European Corporate Credit Outlook 2020

In the Balance

January 24, 2020

Key Takeaways

– **Holding steady.** Decisive central bank action is likely to contain the global manufacturing downturn and curtail the deterioration in credit quality seen last year. Corporate cash flows should consequently continue to expand, and financing conditions should remain supportive.

– **Weaker credits at risk.** While stronger credits are likely to benefit from these conditions, weaker credits face challenges. Leverage multiples are well past the prior peak, leaving less room to absorb shocks. Nearly 40% of European nonfinancial speculative-grade companies reported a decline in net income last year, and close to 20% meet the BIS definition of “zombie firms” with a persistent pattern of EBIT not covering interest costs. Greater risk differentiation is likely to be reflected in the cost of credit for weaker companies.

– **Disruptive trends and regulatory changes present further challenges.** While macro trends are supportive, European nonfinancial corporations still face considerable operating challenges: rising costs, technological disruption and associated investment needs, greater regulation in response to environmental concerns, and uncertainty surrounding trade and supply chains.

– **Event risk.** Determined central bank support is likely to counterbalance concerns over rising debt, generous valuations, and operating trends. Disruptions to market conditions are most likely to come from event risks, particularly in relation to trade uncertainties with the U.S. and renewed tensions over the future trading relationship between the U.K. and EU.

Markets have entered a new decade with the outlook very much in the balance. Renewed policy stimulus efforts from central banks appear to have curtailed a sharp deterioration in global manufacturing that has had a sizable impact on corporate confidence and credit quality (see chart 1). In Germany, for example, encouraging early signs of a stabilization in manufacturing sentiment are now apparent (see chart 2) and suggest that the rate of decline in new factory orders should start to ease off. Even so, this apparently successful elongation of the economic cycle brings with it concerns that monetary policy has very little further room for maneuver in Europe in particular, and does not negate broader worries about top-of-range market valuations and elevated debt levels.

Agreement of a so-called “Phase One” deal between the U.S. and China has helped attenuate concerns about global trade tensions, another of last year’s prime drivers of sentiment. Despite this, 2019’s additional tariffs largely remain in place, and renewed escalation cannot be ruled out. Global trade growth is still subdued and the sense that the post-war global trade framework is facing a fundamental and disruptive reordering has not gone away. Closer to home, it is still possible that smoldering U.S.-EU disputes could ignite given a large U.S. trade deficit and flashpoints in aircraft-manufacturing, autos, and efforts to tax cross-border digital services.

This kind of dualist, yin and yang situation applies to many of the factors likely to determine prospects for the year ahead. In our view, this balancing of positive and negative forces—precarious though it is—will likely hold steady, with growth positive, if weak, and significant adverse credit developments likely be contained to the most vulnerable parts of the credit spectrum.
The global manufacturing slowdown has had a clear and significant impact on credit quality. The European non-financial corporate net outlook bias—the percentage of ratings with a negative outlook less those on a positive outlook—fell to its most pessimistic post-recession level at the end of 2019 (see chart 3), driven mostly by an increase in negative outlooks (see chart 4). One-fifth of rated European nonfinancial corporates have negative/CreditWatch negative outlooks.

The breadth of the deterioration is clear in sector ratings trends: 17 out of 20 sectors (85%) have seen their net outlook bias deteriorate over the past 12 months (see chart 5), with cyclical and commodity sectors—autos, leisure, capital goods, metals and mining, and chemicals—the most severely affected. Secular trends are at work here, such as the technological disruption shaking up the auto sector. But for the most part this deterioration is indicative of the loss of industrial confidence, orders, and capex triggered by the global manufacturing slump.
Once again, central banks have stepped in quickly to try and prevent the manufacturing slump from sparking a broader recession by means of lower rates or expanding their balance sheets further (see chart 6) with quantitative easing. In the case of the eurozone, the ECB applied stimulus on multiple fronts: lower negative deposit rates, reserve requirement exemptions, renewed asset purchases, and enhanced terms for long-term refinancing operations. For companies and consumers alike, the end result is that financing conditions—both in terms of interest costs (see chart 7) and availability—remain exceptionally benign.
Renewed stimulus has also had an analgesic effect on credit markets, curtailing a modest rise in volatility (see chart 8), keeping ‘B’ and ‘BBB’ spreads exceptionally tight, and even easing the more determined repricing of risk apparent in ‘CCC’ spreads (see chart 9).

Chart 8
Credit Volatility Remains Relatively Low

Chart 9
...And Spreads Are Tight Or Tightening Across The Ratings Spectrum

In S&P Global Ratings’ view, 2020-2021 are likely to be years of below-potential economic growth in Europe, but not of recession (see table 1). A limited recovery in global manufacturing will help, but it is the continuing, positive growth contribution from the dominant services sector that is central to this view. Households are likely to get another decent boost in purchasing power from strong wage growth and low inflation. Wages are rising at their highest pace since 2009. We expect them to moderate next year, but as long as labor markets remain tight, firms will remain under pressure to pay higher wages to retain and attract employees.

