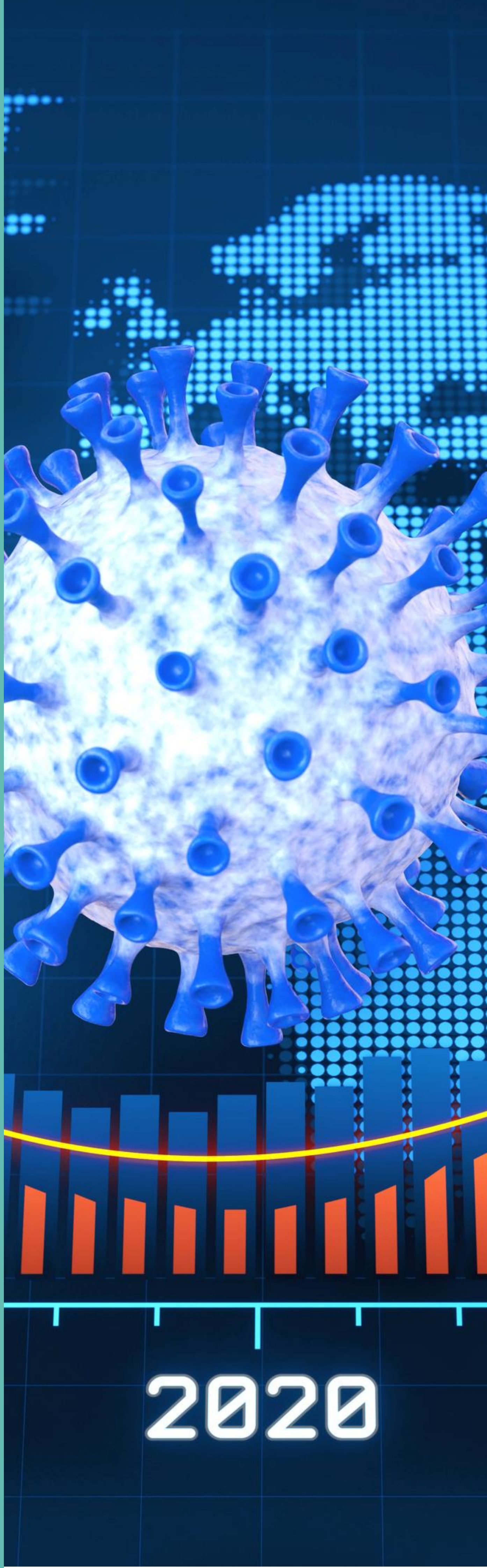
Credit Benchmark

The Covid Year: Review of Credit and Solvency Trends in 2020



January 2021

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Executive Summary

- Global corporate credit risk increased nearly 20% in 2020. Global Financials credit risk increased nearly 10%.
- The global percentage of investment grade corporates dropped from 50% to 46%.
- The proportion in category c has more than doubled.
- North American credit risk rose 24%. Sovereign risk has risen by 5%.
- Fallen Angels: nearly half of the Travel and Leisure sector dropped from investment grade to high yield. The average across all sectors is 14%, compared with 8% for the same period in 2019.
- Rising Stars: nearly 20% of the Aerospace and Defense sector moved from high yield to investment grade, but more than a quarter of the same sector are Fallen Angels – showing how Covid is disrupting traditional business classifications.
- A number of global industries saw credit risk increase by more than 30%. In some global sectors, credit risk increased by as much as 70%. Regional increases have been even higher: US Hotel credit risk rose by a staggering 340%. Airlines globally deteriorated 160%, equivalent to two notches in the 21-category credit scale. UK Aerospace insolvency risk rose 56% and is still deteriorating.
- Global leveraged loan private issuer credit quality deteriorated more than 60%; public issuers by about 40%.

1. Introduction

The 2020 pandemic brought various forms of disruption, hardship and human tragedy. Governments and businesses around the world had to rely on trial and error to find the best response.

Lockdowns helped to prevent medical services being overwhelmed, but at astronomical economic cost. The hunt for a vaccine saw the scientific community at its collaborative best. A collapse in air travel and initial restrictions on road trips temporarily reduced urban pollution and reintroduced many to the sound of birdsong.

Accusations of partisan access to PPE and cronyism in Government contract awards became flashpoints in many countries. Public debates openly focused on the relative value of old versus young lives.

As supply chains collapsed and global GDP began to shrivel, markets entered full-blown panic with equities falling by more than 30% in the first month of the crisis, while credit spreads reached 400 Bps (US IG) and 1000 Bps (US HY) in March. But the subsequent recovery, fuelled by further quantitative easing, propelled some markets to new highs.

Governments have provided unprecedented levels of financial support to the private sector, and taxpayers face a huge public debt burden that will last for a generation. Concern about Government debt and uncontrolled money printing has boosted the gold price and catapulted the Bitcoin price to staggering levels.

There have been some high-profile corporate winners – companies that support home working, online delivery and logistics providers, packaging firms, some pharmaceuticals. But Covid has highlighted economic and social inequalities, and added “health poverty” to the lexicon.

There have also been many losers, with almost entire industries being downgraded to junk. But default rates have been low, due to massive government support programs, and a wave of mergers and acquisitions as larger firms with strong balance sheets swallow their struggling competitors. Good news for investment banks, who along with insurance companies have weathered the crisis well.

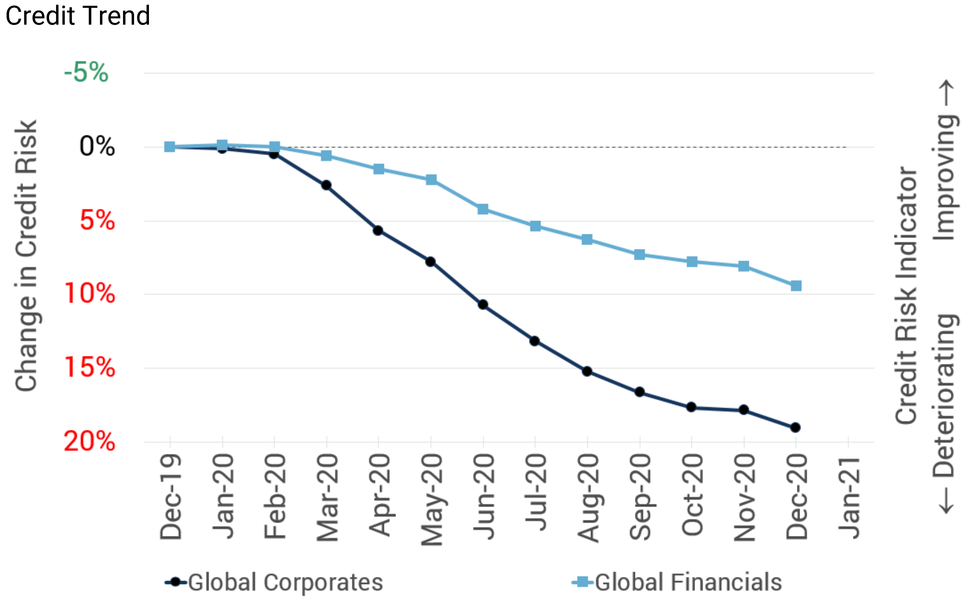
Looking forward, a new president may bring a different approach to handling the pandemic in the US. The UK’s departure from the EU brought the expected disruption on the movement of goods and people, but it has already had some positive impacts – e.g., on vaccine approval speed.

This report shows the key credit and solvency trends that emerged in 2020 and provides some pointers towards what we can expect in 2021.

