The Ratings View

September 20, 2023

This report does not constitute a rating action.

Key Takeaways

- The U.S. leveraged loan default rate could rise to 2.75% by June 2024, versus 1.9% now.
- Theft is becoming a top risk for the U.S. retail sector.
- U.S. airlines can manage higher jet fuel prices for now.

S&P Global Ratings expects the U.S. leveraged loan default rate to climb to 2.75%, near the historical average of 2.5%, by June 2024. This compares with a leveraged loan default rate of 1.9% as of August. Macroeconomic conditions, including slowing GDP growth, continue to weigh on operating performance as liquidity grows increasingly constrained for speculative-grade issuers. Restrictive primary markets have reduced access to capital, and we expect both liquidity and refinancing risk to increase over the next 12 months.

Data as of August 2023.
Sources: Leveraged Commentary and Data (LCD) from PitchBook, a Morningstar company, and S&P Global Ratings Credit Research & Insights.

Default, Transition, and Recovery: The U.S. Leveraged Loan Default Rate Could Climb To 2.75% By June 2024 As Economic Growth Grinds Lower

Theft is a growing problem and now among the top risks to the U.S. retail sector. At least a dozen companies cited inventory loss or "shrink," which includes theft, as eroding profits in quarterly earnings this summer, including Target Corp., Lowe's Cos. Inc., and Dick's Sporting Goods Inc. In our view, retail theft is not a short-term cost problem--estimates have pinned shrink's impact as 2% of net sales or below--but a long-term revenue problem through its impact on customer traffic. Bring shoppers back into stores after the pandemic has been a challenge and theft's impact on perceived customer safety is another material set back. Theft will likely contribute to negative rating actions in the next six to twelve months, particularly given that 70% of our rated companies are in the speculative-grade category of 'BB+' or lower and have seen their interest burden skyrocket amid higher rates over the past year.

Crime, No Punishment: Theft Poses Risk To U.S. Retailers This Holiday Season

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**The Ratings View**

**U.S. airlines can manage higher jet fuel prices for now.** Several U.S. airlines recently revised lower their expectations for third-quarter earnings as a result of rising fuel costs, which have increased by nearly 50% since May. Our fuel price assumptions for 2023 have remained higher and more conservative than the airlines' this year, so the recent uptick in fuel prices has an overall limited effect on our estimates for now. Passenger demand also remains favorable following a very strong summer travel season. Nevertheless, sustained, higher jet fuel prices remain a downside risk to our forecasts, particularly if not accompanied by higher fares.

**U.S. Airlines Can Manage Higher Jet Fuel Prices For Now**

**U.S. auto worker strikes could materially reduce auto company earnings and liquidity** relative to our base case for 2023. Simultaneous strikes affecting Ford, General Motors, and Stellantis will lead to stoppage of production for several profitable, high-demand vehicles including the Ford Bronco, Jeep Wrangler, and Chevrolet Colorado. If the strike persists for more than a week and expands to more plants, the financial impact could become material. We have limited visibility on the likely duration of an extended strike but address the potential ratings impact in the FAQ report available from the link below.

**Credit FAQ: How Will The United Auto Workers Strike Impact Ratings In The U.S. Auto Sector?**

**Electrical grids are rapidly transforming due to greater renewable energy penetration.** Reliability is a key consideration as generation is poised to become more intermittent and as load patterns change. Meaningful regulatory reforms will likely help counter the stress on the grid, but also introduce the risk of unintended consequences. Larger, more-diverse power producers are better-positioned to adjust given their ability to expand their fleet and better access to capital. Project finance issuers might have a harder time adapting due to their fixed asset bases and limited capital structure flexibility.

**Step Up Transformers: How Will North American Power Producers Adapt To An Evolving Grid?**

**Germany's accelerated greening of its power mix to 80% by 2030 has profound implications for power utilities** as it requires massive investments into new generation capacity and grid strengthening over the next decade. Favorable prices and lower supply risks should give generators the financial headroom to accelerate investments in the energy transition. For power grid operators, an increased state presence should help bridge the vast funding gap to achieve the energy transition. Facing a long-term business impasse, gas grids may build headroom through moderate investments in the next few years to be able to seize green gas market development opportunities. Thus, they may remain relevant in the long term provided a supportive regulatory framework is in place.

