Downgrades & Defaults: Where are we this cycle for Corporates and COVID-19?

August 10, 2020

Covid-19 has wreaked havoc across the global markets. With broad parts of the economy remaining shut, the impact across industries has been widespread. We take a closer look at how this crisis is impacting the leverage profile, ratings trajectory, default rates and recoveries across the corporate market.

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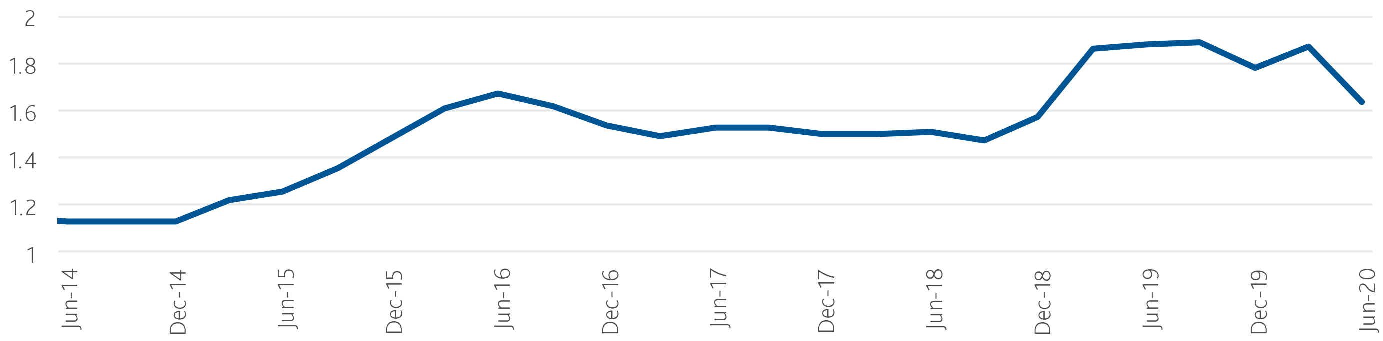
LEVERAGE

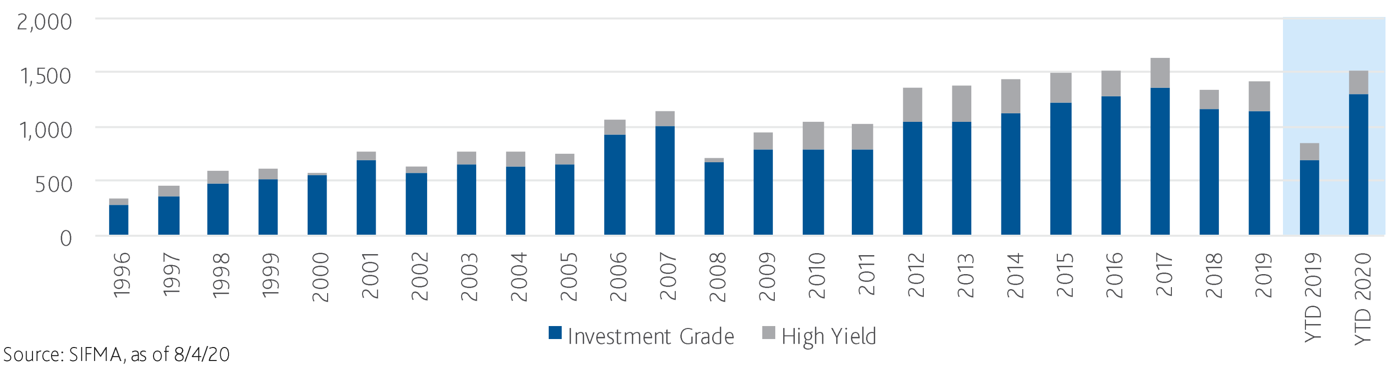
US companies entered the COVID-19 pandemic with diminished credit profiles as leverage had steadily increased over the years due to large debt funded acquisitions and recapitalization that weakened corporate balance sheets. The unexpected Covid-19 induced recession has only exacerbated balance sheet pressures. In the early part of the crisis, access to funding became challenged with some companies tapping their lines of credit facilities outstanding with financial institutions. Following announcements by the Federal Reserve in late March to purchase corporate bonds, there was increased corporate debt issuance to raise cash (see second chart below). Many companies boosted their liquidity given the uncertainty surrounding the duration and severity of shutdowns. The expectation is that companies will use this additional cash to pay down debt and improve their balance sheets as economic activity resumes, but this is vulnerable to the timing of a vaccination. We are seeing companies demonstrate more conservative behavior including reduced M&A activity, share repurchases and dividend payments to preserve cashflow. In the initial stages of the crisis, we analyzed all of our holdings to assess the liquidity and defensiveness of corporate business models. We identified sectors that were likely to see the greatest impact on their leverage including sectors like media, autos and transportation and looked at levers each company had to provide support to their overall credit profile.

