S&P Global Ratings has embarked on an expanding study of the impact that a potential credit cycle downturn involving deteriorating economic and credit fundamentals—with rising defaults and scarce liquidity—may have on ratings and market conditions. This article, which will be periodically updated, is an edited compilation of the key takeaways from our "When The Cycle Turns" series.

Key Takeaways

Cross-sector

China's Long Credit Cycle Has Ended And Deleveraging Has Begun: Can It Be Sustained?, Aug. 19, 2018
- China's long credit cycle that begun in 2004 is over. Measured from peak to peak and using credit-to-GDP ratios, most key metrics are heading south.
- Based on past credit cycles, the authorities' current three-year deleveraging horizon will need to be made data-dependent, and most likely extended.
- Already we are seeing evidence that the authorities are fine-tuning the pace of deleveraging in response to (perhaps) larger-than-expected growth effects as well as the trade dispute with the U.S.

Leveraged Finance--Will The Worst Deals Be Done In The Best Of Times, Again?, April 10, 2018
- Cashed-up private equity is seeking debt from the leveraged loan markets to help fund mergers and acquisitions in 2018.
- The chase for yield is eroding debtholder returns at a time of escalating risks, making the risk/return profile of many leveraged loans issued so far in 2018 the weakest since late 2008.
- Meanwhile, institutional loans that are covenant-lite, have limited security packages, and borrower-friendly terms are widespread, adding to lender risks.
- As the credit cycle peaks, lenders are becoming more vulnerable to a sudden, sustained turn in risk appetite and tightening credit conditions.

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When The Cycle Turns: Key Takeaways From Our Articles

Corporates

Credit FAQ: When The Cycle Turns: ‘BBB’ Downgrade Risks May Be Overstated, Dec. 3, 2018

- Ratings on U.S. nonfinancial corporate issuers in the ‘BBB’ category have performed well over the past 35-plus years, even during periods of economic stress.

- Sizing downgrade risk based on our scenario analysis indicates $200 billion-$250 billion in potential fallen angel debt in the next recession. While material, this would be in line with past cycles when viewed as a percentage of the speculative-grade bond market, although we recognize further risks include the timing and composition of downgrades.

- While every cycle is unique, we believe strong business fundamentals and cash flow generation will support future ratings performance.

- Risks are posed by the significant amount of ‘BBB’ debt, the sizeable debt burden of a handful of issuers, as well as small pockets of higher leverage.

- Still, debt tends to be concentrated among the most stable sectors and issuers, with the majority of ‘BBB’ issuers leveraged below 3x in 2018 and 2019.

How Would Major Media Companies Fare In A Downturn?, Oct. 29, 2018

- Media companies are less exposed to economic cyclicality than in the past as non-advertising revenues, such as per-subscriber distribution fees, account for a greater share of overall revenues.

- Balance sheets for the companies we surveyed are already stretched because of merger and acquisition activity or aggressive share repurchases. Those companies, which already suspended or will soon suspend, share repurchases to reduce leverage, have limited financial tools to increase the pace of debt reduction in the event of an economic downturn.

- Our stress analysis shows that our ratings on Comcast, Disney, and Viacom are more vulnerable to economic stress. CBS and Discovery potentially have the financial flexibility (for example, the ability to halt or, in the case of Discovery, not resume share repurchases) to keep leverage within the bounds of the current ratings, although actual ratings performance will depend on the extent of an eventual downturn and each company's corresponding financial policy decisions. For AT&T, leverage is unlikely to worsen materially even in a recession because of the steady results from its wireless operations.

U.S. Coal Companies Seek Paydirt In Exports, Oct. 26, 2018

- U.S. coal producers are increasingly turning to export markets as domestic coal-fired power plants close down and utilities opt for natural gas and renewable sources for fuel.

- Falling domestic demand means that producers are taking on additional operating and financial risks when they look to sell into overseas markets.

- Producers with the highest-quality coal and best transport options to export their coal will have an advantage, even with moderate shocks to domestic demand and foreign currency and price risks.

- Credit quality is stabilizing for U.S. coal producers, as financial restructuring and capital constraints give way to shareholder returns and increased capital spending.

- We expect demand for coal in traditional overseas markets in Europe and Latin America to remain steady over the next year, while growth in Asia-Pacific markets will increase slightly.
When The Cycle Turns: Key Takeaways From Our Articles

Leverage Continues To Climb--Has It Finally Peaked?, Oct. 9, 2018
- Excessive leverage lowers issuers' financial flexibility and increases reliance on stable capital markets.
- Exacerbated volatility when the credit cycle turns may give rise to liquidity stress and potential defaults if market access is limited.
- With overseas cash more easily fungible, debt issuance to fund shareholder-friendly activity will most likely begin to deaccelerate.