Table 1
GDP Growth And Unemployment Forecasts For Selected European Countries

<table>
<thead>
<tr>
<th></th>
<th>Real GDP Baseline forecast</th>
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<tbody>
<tr>
<td></td>
<td>2019f 2020f 2021f</td>
<td>2019f 2020f 2021f</td>
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<tr>
<td>France</td>
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<td>10.0 9.9 9.8</td>
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<tr>
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<td>1.7 1.3 1.4</td>
<td>3.4 3.4 3.4</td>
</tr>
<tr>
<td>Spain</td>
<td>2.0 1.7 1.6</td>
<td>14.0 13.3 12.7</td>
</tr>
<tr>
<td>Eurozone</td>
<td>1.2 1.0 1.2</td>
<td>7.8 7.4 7.3</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.7 1.1 1.4</td>
<td>2.4 2.5 2.5</td>
</tr>
<tr>
<td>U.K.</td>
<td>1.3 1.0 1.7</td>
<td>3.9 4.1 4.4</td>
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Source: S&P Global Economics

In the U.K., economic risks have eased as a result of a decisive outcome to the December general election. The clear Conservative victory removes the risk of renationalization of some sectors---which could have triggered capital flight and market volatility--as well as removing the political volatility surrounding Brexit, which was creating economic uncertainty. It is possible that this greater clarity may provide a short-term boost to confidence and growth, even if longer term questions remain unanswered. The U.K. will now leave the EU legally at the end of January, entering a transition period--a status quo ante--currently set to run to year-end. However, the government’s expectation of concluding a new free-trade agreement with the EU by year-end may prove optimistic and, even if not, the resulting agreement is likely to mean greater trade friction for sectors reliant on just-in-time, check-free cross-border trade. A rapid deal with the U.S. is also possible, but will complicate aspects of the EU negotiations, particularly in regard to regulation.
External shocks remain the most likely trigger for a European downturn

In our view, the greatest risks to this scenario are likely to come from external actions and events. Of particular concern is the continuing possibility that the U.S., having achieved some degree of change to tariffs and trade agreements with two of the three countries/blocs that account for the largest part of its visible trade deficit, namely China and Mexico (see chart 10), may yet direct its attention to the EU. Germany, Italy, and France all run substantial visible trade surpluses with the U.S. (see chart 11) and tensions surrounding this and exploitable points of difference about Airbus subsidies or plans for digital revenue taxation, seen as discriminating against the U.S. tech giants that dominate this area, may easily flare up into tariff measures. The fact that this a U.S. presidential election year adds further uncertainty, as this could equally increase the motivation to act for political effect or be a disincentive to act given the likely adverse market impact.

Fiscal stimulus could lessen reliance on monetary policy

Although we expect the European economic policy mix to remain heavily tilted towards monetary policy, greater fiscal stimulus could be a positive surprise particularly in relation to infrastructure spending. This could boost revenues of infrastructure-linked sectors and help counterbalance some of the pressures of technological disruption and environmental regulation.

Growing recognition of the urgency surrounding climate change (see chart 12) has spurred the EU to launch the European Green Deal. To achieve its ambitions there are significant investment needs, with the European Commission estimating that achieving current 2030 climate and energy targets will require €260 billion of additional annual investment, about 1.5% of 2018 GDP. In the U.K., pro-Brexit former industrial areas contributed significantly to the new government’s victory and a desire to encourage stronger growth outside of the south-east of England may spur less restrictive fiscal policy.
Corporate sector growth forecasts are positive but muted

These base-case economic assumptions translate into positive, if muted, revenue and EBITDA growth for rated European non-financial companies. Aggregate S&P Global Ratings analyst forecasts suggest revenues will grow 3.6% this year (versus 4.6% in 2019) and a mere 2% next year (see chart 13). EBITDA growth projections are marginally better at 5.1% for 2020 and 3.3% for 2021 (see chart 14).


At the sector level, the picture is more encouraging, with most sectors expected to expand revenues in 2020 (see chart 15), often at a notably stronger pace than the overall trend. Weaker growth rates from some of the largest sectors—oil and gas, autos, telecoms—are the cause. EBITDA margin forecasts are also positive, particularly in the context of tight labor markets, with most sectors expecting a slight improvement in profitability in the year ahead.

Source: S&P Global Ratings.
Fundamental concerns for speculative grade credits

Despite near-zero European Central Bank (ECB) and Bank of England (BOE) policy rates for over a decade, there is little evidence to suggest the European nonfinancial corporate sector as a whole has lost cash flow discipline. Cash outlays on capex, dividends, acquisitions, and buybacks have kept broadly in line with incoming cash flow (see chart 16), and the last 12 months have seen capex and acquisitions quickly dialed down in response to the global manufacturing downturn. We have not seen cash outlays rapidly outpacing inflows as they did from 2006-2008.

With regard to debt, however, European companies have been accumulating debt with debt-to-EBITDA multiples now comfortably above the 2009 peak (3.8x on last-12-month figures versus 3.3x in 2009; see chart 17). Low interest rates have made this debt comfortably serviceable in current conditions with aggregate cash interest cover measures far healthier than in the run up to the 2008-2009 crisis. Should a recession take hold, however, higher starting debt levels would amplify the deterioration in affordability for a given drop in EBITDA. The slow but steady revenue and EBITDA growth forecasts under our base case and the clear willingness of central banks to act quickly in response to evidence of deteriorating economic conditions, do not suggest imminent threats to corporate credit quality. The main area of concern is the speculative-grade sector (issuers rated below ‘BBB’), where debt levels have hit new highs but where profit margins are dwindling and close to post 2004 lows (see chart 18).

