporate bonds surged to almost \$10 trillion by late 2019, \$7.8 trillion of which were investment grade.[18] Investment grade quality has deteriorated post financial crisis. As of December 2019, 50% of investment grade corporate bonds were rated BBB, compared to 35% in 2007.[19] Based solely on leverage, 50% of BBB companies have implied ratings below investment grade.[20] In a time of volatility and recession concerns, liquidity in the credit market may dry up quickly, leaving companies with high leverage unable to refinance at low costs, thus heightening bankruptcy risks.

Increased distress and bankruptcy risks in connection with COVID-19 may bring a rise of bankruptcy-related litigation.

As COVID-19-related bankruptcies increase, a wide range of litigation is likely to ensue. Stakeholders will litigate over the valuation of the debtor's business and the allocation of value among parties with claims on the company's assets. One area of contention may be the premise and standard of value appropriate for valuation, based on different interpretations of a company's distress caused in part by COVID-19 and its ability to continue as a going concern, which can yield vastly different valuations.

There may be causes of actions against a company's officers and directors for inadequate disclosure of risks relating to material contracts or events, and/or failure to fulfill their duties in addressing business issues during a pandemic. Creditors may attempt to seek recovery from directors and officers insurance claims. Auditors may also be exposed for

having failed to identify material risks that are later exacerbated by the impact of COVID-19.

Certain types of insurance policies may be responsive to COVID-19, such as business interruption coverage, trade disruption insurance, and civil authority coverage. Litigation over the interpretation of specific insurance policies may arise as stakeholders seek recovery from insurance companies.

The world has a lot to learn about the disease and its potential impact, and uncertainties will likely remain for months or even years to come. This article does not attempt to list all possible repercussions, but rather is intended to provide an analytical framework and facilitate a conversation in the restructuring and bankruptcy industry about what practitioners should expect as the impact of COVID-19 unfolds.

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