BBB downgrade risk: Less than meets the eye?

Worries over declining credit quality may be overblown
In recent months, much attention has been focused on the perceived risks posed by the rapid growth in BBB-rated corporate debt. This bottom rung of the U.S. investment-grade (IG) ladder represents more than 50 percent of the IG universe. In dollar terms, at more than $2.3 trillion, BBB debt is now nearly triple its level in 2011.

Some market watchers worry that an economic downturn could trigger widespread downgrades of BBB credits into high yield (below BBB—at S&P or Fitch/Baa3 at Moody’s), which could result in substantial losses in value for existing bonds and lead to corporate distress as their borrowing costs rise significantly. There’s also concern that a wave of downgrades could be large enough to swamp the high-yield segment with new supply, which could hurt prices for existing bonds.

But in an investment-grade debt market worth nearly $4 trillion, broad-brush generalities can gloss over important generalities. A deeper understanding of the BBB segment requires an expertise in fundamental credit ratios, which are the material drivers of credit ratings. These ratios include leverage, interest coverage and EBITDA growth.

Sources: JP Morgan Chase, USAA Investments, A Victory Capital Investment Franchise.

1 EBITDA: Earnings before interest, taxes, depreciation and amortization. EBITDA is a commonly used alternative to net income when measuring financial performance.
In recent years, BBB leverage has largely remained stable, which is ratings-neutral, while improving interest coverage and EBITDA growth are positive.

Closer scrutiny of trends during the current cycle reveals that about a third of the BBB increase came from downgrades of higher-rated companies. Such downgrades can be due to the assumption of additional debt (often as a result of an acquisition) or the sale of a portion of the business and the return of capital to shareholders.

About 15% of the BBB increase came from opposite direction—speculative-grade companies being upgraded to IG status. This cohort includes “rising stars”—relatively new issuers that have built a solid credit record. Since 2013, the cumulative value of issuance by rising stars ($296 billion) is roughly equal to that of “fallen angels” ($305 billion)—issuers that have dropped from IG status to high yield.

The remaining 50% or so of new BBB debt was issued by BBB companies—these include a significant number of new issuers taking advantage of low borrowing costs and strong investor demand.

Closer scrutiny of trends during the current cycle reveals that about a third of the BBB increase came from downgrades of higher-rated companies.
BBB trends can vary by sector

Market sector can also matter when analyzing upgrades, downgrades and those BBB issuers holding steady. Fixed income analysts at USAA Investments, A Victory Capital Investment Franchise, have identified sectors that illustrate each of the three categories, and they offer some color on current risks and opportunities.

Technology

The growth of BBB-rated technology bonds is largely from companies whose fundamentals improved as a result of acquisitions or because they issued secured debt, according to analyst Domingo Villarruel. About 40 tech companies issued BBB-rated debt, with Broadcom and Dell accounting for 11% of the issuance. Both were upgraded to BBB in 2016 after transformative acquisitions. Broadcom fits the profile of an A-rated company based on scale, margins and free cash flow, but its elevated leverage and acquisition history have weighed on its ratings. Villarruel says Broadcom’s $33 billion debt load gives management a powerful incentive to remain IG—slipping back into the high-yield ranks would likely raise its borrowing costs and complicate the funding for any future acquisitions.

Food and beverage

Senior analyst Michael Duncan says leveraged transactions by companies in the food and beverage subsector have hurt credit ratings and, in some cases, have led to downgrades. Anheuser Busch-InBev and Altria, for example, have been downgraded to BBB by two of the three major rating agencies, while all three agencies rate British American Tobacco at BBB. Debt-funded acquisitions have also weakened the credit profile of a number of existing BBB names—among them, General Mills and Campbell Soup—but not to the point of pushing them down to high yield. Many of these companies could sell off non-core assets or cut their dividends to alleviate ratings pressure, but for others, flexibility is limited by a tougher competitive landscape and diminishing brand strength. This suggests their resiliency may be reduced in the event of an economic downturn.

Pharmaceuticals

Senior analyst Bobby Jones, who tracks the health care sector, says leverage, as measured by the ratio of net debt to EBITDA, has increased among pharmaceutical makers. But that trend is offset to a large degree by the rising value
of these companies in terms of the ratio of enterprise value to EBITDA. All else equal, high enterprise valuations indicate a greater ability to support leverage and repay debt. Strong cash flows, desire to retain access to lower-cost funding and the option to reduce share repurchases all suggest to Jones that a number of companies—Allergan is a good example—have the means and the motivation to maintain their IG credit ratings. Mylan is another company with ratings at the lowest rung of the IG ratings ladder, but this, too, looks to be an improving situation given the recently announced merger with Pfizer. Combining their off-patent medicine businesses, both branded and generic, would likely lead to a ratings upgrade for the new company, Jones believes.

It’s important to keep in mind that the agency ratings only tell you so much about a company’s credit outlook.

We believe that these ratings should be just the starting point of rigorous fundamental research. For us, that means generating our own independent rating on each bond we hold, as well as continuously monitoring credit quality. This is especially important in lower credit rating tiers where nuances matter and the market might make incorrect assumptions. We maintain that our process provides us with a more detailed view of the risks and potential rewards, and it enables us to be responsive when that risk/reward balance changes.

DEBT RATIO IS UP FOR PHARMA, BUT SO IS SECTOR VALUE
Net debt/EBITDA versus Enterprise value/EBITDA

It’s important to keep in mind that the agency ratings only tell you so much about a company’s credit outlook.
Consider the investment objectives, risks, charges and expenses of the USAA Mutual Funds carefully before investing. To obtain a prospectus or summary prospectus containing this and other information visit www.usaa.com/prospectus. Read it carefully before investing.

All investing involves risk, including potential loss of principal. There is no guarantee that the Fund will achieve its objective.

As of July 1, 2019, Victory Capital Management Inc. is the investment advisor for USAA Mutual Funds.

Investing involves risk, including the possible loss of principal and fluctuation of value. Past performance is no guarantee of future results.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Net debt is a company’s total debt less its cash holdings. The net debt/EBITDA ratio is a commonly used measure of a company’s ability to pay its debts.

Enterprise value (EV) measures a company’s economic value. It includes market capitalization, long-term and short-term debts, and cash holdings. EV/EBITDA is a commonly used ratio to determine a company’s valuation relative to other companies, its sector or the market as a whole.

Victory Capital means Victory Capital Management Inc., the investment manager of the USAA Mutual Funds. USAA Mutual Funds are distributed by Victory Capital Advisers, Inc., a broker dealer registered with FINRA and an affiliate of Victory Capital. Victory Capital and its affiliates are not affiliated with United Services Automobile Association or its affiliates. USAA and the USAA logo are registered trademarks and the USAA Investments logo is a trademark of United Services Automobile Association and are being used by Victory Capital and its affiliates under license.

©2019 Victory Capital Management Inc.
V19.119 // 2Q 2019 USAA BBB Downgrade Risk ART

Do you want to learn more about fixed income products from USAA Investments, A Victory Capital Investment Franchise? Please contact your financial advisor, visit www.vcm.com, or call the sales desk at 800.991.8191.