



# THREE QUESTIONS ON CREDIT: CORPORATE DEBT & DOWNGRADES

## FEATURING CHRIS GOOTKIND

### HOW MUCH OF THE IG MARKET DO YOU THINK IS LIKELY TO BE DOWNGRADED?

A lot more than we thought just a month or two ago! Internally, we have already downgraded nearly \$200B of debt year to date, including \$150B in March. Per data they've released, Moody's has downgraded roughly \$80B year to date, including ~\$50B in March, while Standard & Poor's has downgraded ~\$180B year to date and ~\$130B in March. How much more will be downgraded depends on many factors, including: the length and severity of this COVID-19-driven downturn; the pace of recovery when we move past at least the worst of it; fiscal stimulus and the form it takes (debt, equity, conditionality such as dividends and stock buybacks) and lastly, how much "latitude" and "forbearance" the rating agencies may provide. We feel the sectors most at risk are hospitality-related, airlines, energy and consumer discretionary (e.g., autos). With those caveats, we could expect 20%-25% of BBB-rated debt to be downgraded to high yield, with a bias toward a higher number.

### HOW STRONG ARE CORPORATE FUNDAMENTALS?

Raw credit quality metrics were mostly historically weaker going into this crisis, especially debt leverage. However, given low borrowing costs, interest coverage was strong and issuer liquidity was solid (cash on balance sheets, termed-out debt). Additionally, the BBB index composition was stronger than the headline number, as a lot of the BBB-rated issuers were large companies that had volitionally levered up due to low-cost debt, instead of weak business fundamentals. That said, the speed of deterioration for many businesses is astonishing, as revenue has decreased sharply or in some cases nearly vanished as governments basically shut down huge swaths of the economy. This could have an enormous negative impact on profitability and cash flow, especially for sectors with high fixed costs. Fiscal and monetary stimulus programs are providing access to liquidity to help companies get through this crisis. It's too early to assess fiscal effectiveness, as economies are still in "lockdown" mode. We believe more stimulus programs will almost certainly be required for businesses, industries and consumers. We don't think all companies/industries will be "saved." Lastly, much of the aid will take the form of debt. That debt will have to be serviced and will result in higher leverage and overall debt levels. Eventually, it will have to be repaid or refinanced.

We've already seen some evidence that the rating agencies will move quickly to downgrade. In conversations with them, they've indicated a greater likelihood to do so, especially for those companies and industries that were already "weakly positioned" in their rating category and/or those most disrupted by this severe economic contraction. What's different this time is the breadth of the industries being hurt, as well the speed and severity, in our view. In 2008, banks (and the financial system) were the epicenter of the crisis. Today, they are much stronger and viewed more as part of the solution than the problem.

### THERE IS A LARGE PILE OF IG DEBT MATURING IN 2020. HOW WILL THE DOWNTURN AND HIGHER YIELDS AFFECT ISSUERS' ABILITY TO REFINANCE MATURING DEBT OR RAISE NEW DEBT?

This was a big concern of ours until just recently. But we've seen an "alphabet soup" of programs, such as the Corporate Sector Purchase Programme (CSPP), the Primary Market Corporate Credit Facility (PMCCF) and the Secondary Market Corporate Credit Facility (SMCCF). Basically, they're forms of corporate quantitative easing, and they've helped loosen up the new issue market to enable corporate borrowers to roll over their debt and/or issue new debt.

We believe that loosening and appreciably higher yields/spreads have attracted bond investors back into the market too. As a result, we've seen record amounts of new issue supply in the past few weeks. Rollover and new debt will cost the issuers more, and will result in higher debt levels and weaker credit metrics.

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