"Apocalypse soon? Impending fallen angels wave is too broad a brush"

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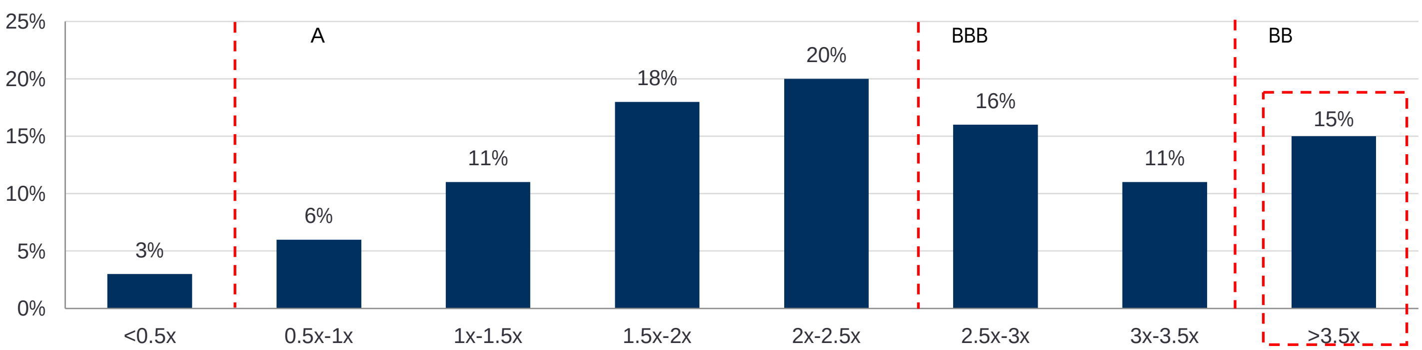
Heightened market volatility and a string of credit-specific events (e.g., GE, PCG) have rendered investors increasingly concerned about surging credit risk in the BBB rated category of the investment grade corporate market. These fears have crystallized, almost counterintuitively, in an environment of recently accelerating EBITDA growth. Yet, the BBB rated segment experienced a 3% loss in 2018 -- its worst performance since the last crisis. The concern around the vulnerability of the approximately $2.5 trillion BBB rated corporate market to rating downgrades originates primarily from the brisk growth of this segment (in both absolute and relative terms). Rising leverage is also a source of investor anxiety, as record debt-funded M&A activity has resulted in a higher proportion of BBB credits' leverage metrics mirroring BBs'. While much of the concern surrounding market size and leverage is understandable, a granular look at the data paints a more nuanced picture.

Chart 1: BBB rated corporates' leverage and implied rating



Source: Credit Suisse

Note: Rating denotes implied rating from leverage ratio levels (e.g., 15% of BBBs carry leverage > 3.5x, which maps to a BB rating)