2. Key Trends: Global Corporates vs Financials

Figure 2.1 shows the change in one-year probability of default ("PD") for Global Corporates (consensus covers 16,270 companies) and Global Financials (consensus covers 7,584 firms)

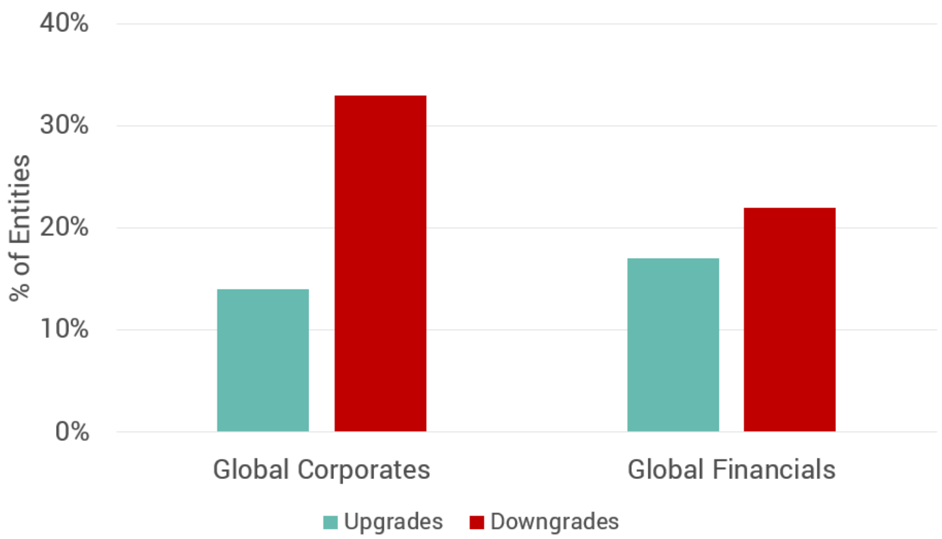
Figure 2.1 PD Trends, Global Corporates and Global Financials



The credit risk of Corporates has increased by 19% over the last year, from 44 Bps to 53 Bps. Financials have been deteriorating as well but at a lower rate, their credit risk increased by 9% to 29 Bps.

Figure 2.2 shows the balance of Upgrades and Downgrades for Global Financials and Corporates.

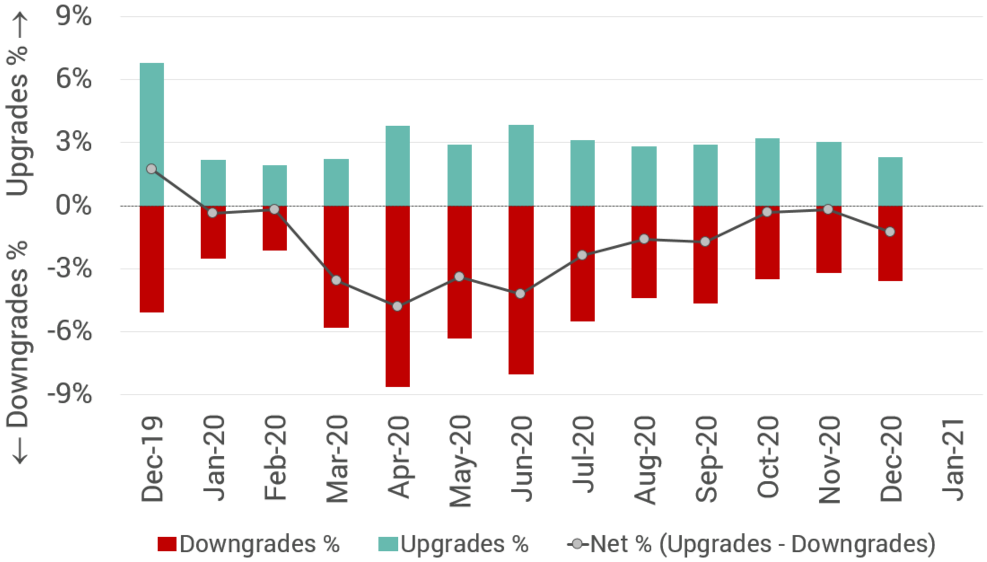
Figure 2.2 Downgrades vs. Upgrades, Global Financials and Corporates



For both groups of issuers, Downgrades outweighed Upgrades. More than 30% of the Global Corporate universe was downgraded by at least one notch; for Financials it is closer to 20%. Financials also saw more upgrades – about 17% - with Corporates at 14%.

Figure 2.3 shows global Corporate upgrades and downgrades, and the net balance, over time.

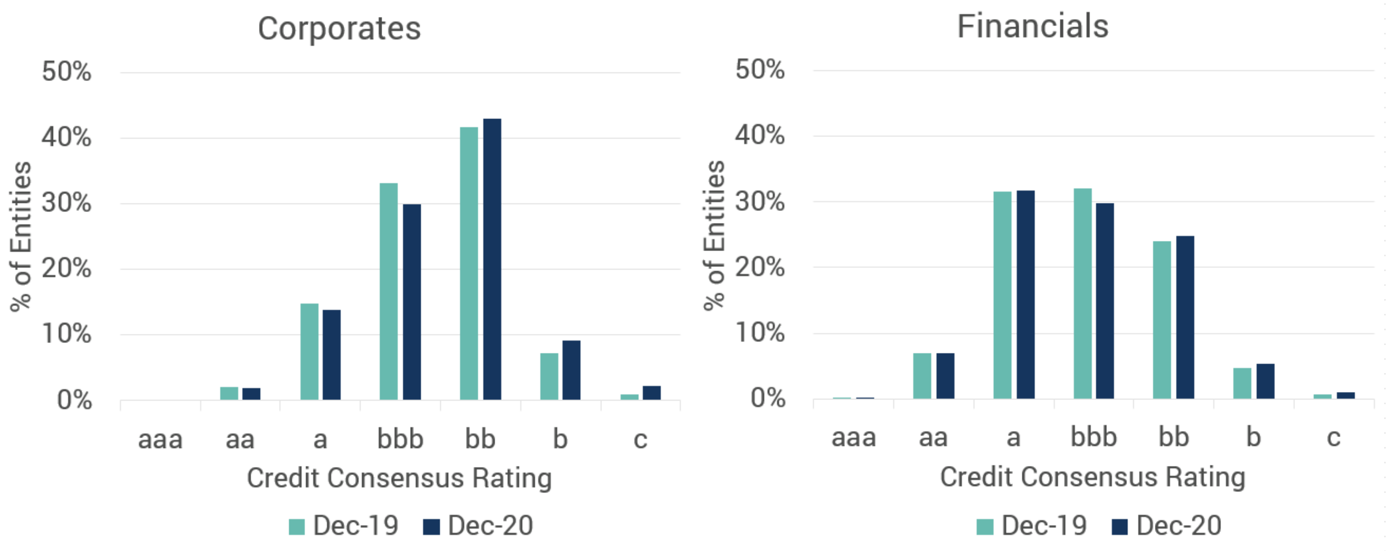
Figure 2.3 Global Corporate Upgrades and Downgrades, Plus Net Balance, % of Universe, 2020



Downgrades were highest in April 2020 (9%, rising from a low of 2% in February 2020) with another smaller peak in June 2020. The net balance was also at its most negative in April 2020, at 5%.

Figure 2.4 shows the impact of upgrades and downgrades on the overall credit distributions for Global Corporates and Financials.

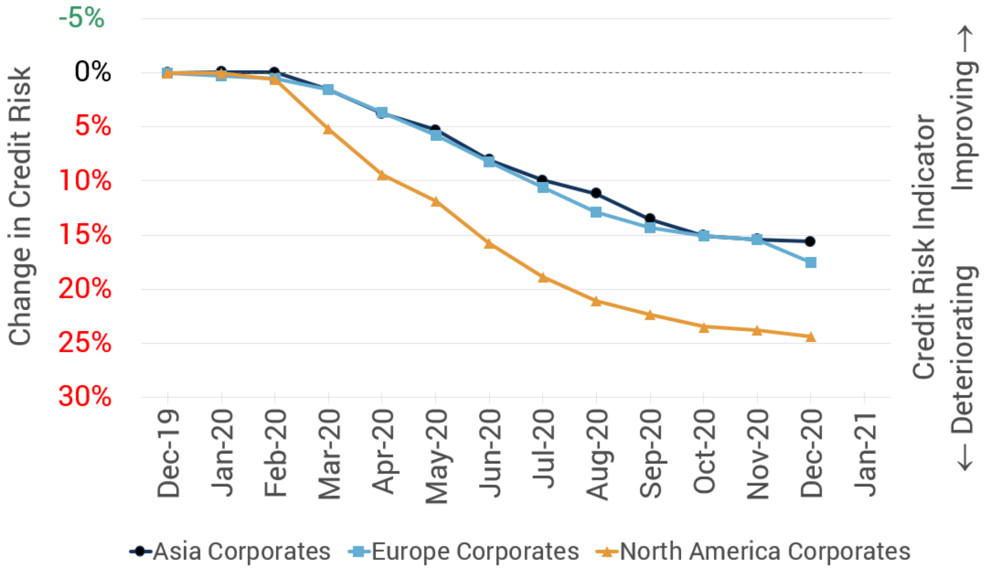
Figure 2.4 Credit Distributions: Global Corporates/Financials, % per Credit Category, 2020 vs. 2019



Global Corporates show a significant shift from investment grade to high yield, the percentage of entities rated as investment grade decreased from 50% in December 2019 to 46% in December 2020. The share of Corporates rated as c more than doubled over the time. Financials show a stable representation in aaa to a categories but the percentage of entities in bbb decreased by two percentage points, moving to high yield categories.