This is all the more concerning given the surge in speculative-grade issuance. ‘CCC’ ratings have expanded rapidly to become far more numerous than ‘AA’ ratings (see chart 19). It should be kept in mind, however, that the European speculative-grade sector is far smaller in debt terms than investment grade, accounting for only 16% of total balance sheet debt for European rated nonfinancial corporates on a last-12-month basis. And debt securities remain a relatively smaller part of the overall financing structure than equities or loans (see chart 20).

Even if systemic concerns can be downplayed, higher debt levels and deteriorating profitability in the speculative-grade segment suggest that the greater differentiation seen last year in credit risk pricing between stronger and weaker credits should continue and intensify. A worrying illustration of poor credit health at the weaker end of the spectrum is the rising proportion of European speculative-grade companies reporting losses. In 2018, 38% of these companies reported net income losses (see chart 21) versus only 12% in 2008. So-called “zombie firms”--those where EBIT has been less than net interest payments for three years or more--are becoming more prevalent. On this Bank of International Settlements definition, nearly one-fifth of rated European nonfinancial corporates currently count as zombies, reliant on cheap refinancing to survive.
Most of the risks in weaker-end credits are essentially idiosyncratic in nature, particularly in the context of our base case of broadly favorable credit conditions overall. Sector issues can be a useful risk overlay, however, as evidenced by the surge in retail defaults last year that were a function of industry pressures brought about by tech disruption and rising rents. Chart 23 shows aggregated S&P Global Ratings financial risk profile scores for European speculative-grade credits, weighted by total debt. It suggests that financial risks are most acute for homebuilders, oil and gas, utilities, metals and mining, and consumer products.

Reassuringly, these sectors not among the sectors with the biggest refinancing needs in 2020. Chart 24 shows the amount of debt coming due this year based on data provided by S&P Global Market Intelligence. The aggregate amount due is $70.4 billion, with the largest nominal repayments expected for telecoms, business and consumer services, health care, and autos.
A final speculative-grade concern is the potential vulnerability of ‘B-’ credits. As in the U.S., the number of issuers in this category has surged over the past few years (see chart 25) and the percentage of ‘B-’ leveraged loans in the S&P ELLI Loan Index stood at 11.5% at end December 2019. This rating segment has much higher earnings volatility and a higher likelihood both of downgrades and default, and can pose problems for collateralized loan obligation (CLO) investors in the event of downgrades to ‘CCC’. Chart 26 shows the share of nonfinancial ‘B-’ rated debt by sector and offers some reassurance in that negative outlooks—those most at risk of downgrade—are heavily concentrated in chemicals and technology, which account for only 14% of total ‘B-’ debt. The four sectors with the most debt account for 53% of total debt outstanding in the ratings category, but only 7% of that debt has a negative outlook.

Chart 25
European ‘B-’ Rated Non-Financial Corporate Issuer Count

[Graph showing European B- Ratings (Count) for years 13 to 19]

Chart 26
Share Of Non-Financial ‘B-’ Rated Debt Outstanding By Sector

[Graph showing sector share of B- Debt Outstanding (%) and sector share of B- Debt with Negative/Watch Negative Outlook (%)]

Source: S&P Global Ratings.

Headwinds from tech disruption, regulation, and environmental costs

Although our macroeconomic base case and aggregate forecasts do suggest a broadly positive cyclical outlook, there remain significant headwinds to the corporate sector from more structural factors such as technology disruption, regulation and the burden of adapting to rising environmental costs. These risk are less easily quantified but have the potential to dramatically alter credit risk over time. An example would be the electrification of autos which is necessitating substantial investment outlays as automakers seek to hold onto market positions governed up to now by combustion engine skills and competence.
These risks feature heavily in the recently published fifth annual series of Industry Top Trends reports, which cover 25 global corporate and infrastructure industries. These set out key industry assumptions, risks, and opportunities seen by S&P Global Ratings analysts for the year ahead. Table 2 provides a summary of these key risks and opportunities in relation to European companies. A consistent theme that emerges is that almost all industries are battling against powerful headwinds that are constraining growth and posing significant risks to credit quality.

Although highly sector-specific in their nature, technological disruption, environmental, social, and regulatory costs, as well as regulations loom large across many sectors. Many aren’t new, but it is striking how central these risks have become to sector credit conditions and outlooks. There are three broad clusters of risks:

- **Technological disruption** that is threatening market positions and altering consumer consumption patterns;
- **Regulations**, encompassing a wide spectrum that includes efforts to address environmental concerns and pricing mechanisms to better reflect climate-related risks and impacts, and the governance of emerging technologies; and
- **Litigation**, which includes ongoing cases in relation to opioids and health care and emissions breaches for autos, as well as sizeable fines for data breaches under GDPR.

In all cases, these pressures pose significant credit risks, particularly in terms of weaker revenues (new competition, changing preferences, pricing pressures), heightened capital expenditure requirements (for example to meet new regulatory standards, develop new technologies, or compete for market share), and a greater need for M&A (to find new sources of growth or protect market share). These all pose risks to cash flow growth and predictability, and often requires substantial funding commitments. An additional layer of uncertainty in reacting to these pressures comes from ongoing uncertainties surrounding trade policy, which can affect supply-chain decision making.

