Will Fallen Angels Drive the Market? A Look into BBB Bonds

Disruptive Forces in Investing

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Anu Rajakumar: In 2019, there were no shortage of headlines about the size and possible fragility of the triple-B corporate credit market, which stands one notch above high-yield or junk status. With about half of the investment-grade credit market categorized as triple-B, the uneasiness stems from the concern that a slew of downgrades could trigger mass selling pressure by investors with strict higher-quality requirements in their bond portfolios. After relatively benign fallen-angel activity over the past few years, in the first eight weeks of 2020, we've seen six major companies lose their investment-grade status. But my guest today, David Brown, Neuberger Berman's co-head of investment-grade fixed income, expects to see modest growth in the triple-B category this year. I'm your host, Anu Rajakumar; and Dave, thank you for joining me today.

David Brown: Thanks so much for having me.

Anu: So let's start with the macro picture here. Talk us through what exactly has contributed to the triple-B market growing so rapidly over the last few years.

David: Sure, thanks. So after the financial crisis in 2008, central banks around the world, particularly the Federal Reserve Bank, introduced accommodative monetary policy; and that resulted, generically, in lower interest rates around the world. And corporate America responded to those lower interest rates through various ways to employ financial engineering, actually to improve their earnings trajectory. Examples include large share buybacks, but in particular a lot of large M&A acquisitions that were debt financed over the period – call it 2012 to 2015 in particular. So many of those acquisitions were single-A companies that moved into the triple-B category with very large debt loads. So that was a big part of the thrust of a larger triple-B sector. Now, the other interesting thing around that time is many of the sectors and companies that decided to take on those types of acquisitions were of a different cohort than we had seen previously in triple-B. It was much more healthcare driven, cable and media, telecom, much more defensive cash flows. But nonetheless, these companies used a much higher level of financial leverage in order to execute their deals; and they therefore ended up as triple-Bs. There were other more idiosyncratic reasons; in particular the midstream sector grew to be a much larger part of the triple-B sector that was, essentially, as North American Shale production was looking to move their oil around North America, needed pipeline. So a lot of those companies grew at a rapid pace. But ultimately that really was what resulted in the triple-B sector becoming much larger, number one. But number two, which I don't think gets as much focus, it did have a different character in the types of companies that were composing it.

Anu: And so, now with that in mind, why is it that we've seen some of these larger companies in particular, like Macy's and Kraft Heinz, lose their investment-grade status recently? Is it based on idiosyncratics or their commonalities for these fallen angels?

David: As with most questions like that, it's a little bit of both.

Anu: Right.

David: Those companies are both in kind of consumer-driven sectors that have seen a combination of higher leverage. We saw that particularly through Kraft Heinz with their merger; well, with Kraft buying Heinz. But you also are seeing changing behavior of consumers, right; so the department-store sector, as an example, has, for well over a decade, been struggling with its competition from online retailer and retailers, and just really changing consumer behavior important. So Macy's in particular probably had difficulty just more focused on that changed behavior. And retailers in general have been having that difficulty, particularly in the department-store sector. Kraft Heinz, though, was a little bit different; certainly had a lot of the same secular pressures of changing consumer behavior around processed foods in particular. That became a little more prevalent over the last three to five years. But they also did have the ability, if they had chosen to do certain things to their capital structure, to stay investment grade. And for various reasons, not the least of which is probably their unique ownership structure of having a couple large shareholders participating in their equity, they decided that the costs to stay investment grade were simply larger than what they'd wanted to do. But nonetheless, it was the same secular pressures that some of these consumer-driven companies that put them to have to make that decision. So again, as with any of these credit stories where you get a downgrade, there's always some idiosyncratic issue. But, the commonality was changing consumer behavior.

Anu: Sure. And now for, for these companies in particular, or just companies in general who are being downgraded, what are the opportunity costs that companies are willing to incur by shifting down below investment grade?

