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Downgrade risks when zombies become fallen angels

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High yield braces for fallen angels

The twin shocks to the global economy of the Covid-19 outbreak and the sharp oil price decline have resonated through all asset classes. The high yield bond market must now contend with a third potential shock - an influx of downgraded investment grade bonds.

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Last year, we released a paper about the rise of 'zombie' companies since the financial crisis - firms that show little signs of life but manage to survive thanks to cheap borrowing costs. At the time, many zombies were rated as investment grade quality, although most were positioned on the lowest rung in this category (BBB).

In *The next recession: Zombie killer*[1], we argued that a recession would be a necessary catalyst to shake some zombies out of the system and free up resources for companies that could use them more efficiently. With a recession now upon us, many zombies are at risk of being downgraded into high yield and becoming fallen angels. This has significant implications for a global high yield market already reeling from the abrupt economic downturn.

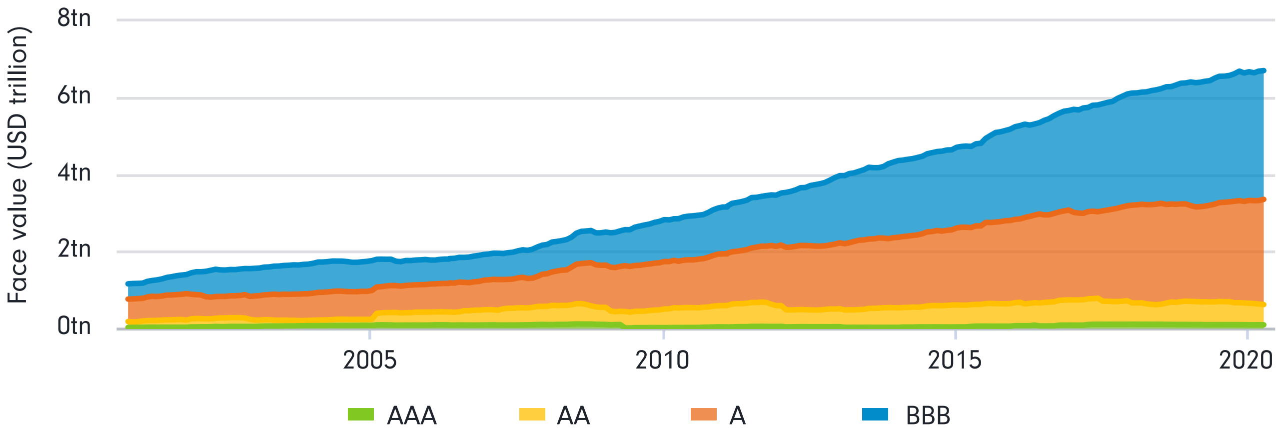
Fallen angels are attractive to high yield investors

Usually fallen angels find ready buyers in the high yield market. Most fallen angels are asset rich companies with some ability to generate financial flexibility. Passive investors will be compelled to buy them. For active investors, fallen angels represent credits that often have better access to capital than smaller, more levered companies - a highly desirable attribute in this crisis to help avert liquidity stresses later in the year. Trading liquidity is also much better in the bonds of fallen angels than in those of smaller high yield issuers.

Historically, fallen angels tend to outperform when they move to the high yield index, with the precise moment of the second rating agency downgrade being the perfect time to buy. However, there is reason to be cautious today, given the amount of bonds at risk of a downgrade to high yield.

[1]Link: https://www.fidelityinternational.com/article/the-next-recession-zombie-killer-d5d5ef-en5/

Chart 1: The amount of US BBBs has ballooned since the financial crisis

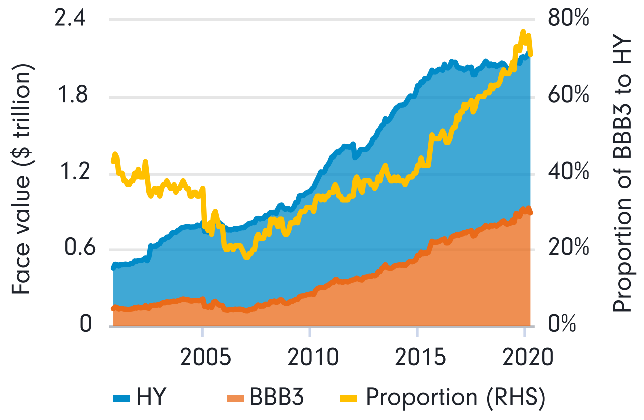


Index: C0A0. Source: Bloomberg, Fidelity International, April 2020.