The EBITDA Add-Back Fallacy, Sept. 24, 2018
- Our review of a sample of transactions originated during 2015 show that on the aggregate level, add-backs inflated projected EBITDA by an average of 45%.
- Our data indicate that management projections at deal inception were very aggressive; showing that on average, actual reported net leverage was 2.9 turns higher than forecast for 2016, growing to 3.6 turns in 2017. Overstated earnings was the primary contributor to the leverage disparity with reported EBITDA 29% below management projected adjusted EBITDA during 2016, growing to 34% in 2017.
- We conclude that 1) management-adjusted EBITDA including add-backs is not necessarily a good indicator for future EBITDA; 2) companies overestimate debt repayment; 3) combined, these effects understate future leverage and credit risk; and 4) add-backs also present incremental credit risk in the form of future event risk since covenants that rely on EBITDA may provide additional flexibility under negative covenants and restricted payments (dividends, debt and lien allowances, etc.)

Some Sectors May Hit A (Maturity) Wall, Sept. 20, 2018
- "When" the credit cycle turns may be important, as many companies have looming debt maturities that could coincide with a downturn.
- The oil and gas and retail and restaurants sectors are in particular danger, as both have a significant amount of speculative-grade debt coming due in the next few years. These approaching maturities--combined with a downturn--could lead to defaults across both sectors.
- Refinancing risk is manageable for now, but the market has experienced volatility that could cause panic.

U.S. Midyear Corporate Outlook: Peak, Plateau, Or Peril? As The Cycle Matures, A Stable Outlook For Now, Aug. 6, 2018
- At the end of the first half of 2018, 75% of U.S. corporate borrowers we rate had stable outlooks.
- Median leverage in the 'BBB' ratings category increased to 2.3x at the end of last year, from 1.9x in 2008, but this remains in line with our parameters for the category.
- S&P Global Ratings economists forecast U.S. real GDP growth of 3% and 2.5% in 2018 and 2019, respectively, with a low (10%) probability of a recession in the next 12 months.
- Heightened trade tensions, increased financial market volatility, and rising interest rates pose the greatest threats to favorable credit conditions.

U.S. 'BBB' Corporate Profiles Remain Firm Despite Rising Debt, July 25, 2018
While total adjusted debt among U.S. nonfinancial corporate firms we rate in the 'BBB' category has swelled to $2.66 trillion, median leverage in the category remains low, at about 2.3x, up from 1.9x in 2008.

U.S. corporate cash flow conversion has improved in the past decade thanks to factors such as corporate restructuring and, more recently, the U.S. tax bill.

A strong mix of business risk profiles support investment-grade ratings. Low borrowing costs have resulted in some voluntary migration down the ratings scale; these credits typically have more levers to pull in times of stress (for example, reduction in their shareholder returns).

While M&A could pose heightened risks, ratings have generally performed well over the two-year outlook horizon following large M&A deals in the 'BBB' category.

How Have M&A Transactions In Consumer Products Performed?, July 25, 2018

- We believe most consumer products companies can reduce the leverage on their balance sheets even if the assets they acquire aren't as successful as they expected at the outset of deals—which demonstrates the strength of these companies' cash flows, generally.

Will Consumer Companies' M&A-Related Debt Result In An Exodus From Investment Grade?, July 25, 2018

- For the past several years, consumer products companies have gorged on M&A as a way to counter anemic revenue growth--mainly among packaged food companies--that has fallen shy of economic growth.

- In part thanks to the benefit of the U.S. tax bill and the expected rise in interest rates, large transactions picked up late last year and into 2018.

- Capital structures at many borrowers we rate have become more aggressive, with leverage rising beyond historical levels. However, we believe these borrowers can reduce leverage over a two-year window and maintain investment-grade credit ratios.

As U.S. 'BBB' Debt Growth Sparks Investor Concern, Near-Term Risks Remain Low, July 25, 2018

- 'BBB' rated corporate debt accounts for a growing share of the U.S. corporate debt market, and 'BBB' bonds now surpass $3 trillion, outpacing the entire speculative-grade segment.

- The weighted-average annual downgrade rate for 'BBB' rated issuers to the speculative-grade categories is 4.5%, and during the most recent credit cycles the annual downgrade rate for 'BBB' rated issuers peaked at 7.6% in 2009 and 9.2% in 2002.

- Both the number of potential fallen angels (which are issuers rated 'BBB-' with negative outlooks or ratings on CreditWatch with negative implications) and their related debt (less than $90 billion in associated debt) remains well below the highs reached during stress periods in 2002 and 2009.

- Although the current population of 'BBB' rated firms in the U.S. is large, it should remain stable from a credit perspective in the near- to medium-term horizon.

Public Finance

Are California's Historically High Budget Reserves Also A Bare Minimum?, Oct. 23, 2018

- Despite eight years of an improving budget position, California remains vulnerable to significant
fiscal stress in a recession.