David: Yeah, and I think that's really the most important question that we face going forward, as we've had an example of a company that while given the opportunity to stay investment grade decided that the cost was too much. And there are really multiple different costs. There's been a lot of focus on financing issues and costs to going below investment grade. Ultimately, though, there are multiple issues that a company has to think about. One would be decreased financial flexibility by going below investment grade, and that's important; in particular, as you get concerns around lower growth or perhaps a recessionary environment. Frankly, the environment we've seen over the last few days around Coronavirus demonstrates, as you get volatility in capital markets, there is some value to being higher rated, having full access to capital markets, having full access to a very cheap financing at banks. Another thing that companies forego to some extent, if they choose to go below investment grade, is the ability to really do large debt-financed acquisitions; particularly as you enter a low-growth environment. There is a certain level of attractiveness to combining large companies and taking out costs through mergers. If you go below investment grade, your capacity to do that is much more limited. And then, really financing cost is important. Now, the financing costs today are modest, the financing-cost changes. So, that is something right now that would tend to make one believe that, perhaps, moving below investment grade is not terribly costly. But we think that, overall, that the value of having capacity to do acquisitions, as well as the ability to have financial flexibility really in all markets, is important. And finally, if – what's really important is when a company moved below investment grade, it then takes a number of years to make their way back up. So while today financing costs are very modest, 18 months from now, as an example, perhaps when more refinancing is needing to be done, we have no real understanding of what that cost difference would be. So you can't just decide when it's convenient for you to make yourself investment grade again. So that's the other thing: you're really giving up that optionality by moving below investment grade.

Anu: And so maybe on that note, there's been a lot of focus on the fallen angels; but as I mentioned in the opening, your view is for modest growth in the triple-B category this year. So what's the rationale for that view?

David: Well, it, it's our view that the, the fallen-angel story is still going to remind modest this year. If you look at the largest issuers in the triple-B sector right now, certain companies – even a company like AT&T – is very focused on their deleveraging program and that is an example of many of the larger capital structures who are different from Kraft and Macy's, because they are definitely executing on their deleveraging program. There's kind of an alliance between equity holders and shareholders where both constituents think that is the right strategy. And there is deleveraging going on. So we think that those companies will maintain their triple-B status across the course of the year. M&A-financed acquisitions should be modest, but there could be, certainly, some to add into the triple-B market. And, you know, ultimately, as a few companies get downgraded, but after Kraft, most of the other downgrades have been very small in size. So we don't expect there to be a large fallen-angel problem this year, unless there's a change in growth, in the economy. And that's also not our view.

Anu: Now, you've mentioned mergers and acquisitions as being a key driver of some of the recent movements into the triple-B category. How would you categorize the current M&A environment?

David: The current M&A environment is much lower than it had been, call it from, again, 2012 to 2015. And there were a couple reasons for that. The, the first and probably the most important reason is, right now, today, we stand with a lot of uncertainty in the market; in particular with the political realities that are facing America right now, and that's the upcoming election. The results of that election are going to result in very different policy decisions, including tax policy and regulatory policy in particular; and it's very difficult for companies to make large acquisitions when those two issues in particular are, are somewhat unknown. A second, and also very important, reason is that a lot of these leverage – deals have already occurred. We're really dealing right now with a lot of the triple-B companies in deleveraging mode. They're reducing debt, and they're not in the position right now to make a large acquisition. There certainly could be more single-A companies that choose to execute large deals. There are not as many as they used to. A lot of that has already moved into triple-B. And importantly that other issue around uncertainty; not only around the political environment in the U.S., but also a growth environment, which is much more modest; we think results in 2020 being a reasonably low year of M&A activity. Where there is M&A activity, we've seen seeing much more of it being equity financed, so with equity multiples being generally higher than they had been four or five years ago. Doing debt-financed acquisitions are becoming less attractive. So we are seeing an increasing amount of equity-financed acquisitions as well. So therefore M&A done through debt financing, we think, should be modest in 2020.

Anu: Now, Dave, you've had a 25-plus-year career of investing. I'm sure you've seen several companies fall to high yield and, in some cases, return to investment grade over time. Given the construct of triple-Bs today versus other times in history, what's different now?