Figure 2.5 plots changes in credit risk for Corporates across North America, Europe and Asia.

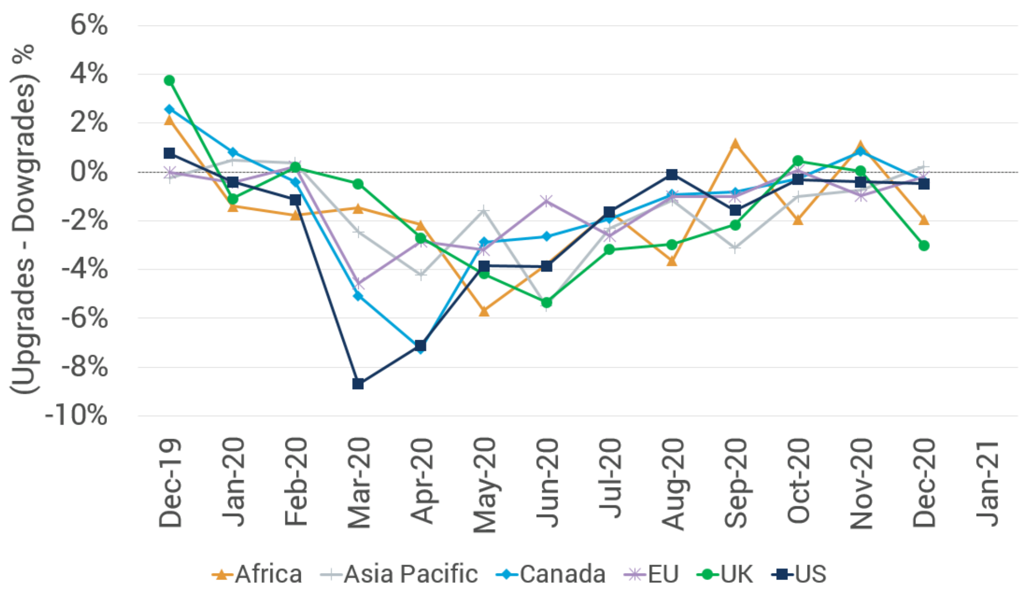
Figure 2.5 PD Trends, Corporates by Region, % Change



North America shows the largest change, with average credit risk increasing by 24% over the past year. Europe is 18% higher and Asia has increased by about 16%.

Figure 2.6 shows the regional corporate net balance between downgrades and upgrades over time.

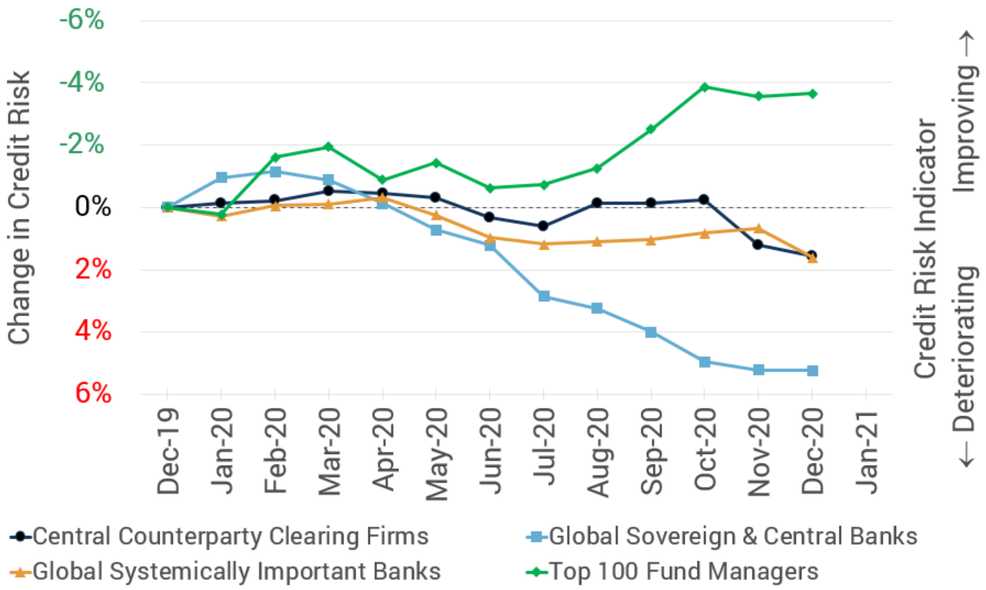
Figure 2.6 Net Balance of Downgrades vs. Upgrades, Corporates By Region, % of Regional Universe



All regions show a bias towards downgrades for most of the COVID crisis months, peaking between March 2020 and June 2020. The lowest peak was the US in March 2020 at close to 9% net balance towards downgrades (Canada was very similar in April 2020). Even though the balance has been recently improving, UK and Africa show recent spikes down with downgrades outweighing upgrades by nearly 3% in December 2020.

Early concerns about the effect of COVID on the health of the financial system have receded as a result of massive Government support for Corporates and employees. But these programs have put an enormous strain on public finances, with many Governments facing debt levels are equivalent to the 1940's. Figure 2.7 shows trends for Sovereigns, GSIBs and CCPs over the past year.

Figure 2.7 PD Trends for Sovereigns, GSIBs, CCPS and Fund Managers 2020

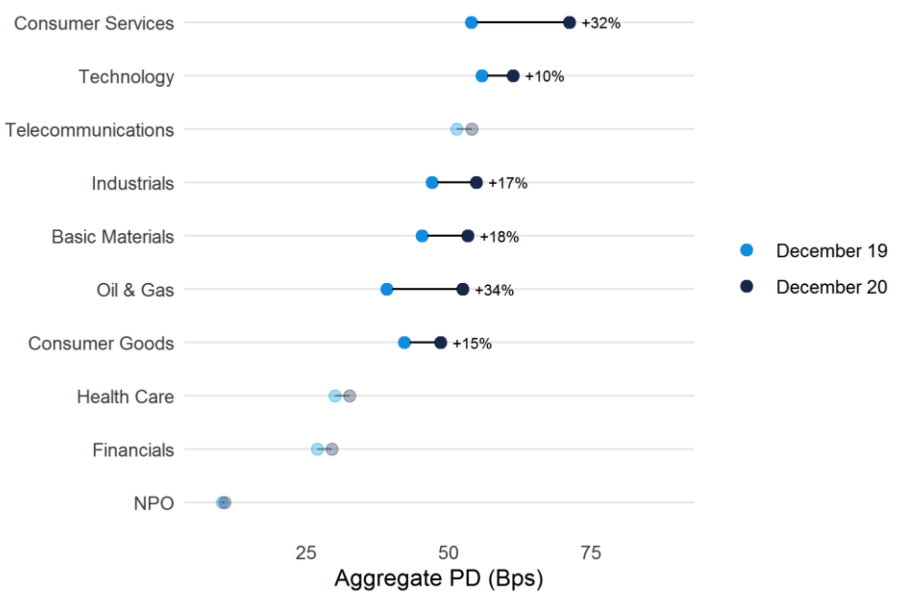


CCPs and GSIBs show no material change, with credit deteriorating by less than 2% from a low base. Sovereigns and Central Banks have seen more of an impact, with risk rising by about 5%. Fund Managers show an improvement of nearly 4%, helped by markets making fresh highs as Central Banks extended their QE programs.

3. Industries

Figure 3.1 shows Credit Risk Levels and Changes by Global Industry.

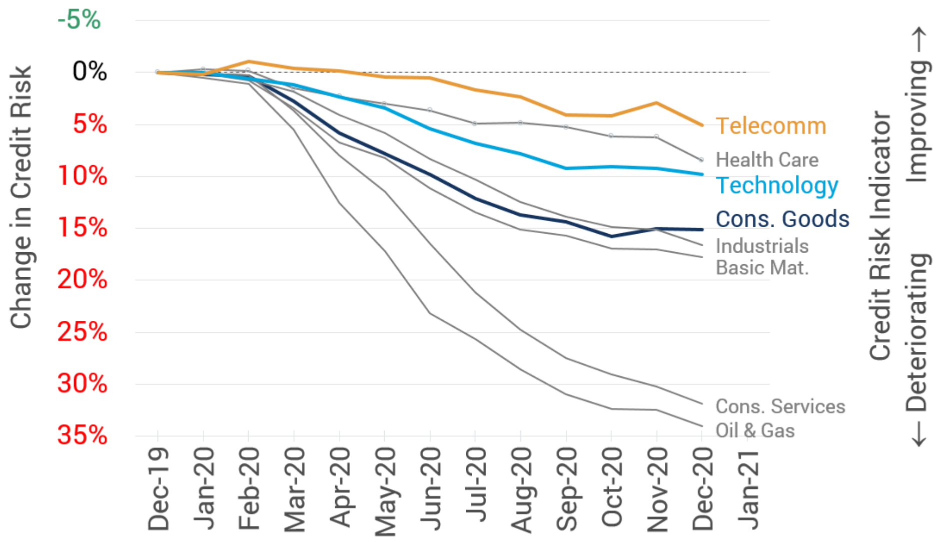
Figure 3.1 Credit Risk Levels and Changes, % by Global Industry, 2020



Oil & Gas and Consumer Services are the most impacted industries with credit risk increasing by more than 30%. Consumer Services are also the industry with currently highest credit risk level of 71 Bps, suggesting that around 1 in 140 companies in the industry is expected to default over the next year, an increase from 1 in 185 companies a year ago.