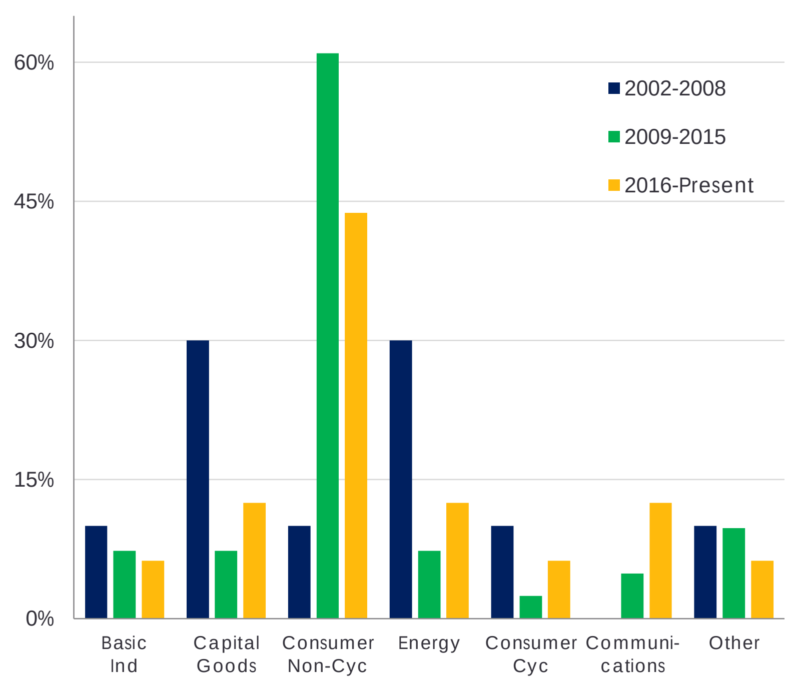
BBB credits are disparate

The amount of outstanding BBB debt has grown significantly, comprising half of the investment grade market from one-third a decade ago, and is almost twice the size of the high yield market. On the surface, the eruption of BBB rated debt seems concerning, particularly against a backdrop of higher leverage. Credit Suisse estimates that 15% of the BBB corporate market or approximately $400 billion carries a leverage above 3.5x -- a level typically commensurate with a high yield rating.

Nonetheless, leverage risk is not distributed evenly across all industries. The increase in leverage over the last several years has been driven primarily by a spate of M&A-related activity, mostly within low-beta, non-cyclical industries such as healthcare and food and beverage.

Although more defensive sectors are not immune to downgrade risk in a downturn, they have displayed a smaller propensity to be downgraded historically.

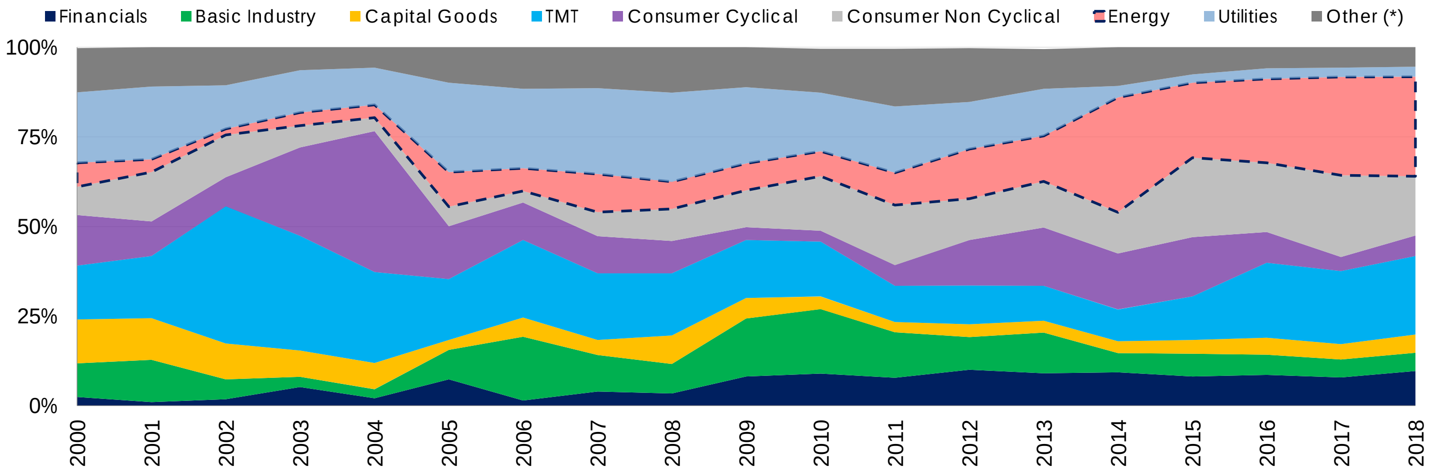
Chart 2: Historical large IG M&A transactions by sector [% of deals]



Source: Barclays

Moreover, a significant portion of BBB rated debt from enterprises levered above 3.5x emanates from the Technology, Media, and Telecom (TMT) and Energy sectors. These two sectors represent half of low BBB rated debt -- the segment most exposed to downgrade risk to high yield.

