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U.S. BBB Corporate Risk: Flexibility in Focus

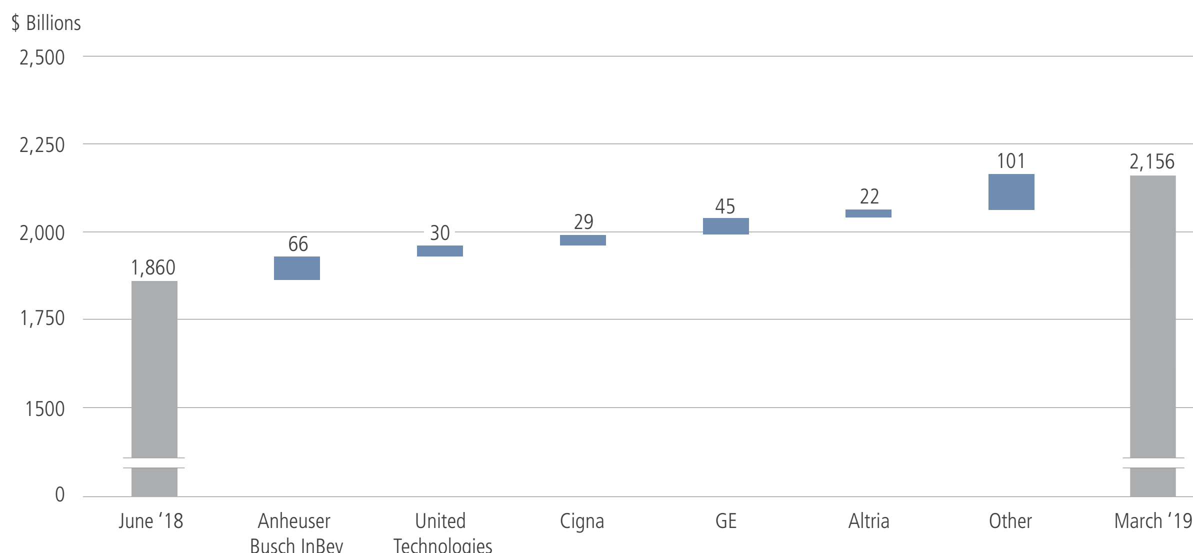
In a varied landscape, accurately assessing vulnerability to downgrades will come down to specifics.

The BBB investment universe has expanded in recent years, prompting broad fears about mass downgrades and market dislocation as the economic cycle moves into late innings. As discussed in our 2018 white paper, *BBBs: Beyond the Headlines,* we believe that while leverage has increased, the consensus has been too general in its assessment of BBBs, painting too many issuers and sectors with the same broad brush.

In the months since our publication, BBB rated corporate debt has continued to grow, but still accounts for half of the overall U.S. investment grade credit market. Growth has been driven by downgrades of several issuers, including General Electric and Anheuser Busch InBev, as well as M&A-related transactions completed by companies like United Technologies and Cigna. The downgrades and new issue supply have been absorbed by the market with little fallout. Importantly, we have seen virtually no "fallen angels" from BBB during this period, perhaps signaling economic resiliency, but also the exaggerated nature of recent BBB market-related worries.

RECENT BBB GROWTH IS DUE TO SELECT DOWNGRADES AND M&A TRANSACTIONS

Roughly 60% of the growth in U.S. BBB Industrials since June 2018 has come from five issuers.



Source: Bloomberg Barclays U.S. Credit Corp. ex-Financial BBB Index, March 2019.

Although late 2018 saw reduced investor tolerance for risk assets, the Federal Reserve's shift toward more dovish monetary policy helped tighten spreads and increase confidence in the potential for an economic soft landing in 2019. Many BBB issuers underperformed in the fourth quarter's risk-off environment, but have since rallied in 2019, supported by earnings that were generally in line with expectations as well as an improved technical backdrop.

While risk sentiment has generally improved thus far in 2019, we do not want to minimize the value of carefully assessing risk in the current climate. The need for fundamental credit research to help distinguish between stable and vulnerable issuers within and across sectors and ratings, particularly BBBs, remains paramount. In this article, we present a framework for such assessments and identify potential "levers" that companies may use to potentially mitigate credit deterioration.

Grouping Companies by Fundamental Position

To distinguish among BBB issuers, we believe it is important to understand companies' motivations for keeping an investment-grade rating. Reasons for maintaining IG ratings include 1) easy access to capital markets throughout the economic cycle, 2) flexibility to pursue acquisitions and finance growth, 3) attractive financing costs and 4) customer preference for better-rated counterparties, among other business risks.

In a soft-landing scenario for the U.S. economy (which our firm's Asset Allocation Committee currently anticipates), we would expect companies to take mitigating actions to strengthen balance sheets and maintain or improve credit quality over time. In a recessionary environment or one where sector-specific disruption intensified, we would expect these actions to accelerate both in magnitude and frequency. In some cases, credit quality may not improve quickly enough to withstand rating-agency downgrades; however, in many cases prospects could be much better—with outcomes depending on exposure to a variety of risks.

