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BBBs: Beyond the Headlines

Amid growing concern about credit risk in the investment grade market, the BBB rating category has been a particular focus of commentators due to its size and the threat of potential downgrades into high yield in the event of a cyclical downturn. In this paper, we take a closer look at the BBB space, finding that while risk has increased, a careful analysis reveals that the fundamental picture is actually quite varied—with pockets of opportunity and, in some cases, surprising vulnerability.

Introduction

Investors have become increasingly concerned about growing credit risk in the investment grade corporate market. A large part of this focus is on the BBB rating category, which now accounts for roughly half of the investment grade index and is a third larger than the high yield market. The fear is that when the U.S. reaches the end of its economic cycle, much of the BBB segment will be vulnerable to downgrades that disrupt the credit markets by flooding the high yield market with "fallen angels."

While much of the concern surrounding leverage is valid, we believe it is important to have a perspective that is more nuanced than the headline story both to accurately gauge the extent of the danger and to understand where vulnerabilities exist. Indeed, credit issues are generally limited to the Industrials segment, in particular affecting sectors facing secular headwinds and undergoing business model disruptions. These have led to leveraging M&A transactions and "shareholder-friendly" activities detrimental to bondholders.

We explore the BBB landscape in this short paper.

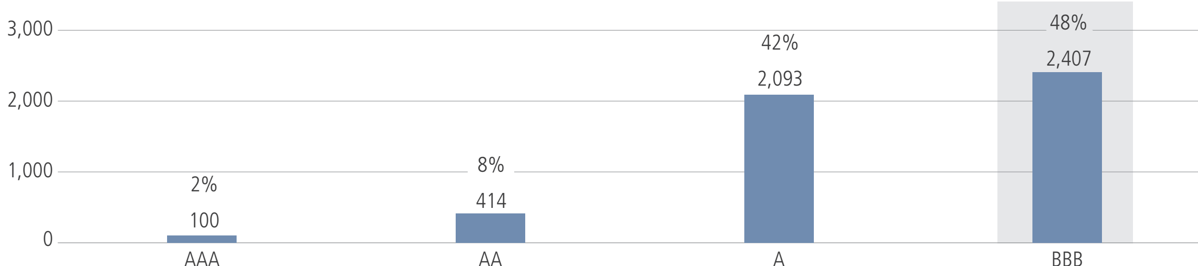
Key Takeaways

- The growth of the BBB universe has been consistent with the broader investment grade universe
- Recently, lower-quality issuers have accounted for an outsized portion of BBB growth
- Most BBB credit risk is concentrated in a handful of sectors, whose specific fundamentals will affect their ability to preserve their credit ratings in the next economic downturn

The BBB Credit Picture

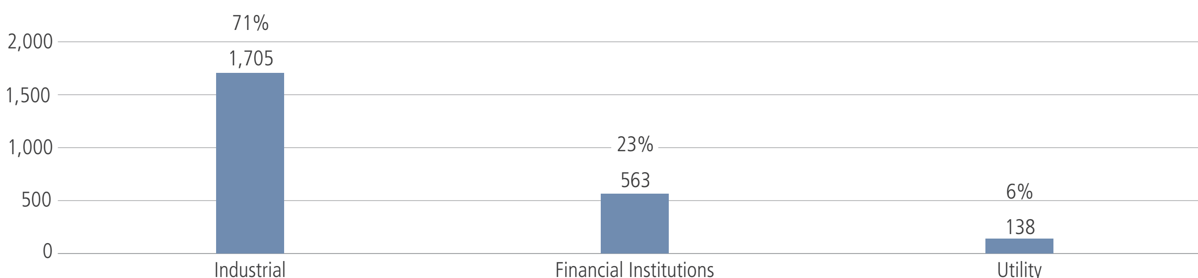
BBB rated companies currently make up nearly half of the U.S. Investment Grade Credit Corporate Index. Within the BBB component of the index, more than two-thirds of market capitalization is in Industrial bonds, while roughly a quarter is in Financials and the remainder is in Utilities.

FIGURE 1. U.S. CREDIT CORPORATE MARKET VALUE BY RATING ($ MILLION)



Source: Bloomberg Index Services, June 2018.