Figure 3.2 shows the recent Credit Risk Trends for the main global industries

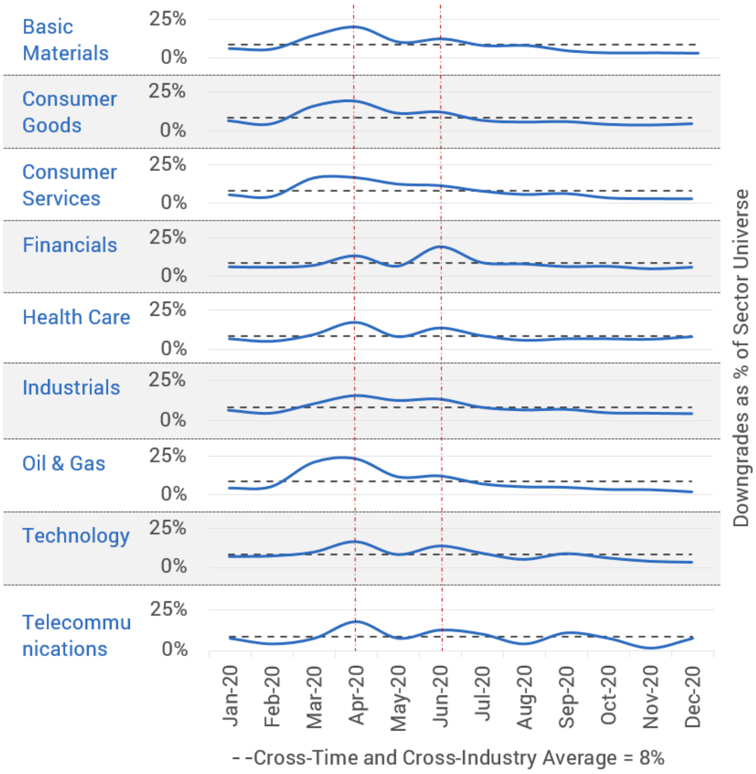
Figure 3.2 Credit Risk Changes,% by Global Industry



Some industries such as Telecommunications, Technology and Consumer Goods have started to improve in Q4 but this trend was halted by the impact of the current third COVID wave.

Figure 3.3 shows the time series of downgrades as a % of each global industry universe.

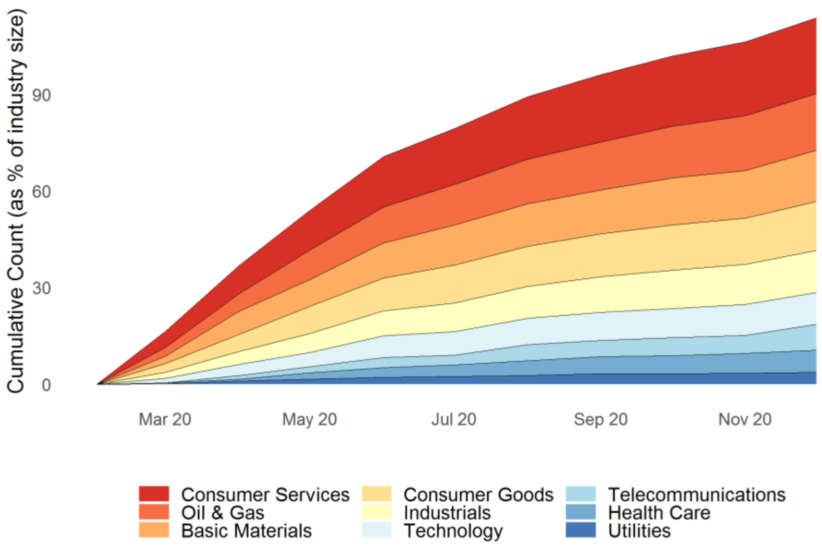
Figure 3.3 Downgrades, % of Global Industry, 2020



Industry-level downgrades peaked in April 2020, with another broad-based spike in June. Basic Materials, Consumer Goods and Consumer Services, as well as Oil & Gas all showed early spikes in March 2020.

Figure 3.4 shows the cumulative increase in Fallen Angels, with each layer showing the cumulative % total of the respective industry universe, by December from a March start date corresponding to the onset of the pandemic.

Figure 3.4 Cumulative Fallen Angels Global Industries, March 2020 to December 2020

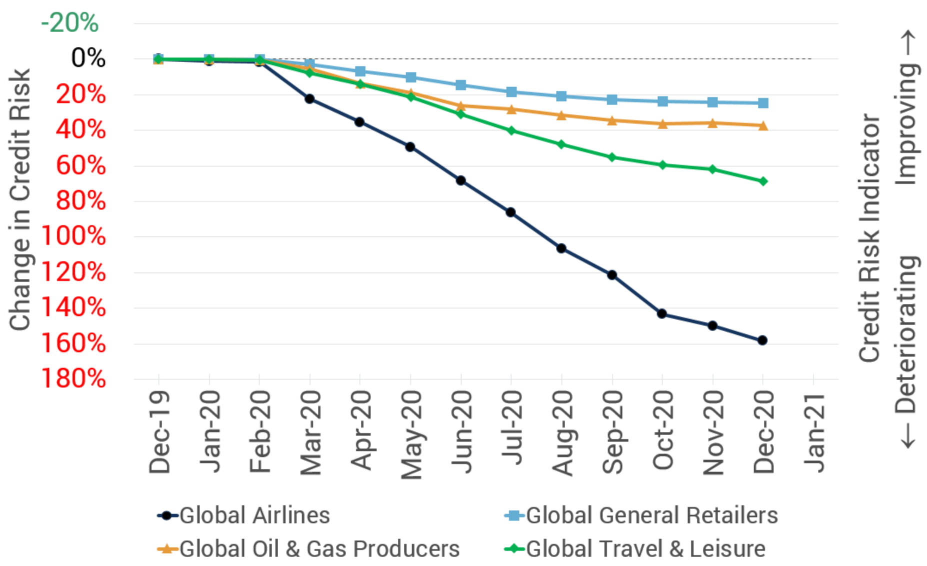


Globally, industries with highest percentage of Fallen Angels are Consumer Services followed by Basic Materials and Oil & Gas. Those with the least are Utilities and Health Care. The number of Fallen Angels increased the most at the beginning of the COVID crisis represented by the steep slope.

4. Selected Sectors

Figure 4.1 shows that the global credit impact of the pandemic was very sector specific.

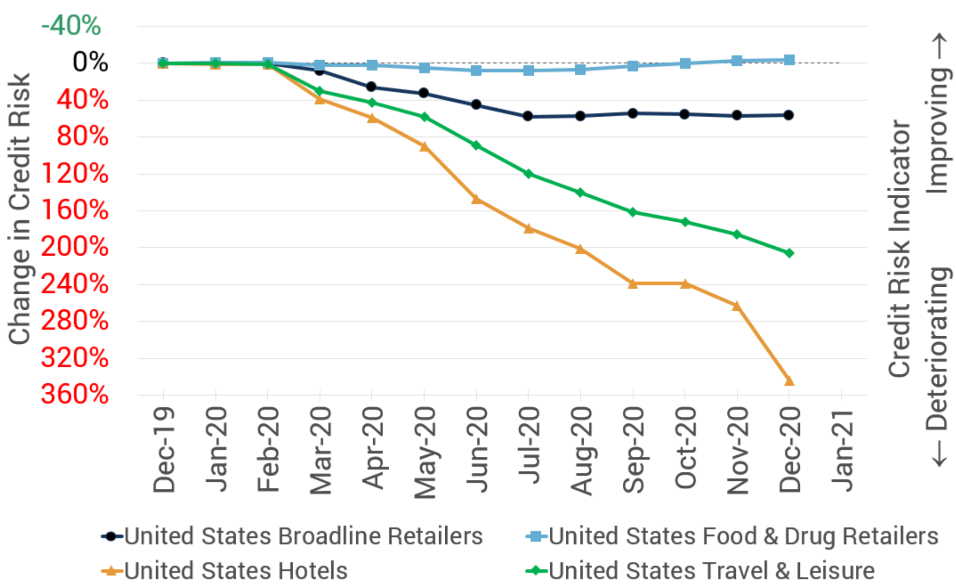
Figure 4.1 PD Trends: Global



Airlines deteriorated by about 160%, equivalent to two notches in the 21-category credit scale. Travel & Leisure increased by 70%, while Oil & Gas Producers – a clear early casualty – only shows a 40% increase in risk. General retailers deteriorated by only 25%, although there were some high profile individual bankruptcies in the sector.