Where a given issuer falls in this continuum is often a function of business-model strength and sector positioning, as well as a willingness and ability to pull the necessary levers. We tend to categorize companies in three buckets: 1) better positioned, 2) "show me" stories and 3) weaker positioned. To help identify where a particular issuer sits on the spectrum, we apply key elements of our Credit Best Practices Checklist (see display) in the areas of 1) business risk 2) financial metrics (cash flow, margin) and 3) management and governance. Environmental, Social and Governance analysis is also integrated into our framework as we believe it can help to identify business risks that could cause deterioration in an issuer's credit profile. We then examine the suite of available mitigating actions that management teams can take to preserve investment-grade credit quality.

CREDIT BEST PRACTICES CHECKLIST: ISSUER CONSIDERATIONS

Business Fundamentals	Quality of Cash Flow	Scenario Analysis
• Product segments • Pricing and demand dynamics • Operating performance • Growth strategy and acquisition history • **Environmental and social policies**	• Cash-generation performance • Interest coverage • Spending flexibility • Shareholder remuneration targets • **Accounting practices**	• Probability-weight potential scenarios • Upside/downside of profitability, credit ratios, spreads and ratings • **Potential contingent liabilities**

Capital Structure	Liquidity	Governance/Management
• Debt and leverage levels • Appropriateness of capital structure • Leverage targets • If applicable, ability to reduce debt	• Expected cash flow • Near-term debt maturities • Cash and equivalents balance • Available bank lines • Plans to raise capital or sell assets	• **Management's abilities and incentives** • **Senior management turnover** • **Board composition** • **Equity ownership**

Items in bold are Environmental, Social and Governance (ESG) factors. Above is intended to reflect a broad overview of the investment team's style, philosophy and process, and is subject to change without notice.

The Spectrum of BBB Risk

While much of the BBB universe has elevated leverage, more resilient companies are better positioned within their sectors to deal with secular and structural challenges, often supported by strong brand equity, pricing power and a solid operational track record. These companies are typically led by credible and experienced management teams who know how to manage through the business cycle and have a history of delivering strong results. In some cases, management incentives may be directly linked to deleveraging, margins or cash-flow objectives. Financial metrics at these companies will show evidence of better margins and free-cash-flow generation relative to sector peers.

Many BBBs are in the "show-me" category. This incorporates companies that are facing sector challenges and have a mixed track record of managing through headwinds. They typically have assets of only average and often declining quality that require investment and optimization to improve. Topline growth trends can be disappointing, and margins and cash flow may be weaker and less predictable. Management teams are typically unproven and require more skepticism about their capital stewardship capabilities. Financial metrics at these companies will need to show improvement over time to prove that a stated strategy is working to move into the stronger category.

The last group of BBBs includes weaker-positioned companies with a diminished ability to defend their credit profiles and ratings. These companies have elevated risk of near-term ratings pressure due to high levels of leverage and a less certain path to improvement. Structural and secular challenges often intensify the underlying business concerns. Management teams are less proven and less dexterous at navigating these challenges. Financial metrics at these companies typically have deteriorated more quickly than management expected, as evidenced by pressured margins relative to peers and weak free-cash-flow generation. Competing interests of equity and bondholders may pose additional challenges as these companies often have underperforming equities that have caught the eye of activist investors.

NOT ALL BBBs ARE ON EQUAL FOOTING

Less Risky ······ BBB RISK SPECTRUM ······ More Risky	Better Positioned	'Show Me'	Weaker Positioned
Business Risk	• Superior assets, best-in-class operations and limited execution risk	• Average assets, but require investment and optimization to improve	• Limited ability to adjust to secular and/or structural changes
Financial Metrics	• Industry-leading growth and margins with strong free cash flow	• Topline growth challenges and lower, less consistent margin and cash flow	• Declining revenue growth, threatened margins and weakening free cash flow
Management & Governance	• Experienced, credible management teams who are often explicitly incented based on profitability, free cash flow and leverage metrics	• Unproven or less proven management who have a mixed track record of managing through headwinds	• Less dexterous at navigating challenges; competing interests of equity- and bond-holders may pose additional challenges (i.e., activist investors)