David: Well, a big part of the difference is, as we've discussed earlier, is the – kind of the sectors that are composing of the triple-B sector. So having healthcare, cable media, telecom, electric utilities, be – as well as midstream - really be the sectors that dominate the triple-B portion of the market is very different from when I started my career, and the triple-B was basically auto companies, energy companies, paper and forest-product companies, metals and mining companies, and other deep cyclicals. So the difference is, if there was an economic cycle change – and there will be at some point – where we have negative growth here in the U.S., or global growth is really challenged; historically the cash flows of the, of the older-style triple-Bs, the more cyclical triple-Bs, cash flows decline very quickly; and the agencies also responded very quickly with very quick downgrades. As an example, in 2005, Ford and GM, on the same day, downgraded to below investment grade. We are expecting that the new construct of triple-Bs will allow for a much more elongated downgrade cycle. Companies are going to have the opportunity to sell assets, to cut

dividends, or reduce dividends; to basically pull levers to maintain their investment-grade status, if they so choose. They'll be given more time to do so because their cash flows are not changing as quickly. And so, in general, our view is that, while there of course will be downgrades as there always are as cycles change, it will not be as dramatic or as sudden as when you saw deep cyclicals. Even in a non-recessionary environment in early 2016, you had a rash of energy companies, all at the same time, being downgraded to below investment grade. That type of behavior is something that we think will be changed and actually healthy for the market by not seeing that.

Anu: And Dave, as we think about disruptions in the investment-grade fixed-income market, the one on everyone's mind right now is, of course, the Coronavirus. Could you share some thoughts about the potential impact and any comments on outlook that you're currently sharing with clients at the moment?

David: Absolutely. It's clearly difficult, because it's one of these that there's so many unknowables. We've obviously transitioned from what we had felt might be a China demand and supply-chain issue; something constrained, though, to China; to something that now we're concerned about global growth. And so part of the question will just be, how long does this crisis persist and how much does it spread. To some extent that is still unknowable, but our view is still that, over the next few weeks to months while there is some disruptions, essentially you'll get much of a rebound in the second half of the year in terms of growth. So what we're kind of consulting clients, and thinking about ourselves a lot, are, where are those sectors that are not directly impacted by Coronavirus today, and less likely in the future as well; and if those sectors have cheapened up as much as, perhaps, say, a chemical sector or the auto sector, there could be an opportunity. We don't think that now is a great time to just jump in and add a bunch of credit risk. Spreads haven't widened that much yet. Don't forget, we were starting at very tight levels to begin with. So in general we're not interested in adding, kind of, a bunch of beta or a bunch of credit risk overall. If there was a cable company, as an example, that was providing as much spread widening as, say, an auto company or one of these more cyclical companies that has exposure towards global trade and global supply chains; that's interesting to us. So those are the types of trades and risk movements we're making in our portfolios right now. We still think it's a little early to be putting on big-risk trades overall.

Anu: And as we wrap up here, Dave, what are a couple of the key highlights that you really want investors to take away with this conversation about the triple-B market?

David: Yeah. So, I think it's really important that investors recognize that the triple-B market is not homogeneous. There are multiple different sectors that are going on through the triple-B market. In the past that was a much more cyclically driven market, now much more defensive economic – cash flows are really what dominates the triple-B market. So what does that mean for investors? It means, as the cycle changes in the U.S. economy, when it changes, you're likely to get kind of their natural-reaction function of triple-Bs selling off dramatically. Right now, more than ever, we think it's important to really allow research and discrimination between those credits to dominate your thinking. As opposed to, in the past, kind of selling cyclical triple-Bs was a much more natural reaction function, and frankly worked, we now think, in the next cycle, you're going to get much more different outcomes. You're going to get some sectors doing much better throughout a cycle than your cyclical sectors. So really thoughtful investment is much more important, we think, in triple-Bs than it had been in the past.

Anu: Well, that's a very helpful update on the investment-grade credit market. So thank you very much for being here, Dave, to go over all of that.

David: Thanks very much.

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