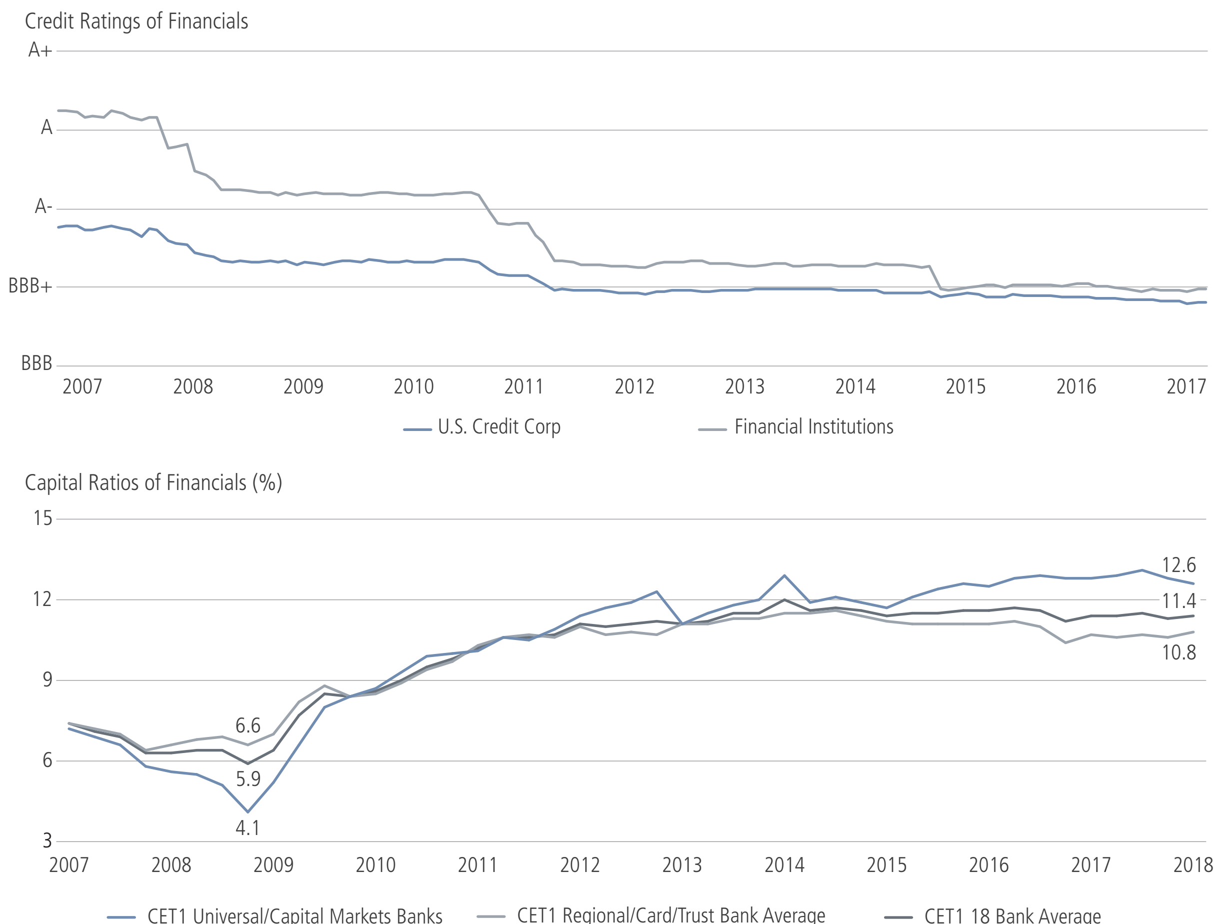
FIGURE 2. BBB MARKET VALUE BY SECTOR ($ MILLION)



Source: Bloomberg Index Services, June 2018.

To more accurately portray the nature of the credit vulnerabilities associated with the BBB universe, we would argue that the Financials sector should be excluded from the analysis. In the wake of the 2008 financial crisis, credit rating standards for financial institutions became far more stringent, while many institutions improved their capital position. This created an anomalous situation in which credit ratings for financial issuers moved lower even as credit quality improved.

FIGURE 3. FINANCIALS: RATINGS ARE DOWN, BUT CAPITAL RATIOS ARE UP



Source: Bloomberg, Company Reports, FDIC, Federal Reserve, SNL Financial.