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Levers to Mitigate Risk

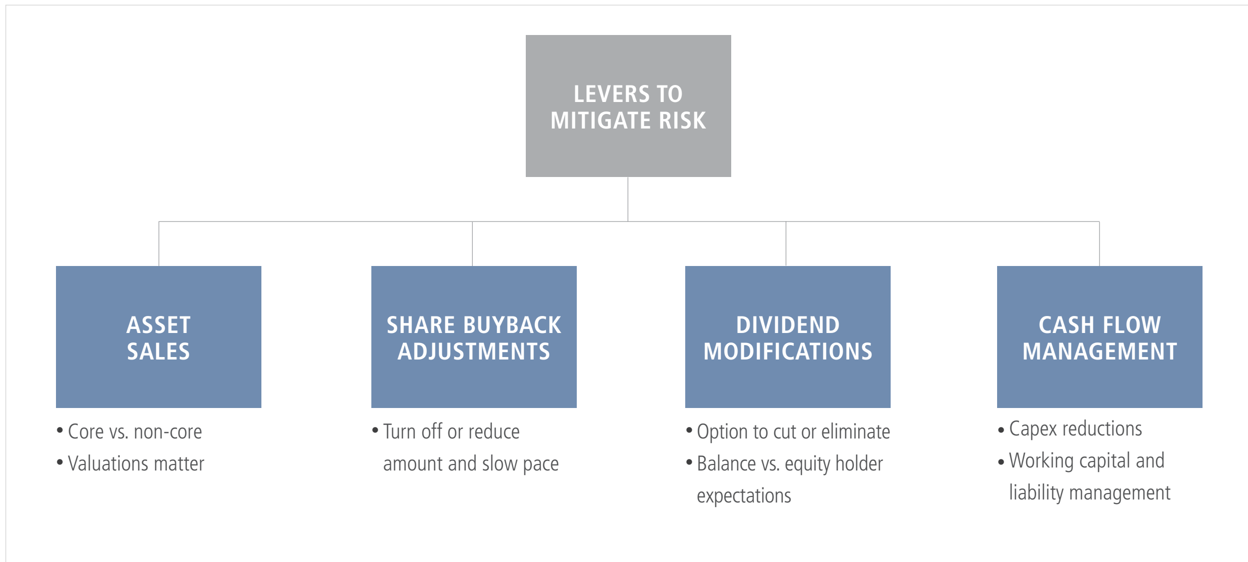
Potential levers available to companies to manage risk when their investment grade status may be vulnerable include 1) asset sales, 2) share-buyback adjustments, 3) dividend modifications and 4) cash-flow management. The effectiveness of these mitigating actions will depend on the sector and issuer. For example, capital-intensive industries such as energy benefit from capex reductions to a greater degree than less capital-intensive industries like tobacco. Each lever has its own set of risks, and successful execution does not guarantee credit improvement or long-term business sustainability.

- **Asset Sales:** These sales can be effective when assets are truly non-core, not impactful to the long-term business success of the company, and sold at an attractive multiple with proceeds used to reduce debt. There are obviously several risks to this lever, the first being the potential for a company to sell assets that are best suited to remain with the business for the long term due to attractive growth and profit characteristics. In an effort to maximize proceeds, companies may have to sell higher-growth businesses that demand higher multiples. Or, they could be in a fire sale situation and be forced to sell businesses at depressed valuations due to temporary market conditions. Another risk is the use of proceeds. Most of the time, companies are able to dedicate proceeds to debt reduction; however, where activists are involved, there may be competing interests, for example pushing for a return of proceeds to shareholders. Finally, asset sales are subject to execution risk as a company's willingness and ability may be mismatched. Management incentives can be helpful in this situation if compensation is tied to leverage metrics.
- **Dividend Modification:** Cuts to dividends are typically a more drastic step than eliminating share repurchases. However, they can aid near-term cash-flow generation, which in turn can be redirected to debt reduction. Dividend modifications can take several forms: an outright cut, modification to policy, or a change to the payout ratio that may be detrimental to shareholders but benefit bondholders. For example, Anheuser Busch InBev cut its dividend in half following slower-than-expected deleveraging in the years following its debt-heavy SABMiller acquisition.
- **Share-Buyback Adjustment:** Eliminating or reducing share repurchases is fairly simple and often an early lever to pull when a company is prioritizing deleveraging after a debt-financed acquisition. Depending on the situation (including the current stock price), management may face competing interests from shareholders and bondholders. However, the fact that buybacks can be stopped

at any time can provide some reassurance in assessing a company's ability to improve its financial situation. Verizon exhibited this behavior when it eliminated share repurchase activity to conserve cash and reduce debt following an acquisition.

- **Cash-Flow Management:** The ability of a company to improve free cash flow may depend on business practices and competitive realities within its industry. Cuts in capital expenditures, for example, are most often employed by cyclical and capital-intensive industries, and can help preserve cash flows for deleveraging. They occurred widely in the energy, mining and metals sectors during the commodity downturn of 2015 – 16. Companies may also focus on liability management as a way to smooth out upcoming debt maturity walls and refinancing needs, better matching debt maturities to free-cash-flow generation to enable debt repayment in any given year. Other measures include cost-cutting and efficiency enhancement, designed to improve EBITDA, or building working capital to provide incremental benefits to cash flows.

THE BBBs FIGHT BACK



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Conclusion: The Value of Flexibility

We expect BBBs to remain a large and important part of the investment grade credit market for the foreseeable future. We think it is important to remember that investment grade companies have flexibility within the context of their capital allocation priorities to maintain or improve credit profiles as conditions warrant. Most investment grade issuers will not stand by idly as their credit profile deteriorates and ratings go lower. Assessing company position along the BBB risk continuum is therefore an important task in evaluating BBB credits, and can provide insight into both investment opportunities and risks.

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