Figure 4.2 shows credit risk trends for some key sectors in the US.

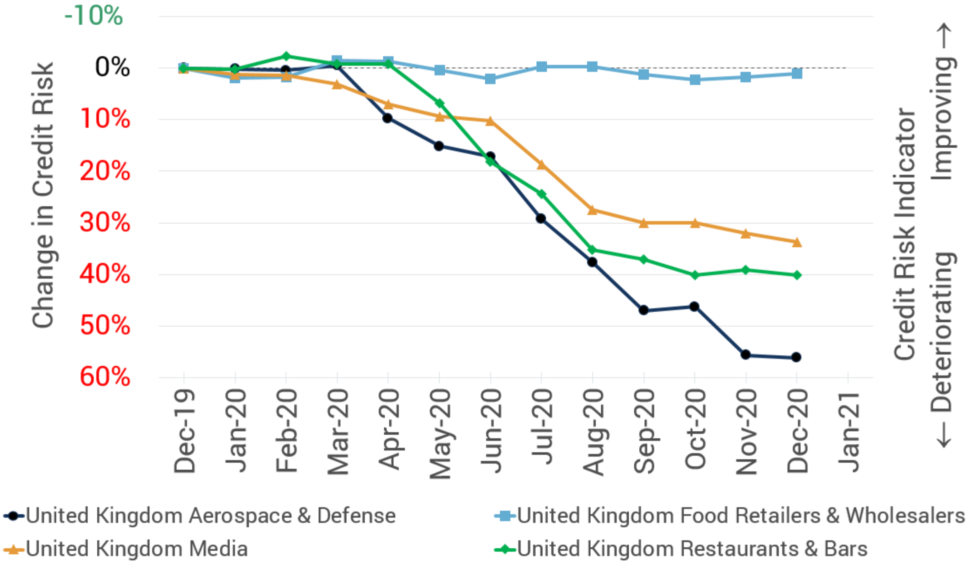
Figure 4.2 PD Trends, Selected Sectors, United States



US Food and Drug retailers show a slight improvement over the year – no surprise in the midst of a pandemic. US Hotels show a staggering 340% rise in credit risk, with the overall US Travel & Leisure sector registering a deterioration of 200%. US Broadline retailers have suffered a more modest but still significant increase in risk of just under 60%. (Typically, a 60% increase is sufficient to move the average sector credit risk by one notch on the 21-notch scale).

Figure 4.3 shows how the risk of insolvency has changed over the year for four high profile UK sectors.

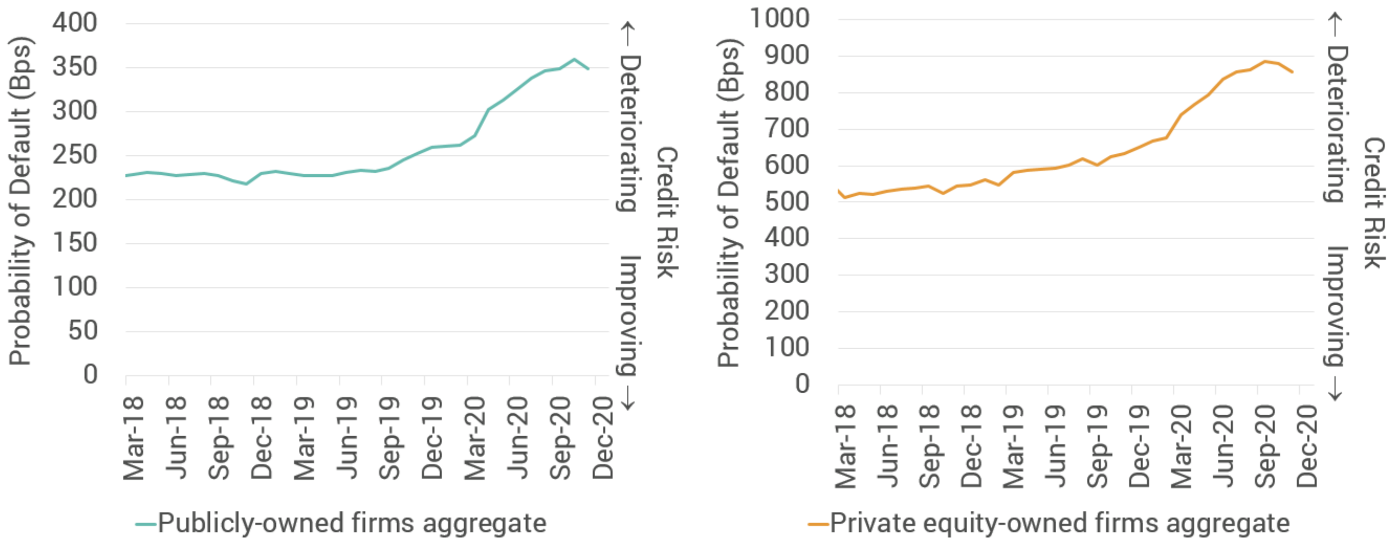
Figure 4.3 PD Trends, Selected Sectors, United Kingdom



The UK Media, UK Restaurant and UK Aerospace sectors all began to deteriorate after March, but Aerospace has been the worst hit with a cumulative increase in credit risk of 56% this year. The current trend is still negative whereas Restaurants and Media have stabilised. UK Food Retailers and Wholesalers show no material change over the year.

Figure 4.4 shows PD trends for Public and Private issuers of Leveraged Loans.

Figure 4.4 PD Trends, Leveraged Loan Issuers, Global, Public and Private, 2018-2020



Leveraged Loan issuer credit quality began to deteriorate in mid 2019, accelerating for both public and private issuers until Q4 2020. Since then, there has been a slight improvement in both categories, although the ECB has recently issued warnings about EU bank exposures in this area[1]. From trough to peak, private issuer credit has deteriorated by more than 60%; public by about 40%. Public credit risk peaked at 350 Bps, Private at nearly 900 Bps. Earlier research from Credit Benchmark on Leveraged Loan credit trends can be found on our website.

[1] Morris, S. et al. (2021, January 17) ECB threatens banks with capital 'add-ons' over leveraged loan risks. Financial Times. Retrieved from https://www.ft.com/content/c87dad6b-fc6d-4b4d-9206-1a45a670102d

Figure 4.5 shows Fallen Angels and Rising Stars by sector, measured by the cumulative total as a % of each sector universe over the March to December 2020 period.

Figure 4.5 Cumulative % of Sector March to December 2020

Fallen Angels

CB_Risk_Entity_Sector	Sample of IG companies end-Feb20	Cumulative # of Fallen Angels Mar - Dec20	Cumulative % of Fallen Angels Mar - Dec20
Travel & Leisure	189	87	46.0%
Leisure Goods	22	7	31.8%
Aerospace & Defense	76	21	27.6%
Personal Goods	65	17	26.2%
Industrial Metals & Mining	64	16	25.0%
Automobiles & Parts	384	75	19.5%
General Retailers	605	117	19.3%
Media	151	29	19.2%
Oil & Gas Producers	492	93	18.9%
Industrial Transportation	346	62	17.9%
Chemicals	388	65	16.8%
Mobile Telecommunications	19	3	15.8%
Household Goods & Home Construction	169	24	14.2%
Full Sample	6,895	972	14.1%
Oil Equipment, Services & Distribution	168	23	13.7%
Construction & Materials	316	41	13.0%
Mining	220	28	12.7%
Forestry & Paper	63	8	12.7%
Support Services	469	53	11.3%
Food Producers	396	42	10.6%
Technology Hardware & Equipment	104	11	10.6%
Food & Drug Retailers	77	8	10.4%
Electronic & Electrical Equipment	204	20	9.8%
Industrial Engineering	219	21	9.6%
Software & Computer Services	253	24	9.5%
Beverages	87	8	9.2%
General Industrials	62	5	8.1%
Pharmaceuticals & Biotechnology	142	11	7.7%
Fixed Line Telecommunications	141	10	7.1%
Health Care Equipment & Services	227	14	6.2%
Gas, Water & Multi-utilities	303	14	4.6%
Tobacco	25	1	4.0%
Electricity	448	14	3.1%
Alternative Energy	1	0	0.0%

