European BBBs – Cause for Concern?

Viewpoint

July 2019

Against a backdrop of increasing global uncertainty, many are concerned about an economic scenario that puts widespread pressure on credit ratings. These concerns are heightened around the BBB rated part of the market, with commentators noting that these credits could be at risk of falling into the much smaller high yield market.

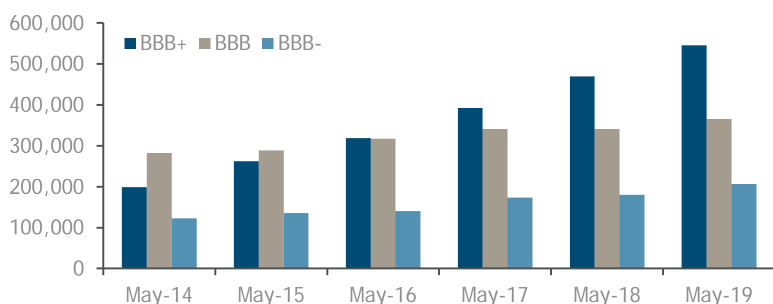
The BBB rated market has seen significant growth in recent years (Fig.1). This, coupled with concerns that credit metrics may be deteriorating, has fuelled fears that an 'overhang' has formed, which the high yield market may not be able to accommodate should rating downgrades materialise.

What Then Gives Us Comfort to Continue to Invest in This Part of the Market?

The European BBB market has indeed grown significantly in recent years and currently represents almost 50% of the European investment grade market.[1] It is now also more than five times the size of the European BB-rated market, up from approximately three and a half times the size in May 2014.[2]

Looking at the sources of this growth, we note that it has not been uniform within this sub-segment of the investment grade market. Fig. 1 shows the breakdown of the BBB market by value outstanding across BBB+, BBB and BBB-rated credits (using Bloomberg composite ratings).

Fig.1 - Outstanding EUR BBB Rated Volumes



Source: ICE BofA Merrill Lynch ER40 Index, Bloomberg composite ratings, 31st May 2014 to 2019.

[1] ICE BofA Merrill Lynch ER00 and ER40 indices, as at 31st May 2019.
[2] ICE BofA Merrill Lynch ER40 and HE10 indices, as at 31st May 2014 and 31st May 2019.

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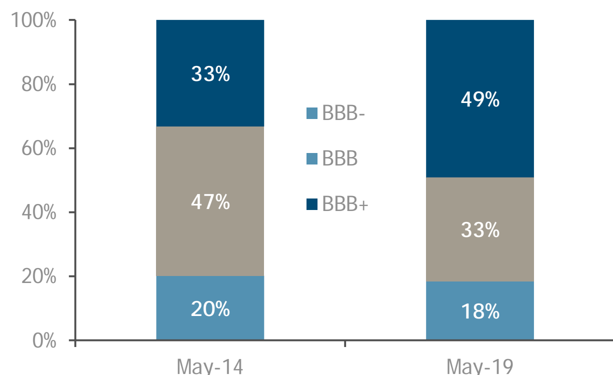
Significantly more growth has been seen in higher rated issues than in lower rated ones. This has resulted in the BBB market in 2019 being far more exposed to BBB+ rated issues than it has been in the past (Fig.2).

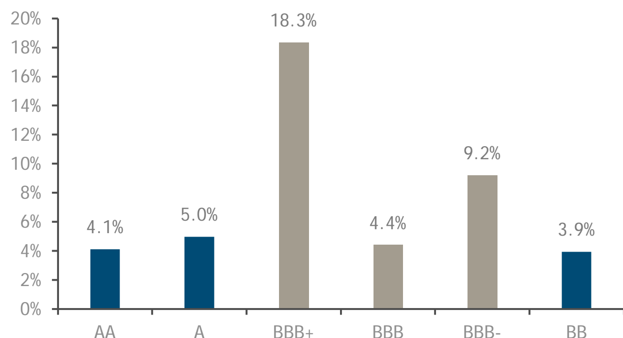
Fig.2 - Breakdown of EUR BBB Rated Market



Source: ICE BofA Merrill Lynch ER40 Index, Bloomberg composite ratings, as at 31st May 2014 and 31st May 2019.

Looking at annualised growth rates over the last five years (Fig. 3), we see that the BBB market has grown at more than twice the rate of the AA, A and BB markets over this period. This growth has been heavily skewed to BBB+ rated issues and to a lesser extent BBB-, whilst mid-BBB volumes have grown in line with broader credit markets.