As a result, we do not believe that the growth of Financial BBB bonds represents a particular issue for investors. In fact, we currently have a favorable view of fundamentals in the Financials sector, where in response to stricter regulations companies have moved to reduce leverage and improve their balance sheets while taking a more even-handed view of bondholder and shareholder interests. Taking into account valuation, we believe the sector appears relatively attractive at this point, even when compared to companies traditionally viewed as defensive late in an economic cycle (more below). To drill down on more meaningful concerns across the BBB universe, therefore, we made the decision to exclude Financials from our assessment.

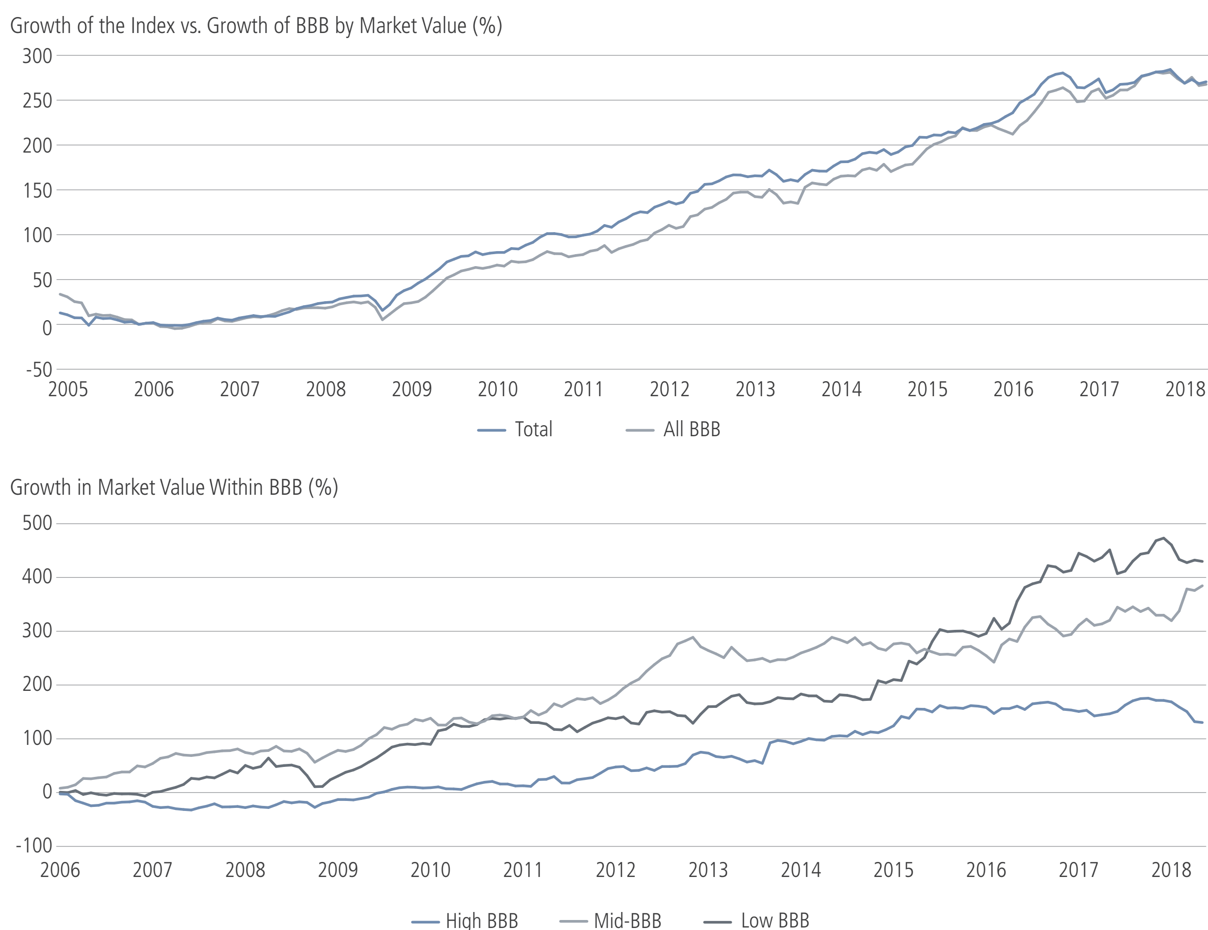
BBB Growth Matches the Market, but Is Weighted to Lower Quality

