The Ratings View

September 7, 2023

This report does not constitute a rating action.

Key Takeaways

- Our latest default forecasts suggest the corporate default rate could hit 4.5% in the U.S. and 3.75% in Europe by June 2024.
- Measures to stimulate investment are having a measurable impact on U.S. growth.
- The Q2 results season saw interest payments surge and EBITDA decline sharply.

We expect the U.S. trailing-12-month speculative-grade corporate default rate to reach 4.5% by June 2024, from 3.2% in June 2023, as persistently higher rates dent corporates’ cash flow, particularly among weaker issuers. Our optimistic 2% default rate could materialize if economic resilience continues alongside falling inflation, producing a "soft landing". If a recession were to occur--particularly if inflation and interest rates remained stubbornly high--it could result in our pessimistic 6.5% default rate. Consumer-facing sectors such as consumer products, media and entertainment, and retail/restaurants comprise a large portion of our weakest issuers. Resilient consumer spending over the year ahead will be critical, but we see early signs of strain.

We expect the European trailing-12-month speculative-grade corporate default rate to reach 3.75% by June 2024, from 3% in June 2023. Firms’ ongoing ability to service debt amid higher interest rates and already flagging cash flow is the primary risk, even as we believe the chances of a recession are lower. While many can still rely on their high cash balances or can free up cash through cutbacks in hiring or capital expenditure, stock buybacks or dividends, these measures are generally less available to lower-rated issuers. Many of the weakest issuers come from consumer-facing sectors like consumer products and media and entertainment. These sectors will likely contribute the most to future defaults.

Federal legislation signed in 2021 and 2022 is having a measurable positive impact on U.S. GDP growth. Private-sector expansion of manufacturing capacity--specifically designed to produce semiconductors, electric vehicle batteries, and other electronics in the U.S.--has far exceeded expectations. Public-sector spending on infrastructure is also adding to growth, and S&P Global Ratings expects this trend to continue in the coming years. The longer-term impact on growth from these fiscal initiatives will depend on how much they add to productivity. The "bang-for-the-buck" impact, although positive, may be smaller than standard estimates once adjusted for where the U.S. is in the economic cycle. However, for now we think these initiatives are tempering the speed of a typical cyclical slowdown.

We updated our assessment of the global Q2 2023 results season for rated nonfinancial corporates, which is now 90% complete. Quarterly EBITDA year-over-year growth has fallen...
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sharply, declining 9%, and is down 2% at an annual rate. Revenues are growing annually, but also experienced a quarterly decline. Margins continue to compress and interest cover ratios continue to weaken. Cash interest payments continue to surge, rising 22% annually, up from 15% in Q1. Median effective interest rates for single 'B' category rated entities are nearing 6% in North America and Europe.

Corporate Results Roundup Q2 2023: Interest payments surge, EBITDA declines

The planned expansion of BRICS next year will likely bring a limited near-term economic boost for member countries. On Aug. 24, 2023, the original BRICS countries--Brazil, Russia, India, China, and South Africa--invited Saudi Arabia, the United Arab Emirates (UAE), Iran, Egypt, Argentina, and Ethiopia to join the group. While an expanded BRICS would comprise about 30% of the world’s GDP and 45% of its population, few factors unite the members economically or politically. Absent new trade agreements and based on the track record of economic relationships between existing BRICS countries, we do not expect materially higher trade and investment flows for new joiners. The ambition to increase transactions in non-U.S.-dollar currencies will probably benefit the Chinese yuan most, albeit with overall volumes remaining small. However, access to new sources of concessional funding from the New Development Bank (NDB; AA+/A-1+/Stable) could provide some relief to countries with high external vulnerabilities like Egypt, Ethiopia, and Argentina.

Broadening BRICS May Have Limited Economic Benefits

China’s reach is quietly growing behind minerals critical to a wide range of products that will shape the future. Facing more restrictive foreign investment policies in developed markets, Chinese firms are pursuing such key minerals as lithium and cobalt in other locations. S&P Global believes China will continue to build its influence over these minerals and the industries that rely on them as it works with governments keen on foreign investments across the developing world.

China’s global reach grows behind critical minerals

Green, social, sustainable, and sustainability-linked bond (GSSSB) issuance has risen this year, despite challenges posed by high global interest rates. We anticipate GSSSB issuance should be in line with our forecast of $900 billion to $1 trillion, or 14% to 16% of total issuance, in 2023. We anticipate issuance of sustainability-linked bonds will decline in 2023 as questions regarding the credibility of targets persist, while green bonds will continue to dominate the GSSSB market, building on a record level of issuance in the first half of the year. Europe will remain the leading region for GSSSBs, while North American issuance may be hampered by lower supply and demand. Emerging markets may see increased issuance in the coming year.

