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Trade War, Interest Rates Loom Large for Restructuring Pros in 2019

The restructuring industry is keeping tabs on the domestic and global political climate as it looks ahead to 2019—specifically, the trade war and expected increases in interest rates.

Since 2016, when Donald Trump won the presidential election, uncertainty stemming from politics has remained the dominant theme when looking ahead in the restructuring industry. While that's the constant, the reasons for uncertainty have changed over the past few years.

The effect of tariffs on certain industries should cause a spike in restructuring activity, especially if interest rates continue to creep up, industry experts told WSJ Pro Bankruptcy.

Marc Hamroff, partner at Moritt Hock & Hamroff LLP

Comparing the present climate to the last three significant restructuring spikes, there's been one undeniable factor in play and that is the current abundant access to capital whether debt or equity. Stress in the marketplace often results from lenders seeking to exit credits and a lack of suitable candidates available to refinance or provide equity infusions. The growth of family offices and PE funds in traditional lending has provided companies with the risk capital to grow, acquire and refinance. If the credit markets tighten in 2019, companies may find credit tougher to obtain and the cost of the financing more expensive.

"The president is beating up on the Fed, suggesting higher rates are bad for the economy. As we deal with the consequences of the trade war and its impact on the economy, rising rates obviously won't be a positive there, either," said Tuck Hardie, managing director in the financial restructuring group at Houlihan Lokey Inc.

Christopher Linscott, a financial consultant at Arizona-based accounting firm Keegan Linscott & Kenon PC, thinks these factors will cause his bankruptcy practice to pick up in 2019.

"Tariffs will hit some industries harder than others, but the constant of political uncertainty will also hurt economic stability," Mr. Linscott said. In particular, tariffs have been a major focus for the long-troubled retail industry, according to a recent report from Wells Fargo Securities LLC.

While there's been a reprieve on the imposition of a final round of tariffs on Chinese exports to the U.S.—President Trump and Chinese counterpart President Xi Jinping agreed in December to a 90-day tariff truce—the continued uncertainty looms over U.S. companies.

To be sure, while these issues look to be "creating a perfect storm" for a wave of restructurings, many issues "could also dissipate if there's a deal with China," said Jeffrey Pomerantz, partner at Pachulski Stang Ziehl & Jones.

Continued volatility in the stock market could further pressure companies in 2019.

Between the general economic uncertainty and the sharp gyrations in the stock market, sentiment is fraying in the debt markets, said Bill Derrough, global co-head of restructuring and recapitalization at Moelis & Co., as well as Douglas Foley, a restructuring partner at McGuireWoods LLP.

If these conditions persist, things could get worse. There could be a repeat of conditions seen in 2007, with highly leveraged companies shut out of the debt markets. That might put companies that need to refinance debt in 2019 in a bind and could push some that face maturities in the next couple of years into bankruptcy. "Once sentiment shifts, banks might say eight-times to nine-times leverage is too much," said Mr. Derrough.

Mr. Foley went further, saying that these factors, which will likely lead to the tightening of credit markets, could head to a recession in 2019, which is "way overdue by historical standards."

S&P Global Ratings recently warned of the effect of the imposition of tariffs and other trade policies, ongoing geopolitical concerns and increased risk aversion among investors.

"If history is a guide, the end to this cycle will likely result from some combination of the bursting of an asset-price bubble, an oil-price spike, or a misstep by the Fed," S&P Global wrote in a December report.

David Meyer, a partner in the restructuring and reorganization practice group of Vinson & Elkins LLP, said there is a general expectation that there will be an uptick in restructuring activity in 2019. Nonbank lenders could also see more opportunity in the coming year in out-of-court restructurings if the credit markets tighten, he added.

However, the large amounts of capital sitting on the sidelines at investment firms, mainly private equity, could affect the wave of restructuring activity, Mr. Meyer said.

"There's a ton of capital sitting on the sidelines waiting for that to happen. Just look at the amount of capital raised by firms like Oaktree, Bain and Centerbridge—the big funds as opposed to the smaller ones," Mr. Hardie of Houlihan Lokey said.

analysis

Mr. Hardie thinks that if there is a bubble that were to burst and lead to an uptick in restructurings, the period would be short-lived.

While uncertainty hangs over the U.S. economy as a whole, industries that have struggled in recent years such as retail, health care and oil and gas will continue to see pockets of distress in 2019, experts agree.

Robbin Itkin, bankruptcy lawyer at DLA Piper LLP

Banks and other financial companies appear to be beefing up their restructuring teams in anticipation of a busy 2019, as loans begin coming due and as a turbulent economy will make repaying or refinancing the debts more difficult. Chapter 11 liquidations, as opposed to traditional reorganizations, are likely to continue in light of more expensive borrowing and harsh terms imposed on borrowers.

Another unfortunate trend seems to be increasing restructuring professionals' work flow: the rise of sexual harassment and assault allegations.

Businesses will continue to crumble under the weight of accusations of sexual abuse and harassment on the job in 2019, observers believe, as women and other victims continue to speak out, and increasingly are heard and believed.

"I believe it's a really pervasive problem," said James Stang, a lawyer who estimates he has advocated for some 2,500 sexual abuse victims in bankruptcy cases over the years, including disgraced producer Harvey Weinstein's Weinstein Co., USA Gymnastics and entities affiliated with the Catholic Church.

Bikram Choudhury's yoga business, Weinstein Co. and USA Gymnastics are the big names brought to bankruptcy in 2018 by accusations that those in charge perpetrated or turned a blind eye to sexual abuse.

Then there are the businesses like broadcaster LBI Media Inc. and Mike Isabella's collection of restaurants in the Washington, D.C., area. Both filed for protection in 2018 with reports of sexual harassment clouding their efforts to grapple with financial problems.

Boy Scouts of America has hired bankruptcy experts to advise it on a possible way out from under a deluge of litigation rooted in allegations it was negligent in preventing molestation.

The Rockefeller University Hospital, where Dr. Reginald Archibald allegedly molested children for decades, has summoned law firm Debevoise & Plimpton LLP to conduct a probe. That's the law firm Weinstein Co. hired to investigate Mr. Weinstein. Dr. Archibald died in 2007 but did research involving children at the hospital for more than three decades, ending in 1982. In a statement, Rockefeller University said patient protections had been improved in the years since Dr. Archibald's alleged wrongdoing.

The law of sexual harassment—who is liable and who is not—has not changed much in recent years. However, the climate has changed as the "Me Too" movement Tarana Burke launched in 2006 ripened into headline-grabbing accusations against top executives, lawyers said. Harassment complaints that used to be handled in human relations now warrant serious attention in the C-suite and even the boardroom.

Litigation or prelitigation settlements are growing in size, and the cost to business is rising as well, said Marie-France Gelot, insurance and claims counsel at brokerage Lockton Cos.

Insurance can go a long way toward saving a business afflicted with a sexual harassment problem, she said. However, employment practices policies cover legal damages; they don't cover the damage to a business from the repercussions of sexual harassment accusations, such as tarnished brands, customer backlash and inability to recruit employees.

"The whole reputational aspect—that's the No. 1 factor that is scaring corporate America," Ms. Gelot said. "It's the reputational damage that these claims can do to a business."

—Compiled by the WSJ Pro Bankruptcy team