Without Financials in the picture, what quickly becomes evident is that, contrary to the perception of "out of control" BBB growth, the segment's expansion since 2005 roughly matches that of the broader credit market, as represented by the U.S. Credit Corporate Index ex-Financials. A more concerning trend, however, is the weighting of growth within the BBB space, where lower quality accounts for the bulk of recent market-value growth. Since 2005, BBB Industrials have grown at a rate similar to the market, at about 270% on a cumulative basis. But within BBBs, low-BBB growth has been the highest, at more than 400%.

In recent years, debt financing related to energy infrastructure projects in the midstream sector has accounted for about 40% of the increase. Following the oil price decline, midstream companies have largely worked to defend and stabilize their investment grade ratings to diminish the threat of ratings downgrades in the event of a cycle turn. The remaining portion of low-BBB growth is attributable to leveraging M&A activity in historically free-cash-flow-generative sectors such as Health Care/Pharma, Food and Beverage, and Cable/Media as companies pursued growth opportunities amid changing industry dynamics.

FIGURE 4. PERSPECTIVE ON BBB GROWTH

U.S. Credit Corp Index ex-Financials



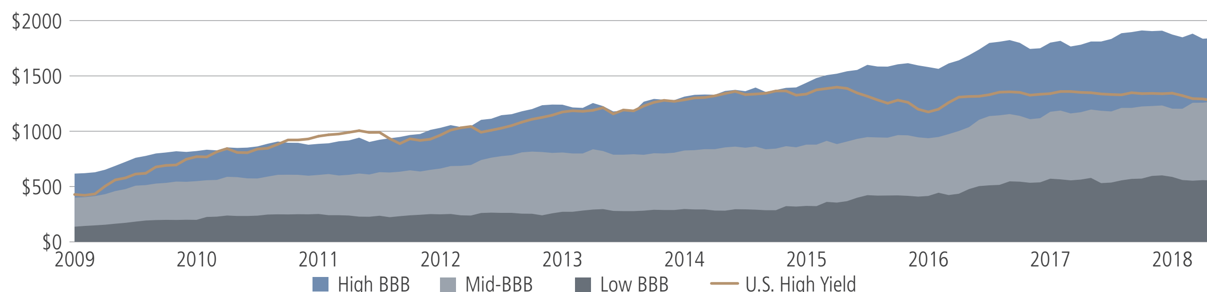
Source: Bloomberg Index Services, June 2018.

Aside from the overall volume of BBB, a source of worry has been growth compared to the high yield universe. Indeed, after moving from rough equality five years ago, the entire BBB Industrials market is now worth $1.8 trillion compared to the high yield total of

$1.3 trillion. Importantly, this change is not the result of acceleration in BBB rated debt growth, but rather a stalling out of high yield growth, as shown in the chart below. On average over the past 20 years, about 3.5% of BBB Industrials by market value have typically migrated from investment grade to high yield each year. It is worth noting that since the auto sector downgrades in 2004, the ratings transition rate from investment grade to high yield in any given year has not exceeded 7.5% of BBB Industrials market value.

FIGURE 5. BBB HAS SEEN STEADY GROWTH WHILE HIGH YIELD HAS STALLED

U.S. HIGH YIELD VS. BBB MARKET VALUE ($ BILLION)