Rising Stars

CB_Risk_Entity_Sector	Sample of HY companies end-Feb20	Cumulative # of Rising Stars Mar - Dec20	Cumulative % of Rising Stars Mar - Dec20
Aerospace & Defense	32	6	18.8%
Electricity	136	23	16.9%
Beverages	39	5	12.8%
Technology Hardware & Equipment	116	12	10.3%
Gas, Water & Multi-utilities	51	5	9.8%
Food & Drug Retailers	93	9	9.7%
Fixed Line Telecommunications	171	16	9.4%
Mining	223	18	8.1%
Pharmaceuticals & Biotechnology	86	6	7.0%
Construction & Materials	291	20	6.9%
Personal Goods	103	7	6.8%
Support Services	546	37	6.8%
Industrial Transportation	437	25	5.7%
General Retailers	634	36	5.7%
Full Sample	6,903	384	5.6%
Household Goods & Home Construction	113	6	5.3%
Chemicals	323	17	5.3%
Industrial Metals & Mining	152	8	5.3%
Software & Computer Services	407	20	4.9%
Automobiles & Parts	299	13	4.3%
Media	230	10	4.3%
Mobile Telecommunications	24	1	4.2%
Electronic & Electrical Equipment	174	7	4.0%
Food Producers	564	22	3.9%
Oil & Gas Producers	467	18	3.9%
Health Care Equipment & Services	216	8	3.7%
Industrial Engineering	216	7	3.2%
Oil Equipment, Services & Distribution	158	5	3.2%
Travel & Leisure	405	12	3.0%
Leisure Goods	37	1	2.7%
General Industrials	76	2	2.6%
Forestry & Paper	78	2	2.6%
Alternative Energy	2	0	0.0%
Tobacco	4	0	0.0%

There are more than 14% Fallen Angels between March and December 2020, i.e. entities that moved from an investment grade category in March 2020 to high yield. This is an increase from 8% of entities over the same period last year. The most impacted sectors are Travel & Leisure, Leisure Goods and Aerospace & Defense.

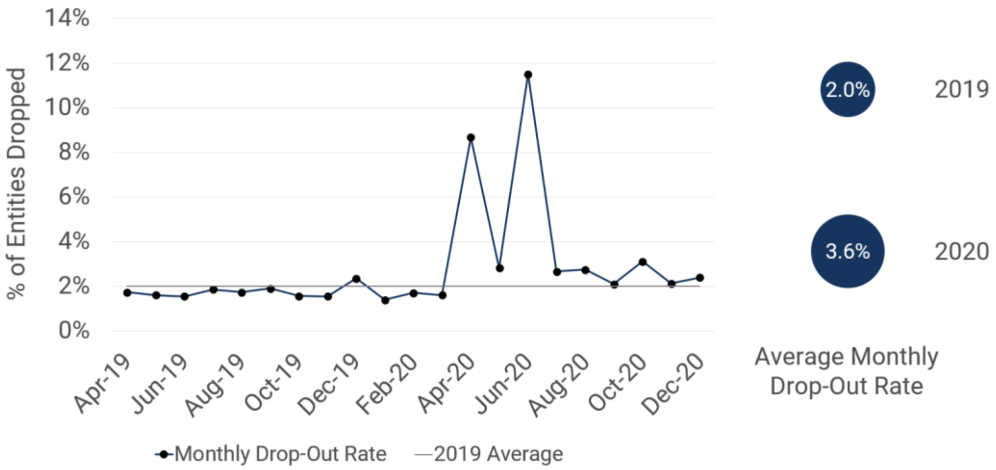
Rising Stars on the contrary mark entities moving from high yield to investment grade. The percentage of Rising Stars dropped from 8% in 2019 to 5.6% in 2020. Sectors with significant percentage of Rising Stars include Electricity and Beverages. Aerospace & Defense is highly represented between both Fallen Angels and Rising Stars which signal a high volatility of the sector.

5. Dropouts and Transitions

The following section further investigates the recent deterioration in credit risk by looking at drop-out rates in Figure 5.1 and transition rates in Figure 5.2.

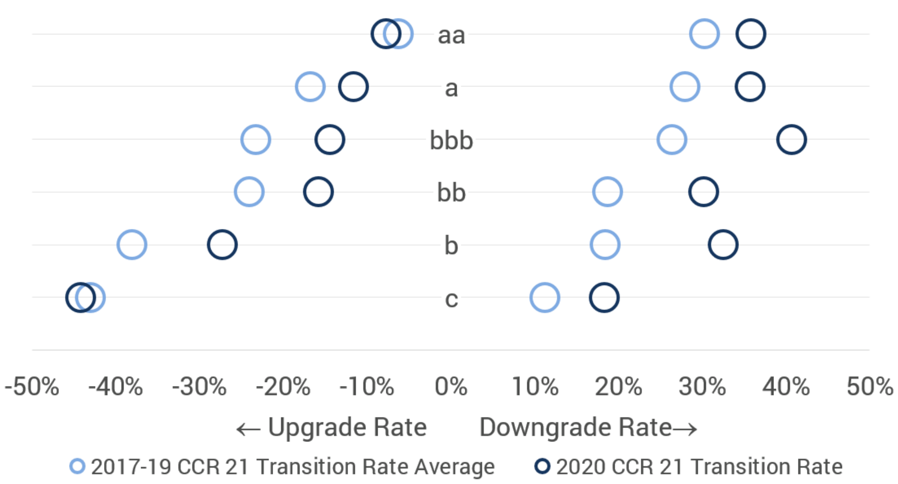
Entities dropping from the Credit Consensus Rating coverage are another potential indicator of deteriorating credit quality. A dropping entity means that at least one financial institution removed it from their portfolio, suggesting that the entity is no longer considered creditworthy.

Figure 5.1 Coverage Dropouts: Global Corporates, Past 18 Months



On average, 2% of entities dropped from Credit Consensus Rating coverage every month in 2019. This proportion of dropouts almost doubled in 2020 to 3.6%, and all months in 2020 starting with April showed values above the 2019 average with marked spikes in April and June. This can be driven by tightening of banks' approval criteria for loans quoted by respondents in "Senior Loan Officer Opinion Survey on Bank Lending Practices" by the Federal Reserve[2] and "The Euro Area Bank Lending Survey" by the European Central Bank[3].

Figure 5.2 Upgrades and Downgrades, by Credit Category, Global Corporates, 2020 vs Recent Years



The Credit Benchmark data allow us to observe not only changes in the portfolio structure but also the credit dynamic of entities in individual rating categories. The upgrade rate decreased from the 2017-2019 average of 24% to 16% in 2020, while the downgrade rate increased from 23% to 35%, and higher rates can be observed across all rating categories.

[2] Retrieved from https://www.federalreserve.gov/data/sloos/sloos-202010.htm
[3] Retrieved from
https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2020q4~e89c77d212.en.html#toc1

6. Single Name Case Studies

Figures 6.1 to 6.4 shows a range of downgrade examples where the consensus data showed multiple downgrades and/or changes of opinion by contributors of credit estimates, sometimes ahead of agency changes.