Chart 3: BBB-rated corporates' composition by sector



Source: Barclays Live, Bloomberg

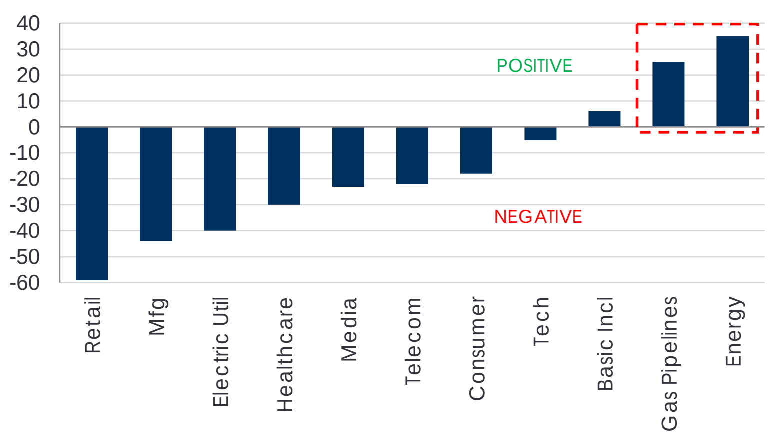
(*) Other includes REITS, Transportation, Insurance, and Other Industrial

This concentration risk could be somewhat concerning given that historical peaks in downgrades have occurred during times when the sectors facing the most stress had a relatively large representation within the BBB index. TMT and Energy represented 38% and 32% of the low BBB market in 2002 and 2014, respectively, before experiencing heavy volumes of downgrades. However, the risk within the TMT and Energy sectors is less worrisome, as net leverage remains extremely low within the cash rich technology industry, and it was added from a relatively low base. And the Energy sector has been cleansed of the weakest companies, as downgrades in the commodity complex produced 71% and 80% of fallen angels in 2015 and 2016 and 25% in 2017. Prospectively, we would not expect downgrades to be pronounced in this sector as the sector's debt cumulates the greatest concentration of positive rating outlooks, as displayed in Chart 4.

Similarly, the TMT sector has already produced 37.5% of 2017's fallen angels.

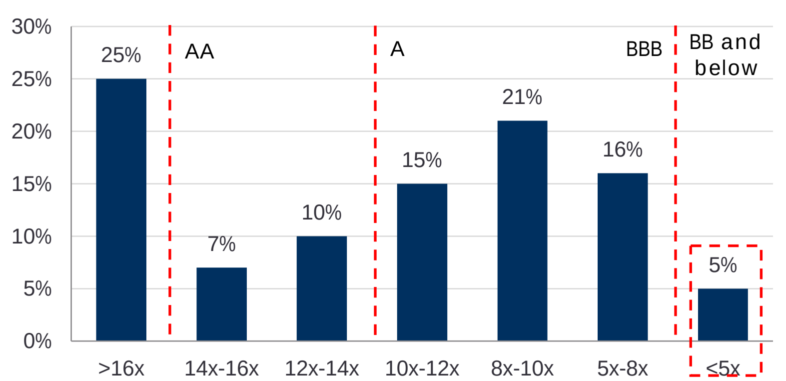
We should also note that leverage should not be construed as the single determinant of downgrade risk. In fact, focus on rising leverage is likely to be obscuring other relevant considerations such as cash flow generation, liquidity, industry dynamics, and flexibility in dealing with economic adversity. Many BBB rated names exhibit high post-M&A leverage rather than severe operating challenges.

Chart 4: BBB net ratings outlook [$bn]



Source: Credit Suisse

Chart 5: % BBB rated corp interest coverage ratio & implied rating



Source: Credit Suisse

Note: Rating denotes implied rating from interest coverage ratio levels

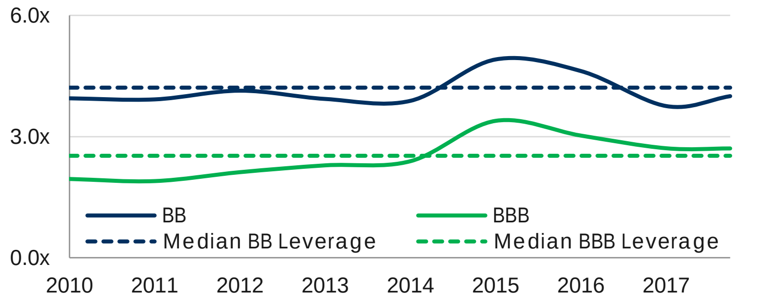
Rating agencies have been permissive

A more prominent risk posed by the deterioration in leverage stems from negative rating agency actions, which appear to have relaxed standards within some industries, allowing certain companies to attain a higher credit rating than one would otherwise assume based solely on the issuer's leverage metrics.