Fig.3 - Annualised Growth Rates of EUR Markets by Credit Rating



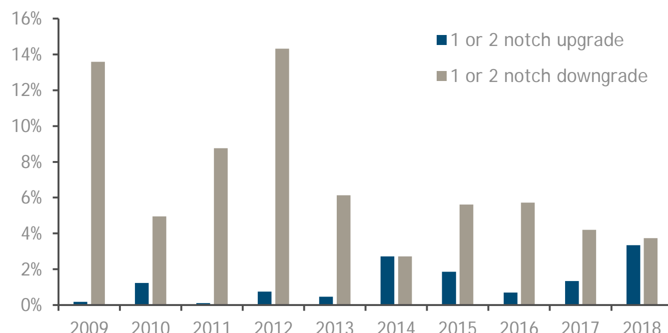
Source: ICE BofA Merrill Lynch ER20 (AA), ER30 (A), ER40 (BBB), and HE10 (BB) indices, 31st May 2014 to 31st May 2019.

This suggests that perhaps there are two themes to consider - one that is driving growth in the higher quality BBB+ segment and a second that is fuelling the BBB- growth.

Ratings Drift of Single-A Rated Issues Entering the Upper End of the BBB Market

According to Moody's data, rating downgrades over the last 10 years in the single-A market have been consistently higher than rating upgrades. Fig. 4 shows the proportion of the single-A rated universe that has seen a 1 or 2 notch rating change in each calendar year since the start of 2009. Over this period, downgrades have averaged 7.0% of the universe on an annual basis, while upgrades have averaged just 1.3%.

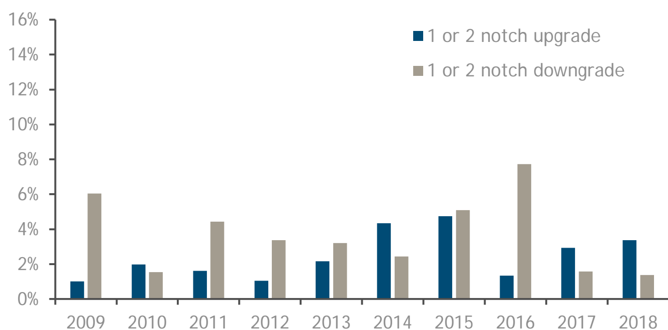
Fig. 4 - Rating Upgrades and Downgrades by Calendar Year in Single-A Rated Issuers (Moody's)



Source: Moody's Annual Default Study 2018, published 1st February 2019.

It is important to note that we have not seen the same trend in the BBB rating category (Fig. 5) - here, 1 or 2 notch upgrades on an annual basis have averaged 2.5% of the Moody's universe per year, while downgrades have averaged 3.7%.

Fig. 5 - Rating Upgrades and Downgrades by Calendar Year in BBB Rated Issuers (Moody's)



Source: Moody's Annual Default Study 2018, published 1st February 2019.

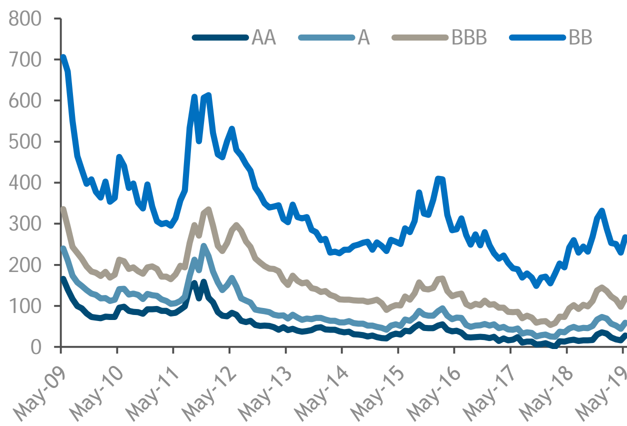
This lack of migration in either direction in the BBB universe - but clear migration down from single-A - suggests to us a gravitation to the BBB space by investment grade rated companies.

So, Companies Want to Be Rated BBB?

To understand this phenomenon, we need to understand the potential benefits to companies of achieving certain credit ratings.

Companies typically try to maintain or improve their credit ratings for several reasons, but primarily to benefit from the lower cost of funding and greater access to capital markets offered to higher rated companies. Fig.6 shows how the credit spreads fall as credit quality increases.