- A volatile revenue structure is California's primary fiscal risk factor.
- Constitutional funding formulas dictate major general fund expenditures and can stabilize budget imbalances automatically.
- Historically large budget reserves provide a significant one-time buffer to unanticipated revenue shortfalls.
- Budget stabilizers plus reserves could enable the state to weather a downturn.

U.S. States May Be Tested In Unprecedented Ways, Sept. 17, 2018

- Budget reserves are a first-line defense against revenue shortfalls and in a majority of states remain insufficient to absorb the first-year fiscal effects of a moderately severe recession.
- Most states nevertheless retain an adequate capacity to make fiscal adjustments in response to a downturn.
- Economic growth has accelerated in 2018, reducing the likelihood of a recession within the next 12 months.
- Evaluating state fiscal strength now, amid an expansion, is relevant because larger federal deficits and a still-low federal funds rate imply there could be less countercyclical support in the next downturn.

REITs

REITs Around The World Are Braced For Rising Rates, Tighter Funding Conditions, Oct. 10, 2018

- The REITS rated by S&P Global Ratings are generally well-positioned to withstand gradual tightening conditions as their capital structured is largely fixed or hedged.
- In the U.S., these entities have shored up their balance sheets against the backdrop of a Federal Reserve that is steadily raising interest rates as it normalizes monetary policy.
- Similarly, rising interest rates and tighter funding conditions pose key risks across the Asia-Pacific real estate markets.
- Most REITs in Europe have fixed or hedged their debt for the next 3-4 years, and the direct effects on funding costs and interest expense coverage ratios appears limited.

Asia-Pacific REITs Build A Rating Buffer As Interest Rates Rise, Oct. 3, 2018

- Asia-Pacific REITs have built a rating buffer that enables them to withstand a moderate rise in interest rates, given their limited amount of floating-rate debt, modest upcoming maturities, and robust interest coverage metrics.
- We expect interest rates to rise moderately across Asia-Pacific, and funding conditions to tighten as investor sentiment points to a potential turn in the U.S. credit cycle.
- Our study finds that a small number of Asia-Pacific REITs would face rating pressure under three stress scenarios of interest rates spiking by 100 bps, 200 bps, and 300 bps.
- Further, our stress tests on Asia-Pacific REITs' asset bases found that their currently elevated asset values mask their potentially higher gearing levels. However, gearing ratios remain within rating tolerances under the stress tests.
When The Cycle Turns: Key Takeaways From Our Articles

U.S. REITs Look Ready To Handle Rising Rates, Sept. 24, 2018
- Healthy balance sheets enjoyed by most U.S. REITs we rate will allow these borrowers to withstand a gradual pace of rate increases with little effect on their credit quality.
- We believe most U.S. REITs we rate can absorb this gradual increase in rates, given their balance sheets hold a limited amount of floating-rate debt and have limited near-term refinancing needs.
- While rising interest rates have the potential to weaken credit protection measures, particularly EBITDA interest coverage and fixed-charge coverage ratios, this risk is mitigated because our rated REIT universe consists largely of fixed-rate debt. Less than 20% of REITs we rate have debt structures with more than 25% exposure to variable-rate debt.
- Meanwhile, aggregate debt maturities are manageable, in our view. Just 3% of outstanding debt comes due during the remainder of this year, followed by 7% and 11% in 2019 and 2020, respectively.

How Would The Credit Quality Of European REITs Withstand Rising Interest Rates?, Sept. 24, 2018
- With a special focus on the 25 largest real estate names that we rate in Europe, we ran stress scenarios incorporating higher floating rates over the next three years to gauge the impact on debt-servicing capacity.
- The direct impact on funding costs and interest expense coverage ratios appears limited and unlikely to be the sole trigger of negative rating actions; most REITs have fixed or hedged their debt for the next three to four years.
- A more significant side effect is likely to be on asset valuations: Limited increases in interest rates, if unaccompanied by higher inflation, would depress asset values.
- To gauge how lower asset values could affect rated European REITs’ asset-based credit metrics, we ran a second round of stress scenarios, incorporating arbitrary drops in portfolio value over the next two years.
- Across our sample, a 5% drop in portfolio value is unlikely to trigger rating actions; a 10% fall is likely to cause at least a few outlook changes and only a handful of downgrades; a 20% drop could trigger downgrades for several companies. We consider double-digit drops in values as ratings remote though.

Sovereigns
Do Not Push The Panic Button On Emerging Market Sovereigns, Oct. 9, 2018
- Recent increases in global interest rates, followed by market turmoil, have raised concerns about potential liquidity problems spreading across emerging market sovereigns.
- We do not think credit problems will spread to the emerging market asset class as a whole.
- A large number of emerging market countries have undertaken reforms over past decades to strengthen their creditworthiness, improving their economic structure and reducing their vulnerability to a potential drop in global liquidity. We expect our sovereign ratings on those countries to be relatively stable over periods of stress.
- An exclusive focus on external imbalances and debt burdens may provide a misleading picture of future credit developments in this asset class.
This report does not constitute a rating action.