Chart 6 exhibits the noticeable convergence in leverage between the BBB rated portion of the investment grade market and the BB rated sector in the post crisis era. In 2018, many companies were given at least two years post-M&A deal closing to reduce leverage to rating targets while retaining an investment grade rating. It is hard to conceive that rating agencies would take such a benign stance if these leverage levels had been achieved in the normal course of business and not as part of an M&A transaction. Nonetheless, this flexible timeline suggests that the likelihood of wide-scale BBB downgrades in 2019 is low. Factors such as scale of business, reliance on M&A synergies, and a pledge to delever quickly have justified this leniency. However, companies that have increased leverage to fund large debt-funded acquisitions have demonstrated in the past a proclivity for slow deleveraging even in a healthy economy. An analysis by Morgan Stanley of a hundred M&A transactions of over $5 billion where the acquirer was initially rated investment grade reveals that even after five years, these companies generally had not returned to pre-acquisition leverage levels.

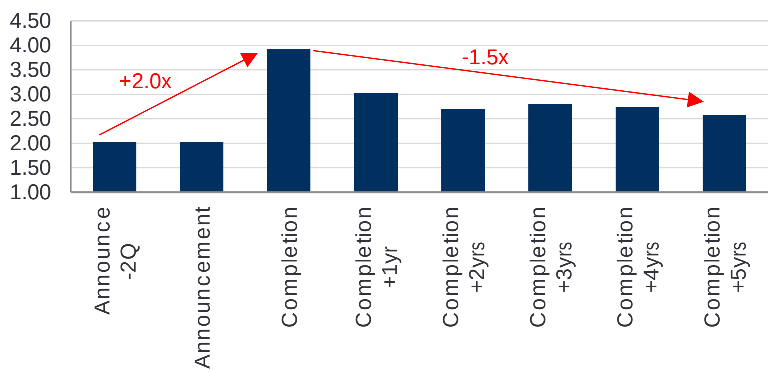
Predictably, as the macroeconomic backdrop has softened, rating agencies have become more stringent with companies that have lagged their deleveraging targets.

Chart 6: BBB net leverage vs BB net leverage



Source: Barclays

Chart 7: Gross leverage for IG acquirers following an acquisition



Source: Morgan Stanley Research, Bloomberg

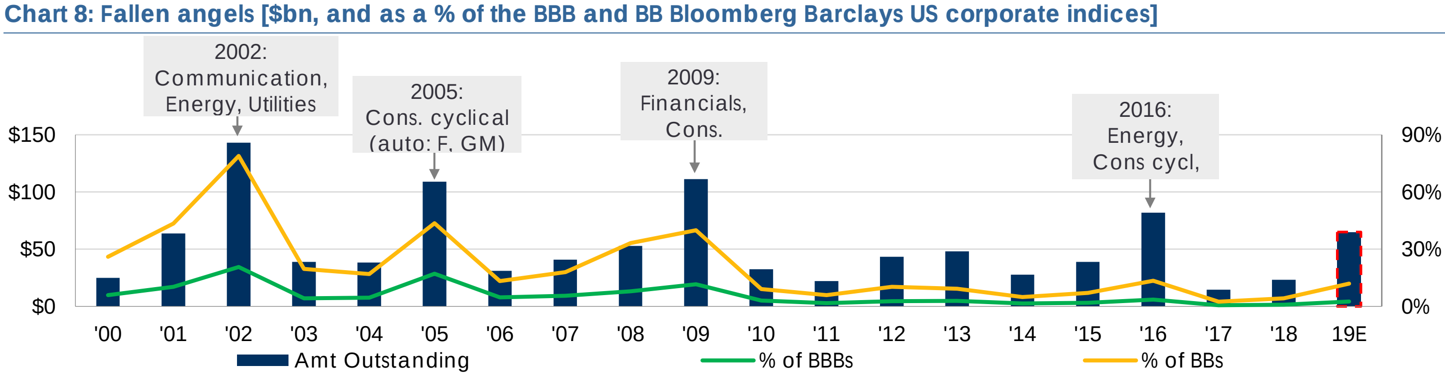
Note: Shows completed deals >=$5bn with IG rating at acquirer pre-acquisition

What are the implications for the market?