The size of outstanding bonds at risk of downgrade is significant

The sheer size of the face value of bonds issued by firms at risk of becoming fallen angels that will need to find a home in the high yield market is a concern. Roughly $215 billion of US debt and €100 billion of European debt is expected to be downgraded to high yield this year.[2] The face value of bonds rated BBB has grown steadily since the financial crisis and faster than the high yield market. In the US, the amount of BBB-rated bonds outstanding now equals around 70 per cent of the entire US high yield market.

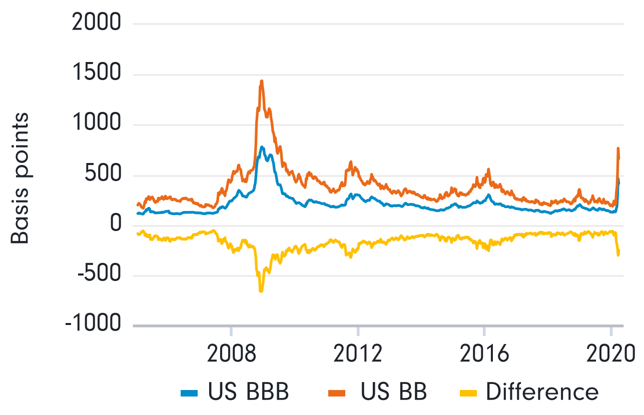
Chart 2: The sheer size of potential fallen angels could overwhelm the US high yield market



IIndices: H0A1, C0A4. Source: Bloomberg, Fidelity International, April 2020.

In the last month, the difference between the spreads of BBB and BB-rated bonds in the US corporate indices has risen to 273 basis points. While this is not yet at the extremes of the financial crisis, it is at a similar level to previous economic slowdowns. This partially reflects the overall performance of respective benchmarks, but we believe the BB spreads are also anticipating an influx of fallen angels into the HY index.

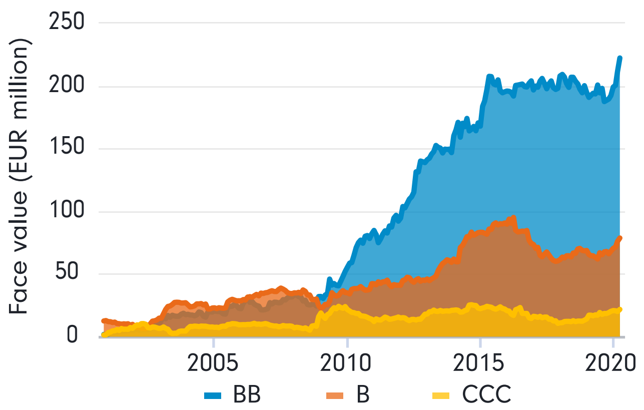
Chart 3: US BBs underperform BBBs to price in arrival of fallen angels



Option-adjusted spread of C0A4 and H0A1. Source: Bloomberg, Fidelity International, April 2020.

To explain further, the possibility of a large amount of debt moving into high yield could cause a crowding out effect for the lower rated (B/CCC) companies in the high yield index. Fallen angels, which will largely move from BBB to BB, will swell the size of the BB category in the index, forcing managers of both passive and active strategies to reallocate from riskier categories to maintain benchmark constraints. Fallen angels will also have stronger balance sheets than lower-rated companies, meaning they will find it easier to issue new bonds, exacerbating this shift.

Chart 4: Lower-rated European high yield firms at risk of being crowded out



Index: HEC0. Source: Bloomberg, Fidelity International, April 2020.

[2]JP Morgan Credit Research, 23 March 2020.

BBB spreads indicate some complacency

Many of the potential fallen angels' bonds already trade at spreads comparable to BB-rated bonds in anticipation of a future ratings moves, so some of the impact of downgrades is already priced in. However, our analysis reveals that only around 5 per cent of the US investment grade index is currently trading at spreads equal to or wider than comparable BB-rated bonds. Considering around 27 per cent of the index is rated as BBB2 or BBB3 - the categories most at risk of a downgrade to high yield - this looks a little complacent considering the near-instantaneous stop to economic activity in some sectors.

Chart 5: Given the potential for downgrades, we would expect more US investment grade to be trading at high yield spreads

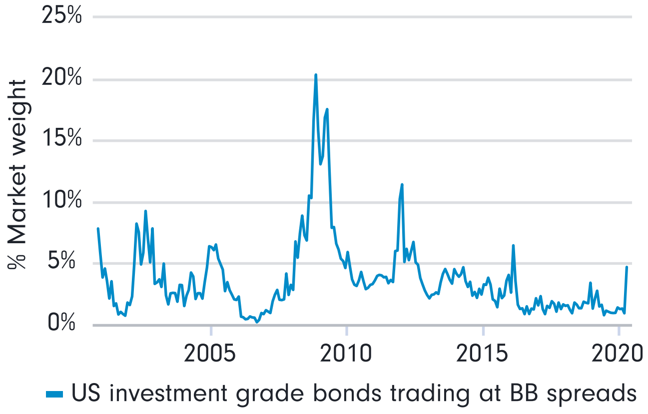


Chart shows market weight of US investment grade bonds (C0A0 index) trading wider than Fidelity's BB quant curves. Source: Fidelity International, Bloomberg, April 2020.