Figure 6.1 Single Name Case Study – Royal Caribbean Group

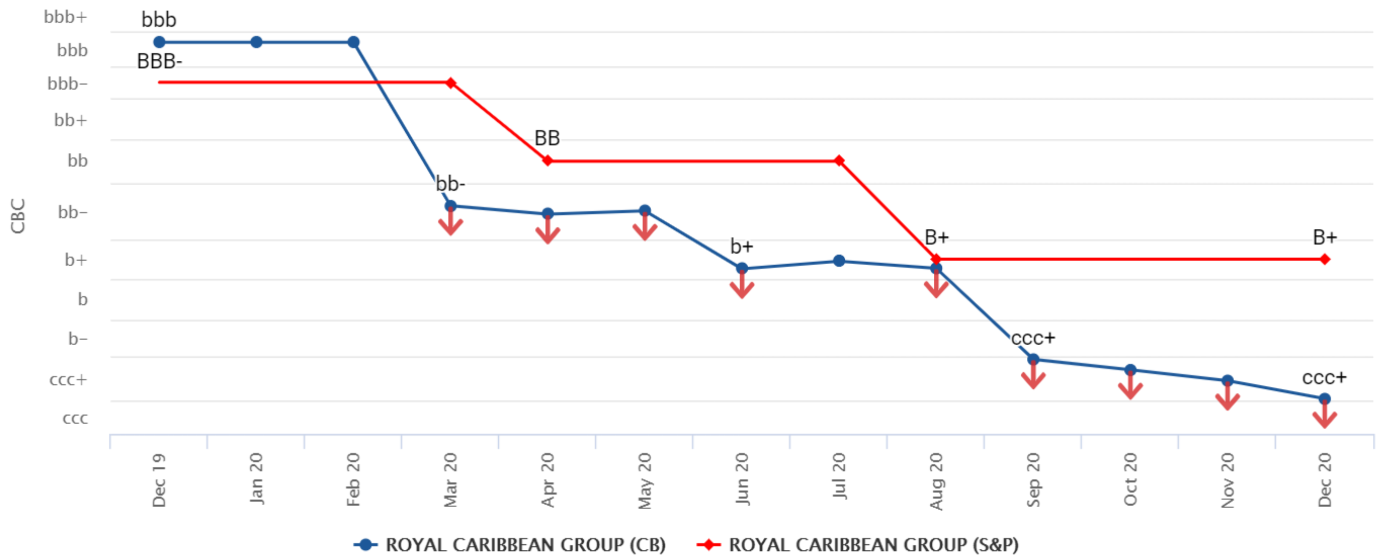


Figure 6.2 Single Name Case Study – Accor SA

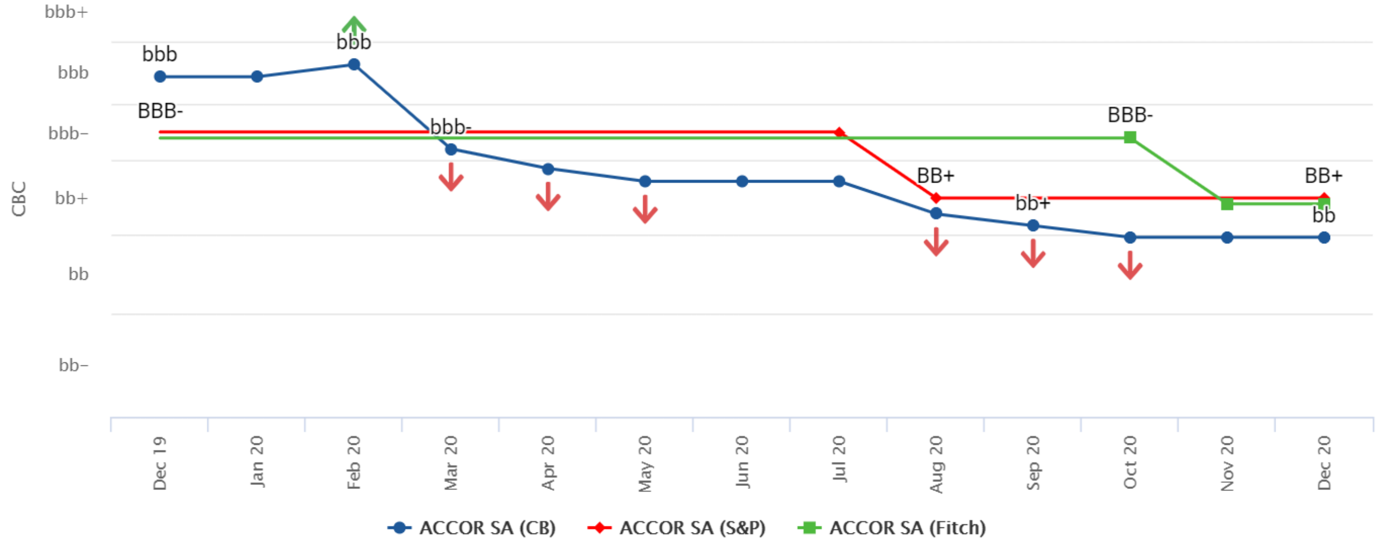


Figure 6.3 Single Name Case Study – Tenneco Inc

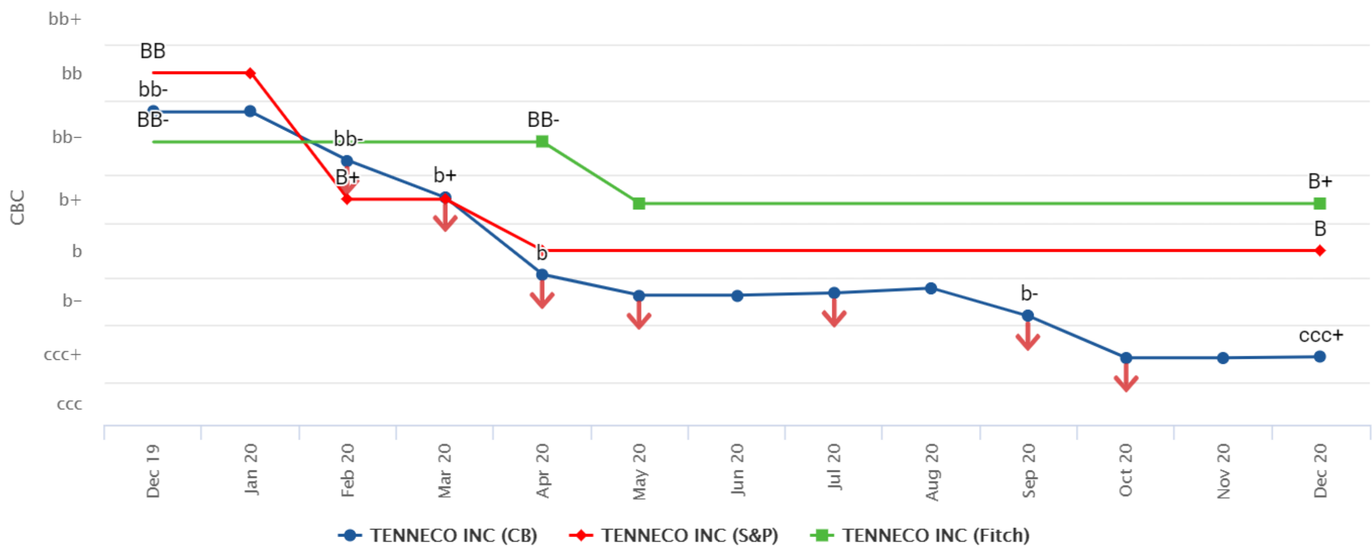
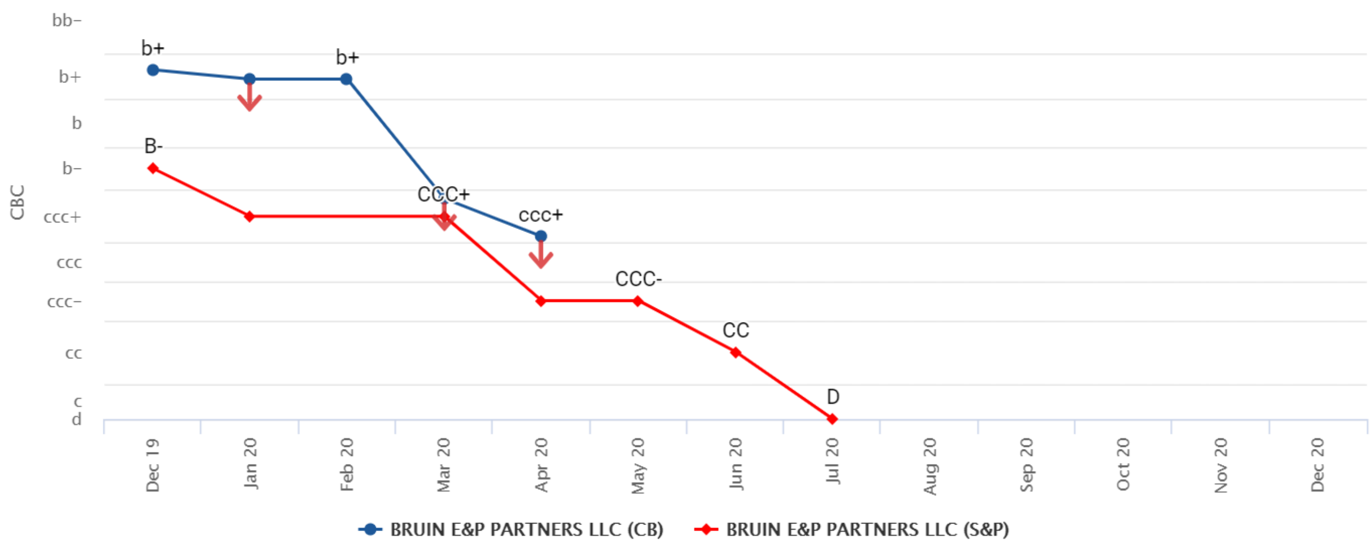


Figure 6.4 Single Name Case Study – Bruin E&P Partners LLC



7. Solvency in 2021

- **Covid:** The outlook hinges on the success of the new vaccines and the race to stay ahead of new variants. If some form of social distancing becomes permanent, then the much-discussed implications for public transport and the office environment will start to have a material impact on public policy, corporate planning and the urban/rural property investment landscape. Tax structures will need to keep up with a permanent shift to online, growing volumes of delivery traffic, the need for delivery and logistics investment. If robotics fills some of the gaps, there will be a growing debate about social safety nets and universal income. Supply chain challenges may force large changes in local economic structures and patterns of consumer demand. A Schumpeter-style global economic restructuring is a real possibility with winners as well as losers.