Many investors ponder whether the US high yield market can cope with the negative technical created by the scale of downgrades that might result from the changed structure of the investment grade market. As outstanding BBB debt has grown, it is reasonable to expect that downgrades will surpass historical averages.

The downgrade rate of BBB rated debt to high yield has been below the long-term average of 4.5% in eight of the past nine years, reflecting a supportive macroeconomic backdrop, with stress in the Energy sector causing the 2016 outlier. During prior recessions, the downgrade rate rose to 10-15% of BBBs as depicted in Chart 8.

Chart 8: Fallen angels [$bn, and as a % of the BBB and BB Bloomberg Barclays US corporate indices]



Source: Barclays

Note: 2019E fallen angels represents BBB rated corporates whose outlook is currently negative by at least one credit rating agency

If we assume the same percentages are applied to a theoretical down-cycle today, approximately $260-$400 billion of debt could be at risk. The low BBB segment, which represents a quarter of the BBB index, naturally exhibits greater downward rating migration risk, but only 10% of this segment carries a negative outlook by at least one rating agency. This suggests approximately $65 billion of potential downgrades in 2019 -- by no means staggering in the context of a $1.2 trillion high yield market. Many of these issues may not translate into downgrades – any outsized fallen angel activity generally requires a meaningful deterioration in credit fundamentals. Most have remained generally stable for the broader BBB category, with the exception of leverage ratios.

Like defaults, rating migrations from investment grade to high yield exhibit a strong macroeconomic component and are inextricably linked to the credit cycle. Credit markets have also experienced downgrade waves outside of recessions, but those have typically been concentrated around one or two sectors, such as Autos in 2005 and Energy in 2016. The current period compares well to the 2015-2016 non-recessionary downgrade wave which saw $121 billion of fallen angels, driven primarily by the deterioration in the Energy sector. To put the magnitude of potential downgrades into perspective, the prior two recessions have produced larger amounts of fallen angels -- $207 billion in 2001-2002 and $164 billion in 2008-2009.

Similar liquidity issues seen in 2016 will probably recur at some point and could be protracted. Absent a recession, downgrade risk among BBB rated issuers appears manageable and likely to remain contained to structurally and cyclically challenged sectors and firms. Longer term, a wave of downgrades will be inevitable in the next recession and will be exacerbated by the size of the debt being absorbed by high yield. The buyer base for fallen angels might be limited and more constrained in its willingness to buy downgraded long duration BBB bonds. Nonetheless, as we have seen in prior cycles, it will take time to unfold, as downgrades typically occur over a two to four-year span and tend to lag the market – if 2016 downgrades are any indication, spreads began widening mid-2014 and the wave of energy-related downgrades didn't peak until early 2016, almost two years later.

Conclusion

The quantum of BBB debt is unprecedented, hence gauging the magnitude of the potential impact of broad downgrades is indubitably more art than science. The orthodoxy that the BBB rated segment has become uniformly riskier due to stretched leverage metrics belies the complexity of the issues at play. While it is difficult to predict a sector-driven rise in fallen angels, pockets of risk undeniably exist. The data are hardly persuasive that the BBB corporate bond category indiscriminately poses an imminent threat to credit markets, especially as large amounts of fallen angels have been absorbed by high yield in the past. While even the most "defensive" credits are not immune to downgrade risk late in the cycle, negative credit events have yet to become systemic. Such a scenario would require either an exogenous economic event, such as a recession, or a rapid fundamental deterioration of a significant amount of BBB issuers (or the confluence of both), which we do not envisage in the short term.

About the author:

Sandy H. Jephson Kroeber brings over 14 years of experience in corporate and leveraged finance.

Since joining FPCM in 2013, Mrs. Kroeber has sourced investment ideas and performed fundamental research across high-yield, investment grade, loans and collateralized loan obligations (CLOs).

Immediately prior to joining FPCM, Mrs. Kroeber worked was a Vice President in the Leveraged Finance group at Deutsche Bank. Preceding her time at Deutsche Bank, Mrs. Kroeber was an Assistant Vice President at Merrill Lynch Capital and GE Capital. In this capacity, she was responsible for structuring LBO transactions for middle market and large corporates, with a focus on the Media and Consumer industries. She started her career at Citigroup as an Analyst in the Corporate Finance group, focusing on the Media and Telecom sectors.

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