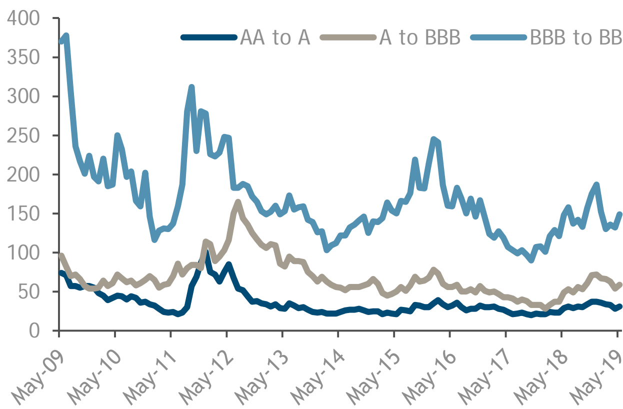
Fig. 6 - Historic Asset Swap Spreads by Rating (bps)



Source: ICE BofA Merrill Lynch ER20 (AA), ER30 (A), ER40 (BBB), and HE10 (BB) indices, 31st May 2009 to 31st May 2019.

Fig. 7 shows that not only have absolute spreads fallen in recent years, but the incremental spread differentials between ratings have also fallen. In mid-2012, the average difference in spread between A and BBB-rated issues was as high as 165bps. In 2018 this averaged approximately 50bps. Funding costs have fallen markedly on both an absolute and relative basis.

Fig. 7 - Historic Spread Differentials by Rating (bps)



Source: ICE BofA Merrill Lynch ER20 (AA), ER30 (A), ER40 (BBB), and HE10 (BB) indices, 31st May 2009 to 31st May 2019.

Thus, we can see that from a funding cost perspective the potential benefits of being rated single-A versus BBB seem to have significantly diminished. The spread differential between BBB and BB however remains heightened at approximately 150bps. The 'sweet-spot' therefore appears to be BBB.

Secondly, companies may want to maintain their credit rating to ensure future access to capital markets. For many issuers, moving from an A to BBB rating is not a concern given that investors and indices typically only differentiate between investment grade and high yield ratings.

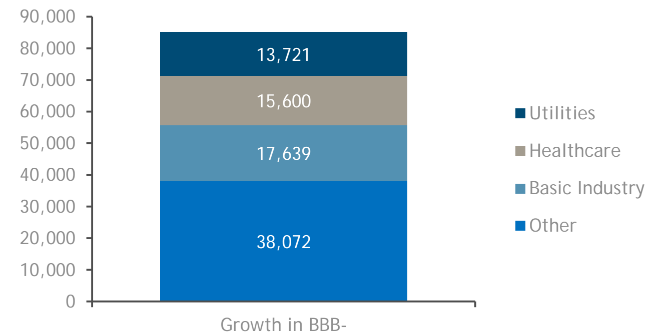
Thirdly, companies may wish to maintain a rating to ensure their business terms with customers or suppliers do not change. Businesses often monitor their counterparty risk to an issuer through their credit ratings. This - once again - is typically not an issue when moving within the investment grade rating spectrum.

In summary, we believe that the current market environment and the discontinuity of incentives across the rating spectrum has resulted in a conscious gravitation of issuers to the BBB rated market.

A Rise in 'BBB-' Rated Issues - Deteriorating Metrics and Downgrades, or Something More Subtle?

The BBB- market has grown from €122.2bn in May 2014 to €207.3bn in May 2019 - growth of approximately €85bn and a 9% annualised growth rate.[3] By looking at the breakdown of the BBB- issues, we can see several significant contributors to this growth. Three industries account for 55% of the increase in outstanding issuance and these are utilities, healthcare and basic industry (Fig. 8).

Fig. 8 - Growth in Outstanding BBB- Issues Between May 2014 and May 2019 (EURm)



Source: ICE BofA Merrill Lynch ER40 index, Bloomberg composite ratings and industries, as at 31st May 2014 and 31st May 2019.

1. European Utilities

Currently, we find that European utilities predominantly have single A or strong BBB senior ratings. We have observed that the utilities sector has been a leader in the issuance of hybrids over the last few years. These are typically rated 2-3 notches below the senior rating. As a result, much of this hybrid issuance has been seen in the BBB- bucket. At the end of May 2019, 55% of BBB- utilities issuance was subordinated.[4]

2. Healthcare

At the end of May 2019, US companies represented 55% of the EUR BBB- rated healthcare universe, with this sector being active in the reverse yankee market (US companies issuing in EUR).[5]

These issuers are large US-based pharmaceutical businesses that have engaged in material M&A transactions with an apparent willingness to allow their credit rating to fall, whilst remaining investment grade.

3. Basic Industry

Lastly, in the basic industry sector, several major rising stars over the last few years have significantly contributed to the increase in issuance here.

So, whilst the BBB space has grown significantly we see that there are two important narratives here - (i) historic single-A rated issuers migrating down into the high BBB space due to the diminishing incentives of a single A rating; and (ii) sector specific trends and rising stars driving growth in the BBB- space. In our opinion these trends are not cause for concern and we note that the overall quality of the market has improved as shown by the ratings breakdown in Fig. 2.

