Berenson Advisory

Berenson's **Restructuring & Recapitalization Practice** advises companies, sponsors and creditors in leveraged and financially distressed situations, with a focus on minimizing and managing financial crises, preserving stakeholder interests and reviving businesses; the practice provides high level, bespoke advice with the firm's senior partners leading the advisory teams.

COVID-19 UPDATE

In recent weeks, we have seen many predictions from prominent Wall Street institutions, Washington policymakers and economists alike as to how the economy will awake from its COVID-19-induced hibernation. These predictions range from a rapid V-shaped recovery to a despondent L-shaped recovery. Before we discuss shapes, it is useful to dimension the scope of the trauma inflicted on the economy by the COVID-19 crisis.

There are several unknown variables that will determine the scope of the ultimate economic recovery, but there is increasing clarity on key metrics such as corporate earnings, unemployment, GDP contraction, fiscal and monetary stabilization/stimulus outlays. The incoming data has been breathtaking and unprecedented in scope:

- *Q1 2020 US GDP shrank at a 4.8% annual pace, driven by a steep decline in consumer spending.*
- *The Congressional Budget Office (CBO) projects the unemployment rate to average close to 14% in Q2 2020 and 16% in Q3 2020 as a record 26 million Americans sought unemployment benefits over the last five weeks, effectively wiping out all of the jobs creation that took place during the past 10 years.*
- *First quarter earnings are down 14.5% thus far with the second quarter expected to be much worse.*
- *Although predictions are all over the map, consensus estimates forecast a GDP Q2 2020 contraction of 25%.*
- *The government's "throw the kitchen sink" response will result in the federal budget deficit growing to $3.7 trillion and the federal debt held by the public is projected to be 101% of GDP by the end of the fiscal year.*

ALL SHAPES AND SIZES: V's, U's, W's and L's

We have seen dozens of outlooks predicting the shape of the recovery using recent economic indicators, impact of existing and future government stabilization/stimulus and historical recession/recovery cycles. While a point of view on the recovery must be taken by the business community and policymakers for planning purposes, we question how useful or constructive the prediction game is given that several critical variables remain unknown, including:

- *Timing of vaccine or treatment; availability and reliability of testing in the meantime*
- *Potential reemergence of the virus in the near-term as shelter-in-place orders are scaled back or later in 2020 due to seasonality; virulence of the virus in the event of a reemergence*
- *Duration of shelter-in place orders and ongoing social distancing guidelines including limitations on non-essential gatherings*
- *Future government stimulus packages*
- *Behavioral response of producers and consumers to a post-COVID world*

Given these unknowns and the variability of each, let us look at a range of potential outcomes and the case for each:

V-SHAPED

In a V-shaped recovery, we would immediately snap back to pre COVID-19 levels and recover all economic output lost as a result of the virus by year-end. Implied in this case is delivery of, or at least visibility into, a vaccine or effective treatment that will allow for the confidence required to drive bull-market corporate and consumer behavior. Influential voices such as Goldman Sachs and Apple's Tim Cook are predicting this recovery as they view a general overreaction to the virus and pent up demand combined with massive government stimulus rocketing us off the bottom.

U-SHAPED

In a U-shaped recovery, the economy will stabilize in the short- to intermediate-term as shelter-in-place orders are lifted and begin to gradually recover in late 2021. Although this spells good news for a return to normalcy, there will be plenty of pain along the way. The CBO is predicting a U-shaped recovery, but it comes with protracted unemployment rates in the double digits and anemic real GDP growth rates. The U-shape predictions have the most variability as the depth and length of the bottom of the "U" have a wide range depending on how one toggles the inputs used in the model.