Navigating fallen angel risk

As we move through this crisis, more zombies will be flushed out and market stresses will begin to dissipate. In the meantime, a good way to navigate the heightened downgrade risk is to run detailed liquidity and covenant analysis on weaker companies to determine how long they can survive without additional funding while access to liquidity remains limited.

Covenant analysis, looking for loopholes that could be exploited by issuers, is especially important in a downgrade cycle. Investment grade bonds are typically issued with no covenants, meaning they are susceptible to being 'layered' - when a company issues debt with higher seniority, reducing the value of existing bonds - as a company moves from investment grade to high yield.

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A further worry for bond investors is the threat of leveraged buyouts. Private equity firms are sitting on significant amounts of capital that they are likely to deploy now that valuations are more attractive. Existing bondholders almost always lose out in leveraged buyouts as the business model necessitates loading up target firms with freshly issued debt.

Despite these risks, we believe investment grade bonds are currently trading at very attractive levels, with US bonds especially well positioned. Within the BBB category, however, thorough research is needed to understand those issuers most at risk from being moved into high yield. At the higher quality end of the high yield spectrum, spreads have reached attractive levels among certain European names, but not so much in the US. A high degree of caution is also necessary at the riskier end of the high yield spectrum (CCC/B). Credit selection here is paramount to identify those companies that, at a minimum, do not need to tap the market for further funding in the next six months.

Sectors most at risk of downgrades

Below we outline which sectors are most at risk of downgrades, with the caveat that government support and economic conditions will vary depending on which stage of the crisis each country is at. In Asia, for example, fewer investment grade bonds currently appear to be at risk of a downgrade than elsewhere, but that could change if conditions worsen. Some companies will also be affected by any changes to sovereign ratings, for example, state-owned corporates and banks in countries such as Indonesia and India.

Energy

The energy sector is most at risk of downgrades, being at the epicentre of both the oil glut and the demand shock from Covid-19. Around $60 billion of investment grade debt at the upstream end of the energy market has already been downgraded to high yield, out of around $90 billion at immediate risk. Despite the already sizeable numbers involved, there is scope for more downgrades if the oil price stays low.

The big issue is liquidity. While leverage is spiking for all companies, it's not high leverage that kills companies, it's lack of liquidity. Many of the issuers already downgraded have bonds maturing this year. With little free cash flow due to the low oil price, these companies face a near-term liquidity strain just to roll over their existing debt.

The problem could continue into next year. Many companies are well hedged against the oil price this year but not next year. And more companies have debt due next year that could run into the same problems unless market dynamics improve in the interim.

Additionally, credit ratings agency S&P has assumed an oil price of around $45 next year in its models to asses energy companies credit rating. Oil futures strips are currently pricing oil at around $35 next year, and this mismatch could lead to further downgrades if the oil price does not rise to meet rating agencies' assumptions.

Autos

The autos sector headed into the coronavirus outbreak in a weak position, due to a softening cyclical backdrop, trade tensions and margin pressures caused by stricter environmental regulations and the need to invest in R&D.

Since the virus outbreak, ratings agencies' base case assumptions for global light vehicle sales have been revised from flat to a fall of 15-20 per cent from last year. But there is significant uncertainty around these estimates as the extent of the damage will depend on how long plants are shut down and consumers must stay at home. Rating agencies have taken slightly different approaches: S&P has assigned ratings according to their base case while Moody's has put most names on review for possible downgrade with the intention to resolve the outlook within 90 days.

Ford recently became the largest ever fallen angel as a direct result of the current crisis. Several more issuers in

the sector are at risk of crossing into high yield, and the aggregate face value of downgrades could be large if S&P becomes more aggressive with its rating actions.

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Aircraft leasing

The aircraft leasing sector (excluding Chinese lessors) is at high risk of downgrades to high yield during this cycle. While many firms have relatively strong liquidity positions to cover expected debt maturities and capex commitments this year, there are several challenges facing the sector.

It is highly likely that all airlines will ask lessors for deferrals on lease payments as they struggle for liquidity while their fleets remain firmly on airport tarmacs. This will impact cashflow for lessors who will have to decide which airlines to support. Airline defaults are likely to rise, resulting in lessors being returned aircraft with limited, if any, re-leasing options. On top of this, lessors may have to take impairment charges on the value of their aircraft, which would directly impact debt-to-equity ratios.

