# Sectors showing structural weakness in 2015

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Against a backdrop of historically low interest rates, 2014 was generally a slow year for bankruptcies and restructurings in the United States.

There were a few large cases, such as the Chapter 11 filing of Energy Future Holdings (EFH), the Texas merchant power producer and utility that had been labouring for several years under a $40bn debt load. EFH filed for bankruptcy in Delaware with a restructuring support agreement (RSA) amongst its equity owners and major creditors. Although EFH terminated the RSA after the bankruptcy filing, the bankruptcy court recently approved a process pursuant to which EFH hopes to sell the utility and effect a tax free spin-off of its merchant power and retail businesses. The EFH case could be one of the largest and most expensive in US bankruptcy history.

But apart from EFH and a handful of other large cases, the restructuring environment was quiet in 2014. Distressed companies were able to take advantage of the favourable rate environment to refinance, or ‘amend and extend’, their capital structures. Even troubled borrowers, who were unable to access the capital markets, did not necessarily need to restructure. Their business conditions and operations might have been quite challenged, but many of them had ample near-term liquidity and few restrictive covenants in their loan or bond documents. They were able to put off for another day, and perhaps forever, the need to deal with their creditors.

Most restructuring professionals and distressed investors expect this scenario to continue in 2015, but with potentially important changes.

**Interest rates**

First, the credit markets seem to expect the Federal Reserve to begin to raise interest rates in 2015. Whether this is a rational expectation, or one that is likely to be realised, is beyond the expertise of the community of restructuring professionals. But if rates do begin to rise, then the effect on restructurings could be profound, particularly if they rise quickly.

In a higher-rate environment, the ability of troubled companies to refinance their debts with cheap new money will obviously be constrained. Additionally, those companies that rely heavily on revolving credit loans or other working capital financing, where interest rates usually float with LIBOR or the US prime rate, will see the cost of their existing financings rise. This could put additional stress on certain areas of the economy, including the retail sector, as discussed below.

**Oil prices**

Second, while the recent steep drop in crude oil prices has been a boon to US consumers, it has begun to cause turmoil in the oil and gas sector of the US economy. From a high of over $100 per barrel, oil prices in the US have sunk to less than $50 per barrel. This unprecedented decline has put literally hundreds of companies on restructuring ‘watch lists’. The first set of firms to be affected in the sector will likely be the oilfield services companies, which supply drilling rigs and other goods and services to onshore and offshore oil producers.

Next will likely be the smaller or mid-size producers, particularly those operating in areas with higher costs, such as the Bakken field in North Dakota. The last set of companies to be affected will be the large producers that have spent hundreds of millions, or even billions, of dollars to develop their fields. These companies typically take a long term view of oil prices and have the capital to withstand dramatic price swings.

At the top of their capital structures, the levered companies in this space typically have bank debt that is covered by a borrowing base. With the oil price decline, however, these borrowing bases will soon show less available liquidity than the companies recently enjoyed. To address a potential liquidity squeeze, these firms might resort to second lien financing, which will likely be available in the marketplace from hedge funds but will be very expensive, or they will need to sell assets. A last resort will be to restructure their debts in or outside of bankruptcy.

All of this would of course happen at an inopportune time for owners of oil-related companies. Indeed, several prominent hedge funds and private equity firms are publicly in the market to raise distressed funds in order to invest in oil sector debt, as a way of earning substantial credit returns or as part of a ‘loan to own’ strategy. Many portfolio managers view the potential shake-out to be of a magnitude similar to that of the US telecom industry in the late 1990s and early 2000s, when dozens of CLECs and other telecom providers restructured in Chapter 11.

## Municipalities

In 2014, Detroit emerged from a contentious Chapter 9 bankruptcy, following court approval of a plan to restructure its financial debts and labour obligations. Several other troubled government entities are assessing whether to follow a similar path.

In January, the Governor of New Jersey appointed an emergency manager for Atlantic City, the seaside resort that has seen many of its casinos shut down as a result of strong regional competition. The governor's executive order gives the emergency manager the power to negotiate with the city's bondholders on a debt adjustment plan. However, it does not give the manager the right to put Atlantic City into a Chapter 9 proceeding. If the governor gives the manager that right in the future through another executive order, such a grant could be challenged as bypassing other appointed and elected officials under New Jersey law.

Similarly, several public corporations in the Commonwealth of Puerto Rico, such as the local power utility, are heavily indebted. These entities are not eligible for Chapter 9 protection. To give them a legal mechanism to restructure, the Puerto Rican government enacted the Puerto Rico Debt Enforcement and Recovery Act, which created a special Commonwealth restructuring court. However, several bondholders have challenged this statute in US Federal court. Very recently, the court agreed with the bondholders and ruled the statute unconstitutional. If this decision is not disturbed on appeal, then the Puerto Rican public corporations would be able to restructure only if they can do so consensually, or if Congress amended Chapter 9 to include them as eligible debtors. Of course, they could simply default, but this would likely lead to litigation with their creditors, during which time they and the rest of the Commonwealth might find it difficult, or perhaps impossible, to access the financing markets.

## Retail

Although the drop in oil prices has benefitted US consumers, who are now paying less for gasoline at the pump than they have in a decade or more, the retail industry is still likely to see more challenges this year. Several retailers reported disappointing 2014 holiday sales, as internet sales are taking an ever larger share of consumer spending. In addition, the retailers that rely heavily on variable-rate, working capital financing, might well see their interest costs rise in 2015 if the Federal Reserve raises rates. Most of the retailers that have filed for bankruptcy in recent years have liquidated rather than restructured. 2015 could see a continuation of that trend.

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