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1 See [https://www.spglobal.com/ratings/en/research-insights/topics/corporate-ratings-industry-top-trends](https://www.spglobal.com/ratings/en/research-insights/topics/corporate-ratings-industry-top-trends) for the 25 individual industry reports as well as a single compilation that brings them all into one publication with an overview that highlights the key themes emerging from the sector analysis.
We are forecasting slower global economic growth in 2020, and a sharper decline could worsen the competition, disruption coming from online providers, changing consumer habits, and geopolitical concerns.

We estimate average steel producer margins will improve modestly in 2020 from currently weak levels. Nondeferrable capex and R&D-linked electrification, connectivity, and autonomous driving will limit the scope of restructuring to accommodate softer market conditions and could drive some suppliers out of the market.

We could see little change in shareholder rewards, M&A, or elevated capital spending. This could hurt credit earnings.

We expect to see negative rating transitions and a potential increase in defaults in the lowest ‘B’ and ‘CCC’ rating categories.

Over time, Brexit could negatively affect supply chains. Smaller defense suppliers would likely be hardest hit because they lack the scale, resources, and liquidity to handle sudden large swings in their working capital.

Brexit could alter the U.K.’s role in the EU’s defense strategy and lead to relocation of production.

A change in U.K. government could impact foreign sales as there have been calls from some U.K. and European political parties to ban defense exports to Saudi Arabia.

Global autos could face considerable pressure from prolonged trade disputes given potential disruptions to supply chains.

Nondeferrable capex and R&D-linked electrification, connectivity, and autonomous driving will limit the scope of restructuring to accommodate softer market conditions and could drive some suppliers out of the market.

Access to funding access is an additional risk, as the clouded industry outlook lowers creditor confidence on the suppliers.

Eased financial discipline is a key risk if there’s a downturn, despite the vast majority of building material companies having stable outlooks.

EMEA’s larger companies have significantly increased their exposure to the U.S. market in recent years, enabling them to improve their results. However, this raises a concentration risk.

We estimate maintenance capex accounts for an average of 5%-7% of cement revenues in developed markets. In the next few years it will likely increase and could reach double digits, due to the search for energy efficiency and the need to comply with more stringent environmental regulations.

We expect divestments and acquisitions to continue as large U.S. European, and Japanese capital goods companies seek to simplify their structures and invest in higher growth technologies.

Large capital goods companies should be able to withstand the downturn well.

We expect to see negative rating transitions and a potential increase in defaults in the lowest ‘B’ and ‘CCC’ rating categories.

A recession in one or more regions is a key risk that could result in lower-than-anticipated demand and earnings.

We could see little change in shareholder rewards, M&A, or elevated capital spending. This could hurt credit quality in an environment of weaker earnings and cash flows.

Companies rated ‘B’ or below, or those concentrated in fewer end markets, are more susceptible to demand and other shocks.

Technology and changes in consumers’ behavior, tastes, and preferences have increased the pace of change in the consumer products industry. Branded goods companies are focusing on being more agile to reposition their portfolios to meet these changes.

The U.S.-China dispute has hurt the smaller, speculative-grade durable and apparel companies.

Speculative-grade credit quality will erode rapidly in case of a recession.

Disruption in the industry creates risk but also opportunities. Health care systems are rapidly increasing their service offerings and expanding out of the hospital and into lower-cost delivery settings.

Pharma ratings have little capacity for M&A following last year’s deals.

The appetite/tolerance for higher leverage has increased in all three main subsectors: pharma, health care services, and medical equipment. Fueled by a combination of a favorable financing environment, high multiples, and rapid consolidation, starting leverage has been increasing steadily to almost 7x.

Speculative-grade credit quality will erode rapidly in case of a recession.

As house prices are growing faster than income and rents in Western Europe, ownership affordability may weaken and somewhat weigh on demand in 2020.

In Russia, the new regulation on project loans will likely affect small developers and create opportunities for consolidations. In the U.K., the upcoming end of Help-To-Buy government incentives will likely soften demand for newly built apartments.

Online gaming in Europe continues to grow strongly, owing to increased mobile penetration and technological innovation. Mergers are likely to increase market share and margins, but also often bolster the portfolio of brands.

We forecast European RevPar to continue slowing down to the low-single-digit area in 2020, mostly due to sagging economic growth, uncertainties surrounding Brexit, and other political risks, and weakening consumer confidence.

The tour operator industry in Europe is in transformation. The traditional packaged holiday tour operator industry has been going through difficult times. It is an extremely fragmented market with intensifying competition, disruption coming from online providers, changing consumer habits, and geopolitical concerns.

Several large media companies are embarking on new services as they look to mitigate the effects of declining pay-TV subscribers by establishing direct-to-consumer (DTC) OTT services.

The regulatory burden is meaningfully increased on online companies’ data privacy, data localization, and antitrust mandates.

A global economic downturn in 2020.

We are forecasting slower global economic growth in 2020, and a sharper decline could worsen the deterioration in metals markets.

Shareholder returns or new investments consume precious capital.