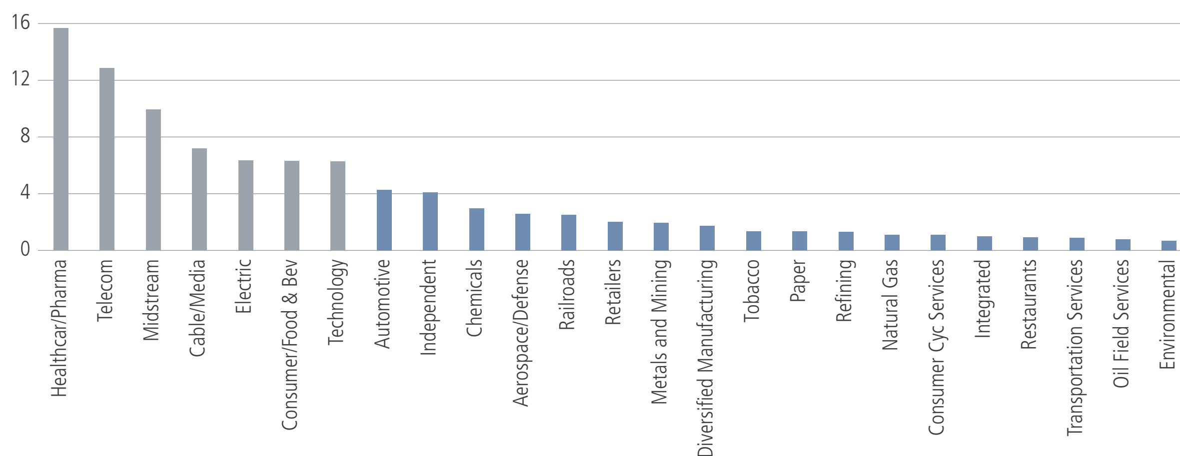


Source: Bloomberg Index Services, June 2018.

Gauging Risk at the Sector Level

Despite these mitigating facts, it is undeniable that the amount of BBB corporate credit in the market has grown, and that leverage within the group has increased as well. With that established, a key task for investors is to identify where the risk lies. An assessment by sector helps draw those lines. In the chart below, the seven sectors at left (out of a total of 25 sectors excluding Financials) represent two-thirds of the category's market value and have been largely responsible for the recent growth in the BBB category.

FIGURE 6. TOP SECTORS IN THE BBB CATEGORY (% BBB MARKET VALUE)