Sustainability Insights: Research: Global Sustainable Bonds 2023 Issuance To Exceed $900 Billion
Sustainability Insights Research: Lost Water: Challenges And Opportunities

In case you missed it: our midyear Industry Top Trend updates point to a nonfinancial corporate sector at a crossroad. Easing cost pressures and resilient economies have sustained financial performance but higher-for-longer interest rates could pose serious difficulties for weaker credits. Demand has softened, but not slumped, and pandemic recovery momentum lingers for some sectors. Failing energy, freight, and commodity prices have eased cost pressures, but labor costs are now top of mind. Refinancing risk for leveraged companies remains high, particularly for sectors with a high proportion of weaker credits. Free cash flow pressure and dwindling interest cover are key concerns. Regulations and legislation are having a profound effect, with energy transition efforts are elevating capital expenditure needs. Defense spending is seeing a sustained increase. Credit implications of AI are still unknown.

Industry Top Trends Update Midyear 2023: At A Crossroad
Asset Class Highlights

Corporates

Notable publications include:

- Sustainability Insights: Research: Decarbonizing Chemicals Part One: Sectorwide Challenges Will Intensify Beyond 2030
- Sustainability Insights: Research: Decarbonizing Chemicals Part Two: The Credit Risks And Mitigants
- Back To Business: Credit Clouds Gathered In August
- Chinese Developers' Profitability Is Searching For A Trough
- Energy Transition Puts Australian Gas Distributors On Track For A Managed Decline

Financial Institutions

- Over the past month, we took actions on several U.S banks.
  - Associated Banc Corp. Lowered To 'BBB-', Associated Bank N.A. Lowered To 'BBB' On Weaker Funding; Outlook Stable
  - Comerica Inc. Rating Lowered To 'BBB' From 'BBB+' On Reduced Predictability Of Financial Performance; Outlook Stable
  - KeyCorp Ratings Lowered To 'BBB' From 'BBB+' On Constrained Profitability; Outlook Stable
  - River City Bank Outlook Revised To Negative On Earnings Headwinds; 'BBB-' Rating Affirmed
  - S&T Bank Outlook Revised To Negative On Funding Pressures; 'BBB' Rating Affirmed
  - Synovus Financial Corp. 'BBB-' Ratings Affirmed; Outlook Remains Stable
  - Truist Financial Corp. 'A-/A-2' Ratings Affirmed Despite Industry Pressures; Outlook Remains Stable
  - UMB Financial Corp. Ratings Lowered To 'BBB+' And UMB Bank To 'A-' On Lower Capital Ratios; Outlook Stable
  - Valley National Bancorp Lowered To 'BBB-' On Funding Pressures; Outlook Stable
  - Zions Bancorporation N.A. 'BBB+' Rating Affirmed; Outlook Remains Negative On Deposit And Margin Pressures

For more details see: Tough Operating Conditions Strain Certain U.S. Regional Banks While Most Rating Outlooks Remain Stable.

- In Africa, we revised our outlooks on all rated Nigerian banks to stable from negative following similar rating action on the sovereign.

- We also published several commentaries:
  - How The Property Downturn Is Hitting Asia-Pacific Banks
- Australian Mutual Lenders: Path Of Least Resistance May Lead To Higher Cyber Risk
- U.K. Banks Enjoy Another Strong Half Year As Margins Peak
- U.S. Banks Webinar 2Q 2023: An Uphill Climb As Funding Costs Rise
- Large U.S. Banks 2Q 2023 Update: Stable Financial Performance Amid Headwinds
- Australian Mutual Lenders' Competitive Edge All But Gone
- Asia-Pacific Financial Institutions Monitor 3Q 2023: Bank Credit Losses To Hit US$485 Billion In 2023
- Despite Brazil's Consumer Debt Renegotiation Program, Lending Growth Won't Accelerate This Year
- SLIDES: Asia-Pacific Banking Country Snapshots: Pain Within Expectations
- Global Bank Exposures To Commercial Property Are Top Of Worry List For Investors, Webcast Polls Show
- EU Banks Resist Tough Assumptions In Latest Stress Tests
The Ratings View

Sovereign

- Mauritius Assigned ‘BBB-/A-3’ Foreign And Local Currency Ratings; Outlook Stable
- Sri Lanka Local Currency Rating Lowered To ‘CC’ From ‘CCC-’ On Domestic Debt Restructuring Plan; Outlook Negative

Structured Finance

- European CMBS: Here are a few “Key Takeaways” from a recent article:
  - More than 70% of the European commercial mortgage-backed securities (CMBS) transactions we reviewed experienced a rise in expenses over the last four years, often in the double- or triple-digit range.
  - In a competitive environment, tenants shy away from properties with high operating expenses.
  - Borrowers also suffer from high operating expenses, which reduce net cash flow and limit their debt service coverage and their ability to refinance mortgages.
  - We expect that loan defaults in European CMBS will rise, albeit from a very low level, and we will continue reflecting our expectations of rising expenses in our reviews of CMBS loans on a loan-by-loan basis.


- U.S. CMBS: See “SF Credit Brief: Overall U.S. CMBS Delinquency Rate Declined 19 Bps To 3.6% In August; Office Loan Delinquency Rate Continues To Climb” published Aug. 31, 2023.

- CLOs: There have been two recent publications related to this asset class. The first one is “SLIDES: U.S. And European BSL CLOs: A Comparative Overview” published August 31, 2023. The second one is “SF Credit Brief: CLO Insights 2023 U.S. BSL Index: Downgrades Of Widely Held Obligors Bump Up ‘CCC’ Baskets; Also, We Compare U.S. And European CLOs” published Aug. 31, 2023.