We estimate average steel producer margins will improve modestly in 2020 from currently weak levels.
Oil and gas

- One of the major sector risks is the debt maturity wall facing speculative-grade companies and their ability to meet maturities.
- A sharp downturn in the global economy would cause a pronounced decline in demand and a fall in oil and natural gas prices.
- New IMO regulations have implications for marine fuel product demand patterns; the flexibility of refiners and traders to produce and supply necessary volumes; and consequences for pricing.

Real estate

- In Europe, landlords we rate have been resilient against the gradual increase in e-commerce. We see some signs of market weaknesses that could erode retail landlords’ capacity either to generate organic growth or dispose of assets for deleveraging purposes.
- Growing risks from rent control in Berlin and—less likely after the election—Brexit could hurt prospects for the real estate sector in 2020.
- We expect real estate issuers to shift focus towards growth versus enhancing credit quality, given access to low-cost debt.

Retail and restaurants

- Across various regions in EMEA we expect anemic top-line growth, with several retailers undertaking extensive and in some cases multi-year restructuring programs. Non-food retail sales have mostly been driven by volume, reflecting significant price competition and discounting.
- No subsector is immune from disruption and we expect these trends to intensify further in 2020. Department stores, apparel retailers, and the casual dining sectors will be most challenged.
- From a margin standpoint, for both food and non-food retailers, moderate price rises have been offset by input cost and wage inflation. In countries, like the U.K., wages in 2019 were the highest in over a decade.

Technology

- Both tariff- and non-tariff related actions have been disruptive to tech companies, adding to business uncertainties, and dampening IT spending growth.
- China’s economy has slowed through 2019 and could slow further amid a protracted trade conflict with the U.S., hurting consumer demand for IT products ranging from smartphones to semiconductors used in autos in the world’s largest market.
- Deteriorating credit quality and rising leverage over the past few years and increased recession risk will likely lead to further downgrades among lower-rated credits.

Telecommunications

- Fixed-mobile convergence could allow operators to contain churn and protect profitability in the face of strong competition. Integrated fixed-mobile operators may also have a cost advantage in the roll-out of 5G.
- Following several years of discipline on distributions, operators could face mounting pressure to make up for underperforming share prices with higher payouts. This could deplete headroom for issuers close to our downside thresholds.
- Brexit, trade tensions, and an economic slowdown could create a perfect storm.

Transportation

- The airlines we rate have been thoroughly preparing themselves to minimize any disruptions from a Brexit scenario. Both the U.K. and EU have given repeated assurances that flights will continue post-Brexit. In our view, it is in both parties’ interests to ensure smooth air traffic.
- Most shipping companies will meet the stricter IMO 2020 requirements. However, with prices for these compliant fuels expected to rise, their earnings stability and ultimate survival (particularly for smaller, more vulnerable players) will depend on their ability to effectively pass through increased fuel costs to their customers.

EMEA Unregulated Utilities

- Zero-subsidy bids within renewable energy will soon become the norm, and sponsors’ and politicians’ growth ambitions remain intact. The next challenge will be to deal with merchant risk. Here again, the market already has a plan: power purchase agreements (PPAs).
- The low cost of debt is tempting companies into M&A.
- While the sector has proved its ability to rapidly restore credit metrics in a downturn, we do not foresee much improvement in this better environment. In most cases, financial policies favor increased investments and shareholder remuneration over debt reduction.

EMEA Regulated Utilities

- We see investments jumping from 2019 onward. This is first and foremost propelled by energy transition and the need to connect and manage huge new renewable power generation projects.
- For some time we have seen utilities’ financial outperformance being largely driven by financial engineering, in other words, more debt.
- Another key development is more differentiation between networks. We believe that gas infrastructure is now less favorably positioned within energy transition, as reflected by the European Commission taxonomy.

Transportation Infrastructure

- Growing trends of protectionism and isolationism have the potential to limit traffic increases.
- The decision from the grantor not to retender some toll-road Spanish concessions exposes operators to cash-flow expiration.
- We are seeing increasing investments in light rail being driven by government policies that favor less carbon-intensive transportation choices.

Risks and opportunities have been simplified and standardized relative to the originals for cross-section clarity. No rank ordering is implied between the risks/opportunities.
Not all sectors mitigate high leverage with strong cash conversion

Credit trends in the primary leveraged finance market are widely tracked and are a thermometer for the credit health of the broader leveraged finance market. However, credit performance plays out over time and varies substantially by sector and credit. So how has leverage and cash flow in the broader market changed over the past five years, and how is it likely to change over this year?

Overall, based on S&P’s rated portfolio, European speculative-grade corporate leverage increased by 0.4x to 4.25x, on an S&P-adjusted basis, between 2014 and 2018 (see chart 27). We forecast that it will have increased further to 4.4x for financial year-end 2019, premised on debt growing well above the meager growth rate in revenues and margins, before easing somewhat to 4.15x in 2020. But there is substantial variation between sectors. Health care, business services, consumer products, media, and transportation are the most highly leveraged sectors. Notably, the technology, health care, and consumer product sectors have increased leverage by 1.7x-1.9x over this period, with leverage at new highs in health care and consumer products at the end of 2018 using latest actual full-year data. Conversely, highly leveraged sectors such as transportation and media have reduced debt by about 0.6x, as has the paper and packaging sector that has been grappling with overcapacity in a changing business environment. The lowly levered auto sector appears to have reduced debt substantially, but this sector is dominated by several large speculative-grade OEMs including a couple that incur substantial debt within their rated captive finance divisions.

