BBB downgrade risk: Less than meets the eye?

Worries over declining credit quality may be overblown

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QUICK READ

> Sharp growth in the BBB credits has raised fears about mass downgrades, losses in value and a swamping of the high-yield segment. We believe this narrative may be overly alarmist, given the sources of the BBB increase.

> For instance, in recent years, the level of new BBB issuance from that of "fallen angels—companies downgraded from investment-grade moving in the opposite direction.

> Agency ratings offer limited information on a company's credit outlook. We use these ratings as just the starting point in our rigorous research process, which yields an independent view of potential risks and rewards.

Digging into the numbers

In recent months, much attention has been focused on the perceived risks posed by the rapid growth in BBB-rated corporate debt. This bottom rung of the U.S. investment-grade (IG) ladder represents more than 50 percent of the IG universe. In dollar terms, at more than $2.3 trillion, BBB debt is now nearly triple its level in 2011.

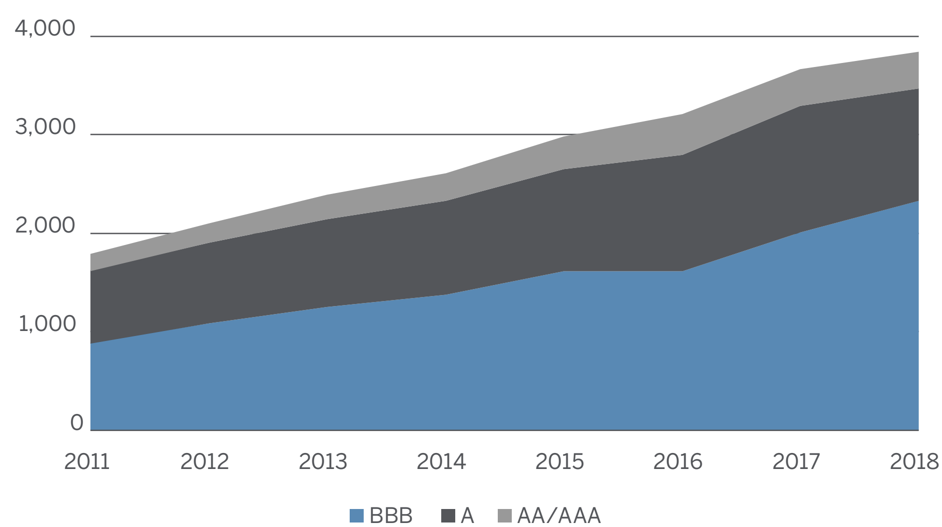
Some market watchers worry that an economic downturn could trigger widespread downgrades of BBB credits into high yield (below BBB— at S&P or Fitch/Baa3 at Moody's), which could result in substantial losses in value for existing bonds and lead to corporate distress as their borrowing costs rise significantly. There's also concern that a wave of downgrades could be large enough to swamp the high-yield segment with new supply, which could hurt prices for existing bonds.

But in an investment-grade debt market worth nearly $4 trillion, broad-brush generalities can gloss over important nuances. A deeper understanding of the BBB segment requires an expertise in fundamental credit ratios, which are the material drivers of credit ratings. These ratios include leverage, interest coverage and EBITDA[1] growth.

1 EBITDA: Earnings before interest, taxes, depreciation and amortization. EBITDA is a commonly used alternative to net income when measuring financial performance.

POST-CRISIS GROWTH FOR BBB SEGMENT

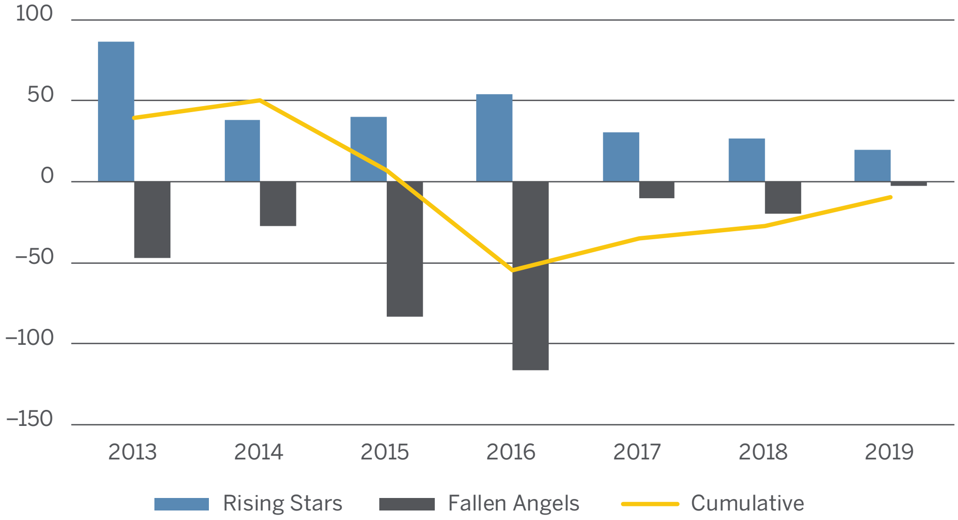
Investment-grade bonds by rating ($ billions)



Sources: JP Morgan Chase, USAA Investments, A Victory Capital Investment Franchise.

RISING STARS NEARLY OFFSET FALLEN ANGELS IN RECENT YEARS

Value of upgrades versus value of downgrades ($ billions)



Sources: Credit Suisse, USAA Investments, A Victory Capital Investment Franchise. As of 9/30/2019..

Closer scrutiny of trends during the current cycle reveals that about a third of the BBB increase came from downgrades of higher-rated companies.

