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Stocks: Bracing for More Bankruptcies

A wave of filings is expected in 2009, putting in jeopardy the value of equity shares and giving investors one more thing to worry about

By Ben Steverman

When it comes to corporate bankruptcies, last year was ominously quiet outside the financial sector. Get ready for the storm.

In the first couple weeks of 2009, chemical company LyondellBasell on Jan. 6 filed for bankruptcy reorganization, followed by another chemical maker, Tronox, on Jan. 11. Telecom equipment provider Nortel Networks (NRTLQ) also sought protection from its creditors with a bankruptcy filing on Jan. 15.

Some bankrupt companies are being forced to take the next step as the funding needed to reorganize their businesses proves difficult, if not impossible, to come by. Circuit City (CCTYQ) filed for bankruptcy last year, but on Jan. 16 the electronics retailer said it would liquidate all 567 of its U.S. stores.

Not Bad—Yet

The largest bankruptcy of 2008 was the collapse of investment bank Lehman Brothers and its almost $700 billion in assets. But other than Lehman, 2008 was relatively quiet for bankruptcies.

According to BankruptcyData.com, 136 public companies filed for bankruptcy in 2008. That's more than in recent years, but—despite more than a year of a U.S. recession and worldwide credit crisis—the tally is only the sixth worst in the past decade.

Edward Altman, a leading expert on bankruptcy who is a professor at the New York University Stern School of Business, estimates the 2008 default rate—a measure that includes both bankruptcies and other credit troubles at corporations—was 4.5%, just one point higher than the historic average.

Comes the Deluge

By contrast, Altman expects the default rate to jump to the double digits in 2009 and 2010.

Other bankruptcy experts agree that bankruptcy filings are set to skyrocket. Bankruptcies often have a delayed reaction to economic and financial difficulties.

Many troubled firms continue to subsist on easy credit terms obtained before the credit crisis began. "There have been a lot of companies hanging on by their nails," says Greg Segall of Versa Capital Management, a private equity firm specializing in distressed investing.

Now, says Michael Shinnick, a portfolio manager at Wasatch-1st Source Long/Short Fund (FMLSX), "We've seen a very abrupt pendulum shift from abundant liquidity to tight [liquidity]." Some firms can't find lenders, while other must pay high interest rates to get financing.

Aftershocks

Segall likens the credit crisis to an earthquake. The crisis may end and the ground may stop shaking. But, he says, "All the damage that was done by the earthquake is going to be discovered for months and years to come."

The prospect of a spike in corporate bankruptcies should worry investors. In a corporate bankruptcy, equity shareholders are last in line to get their money back. Even if a business does survive, most equity stakes are completely wiped out.

Thus the heightened bankruptcy threat is changing investors' calculus, Altman says. "Usually stock [investors] are much more interested in the upside," he says. "Now, I think you need to be much more concerned about the downside."

Next: The Retailers?

Which industries could be hit hardest by bankruptcies? Problems in the automotive industry are already well-known after General Motors (GM) and Chrysler asked for and won federal government assistance late last year.

Al Francesco, a director at consulting and accounting firm CBIZ Mahoney Cohen (CBZ) who handles bankruptcies and business restructuring, expects more retailer bankruptcies soon. A bad holiday season put many retail chains on shaky footing, he says, but there will be a slight lag before bankruptcy filings, as bills for holiday merchandise come due in January and February.

In a downturn, capital-intensive industries—such as chemical makers—are also vulnerable to a serious weakening in their financial condition. Sales can drop steeply in these cyclical industries, even as the companies are stuck with high debt loads to pay for expensive, and now underused, equipment. Energy and shipping companies are also exposed to this phenomenon now that, respectively, fuel prices have dropped and global trade has slowed, says Eric Mintz, a portfolio manager at Eagle Asset Management.

Wider Repercussions

However, with the U.S. battling its nastiest recession in at least a generation, the bankruptcy threat isn't limited to a few troubled areas of the economy. "I'm not aware of any area of the economy that's doing well now," Mintz says.

Well, maybe bankruptcy law. Experts predict bankruptcy filings will come from all corners of the stock market. That puts a premium on investors who know how to evaluate a company's credit risk. For example, Altman in 1968 developed the Z-score formula, which calculates a company's balance-sheet strength to predict the possibility of bankruptcy within two years.

A company's debt level—and whether the business has enough cash flow to cover debt payments—is a crucial factor. But especially these days, investors should "look at debt maturities, when [loans are] coming due," Shinnick says. A company that must pay off or renegotiate a mound of debt in 2009 could be hit hard by the tougher credit markets. Another company's balance sheet might also show a large debt load, but if that debt is not due for several years, the company may stay out of bankruptcy court for longer.

For investors, the only upside of a spike in bankruptcies is that it clears the field of weak players, allowing stronger firms to excel.

Because of years of easy credit, "there are a lot of troubled companies that should have been buried years ago," Segall says.

Weeding Out the Weaklings

Investors can look for companies that can take advantage of their competitors' bankruptcies. Mintz cites Best Buy (BBY) as a retailer that should benefit from rival Circuit City's liquidation.

The problem, though, is that bankruptcies ratchet up the economic pain for everyone. The Circuit City liquidation puts more than 30,000 people out of work.

Bankruptcies have a ripple effect up and down the supply chain in afflicted industries. For instance, Segall warns that many suppliers could be hurt by retailer bankruptcies.

Once it gets going, the bankruptcy trend—and all the investor and employee pain it represents—could prove one of the nastier features of the current downturn.