**Germany’s Green Energy Ambitions Spark A Transformative Decade For Utilities**
Asset Class Highlights

Corporates

Notable publications include:

- Default, Transition, and Recovery: The U.S. Leveraged Loan Default Rate Could Climb To 2.75% By June 2024 As Economic Growth Grinds Lower
- U.S. Airlines Can Manage Higher Jet Fuel Prices For Now
- Step Up Transformers: How Will North American Power Producers Adapt To An Evolving Grid?
- Germany’s Green Energy Ambitions Spark A Transformative Decade For Utilities
- Crime, No Punishment: Theft Poses Risk To U.S. Retailers This Holiday Season
- China Gas Distributors To Squeeze Out A Recovery In 2023

Financial Institutions

- We’ve published our annual update on global banks capitalization (see Top 200 Banks: Capital Ratios Continue To Normalize After Pandemic Peaks). We expect the RAC ratios of the world’s top 200 rated banks to decrease slightly, by around 5 bps over the two years to end-2024, continuing the trend from last year. Bank capital around the world proved resilient to the shock of the COVID-19 pandemic, thanks to strengthened supervision and capital requirements from the past decade, as well as unprecedented government support to the private sector.

- In Europe, we published an update on Swiss banks (Swiss Banking Sector 2023: Balance Sheets Remain Robust). The balance of risks has shifted from economic to industry risk for banks operating in Switzerland. Credit losses continue to be very low and manageable for Swiss banks. At the same time, rising interest rates have led to a deceleration in house price rises, lowering the risk of economic imbalances. Credit Suisse’s failure exposed the limitations of systemic regulation and the regulators’ supervisory toolkits. We expect parliament to scrutinize the supervisory toolkit of Swiss financial regulator FINMA in the upcoming months.

- Also in Europe, we are receiving many questions from the market about the European Central Bank’s (ECB’s) progress with quantitative tightening (QT) and what a potential acceleration of QT could mean for eurozone banks. In a Credit FAQ published last week, “What An Acceleration Of Quantitative Tightening Could Mean For Eurozone Banks,” our credit analysts and economists answer questions relating to the ECB’s QT plans. Today, the ECB holds about €5 trillion in bonds and we believe it could reduce this sum by €1.0 trillion-€1.5 trillion. One important question is at what speed the reduction in bond holdings should occur. For eurozone banks, a hypothetical acceleration of QT would not have a major direct impact on their capital adequacy or liquidity and funding ratios. However, it would fuel the normalization of funding costs and net interest margins already under way. Besides this, the acceleration of QT could lead to unpredictable secondary effects on banks and the financial system at large.

- We have raised our long-term ratings on Crelan S.A. (Crelan) and Axa Bank Belgium (ABB) to ‘A-‘ from ‘BBB+‘, reflecting the development of subordinated additional loss-absorbing capacity as a source of protection for senior preferred creditors.
The Ratings View

- In the U.S., we have placed on CreditWatch our ratings on brokerage and investment advisory firm Aretec, reflecting our expectation that Aretec's credit metrics could potentially deteriorate following its mostly debt-financed acquisition of Avantax.
- We have also rated to 'BB-' our rating on National Commercial Bank Jamaica Ltd. following the same action on Jamaica.

Sovereign

- **Croatia Outlook Revised To Positive On Macroeconomic And Fiscal Resilience; 'BBB+/A-2' Ratings Affirmed**
- **Jamaica Long-Term Ratings Raised To 'BB-' From 'B+' On Improved Finances; Outlook Stable**
- **Sri Lanka Local Currency Ratings Lowered To 'SD' From 'CC/C'**

Structured Finance

- **European Structured Finance**: Our sixth European Structured Finance Conference cast a light on wayward markets, persistently high inflation, and the looming maturity wall. "Keep Calm And Carry On: European Structured Finance Conference 2023 Highlights," published on Sept. 13, 2023, summarizes the main findings from the six panel discussions, which covered:
  - The outlook for the European securitization market
  - Residential mortgage-backed securities
  - Collateralized loan obligations
  - Asset-backed securities
  - Commercial mortgage-backed securities
  - Blockchain innovation in structured finance and financial markets
- **U.S. Auto ABS**: Here are a few “Key Takeaways” from a recent article:
  - Performance continued to deteriorate for the month of July with prime and subprime annualized losses increasing and recoveries declining month-over-month and year-over-year. Additionally, prime losses are at par with pre-pandemic levels of 2019, and subprime losses exceeded pre-pandemic levels.
  - Like in June 2023, 60-plus-day delinquencies rose to the highest ever July level in our composite for subprime and highest July level since 2011 for prime.
  - In August, we lowered our expected cumulative net loss levels on eight U.S. and one Canadian ABS transactions. The U.S. transactions saw 35 upgrades and 21 affirmations, while the Canadian transaction saw affirmations on the two 'AAA' rated classes. There were no downgrades.


- **France’s RMBS market**: Here are a few “Key Takeaways” from a recent article:
  - The underwriting of French residential loans is based on a robust assessment of affordability and the loan-to-value ratio has less importance. Consequently, home loan performance is less linked to house prices than in the U.S. or U.K.
  - A French home loan is generally at a fixed rate for life, which protects borrowers from payment shocks in times of rate rises.
The Ratings View

- France has a strong social benefit support system, which means that home loan performance tends to be less cyclical. In addition, products tend to be standard across the industry, and while buy-to-let home loans exist, the nonconforming home loan segment is nonexistent in France.