CBO'S ECONOMIC PROJECTIONS FOR 2020 AND 2021

	2020				Annual	
	Q1	Q2	Q3	Q4	2020	2021
Real GDP (Percentage change from preceding quarter)[a]	-0.9	-11.8	5.4	2.5	n.a.	n.a.
Real GDP (Percentage change, annual rate)[a]	-3.5	-39.6	23.5	10.5	-5.6[b]	2.8[b]
GDP (Trillions of dollars)	21.6	19.1	20.1	20.7	20.4	21.3
Unemployment Rate (Percent)	3.8	14.0	16.0	11.7	11.4	10.1
Interest Rate on Three-Month Treasury Bills (Percent)	1.1	0.1	0.1	0.1	0.4	0.1
Interest Rate on Ten-Year Treasury Notes (Percent)	1.4	0.6	0.7	0.7	0.8	0.7

W-SHAPED

In a W-shaped recovery, the economy will re-open and recover quickly only to crash again if the virus reemerges. This will be a clear sign of policy failure and phasing out of shelter-in-place and social distancing guidelines too soon; the most recent example being Japan's northern island of Hokkaido, where social distancing guidelines were lifted only to see COVID-19 case return with a vengeance.

Another feature of past W-shaped recoveries has been an economy receiving a significant bounce but unable to sustain this momentum due to structural damage caused to the supply chain, labor force or other economic inputs impacted by the shock. Once the momentum is lost, the economy may start to decelerate while it acclimates to the new normal.

L-SHAPED

An L-shaped recovery portends a difficult few years and could be the product of several factors including prolonged shelter-in-place and social distancing guidelines, inadequate stabilization/stimulus funds, no clear visibility into vaccine or treatment and fundamental changes in producer/consumer economic behavior. In this scenario, consumption will grind to a halt and economic activity will remain stagnant (i.e. a prolonged recession), possibly reducing US GDP by up to 6% for 2020 with growth stabilizing in early 2021 at a lower level. A prolonged recession scenario will likely trigger a wave of defaults continuing well into 2021 and, consequently, the economy would not be able to reach an escape velocity to pull out of this stagnation.

DEBT AND DEFAULTS

Irrespective of the shape of the recovery, a collapse in corporate earnings will place considerable strain on capacity to service debt. We have begun to see an unprecedented surge in corporate rating downgrades and expect them to continue well into Q3. Private Equity-owned businesses are particularly vulnerable given average leverage for buyouts in 2019 approached 6 times EBITDA. A whopping 56% of defaulted debt issuers in Q1 2020 were PE-owned companies, with most of them suspending debt service. The vast majority of leveraged loans consumed by the PE space in the past few years were "covenant-lite" and "contract-lite". This has tempered the waive of defaults in Q1 and the first half of Q2 but we expect a flood of defaults over the remainder of the year as issuers encounter covenant challenges and/or simply stop servicing their debt. A V-shaped recovery predicts that a resurgent economy will enable many of these defaulted leveraged loans to get "worked-out" through an amendment process (with new capital from the sponsor if required). On the other end of the spectrum, an L-shaped recovery will lead to a wave of debt equitizations and bankruptcies as lenders enforce their rights and reorganize or liquidate defaulted businesses.

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OUTLOOK

Proceed with caution when planning for a post-COVID world. We have seen predictions of V, U, W and L-shaped recoveries from credible institutions and economists. In reality, it is impossible to predict with any precision how the economy emerges from this unprecedented shock. Trillions of dollars of fiscal relief have been pumped into the economy, likely softening the blow, but far too many variables remain unknown to have confidence in any underlying predictive model. While we hope Tim Cook is right and the big downturn will be followed by an equally big upswing, we are more sober-minded about the challenges that face the economy for the remainder of the year and 2021. Unlike Apple, most companies (particularly SBE's) do not sit on a mountain of cash and have debt and other fixed obligations that must be managed in this time of uncertainty. The data thus far points to a labor market in chaos, a fractured supply chain, a large swath of SBE's on the verge of collapse, dislocated credit markets outside of government-backed stimulus lending and historically low consumer confidence. Layer onto these issues uncertainty surrounding the containment/treatment of the virus and the monumental challenge ahead for the US economy becomes evident irrespective of the final shape of the recovery.

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