Chart 27
Aggregate Weighted Adjusted Debt/EBITDA For European Speculative-Grade Corporates By Sector
(range 2014 – 2018 and 2020 S&P forecast; ranked in ascending order of 2018 leverage)

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**High cash-conversion rates provide valuable financial flexibility**

High leverage may not be such a high credit risk if companies generate strong positive free operating cash flow (FOCF) after taking account of capital expenditure required to maintain and expand the business. Looking at the whole European market it is striking how stable it has been since 2014, at about 5.3% FOCF to adjusted debt (see chart 28). Indeed, aggregating our base case forecasts through 2020 we expect this level to be maintained, albeit with variations among sectors.

Some sectors are inherently more volatile because they are either cyclical (oil & gas, technology, builders) or are facing upheaval requiring substantial investment (autos, perhaps leisure). Quite a few sectors generate low but stable FOCF relative to debt (media, capital goods, business services, retail, transport). These sectors, at first sight, have less financial flexibility to improve cash flow in a more adverse business climate. Of greatest concern are those sectors where FOCF to debt is low and at the low end of the range experienced since 2014. Consumer products, paper and packaging, and leisure might fall into this category, and capital goods is not far off. Health care remains a sector to monitor carefully because FOCF to debt has fallen consistently from 15.3% in 2014 to 5.3% in 2018, and our forecast for 2019 is 5.1%.

More positively, looking at our base case forecasts for 2020, we do see scope for some modest improvement in FOCF to debt in the technology, metals & mining, telco, retail, leisure, consumer products, and paper & packaging sectors.

**High leverage and low FOCF do not mix well from a credit risk perspective**

In our view, these aggregated adjusted measures of leverage and FOCF to debt in combination provide a more detailed view of how credit risk in the European leveraged finance market is developing. Sectors most vulnerable would be those exhibiting high leverage, low FOCF relative to debt, and those where FOCF is shrinking either because competitive pressures are eroding margins or because substantial investment or R&D is required to adapt to a rapidly changing business environment. On this basis, it is evident from chart 29 that the capital goods sector—sensitive to trade developments—appears quite vulnerable particularly when taking weak prospects for FOCF generation onto account. Media, health care, and business services also appear to be among the more exposed sectors, with high leverage, and little flexibility, in our view, to improve FOCF generation, particularly for health care and media. The auto sector exhibiting low leverage is notable for a deteriorating outlook for FOCF, largely resulting from heavy nondiscretionary investment required to adapt to emissions regulations and electrification.
Primary market trends: Rising leverage is negative for recovery rates

So, while leverage has risen in recent years, this is even more evident in the primary market. First-lien leverage multiples now exceed the levels experienced before the last financial crisis, although average total leverage remains 0.6x below the peak of 2007. Based on data from LCD, European average total leverage levels were 5.3x in 2019. Furthermore, this is a market statistic that incorporates management and structuring adjustments (or “marketing EBITDA”), which generally understates leverage, as these adjustment include growth and cost synergies, cost-saving benefits, and other forward-looking business optimization and growth expectations, much of which is challenging to realize (see “Leveraged Finance: How Leveraged Are European Leveraged Finance Transactions?” Dec. 3, 2019).

Chart 30
Average European Primary Market Issuance Leverage Ratios

It is also notable that European average first-lien leverage is also now 0.6x higher than in the U.S. Persistently high equity cushions in new European transactions, averaging about half of total capitalization, put the higher level of leverage into context and somewhat mitigate debt risk. However, growing flexibility in terms of debt incurrence afforded by looser documentation, tighter
pricing, and interest rates provide plenty of cause for concern that incentives to reduce leverage are limited.

First, expectations for continued low interest rates in Europe, exacerbated by the search for yield and CLO ramp-up, will support increased leverage on new deals versus U.S. peers because cash interest coverage ratios appear on a par or better for European issuers as a result of lower base rates. Second, restrictions on indebtedness in the documentation are loosening with the inclusion of “freebie baskets” (ability to incur a pre-specified amount of additional debt, typically almost as large as 100% of EBITDA), using fixed-charge cover ratios rather than leverage ratios. This, in short, allows for performing credits to relever to original or slightly higher leverage—to fund either acquisitions or dividend distributions. By contrast, nonperforming credits without maintenance covenants are afforded leeway to carry higher leverage levels for longer, subject to having adequate liquidity.

These conditions translate into potentially rising risks over recovery prospects for first-lien debt should the company’s financial performance deteriorate and a capital restructuring ensue. Companies and sponsors in these situations may wait longer to engage with lenders, thereby potentially reducing the intrinsic value remaining in the business as a going concern.

However, we expect those risks to be isolated to individual credits and sectors, demonstrated by pockets of insular, or idiosyncratic, weaknesses rather than a downward impact on the entire asset class. For example, we see continued pressures in retail, consumer goods, commodity chemicals (or those exposed to autos), capital goods, and certain health care operators. We expect the changes in consumer spending, purchasing habits, structural industry changes commanding higher capital investment, and rising input costs to continue negatively impacting profitability and cash flow generation in these sectors.