NET DEBT TO EBITDA



Source: Bloomberg, S&P Index, as of 6/30/20

ISSUANCE ($ MILLIONS)



Source: SIFMA, as of 8/4/20

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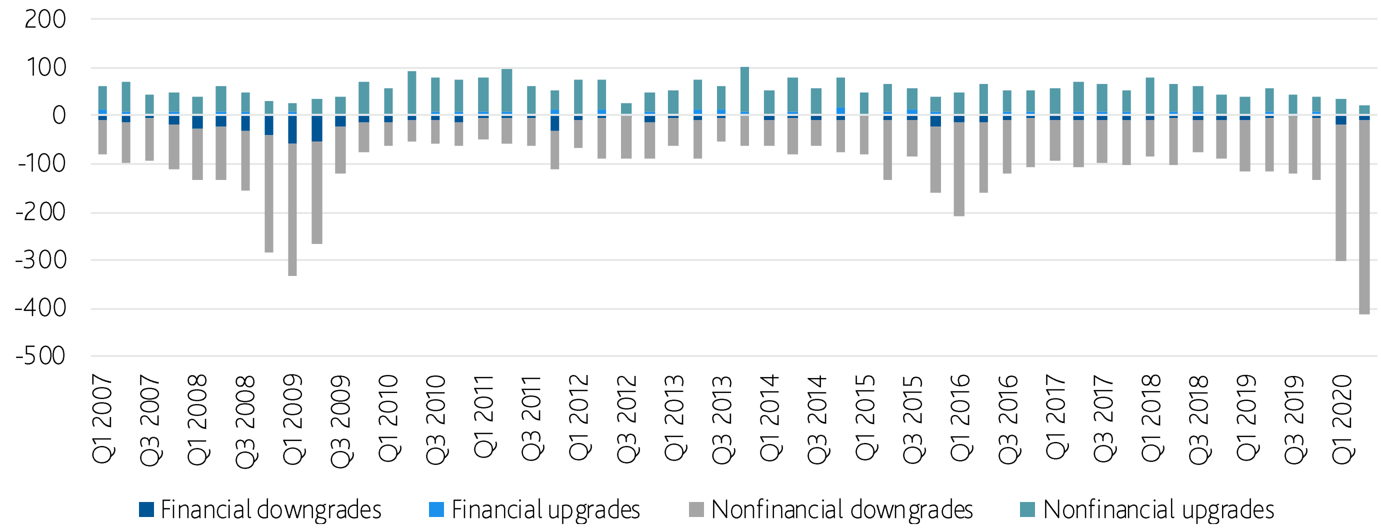
RATINGS ACTIVITY

Ratings downgrade activity accelerated in the early period of COVID-19. Over the past few months, the pace of downgrades has slowed as the agencies largely take a wait and see approach and give companies time to navigate this pandemic. The sectors that have seen the largest ratings impact include the ones that are most vulnerable to the shutdowns including autos, energy and media. And while leverage is currently above the downgrade triggers for many companies, rating agencies have still afforded companies time to manage through the cycle. We have seen a pick-up in fallen angels this cycle as some companies have migrated from the high grade to the high yield universe. (see second chart below)