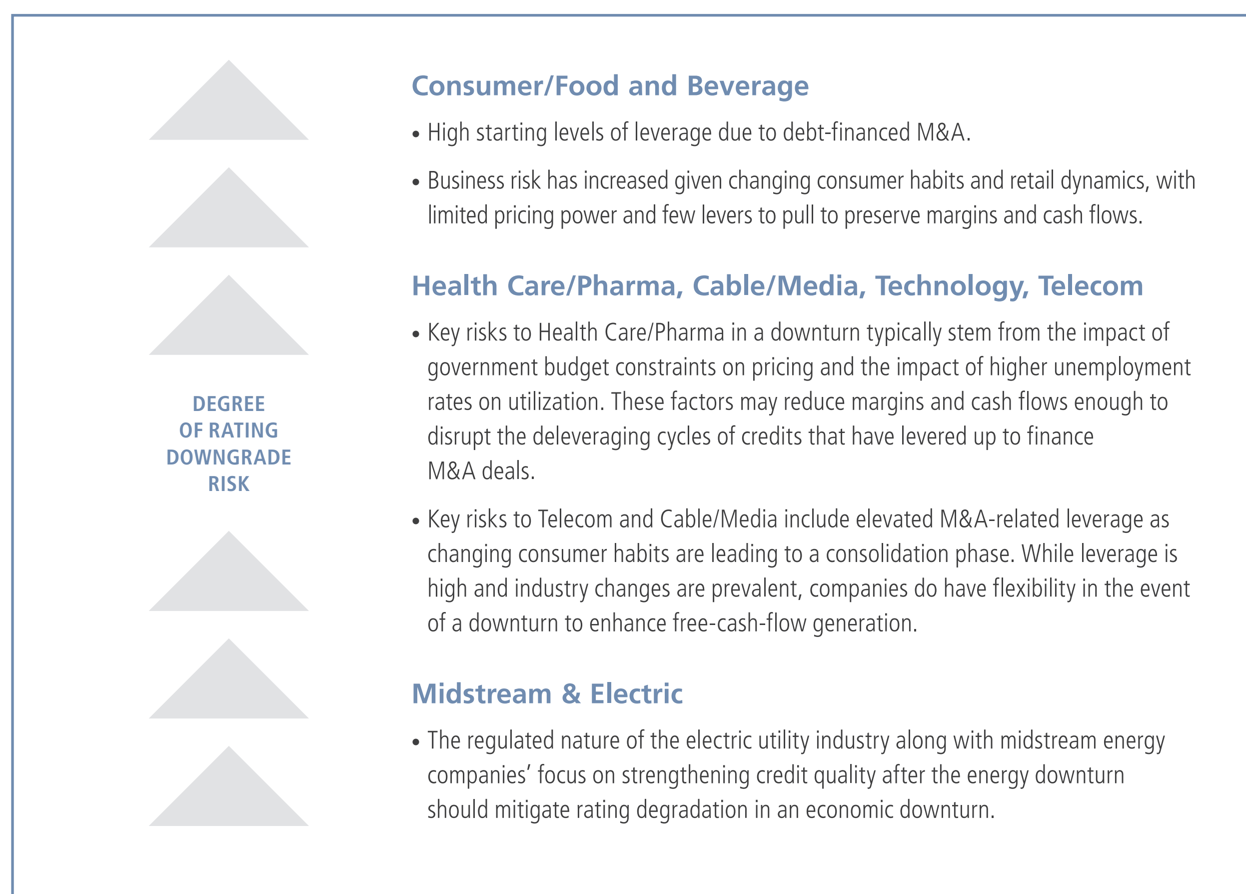


Source: Bloomberg Index Services, June 2018.

Naturally, the mere fact that a sector is a major weighting in the index does not point to additional risk. In the case of the BBB sector, we've seen an increase in general risk levels due to leverage-driven mergers and acquisitions in historically defensive sectors. For example, in Telecom and Cable/Media, changing consumer behavior and technological disruption have resulted in debt-financed consolidation. In Health Care/Pharma, growth challenges in the face of pricing headwinds, patent expirations and maturing portfolios have led to increased M&A as companies search for growth. In Consumer/Food and Beverage, evolving consumer preferences and challenges for retailers have led to leveraged M&A to help "buy" growth.

In our research, we have sought to gauge the vulnerability of these categories to rating downgrades in the event of a cyclical downturn. The key differentiators relate to leverage levels, industry dynamics and the flexibility (or lack thereof) that sectors may have in dealing with economic adversity.

As noted, the growth of the BBB sector has been driven in part by sectors that have historically been regarded as more defensive with predictable earnings profiles. In some of these sectors, we are less worried because we expect free-cash-flow generation to be supportive of near-term debt reduction goals and note the availability of levers that can be pulled to preserve credit quality. Our views are summarized below.



Consumer/Food and Beverage

- High starting levels of leverage due to debt-financed M&A.
- Business risk has increased given changing consumer habits and retail dynamics, with limited pricing power and few levers to pull to preserve margins and cash flows.

Health Care/Pharma, Cable/Media, Technology, Telecom

- Key risks to Health Care/Pharma in a downturn typically stem from the impact of government budget constraints on pricing and the impact of higher unemployment rates on utilization. These factors may reduce margins and cash flows enough to disrupt the deleveraging cycles of credits that have levered up to finance M&A deals.
- Key risks to Telecom and Cable/Media include elevated M&A-related leverage as changing consumer habits are leading to a consolidation phase. While leverage is high and industry changes are prevalent, companies do have flexibility in the event of a downturn to enhance free-cash-flow generation.

Midstream & Electric

- The regulated nature of the electric utility industry along with midstream energy companies' focus on strengthening credit quality after the energy downturn should mitigate rating degradation in an economic downturn.

Conclusion

The purpose of our research was not to somehow discredit the idea that the use of leverage has increased, and indeed we believe that debt has reached unhealthy levels for some companies. However, we think it would be a mistake to panic and indiscriminately sell BBB risk. Financial BBBs simply do not meet the definition of troubled credits, and in our view are currently attractive from a fundamental perspective. Moreover, within the Industrials segments, there is considerable variety with regard to business model and issuer flexibility. Some companies may be vulnerable to downgrades late in the cycle, even in traditionally defensive sectors. Specifically, Health Care/Pharma, Cable/Media and Consumer/Food and Beverage sectors have traditionally been valued for their stable free cash flows late in the cycle, but some issuers in these sectors now carry more aggressive debt levels. In contrast, other sectors like Utilities should be able to perform "as advertised." As always, the ability to make such distinctions is a function of fundamental credit research at the sector, industry and issuer levels.

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