A recovery rating of ‘3’ (indicating meaningful recovery of 50%-70% in an event of payment default) remains the most common assessment for new first-lien issues in Europe, with over 90% of new ratings in that category. The average expected recovery for new speculative grade first-lien debt over the first three quarters of 2019 was approximately 60% (see chart 31), albeit still 13% lower than the actual longer term average first-lien recovery rate of 73% (see *European Leveraged Finance And Recovery Fourth–Quarter Update And Full–Year Summary “ Jan. 23, 2020 and *2018 Annual Study Of Corporate Recoveries In Europe: Little Change, For Now,” May 20, 2019).

By value, 76% of all issuance carries a recovery rating of ‘3’—a 4% increase versus 2018. There has been a decrease in 100% expected recovery ratings, which have largely constituted super-senior revolving credit facilities. This is because there has been an increased drive to refinance bonds through loans coupled with predominantly loan-only new issuance by ‘B’ rated credits. Half of the...
'4' estimated recovery rating bucket consists of debt issued by two sectors, capital goods and health care, as we have applied higher stressors to the run-rate EBITDA. This reflects increased competitive pressures, Brexit-related pressures, and issuer-specific risks that have increased concerns on leverage and potential restructuring.

**Loans for bonds in 'B', and bonds for loans at 'BB'**

European leveraged loans disappointed expectations for a strong year of new issuance in 2019, particularly as European markets did not experience the degree of turbulence the U.S. faced in the last quarter of 2018. M&A activity, although fairly active in the second half of the year with several visible cross-border transactions, failed to fill the pipeline for the year. At €69 billion, institutional loan issuance in 2019 fell by over 30% compared to 2017 highs and by 10% compared to 2018. Term-loans and second-lien loans dominated activity in the 'B' space, as both sponsors and issuers alike preferred the less onerous route to market, with institutional demand supported by strong collateralized loan obligation (CLO) issuance. Corporates typically rated in the 'BB' category, on the other hand, looking to refinance loans and extend yield curves and debt maturities at extremely attractive rates, contributed to a very buoyant primary bond market. For the year, speculative-grade bond issuance was €74 billion—an increase of about 16% on 2018.

**Chart 32 European Leveraged Finance Quarterly New Issuance Volume**

Source: LCD, an offering of S&P Global Market Intelligence

M&A drove around one-half of the volume of speculative-grade new issuance, amounting to €20 billion equivalent. Of this, around €17 billion was supply by first-time issuers, alleviating some of the concerns surrounding lack of portfolio diversification and large redemptions. Long-awaited public-to-private transactions and corporate carve outs came to market in the second half of the year, with predominantly loan-only capital structures. Large cross-border transactions were the exceptions, typically structured as a mix of loan and bond offerings in order to tap into U.S. and euro liquidity to offer issuers best pricing execution.

'B-’ rated new issuance rose in 2019 compared to prior year, driven equally by new issuers coming to market (see chart 32) as well as existing issuers. However, the rise in outstanding debt rated ‘B-’ by S&P is not as pronounced as in the U.S., comprising only 11% of all speculative-grade first-lien debt, compared to one-third in the U.S.
Credit Trends: Downgrades, defaults, and restructurings are slowly rising

Evidence of late-cycle risks is increasingly prevalent, with a continued rise in first-lien and overall leverage levels, as well as idiosyncratic and “one-off” credit issues. Yet, overall 12-month trailing European default rates remain relatively benign, at 2.2% (see Default Outlook article page 22).

We took over 170 rating actions in the European speculative-grade non-financial corporate space in 2019. Downgrades exceeded upgrades by almost four-to-one in 2019 (see chart 33), reflecting earnings weakness and against the backdrop of a weak regional economy and an unsettled geopolitical environment globally. Sectors with the most downgrades and negative outlooks included retail, consumer products, leisure and entertainment, automotive, and capital goods (see chart 34).

Market price and spreads: increasing bifurcation to continue

The resumption of quantitative easing by the ECB that has further supported strong CLO issuance have been the major drivers behind the drop in pricing for 'BB/BB-' and 'B+/B' rated issuers alike by around 1% since 2016. This has resulted in average spreads (and yields) of around 2.9% and 3.9%, respectively. However, within these buckets there is an increased focus by investors on creditworthiness and, in particular, exposure to credit and macroeconomic cycles. Issuers deemed to carry cyclical risk, for example, can expect to pay hefty premiums, sometimes as wide as 1%-2%, or more, in the same 'B' rating category. This bifurcation of creditworthiness is less pronounced for new issuance by 'BB' category rated issuers.
Leveraged finance outlook for 2020

Investors’ perception of “good” credits versus “challenging” ones will continue to be largely reflected in price (cost of debt). Challenging credits, often with complex or unfamiliar business models, will see tightening of documentation terms, in particular flexibility around EBITDA addbacks, additional indebtedness, and restricted payments. Bond-for-loan takeouts by established ‘BB’ rated corporates are likely to drive speculative-grade bond issuance, whereas ‘B’ credits are expected to continue to turn to European loan markets for funding.

