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#fallenangels

Fallen Angels May Rise Again

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Weakness in commodities prices has bucked the five-year trend characterized by higher rising star than fallen angel volumes. About $80bn has been downgraded from investment grade to high yield (Figure 1), the highest level since the financial crisis. As with previous downgrade cycles, the most recent was triggered by a sector-specific shock, this time in commodities. Fundamental deterioration over the first half of the year also kept rising star volumes low by historical standards, at nearly $40bn this year. Moody's, in particular, took a more guarded stance, as downgrades continued to outpace upgrades through 3Q (Figure 2).

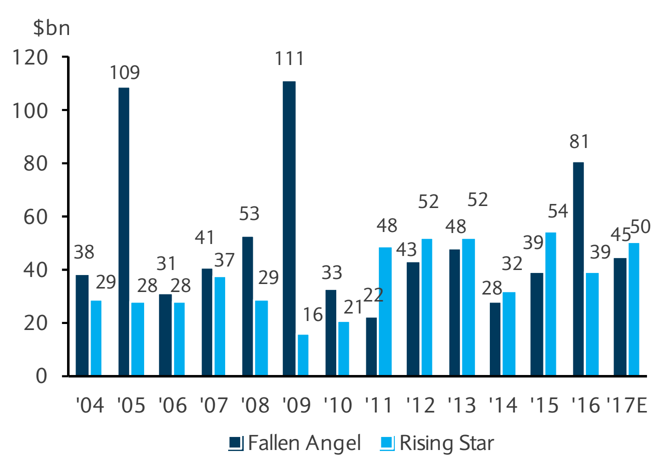
We believe that in 2017, rating agencies will re-adjust their outlooks in light of improving fundamentals and a stable macro backdrop, which may benefit from President-elect Trump's fiscal stimulus agenda. As such, we forecast $50bn in rising star volumes for 2017, up 20% y/y. Unlike last year, when we predicted a large amount of fallen angels concentrated within the commodity-based industries following the sharp drop in oil and metals prices, our base case is for fallen angel volumes to remain more muted next year. We estimate fallen angel volumes of $45bn for 2017. Figures 7 and 10 highlight the most likely rising star (ex-energy) and fallen angel candidates.

Rising Star Outlook

Rising star volumes have been contained in what has been a year dominated by fallen angels. $39bn has migrated to the investment grade index year-to-date, in line with our previous forecast for $40bn through the end of the year. That said, upgrades were more prevalent among issuers in the financials sector; debt issued under Aercap (AER), Royal Bank of Scotland (RBS), Synovus (SNV), First Niagara Financial (KEY), and Fifth Street Finance (FSC) earned investment grade status this year.

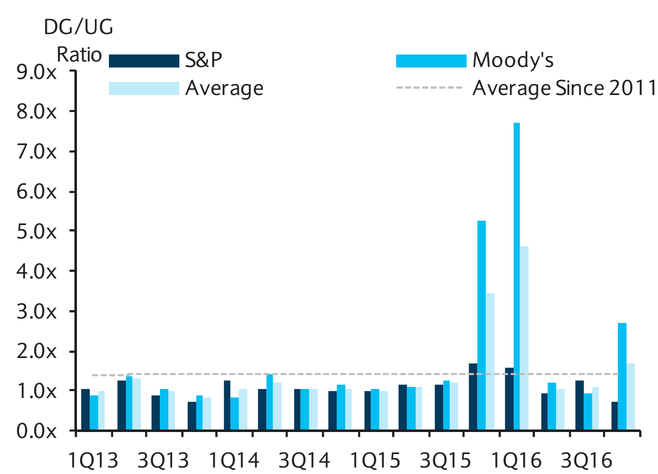
Continuing a trend set in previous years, upgrades to investment grade were driven by idiosyncratic factors, rather than the macro-driven ones that often propel fallen angel turnover. Aercap alone accounted for more than 31% of the volume following its upgrade by Fitch, as $12bn had moved into the investment grade index in July (*AER 2Q16 Earnings: Completes IG Transition* for more details) (Figure 3).

FIGURE 1
Historical Fallen Angel and Rising Star Volumes



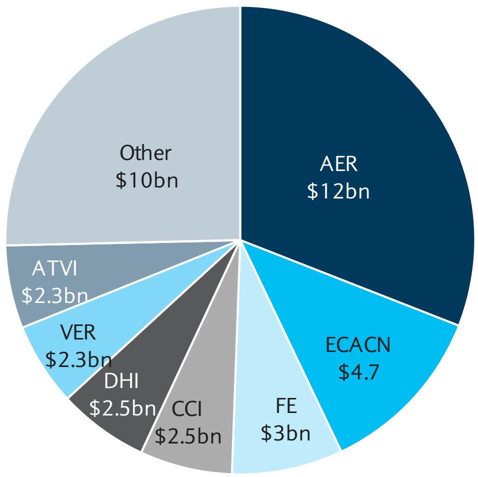
Source: Bloomberg, Barclays Research

FIGURE 2
Quarterly Downgrade/Upgrade Ratios



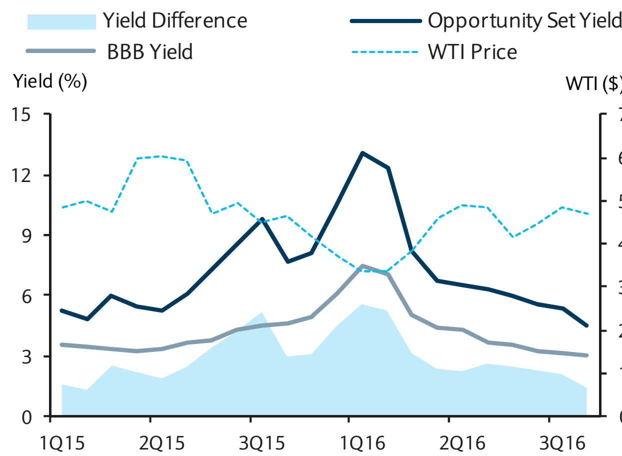
Source: Moody's, S&P, Bloomberg Barclays Indices