- **President Biden:** Pro-environment, pro-international co-operation. We can expect a fiscal boom, a focus on welfare and public healthcare, constraints on big business, more inclusivity, possible interest rate normalisation, and perhaps more inflation.

- **Brexit:** UK will continue to seek new trade deals, but its role as an EU supply chain lynchpin[4] is likely to fade. FTSE companies with their major US exposure are likely to fare better than medium sized firms who are having to pivot away from EU export markets. Domestic firms everywhere are likely to prosper if the global supply chain disruption continues; UK domestics have the added advantage of Brexit-related changes in their favour.

- **The BBB Cliff:** This was frequently discussed in 2019 and 2020[5,6]. Professor Ed Altman estimated that this “over-rating” affected nearly a third of the BBB-rated US bond market outstanding[7] and that many of these bonds should be BB or lower. Consensus data is also showing that there are some major divergences within the bbb category[8]. And while agency downgrades initially focused on High Yield names, the huge spike in Fallen Angels in the consensus data discussed here suggests that a further wave of agency downgrades in the BBB category may be in the pipeline.

- **Defaults:** How high could they go? Many companies are on Government life support, and may not survive when this is withdrawn. The expected wave of Covid bankruptcies has been delayed, but it cannot be avoided for ever. Estimates of default rates in 2021 and 2022 vary widely, but credit migration data gives some robust clues[9]. With the proportion of corporates in the c category doubling this year, and with the typical Fallen Angels rate also close to double that of 2019, we can expect the *average* default rate to show a similar quantum of increase. Some sectors – such as those at the top of the Fallen Angels list, and those that have very high levels of high yield credits – can expect to see a much higher increase in default rates as Governments wind down their involvement.

- **Short term interest rates:** Likely to remain low for a long time, but there are already signs in the US that long dated bond yields are starting to rise, as the market adjusts to the risk of higher inflation – due to money printing, low productivity, and supply chain disruption. But recent investment bank results[10,11,12] show that M&A activity is accelerating; COVID may be the catalyst for a restructuring and modernisation of the global economy.

[4] https://www.creditbenchmark.com/supply-chain-credit-risk/
[5] https://www.wsj.com/articles/investment-grade-bonds-could-turn-to-junk-amid-global-rout-11584060834,
[6] https://www.creditbenchmark.com/bank-lenders-sound-alarm-on-corporate-credit-risk/
[7] https://www.creditbenchmark.com/ed-altman-discusses-credit-before-and-after-the-virus/
[8] https://www.creditbenchmark.com/the-solvency-boundary/
[9] https://www.creditbenchmark.com/corporate-defaults-and-covid-19-credit-migrations-are-key/
[10] https://www.wsj.com/articles/citigroup-reports-better-than-expected-profit-11610717455
[11] https://www.wsj.com/articles/morgan-stanley-quarterly-profit-climbs-51-11611147469
[12] https://www.wsj.com/articles/goldman-sachs-profit-more-than-doubles-powered-by-trading-11611060879

Appendix

About Credit Benchmark

Credit Benchmark produces a comprehensive view of credit risk by creating Consensus ratings and analytics on the credit quality of companies, financial institutions, sovereigns and funds.

The data is sourced from the risk departments of more than 40 global financial institutions, representing the work of over 20,000 analysts and is also used by regulators to monitor Basel rules on capital adequacy.

Credit Benchmark collects a specific measure of credit risk: a one-year, forward-looking Probability of Default (PD) and forward-looking senior unsecured Loss Given Default (LGD).

The underlying inputs from contributors are subject to a rigorous data quality approval process and derived from models that are approved by regulatory authorities. The resultant accuracy of each PD and LGD leads to a credible market view of credit risk.

After being anonymized and aggregated, the contributed risk estimates are mapped to the appropriate credit category on the Credit Benchmark Consensus scale, which is calibrated periodically and can be used as a comparison to the scales published by the rating agencies.

Credit Benchmark produces regular data updates with history going back to 2015.

More from Credit Benchmark

Credit Benchmark data is now available on Bloomberg – high level credit assessments on the single name constituents of the sectors mentioned in this report can be accessed on CRPR <GO> or via CRDT <GO>.

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- The Financial Counterpart Monitor provides a unique analysis of the changing creditworthiness of financial institutions. The report, which covers banks, intermediaries, buy-side managers, and buy-side owners, summarizes the changes in credit consensus of each group as well as their current credit distribution and count of entities that have migrated from Investment Grade to High Yield.

- The Industry Monitor shows the changing creditworthiness of a selection of industries and sectors. The report shows the number of entities per category with a Credit Consensus Rating, their month-on-month changes in credit distribution, and their transitioning credit quality.

- Credit Consensus Indicators (CCIs). The CCI is an index of forward-looking credit opinions for US, UK and EU Industrials. The CCI tracks the total number of upgrades and downgrades made each month by credit analysts to chart the long-term trend in analyst sentiment for Industrials.

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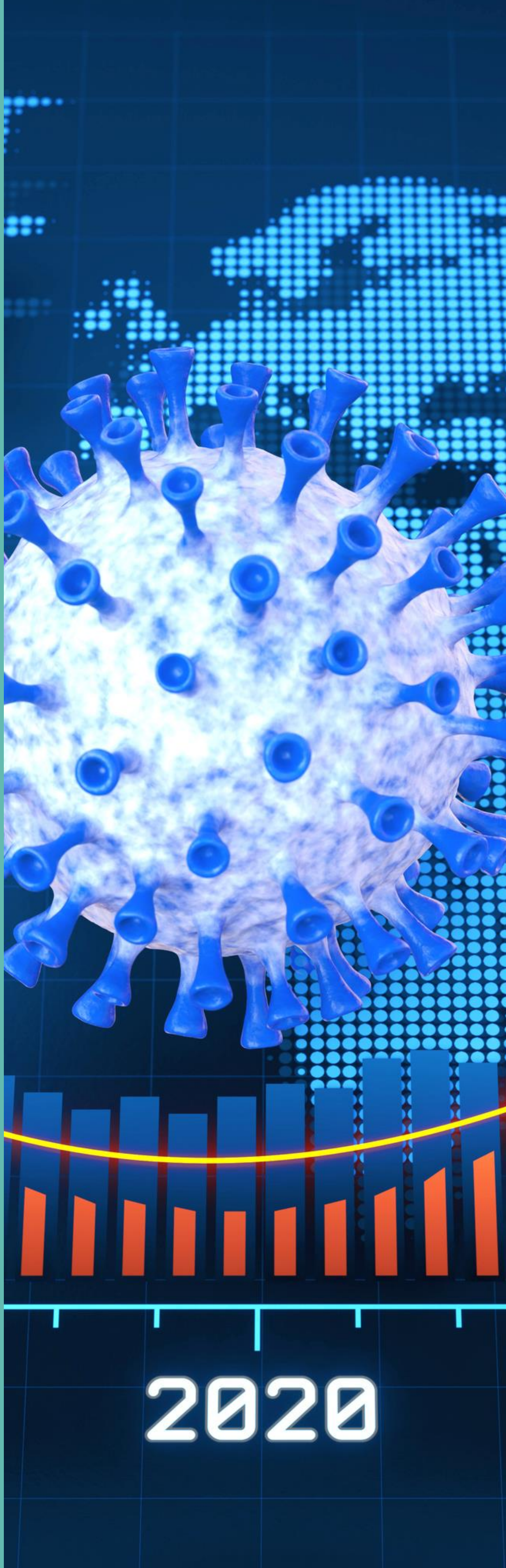

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