- Most French home loans are guaranteed by an industry-wide guarantee provided by Crédit Logement. French banks can draw on the guarantee generally as soon as there is a failure to pay, and the guarantor will reimburse the bank with all the guaranteed amounts. This is a unique feature of the French market.


- **German Covered Bonds:** Here are a few “Key Takeaways” from a recent article:
  
  - Year-to-date German benchmark covered bond issuance is lower than the total last year, but issuance has remained resilient with €31 billion issued by the beginning of September. This makes Germany the second largest market for covered bond issuance so far in 2023.
  
  - Rising interest rates and sticky inflation are negatively affecting the German housing market and we expect prices to reach a low point by the end of 2024.
  
  - Issuance of shorter covered bond maturities may lead to higher asset liability mismatches and increase target credit enhancement. However, most of our mortgage programs only need to cover ‘AAA’ credit risk for the current ratings.
  
  - We do not expect higher mortgage rates to lead to significantly increased mortgage payments, as German borrowers have long interest rate fixings and current rates are comparable to those of 10 to 15 years’ ago.


- **Australia RMBS:** Australian prime home loan arrears remained steady in July and nonconforming home loan arrears rose. That’s according to S&P Global Ratings’ recently published “RMBS Arrears Statistics: Australia.” The Standard & Poor’s Performance Index (SPIN) for Australian prime mortgages loans excluding noncapital market issuance were mostly unchanged in July, edging down to 0.96% from 0.97% a month earlier. Nonconforming arrears rose to 3.63% from 3.47% in June. The movements were partly influenced by trends in outstanding loan balances. Outstanding loan balances increased in the prime sector, diluting the prime SPIN, and decreased in the nonconforming sector, contributing to a rise in arrears in percentage terms.

  In a normal arrears cycle, arrears tend to decline in the second half of the year before rising again in the lead up to Christmas. October and November typically mark the low point in the arrears cycle. The impact of multiple interest rate rises is having a disproportionate effect on lower-income households with fewer buffers and higher levels of leverage. A recent turnaround in property price declines might be helping some borrowers to self-manage their way out of financial pressure by voluntarily selling their properties and unlocking any potential equity gains. Rising property prices can also help improve borrowers’ refinancing prospects by improving their loan-to-value ratio positions. Robust labor markets have kept advanced arrears low to date but rising unemployment would increase debt-serviceability burdens and, by extension, migration from early arrears to more advanced arrears categories.

- **Australia and New Zealand ABS:** Arrears levels were mainly stable for Australian and New Zealand asset-backed securities (ABS) transactions during the second quarter (Q2) of 2023.
That’s according to the recent edition of S&P Global Ratings’ "ABS Performance Watch: Australia And New Zealand." Most classes of notes have built up credit support due to the relatively low cumulative losses experienced to date. We believe this would provide a buffer for transactions should there be any deterioration in performance.
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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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<tr>
<td>13-Sep</td>
<td>Upgrade</td>
<td>Jamaica</td>
<td>Sovereign</td>
<td>Jamaica</td>
<td>BB-</td>
<td>B+</td>
<td>5,649</td>
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<tr>
<td>12-Sep</td>
<td>Upgrade</td>
<td>Accor S.A.</td>
<td>Media &amp; Entertainment</td>
<td>France</td>
<td>BBB-</td>
<td>BB+</td>
<td>4,608</td>
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<td>13-Sep</td>
<td>Downgrade</td>
<td>PEGF USS Intermediate Holding III Corp.</td>
<td>Chemicals, Packaging &amp; Environmental Services</td>
<td>U.S.</td>
<td>CCC</td>
<td>CCC+</td>
<td>2,550</td>
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<tr>
<td>13-Sep</td>
<td>Upgrade</td>
<td>Delta Topco Ltd.</td>
<td>Media &amp; Entertainment</td>
<td>U.K.</td>
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<td>Downgrade</td>
<td>Advance Auto Parts Inc.</td>
<td>Retail/Restaurants</td>
<td>U.S.</td>
<td>BB+</td>
<td>BBB-</td>
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<td>15-Sep</td>
<td>Downgrade</td>
<td>Claudia Finance Parent SARL</td>
<td>High Technology</td>
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<td>Financial Institutions</td>
<td>Portugal</td>
<td>BBB-</td>
<td>BB+</td>
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<td>11-Sep</td>
<td>Downgrade</td>
<td>Forest City Realty Trust Inc. (Brookfield Corp.)</td>
<td>Homebuilders/Real Estate Co.</td>
<td>U.S.</td>
<td>B-</td>
<td>B</td>
<td>1,241</td>
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<td>Consumer Products</td>
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<td>B-</td>
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<td>CCC+</td>
<td>B-</td>
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For further credit market insights, please see our This Week In Credit newsletter.