In recent years, BBB leverage has largely remained stable, which is ratings-neutral, while improving interest coverage and EBITDA growth are positive.

Closer scrutiny of trends during the current cycle reveals that about a third of the BBB increase came from downgrades of higher-rated companies. Such downgrades can be due to the assumption of additional debt (often as a result of an acquisition) or the sale of a portion of the business and the return of capital to shareholders.

About 15% of the BBB increase came from opposite direction—speculative-grade companies being upgraded to IG status. This cohort includes "rising stars"— relatively new issuers that have built a solid credit record. Since 2013, the cumulative value of issuance by rising stars ($296 billion) is roughly equal to that of "fallen angels" ($305 billion)— issuers that have dropped from IG status to high yield.

The remaining 50% or so of new BBB debt was issued by BBB companies—these include a significant number of new issuers taking advantage of low borrowing costs and strong investor demand.

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Market sector can be important when analyzing issuer upgrades and downgrades.

BBB trends can vary by sector

Market sector can also matte when analyzing upgrades, downgrades and those BBB issuers holding steady. Fixed income analysts at USAA Investments, A Victory Capital Investment Franchise, have identified sectors that illustrate each of the three categories, and they offer some color on current risks and opportunities.

Technology

The growth of BBB-rated technology bonds is largely from companies whose fundamentals improved as a result of acquisitions or because they issued secured debt, according to analyst Domingo Villarruel. About 40 tech companies issued BBB-rated debt, with Broadcom and Dell accounting for 11% of the issuance. Both were upgraded to BBB in 2016 after transformative acquisitions. Broadcom fits the profile of an A-rated company based on scale, margins and free cash flow, but its elevated leverage and acquisition history have weighed on its ratings. Villarruel says Broadcom's $33 billion debt load gives management a powerful incentive to remain IG—slipping back into the high-yield ranks would likely raise its borrowing costs and complicate the funding for any future acquisitions.

Food and beverage

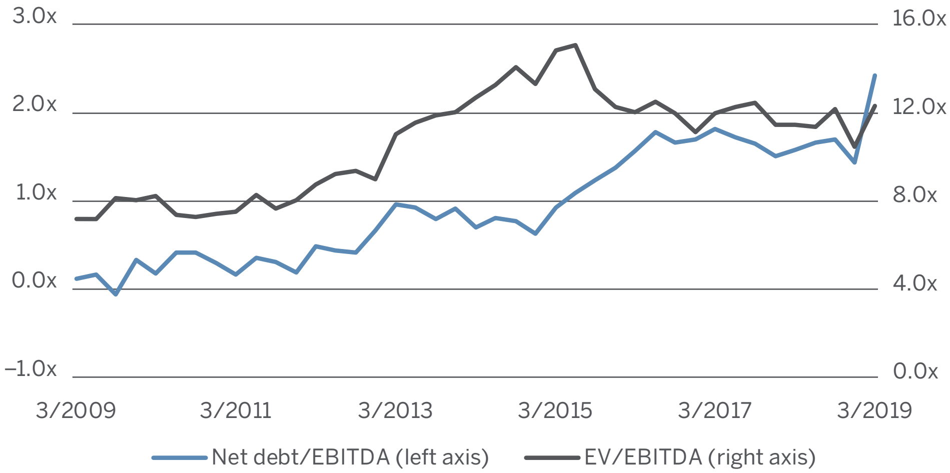
Senior analyst Michael Duncan says leveraged transactions by companies in the food and beverage subsector have hurt credit ratings and, in some cases, have led to downgrades. Anheuser Busch-InBev and Altria, for example, have been downgraded to BBB by two of the three major rating agencies, while all three agencies rate British American Tobacco at BBB. Debt-funded acquisitions have also weakened the credit profile of a number of existing BBB names—among them, General Mills and Campbell Soup—but not to the point of pushing them down to high yield. Many of these companies could sell off non-core assets or cut their dividends to alleviate ratings pressure, but for others, flexibility is limited by a tougher competitive landscape and diminishing brand strength. This suggests their resiliency may be reduced in the event of an economic downturn.

Pharmaceuticals

Senior analyst Bobby Jones, who tracks the health care sector, says leverage, as measured by the ratio of net debt to EBITDA, has increased among pharmaceutical makers. But that trend is offset to a large degree by the rising value

DEBT RATIO IS UP FOR PHARMA, BUT SO IS SECTOR VALUE

Net debt/EBITDA versus Enterprise value/EBITDA



Source: USAA Investments, A Victory Capital Investment Franchise.

It's important to keep in mind that the agency ratings only tell you so much about a company's credit outlook.

of these companies in terms of the ratio of enterprise value to EBITDA. All else equal, high enterprise valuations indicate a greater ability to support leverage and repay debt. Strong cash flows, desire to retain access to lower-cost funding and the option to reduce share repurchases all suggest to Jones that a number of companies—Allergan is a good example—have the means and the motivation to maintain their IG credit ratings. Mylan is another company with ratings at the lowest rung of the IG ratings ladder, but this, too, looks to be an improving situation given the recently announced merger with Pfizer. Combining their off-patent medicine businesses, both branded and generic, would likely lead to a ratings upgrade for the new company, Jones believes.

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Net debt is a company's total debt less its cash holdings. The net debt/EBITDA ratio is a commonly used measure of a company's ability to pay its debts

Enterprise value (EV) measures a company's economic value. It includes market capitalization, long-term and short-term debts, and cash holdings. EV/EBITDA is a commonly used ratio to determine a company's valuation relative to other companies, its sector or the market as a whole.

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