[3] ICE BofA Merrill Lynch ER40 Index, Bloomberg composite ratings and industries, as at 31st May 2014 and 31st May 2019.
[4,5] ICE BofA Merrill Lynch ER40 Index, Bloomberg composite ratings and industries, as at 31st May 2019.

Is Leverage Rising in BBB Rated Issuers?

Another trend that is being flagged with increasing frequency is the rising leverage in the BBB space.[6] Anecdotally we believe that much of this has come from three sectoral trends.

1. Real Estate - A Relatively New Sector

A sector that represented just 2% of the BBB market in 2014 has grown to 6% in 2019.[7] Companies in this sector are typically portfolios of rental properties, across residential and commercial assets. Given the asset intensity of these businesses, they are typically assessed using a loan-to-value (LTV) measure rather than traditional net leverage (net-debt/EBITDA).

As a result, companies in this sector tend to display a higher leverage (in the traditional sense) than would usually be acceptable for a BBB rating, thus skewing the market average higher.

2. Reverse Yankees - Using the EUR Market to Fund Levered M&A

In recent years, various sizeable EUR denominated bonds have been issued by major US firms to fund M&A, particularly in the healthcare sector as discussed above. Rating agencies are typically tolerant of a higher leverage figure than might usually be acceptable if the company has a clear commitment and ability to de-lever through cash generation.

The leverage of these companies has risen significantly above the levels guided by rating agencies for the BBB rating, but due to the scale, product diversification and cash generation of these issuers, many are able to retain an investment grade rating.[8]

3. Utilities - BBB Hybrid Issuance

We note that European utilities have been active in issuing hybrid securities. In particular, we have seen issuance from utilities with leverage commensurate with a high proportion of regulated earnings. These issuers typically have leverage significantly higher than other BBB rated companies.

Once again, this issuance tends to increase the average issuer leverage, but not due to deteriorating fundamentals.

These three themes at least partly explain why leverage in the BBB market may have optically crept up in recent years. Nonetheless, we do accept that leverage has likely risen on a broader basis given that companies have been able to borrow at historically low rates. However, for these reasons we believe the deterioration is less severe than the data might initially suggest.

Our Conclusion

In conclusion, we remain comfortable investing in European BBB rated issuers, but note that credit research is arguably more important than ever.

We believe that the BBB market needs to be approached with increased caution rather than fear, given that so much of the growth has been in the higher rated part of the market or can be explained by various changes to the market structure.

For lower rated names, it is important to understand the nature of the leverage and issuance. We are less concerned by rising stars that have proven their ability to deleverage; highly cash generative companies that have raised leverage to achieve acquisitions; and companies for whom leverage is not necessarily the most appropriate measure of risk.

However, there are issuers with less control over their financial profile that may have borrowed in a manner inconsistent with their cash generation and business cyclicality – we believe these must be treated with particular caution.

We continue to believe that credit research should form a core part of investing in BBB rated issuers. We also believe that the recent growth and increased diversification of issues brings opportunities that can be identified through fundamental credit analysis.

[6] Various news articles including those published in the Financial Times on 24th May 2019 - *BoE staff highlight corporate bond market dangers*; on 8th January 2019 - *Triple-B movie: 'Big Short' star fears for debt-laden companies*; and on 13th November 2018 - *Triple B corporate bond bulls aren't blinking.*
[7] ICE BofAML ER40 index, Bloomberg composite ratings and industries, as at 31st May 2014 and 31st May 2019.
[8] Moody's rating methodologies – *Medical Product Device Industry* (published June 2017); and *Pharmaceutical Industry* (published June 2017).

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Index Descriptions

ER00 - The ICE BofAML Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch) and at least 18 months to final maturity at the time of issuance. In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

ER20 – The ICE BofAML AA Euro Corporate Index is a subset of ICE BofAML Euro Corporate Index including all securities rated AA1 through AA3, inclusive.

ER30 - The ICE BofAML Single-A Euro Corporate Index is a subset of ICE BofAML Euro Corporate Index including all securities rated A1 through A3, inclusive.

ER40 – The ICE BofAML BBB Euro Corporate Index is a subset of ICE BofAML Euro Corporate Index including all securities rated BBB1 through BBB3, inclusive.

HE00 - The ICE BofAML Euro High Yield Index tracks the performance of EUR dominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

HE10 – The ICE BofAML BB Euro High Yield Index is a subset of ICE BofAML Euro High Yield Index including all securities rated BB1 through BB3, inclusive.

You cannot invest directly in an index, which also does not take into account trading commissions or costs. The volatility of indices may be materially different from the volatility performance of a fund. Historic market trends are not reliable indicators of actual future market behavior.