Furthermore, lessors are wholesale funded, so must continuously refinance their maturing bonds, and it's likely that none of the lessors will have access to unsecured bond markets for the foreseeable future. Lessors will therefore have no choice but to repay maturing debt from cash and undrawn facilities (reducing liquidity headroom) or to tap secured funding lines which would increase debt encumbrance and directly subordinate unsecured bondholders. Secured debt as a percentage of tangible assets is a key metric that ratings agencies use, further increasing the risk of downgrades.

Airports

Unsurprisingly, airports are struggling in the current climate. In the past, downturns meant lower revenues but not the total shutdown of air traffic. Airports are large fixed cost businesses and are now generating significant negative free cash flow. The path to the normalization of travel is also uncertain due to the impending steep fall in economic growth as well as travel restrictions.

On top of the operating challenges, many airports have put in place highly complex debt structures with high leverage. The covenant 'protections' that were there for investors to compensate for higher leverage have now rendered airport financing structures too inflexible to deal with the current conditions. As a result, many of these structures are in precarious positions and the risk of downgrades to high yield is much higher than it has ever been.

Mineral and mining

The investment grade metals and mining sector is now considerably better placed than it was going into the previous commodity down cycle of 2015-2016. Large cap diversified mining companies have reduced their absolute net debt levels by as much as 50 per cent or more since then, and net leverage ratios are close to or below 1x, having peaked in 2015 in many cases above 4x.

Levels of liquidity have been bolstered and average debt maturities have been lengthened, reducing the need for near-term funding. Hence, while the impact on earnings and cashflow will be significant again, the impact on credit ratings should be less severe than in 2016. Miners often operate in emerging market countries where exchange rates have depreciated significantly. This helps those companies as revenues are in dollars and a large proportion of costs are in local currencies.

Retail

Retail in the time of coronavirus is a tale of two groups. Food and essential retailers will do just fine. Demand has spiked from stockpiling and the switch to 'at home' preparation and consumption patterns. Food retailers will be among the clear winners and there is no downgrade pressure in the sector as a result of the virus outbreak.

Discretionary retail, however, is under heavy pressure from mandated closures under lockdown. Aside from e-commerce, there is no revenue coming into many companies during this time, and even e-commerce is liable to logistics disruption due to employee health concerns.

A prolonged lockdown of 1-2 quarters means discretionary retailers will be relying largely on existing liquidity (cash, credit facilities, supplier/vendor support) and their ability to manage, cut or defer fixed costs. This has led to large employee furloughs by retailers, only some of which are offset by government support, rent deferrals, cancelled orders, refusal to accept shipments, senior management salary cuts and dividend and share repurchase suspension.

Given the focus on basic liquidity for survival, rating agencies have been very active in the retail sector with notable downgrades to high yield for several companies already. Many other mid-low BBB retail credits are also at risk of further downgrades if lockdowns are extended.

Beverage and food distribution

Many restaurants, bars and cinemas are closing as governments around the world enforce social distancing policies. Data from Open Table indicates that global bookings are down 100 per cent in most geographies tracked since mid-March. Fast food may fare slightly better, but recent data still indicates declines.

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This demand shock doesn't just hurt restaurants, but also their suppliers, including many beverage companies and food distributors. Beverage companies, particularly those with large emerging markets exposure, are likely to face challenges even in their off-trade (retail sales) as the economic impact of Covid-19 will hit discretionary spending. Many of the beverage companies and food distributors had levered up in recent years to fund acquisitions and they may find themselves poorly positioned within the investment grade ratings category to manage this incremental shock.

Leverage remains high among some US and European food companies, even though headlines indicate these companies have benefitted from consumer hoarding. To be fair, some issuers have done what they said they would do and deleveraged prior to this downturn, and some of the risk has already moved to high yield. Our base case is that most packaged food companies should remain investment grade, but leverage remains high in the BBB segment and there is some risk.

Leisure and gaming

The investment grade downgrade risk in leisure and gaming varies considerably by sector. Lodging companies and online travel agents have generally moved to an asset-light model meaning that they are far less exposed to the current downturn than they were in past cycles. Therefore, only those that were already weakly positioned within the investment grade category should see downgrade pressure.

In contrast, the cruise industry is asset heavy and, therefore, faces far greater downgrade risk. Operating leverage plus significant negative working capital outflows have dramatically changed balance sheet and liquidity positions and we believe high yield downgrades are very likely.

The risks of rating changes at the few gaming companies with an investment grade rating are mostly idiosyncratic. Generally, we view the risk as being higher in the gaming REITs. For operators, only the highest quality and most conservatively financed companies had an investment grade rating, leaving these operators better positioned to manage through industry turbulence than most of their peers.

Important Information

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