Against a weak economic outlook and aggressive financial policies, failure to achieve growth targets will mean that “marginal” credits will come under increasing rating pressure from their burgeoning leverage, potentially leading to an increased pool of credits rated ‘B-’ or below. Inability to generate positive free operating cash flow over our rating horizon remains a key differentiator between ‘B’ and ‘B-’ credits.
Default Outlook

S&P Global Ratings Research anticipates that the 12-month trailing speculative grade default rate will stand at around 2.3% through September 2020, little changed from 2.2% at year-end 2019 (see chart 36). This continues the remarkably benign period for defaults since early 2011. Some recent ratings-based indicators, such as ratings transitions and the distribution of ratings outlooks, point to rising aggregate default risk, but these are largely offset by our expectation of continued easy financing conditions. Of the 15 defaults in 2019, six were domiciled in the U.K., with three in retail reflecting ongoing pressures from online competition, business rates, and Brexit-induced consumer caution. The five defaults in the capital goods sector highlight some sensitivity to cyclical and commodity-type end markets, particularly smaller companies without market-leading competitive positions.

By value, debt outstanding at default in 2019 amounted to €22.7 billion (see chart 37)--at the top of the range since 2013 (aside from the Intelsat spike in 2016). By sector, apart from capital goods and retail, oilfield service provider Weatherford International filed for Chapter 11 with $8 billion reported debt, and in health care U.K. headquartered Mallinckrodt plc was the major contributor after conducting a distressed exchange.

Outstanding European Corporate Debt At Default By Year And Sector

Source: S&P Global Ratings and S&P Global Market Intelligence’s CreditPro®. Note: Shaded areas are periods of recession as defined by the CEPR-EABCN. Data as of Dec. 3, 2019.
M&A Outlook

Deal activity looks set to improve

The weak economic backdrop and challenging political climate in Europe has deterred corporates from aggressively pursuing acquisitions in the EU31 countries. M&A volumes dipped by about 11% year on year to €459 billion in 2019 (see chart 38). While economic growth in the region is expected to slow in 2020, we expect deal activity to see a revival. Rising geopolitical tensions since Q4 2019, Presidential elections in the U.S., and the volatile nature of trade talks are expected to impede global deal activity in 2020. However, this may augur well for Europe, as the region is experiencing a period of reasonable political stability, which will be further supported by diminishing fears of a disorderly Brexit and low interest rates. Conditions, too, appear ideal for private equity firms—sitting on record levels of cash—to aggressively look for opportunities in Europe.

We expect heightened acquisition volumes in health care, IT, media, gaming, real estate, transportation, and unregulated utilities. It is likely to be muted in more cyclical sectors, such as automobiles, capital goods, consumer products, and metals. M&A activity in sectors sensitive to global growth will perhaps be dominated by consolidation among larger players and firms looking to becoming leaner to lower their vulnerability to prospects of slower global growth.

Cashing in

Sponsor-backed acquisition volumes stood at €104 billion in 2019 (see chart 39), the highest level since the financial crisis and 6% up on the preceding year. We expect private equity firms to up the ante this year, as European corporates, particularly firms operating in cyclical sectors, will continue sell their noncore assets to improve competitiveness and profitability. The sale of Nestlé’s skin-care portfolio, WPP’s sale of its market-research unit Kantar, and BASF’s construction chemicals business were a few large deals completed last year. Entities operating in capital goods, consumer products, and pharmaceuticals sectors are expected to cash in on the rising demand by divesting businesses that are not part of core portfolios.
A decade of transformational deals

As European corporates enter a period in which organic growth remains challenging, the upcoming decade will lead firms to pursue unconventional deals to mitigate disruption, cater to changing consumer behavior, diversify product mix, and enter new markets. A few deals from 2019 are curtain raisers for deal activity in the decade ahead. Peugeot and Fiat’s proposed merger is a good example of a transformative deal where the merger will provide greater scale and financial strength to deal with the major disruption facing the sector in the coming years. U.S. toy company Hasbro’s proposed deal to purchase U.K.’s Entertainment One is aimed at gaining access to merchandising of pre-school children’s content, such as Peppa Pig and PJ Masks. The deal also offers access to the booming content market.

While regulators are likely to be put under pressure from unconventional deal activity, they are expected to remain stringent, maintaining their focus on safeguarding strategic and national interests. In the protectionist environment, scrutiny of risk is also expected to change. With consumers and stakeholders becoming increasingly conscious about social factors, we expect a greater degree of scrutiny on environmental, social, and governance (ESG) standards during the due diligence process. The focus will be on emissions and governance, but we expect scrutiny to extend to factors such as gender inequality and employee rights by the end of the decade.
Related Research

- European Leveraged Finance And Recovery Fourth-Quarter Update And Full-Year Summary, Jan. 23, 2020
- German Corporate Credit Outlook Fades Alongside Global And Chinese Slowdown, Dec. 11, 2019
- Industry Top Trends 2020: Compilation and Key Themes, Dec. 3, 2019
- Credit Conditions EMEA: Low Growth, Lower Rates, Dec. 3, 2019
- Economic Research: Eurozone Economic Outlook: Consumers Won't Give Up In 2020, Nov. 28, 2019
- Recovery Prospects Soften On Uptick In 'B-' Issuance: European Leveraged Finance And Recovery Update, 3Q 2019, Oct. 25, 2019
- 2018 Annual Study Of Corporate Recoveries In Europe: Little Change, For Now, May 20, 2019

This report does not constitute a rating action