CLO Insights 2023 U.S. BSL Index*

<table>
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<tr>
<th>Category</th>
<th>’B+’</th>
<th>’CCC’</th>
<th>Nonperforming</th>
<th>Avg. cushion at the junior OIC test</th>
<th>Weighted average price of portfolio</th>
<th>SPWARF</th>
<th>% of target par</th>
<th>% of negative outlook</th>
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<tr>
<td>Rated Issuers</td>
<td>28.33%</td>
<td>6.87%</td>
<td>0.60%</td>
<td>4.01%</td>
<td>95.50</td>
<td>2757</td>
<td>99.82%</td>
<td>5.90%</td>
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Change during prior month:
- Risk increasing
- Risk decreasing
- Not applicable

N/A—Not applicable.
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- China Structured Finance: Here are a few “Key Takeaways” from a recent article:
  - The weighted-average 30-plus-day delinquency rate for auto asset-backed securities (ABS) dropped to 0.23%, while the severe delinquency rate narrowed to 0.11% in July.
  - The three-month median of coupons on the most senior tranches of recently closed auto ABS further fell to 2.34% following a recent rate cut.
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- The weighted-average 90-plus-day delinquency ratio of residential mortgage-backed securities (RMBS) that we rate further climbed to 1.28% in July from 1.21% in June, in part because the underlying pools continued to pay down.

- The auto ABS transactions that we rate remain stable. We don’t expect any meaningful direct impact on our rated RMBS from the Country Garden saga, but we will watch out for potential secondary effects.


- **LIBOR Transition - CLOs:** Here are a few “Key Takeaways” from a recent article:
  - We received official notices, executed supplemental indentures, notification through the DTCC platform, and/or confirmation from trustees and collateral managers for the entire S&P Global Ratings-rated LIBOR-based CLO universe.
  - All of the CLO transactions we rate have transitioned (or will transition) to the same rate, CME term SOFR, and with similar CSAs of 0.26%.
  - To date, there has been no rating impact driven solely by the transition away from LIBOR.


- **U.S. Credit Card ABS:** We recently published the “U.S. Credit Card Quality Index: Monthly Performance—July 2023” on June 30, 2023. The CCQI is a monthly performance index that aggregates performance information of securitized credit card receivables in the following key risk areas: receivables outstanding, yield, payment rate, charge-off rate, delinquencies, base rate, and excess spread rate.
The Ratings View

Chart 1
Global Rating Actions (Rolling 52-Weeks)


Table 1
Recent Rating Actions

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Issuer</th>
<th>Industry</th>
<th>Country</th>
<th>To</th>
<th>From</th>
<th>Debt vol (mil. $)</th>
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<tbody>
<tr>
<td>30-Aug</td>
<td>Downgrade</td>
<td>3M Co.</td>
<td>Capital Goods</td>
<td>U.S.</td>
<td>BBB+</td>
<td>A-</td>
<td>13,744</td>
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<tr>
<td>1-Sep</td>
<td>Downgrade</td>
<td>Carvana Co.</td>
<td>Automotive</td>
<td>U.S.</td>
<td>D</td>
<td>CC</td>
<td>5,725</td>
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<tr>
<td>30-Aug</td>
<td>Upgrade</td>
<td>Royal Schiphol Group N.V.</td>
<td>Transportation</td>
<td>Netherlands</td>
<td>A</td>
<td>A-</td>
<td>4,221</td>
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<tr>
<td>1-Sep</td>
<td>Upgrade</td>
<td>AppLovin Corporation</td>
<td>Media &amp; Entertainment</td>
<td>U.S.</td>
<td>BB</td>
<td>BB-</td>
<td>3,000</td>
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<td>28-Aug</td>
<td>Upgrade</td>
<td>Primo Water Corp.</td>
<td>Consumer Products</td>
<td>Canada</td>
<td>B+</td>
<td>B</td>
<td>2,204</td>
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<td>29-Aug</td>
<td>Downgrade</td>
<td>Rite Aid Corp.</td>
<td>Retail/Restaurants</td>
<td>U.S.</td>
<td>CCC-</td>
<td>CCC+</td>
<td>2,169</td>
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<td>31-Aug</td>
<td>Upgrade</td>
<td>Quimper AB</td>
<td>Forest Products &amp; Building Materials</td>
<td>Sweden</td>
<td>B+</td>
<td>B</td>
<td>1,958</td>
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<td>30-Aug</td>
<td>Upgrade</td>
<td>Shearer's Foods, LLC</td>
<td>Consumer Products</td>
<td>U.S.</td>
<td>B</td>
<td>B-</td>
<td>1,325</td>
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<td>U.S.</td>
<td>BB</td>
<td>BB-</td>
<td>1,275</td>
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<td>PLZ Corp.</td>
<td>Chemicals, Packaging &amp; Environmental Services</td>
<td>U.S.</td>
<td>B-</td>
<td>B</td>
<td>1,044</td>
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For further credit market insights, please see our This Week In Credit newsletter.