

# The Coming Wave Of Debt Defaults

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Sam Rovit and David Sweig 12.08.09, 5:29 PM ET

The trouble in the commercial real estate markets is getting ugly, as the precarious situation of Dubai World has made all too clear.

Expect many more unpleasant situations like that one. Speculative-grade debt issuers are bracing for the default rate to hit 12% to 14% by the end of 2009, according to our projections at Bain & Company. The last time the U.S. economy experienced default rates of that magnitude was 28 years ago. The current long-term average default rate is 4.5%; as recently as 2007, it was just under 1%. These failures are not limited to small or marginal firms; they are happening at large companies with at least \$100 million in assets, and have, after all, already hit legendary businesses like General Motors, Lehman Brothers and General Growth Properties.

What's significant is not just that big, high-profile companies have defaulted--by missing a payment, making a distressed exchange with lenders to buy time or filing for bankruptcy--but that virtually every sector of the U.S. economy has been touched, including automotive, home building, industrial products, entertainment, media and financial services. Now watch for commercial real estate.

In aggregate, default rates will probably peak this year, but above-average default rates will last through 2011, since defaults historically lag changes in gross domestic product by 12 to 18 months. Like depth charges, defaults will continue to explode as cash positions sink, even as the economy recovers. By the end of this year, we will have seen nearly 300 speculative-grade issuers default on their debt in 2008 and 2009; only 116 did in the four years between 2004 and 2007. Yet as many as 300 more companies are likely to default by the end of 2011, and that could increase if current GDP expectations prove too optimistic. This could hit commercial real estate particularly hard since cash flows there are tightly linked to employment growth, making prolonged high unemployment an additional challenge on top of other economic woes.

Meanwhile a big chunk of recent defaults remain disasters waiting to happen, since they've been papered over by "extend and pretend" refinancings, amendments and waivers. About a third of those defaults have resulted in distressed exchanges, and only about a quarter have led to actual bankruptcy filings. This reflects the natural desire among issuers to buy time and fight another day, and the strong preference among lenders to avoid a loss or the hassle of taking control.

Delay, however, can't fix the underlying problem of a weak balance sheet. The cost of postponement is likely to be more debt or higher rates, which makes the ultimate challenge even greater. In the past, management teams could often avoid the day of reckoning by refinancing, but the combination of recession and evaporating credit has made much less credit available.

As if that weren't stressful enough, a big new wave of maturities is coming due, at least \$200 billion in commercial real estate senior bank loans and commercial mortgage-backed securities in the next 24 months. Thanks to the boom in leveraged deals of the early 2000s, we will see a 50% increase in speculative grade debt coming due next year, and a doubling the year after.

For companies with weak balance sheets, complicated financing structures and short reserves, the room to maneuver is extremely limited. The options look better for companies with more solid resources. We see at least 15 months ahead of negative to very low growth in the U.S and Western Europe, so we believe that senior managers must take an integrated approach and work both the balance sheet and the profit-and-loss statement to generate cash.

At the most successful companies, the cash imperative is driven by the chief executive, who recruits an internal team, assigns a cash czar and ensures there is a program office with a weekly conference call to discuss cash that includes the heads of business units. Also, these companies recognize that compensation tied to strategic objectives is a powerful motivator, so they revamp incentives to focus executives on managing for cash. Most important, they create a way to track performance based on a rolling 13-week cash and balance sheet forecast rather than on traditional profit metrics.

The danger for many companies is that they will focus too narrowly on the balance sheet, on layoffs and, especially, on trying to fix things that are better closed or sold. An effective cash strategy requires a deep understanding of what is truly core to the company, at business, geographic, product and customer levels. It requires determining whether there are nonstrategic elements draining large amounts of cash and capital. Experience shows that most companies are usually better off jettisoning rather than tuning.

One example is General Motors. Although it wound up in bankruptcy, it also took both tactical and strategic steps: divesting its corporate jets and selling or closing its Pontiac, Oldsmobile, Saturn, Hummer and Saab entities--tough decisions that management had delayed for years. Likewise Johnson & Johnson just announced both layoffs and a restructuring, based on what it called a broad, global view of the changing health care industry, in order to save an estimated \$900 million in 2010.

If you don't understand the possible calls on your cash and your ecosystem's cash, and you don't have a cash-crunch plan, you're in danger from unexpected threats. They can be quick to develop and therefore devastating. If you're a truly forward-thinking executive, though, you can

map plans to prevent such disaster--and take advantage of changing conditions, as well.

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