UPGRADES AND DOWNGRADES



Source: S&P, as of 3/31/20

LARGEST US FALLEN ANGELS IN 2020

Issuer	To	From	Sector/subsector	Country	Rated debt affected (mil.$)
Ford Motor Co.	BB+	BBB-	Automotive	U.S.	113,862
Occidental Petroleum Corp.	BB+	BBB	Oil and gas	U.S.	43,913
Kraft Heinz Co. (The)	BB+	BBB-	Consumer products	U.S.	31,539
Apache Corp.	BB+	BBB	Oil and gas	U.S.	11,080
Western Midstream Operating L.P. (Occidental Petroleum Corp.)	BB+	BBB-	Midstream	U.S.	8,120
Macy's Inc.	BB+	BBB-	Retail/restaurants	U.S.	7,149
Service Properties Trust	BB+	BBB-	Homebuilders/real estate companies	U.S.	5,350
Continental Resources Inc.	BB+	BBB-	Oil and gas	U.S.	5,200
EQT Corp.	BB+	BBB-	Utilities	U.S.	4,945
Delta Air Lines Inc.	BB	BBB-	Transportation	U.S.	4,550

Source: S&P, as of 6/30/20

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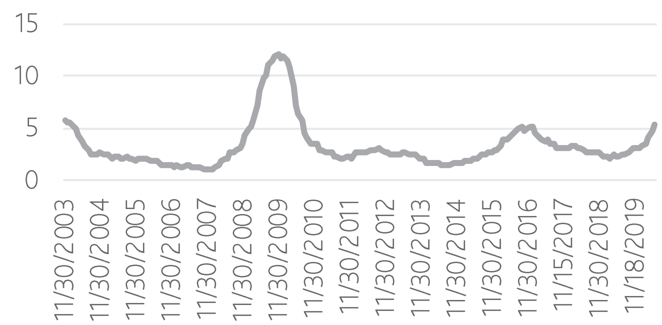
DEFAULTS

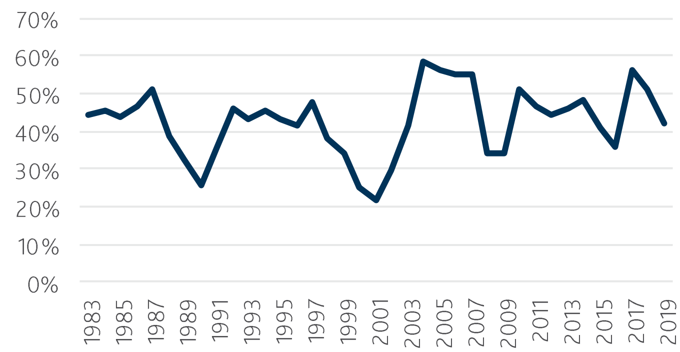
Defaults this cycle may breach the levels seen since after the global financial crisis though we believe this will largely be dependent on the timing of a vaccination and the potential for additional stimulus. S&P's trailing 12-month issuer-weighted US default rate stood at 5.4% as of June 30, 2020. Forecasts for defaults over the next 12 months range from the high single digits to the low to mid-teens. Moody's annual defaulted bond recoveries for 2019 was 42%. During the financial crisis, the recoveries were closer to 34%. Defaults this cycle have been in sectors like energy, retail and media. The majority of defaults this cycle has primarily been due to missed interest payments followed by distressed exchanges and bankruptcies.

U.S. SPECULATIVE DEFAULT RATE (%)



Source: S&P, as of 6/30/20

ANNUAL DEFAULTED CORPORATE BOND RECOVERIES



Source: Moody's, as of 12/31/19

DEFAULTS BY SUBSECTOR

Subsector	Total
Oil & gas	27
Consumer products	25
Media & entertainment	21
Retail/restaurants	19
Metals, mining, steel	8
Transportation	8
Capital goods	7
Healthcare	6
Homebuilders/real estate	5
Telecomm.	5
High technology	4
Midstream	3
Forest products, building materials	2
Utilities	2
Aerospace/defense	1
Automotive	1
Chemicals, packaging, environmental services	1
Finance companies	1
Insurance	1
Total	147

Source: S&P, as of 7/29/20

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