FIGURE 3
Rising Stars in 2016



Source: Bloomberg Barclays Indices

FIGURE 4
BBB Energy and BB+ Energy Yield Difference Compressed

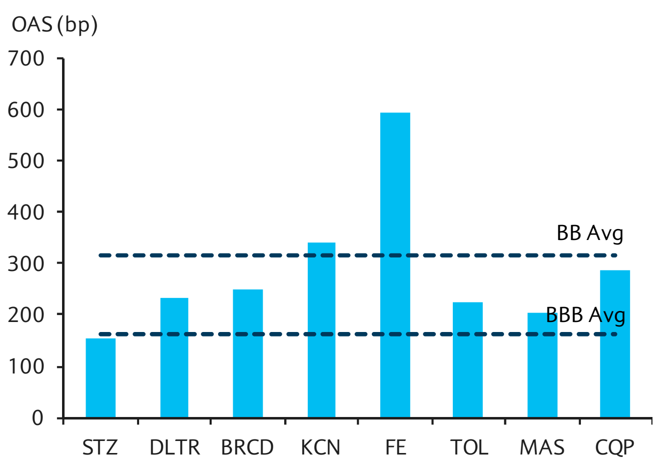


Source: Bloomberg Barclays Indices, Bloomberg

As we had expected, rising star volumes have been particularly tepid for the energy and metals & mining sectors. Although 17 issuers (over $60bn in par amount) fell into the High Yield Index in the immediate aftermath of the commodities-induced sell-off, commodities-related sectors have since produced only one rising star: Encana ($5bn), which fell to high yield for one month before getting a Fitch rating and moving back into investment grade. With the subset of energy names within our opportunity set – which we define as bonds with a BB+ index rating – currently trading inside the tights of 2015, when oil last hovered at $40-50, we believe there is the potential for rising stars to surface among commodity credits if oil prices remain above the $40 threshold and rating agencies gradually reverse their verdicts. Indeed, the rally in risky assets and recovery in oil prices have closed the gap in required compensation between the energy names in our opportunity set and duration-matched peers in the BBB index (Figure 4).

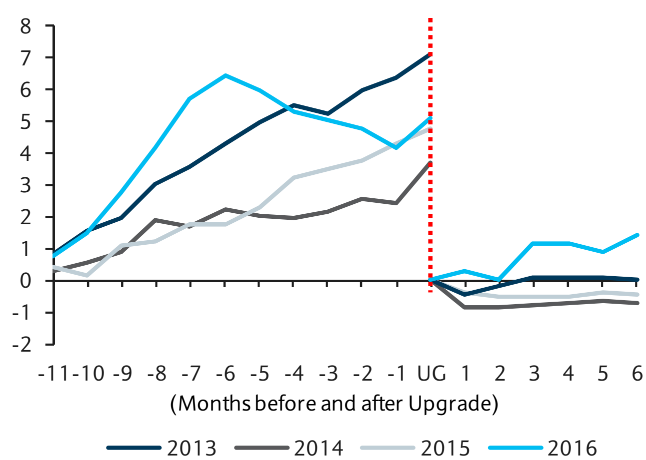
Identifying ratings migrations patterns can provide a path to outperformance in the months leading up to a ratings event. Indeed, this trend repeated in 2016, as rising stars outperformed other credits by about 5% in the 12 months before an upgrade, in line with

FIGURE 5
Rising Star Candidate Spreads



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 6
Rising Star Cumulative Excess Return around Upgrade (%), Relative to the Index



Note: Excess returns measured relative to the high yield index prior to upgrade and the investment grade index after downgrade. Source: Bloomberg Barclays Indices the 2015 total. As in the past, we expect rising stars to outperform the index, although the extent of the rally is likely to be limited this year. Many of the credits that we have identified as rising star candidates trade wide relative to BBBs (Figure 5), although the basis has compressed over the past few months.

2017 Rising Star Forecast

We build our 2017 rising star forecast in a bottom-up approach by categorizing credits reviewed by our fundamental analysts by their likelihood of receiving an upgrade. Given the amount outstanding for each bond within the issuer's capital structure in the High Yield Index, we arrive at an estimate for rising star volumes among covered credits, which accounts for the majority of our forecast. We make a minor adjustment for non-covered BB-rated credits, which we assume have an upgrade probability equal to the historical average rising star upgrade rate. Our total forecast is for about $50bn in rising star volumes. We believe this is in keeping with the broad-based improvement in credit fundamentals as outlined in *We Are Not Worried about Credit Metrics*, November 4, 2016.

We expect the rising star mix to be tilted more toward energy in 2017, for the reasons mentioned above. Other rising star emergences are likely to be more idiosyncratic in nature. Thus, we have highlighted a few examples of ex-energy candidates that we believe have a high likelihood of surfacing as rising stars in Figure 7.

FIGURE 7
2017 Ex-Energy Rising Star Candidates

Issuer	Ticker	Sector	Par ($mn)	OAS (bp)	Index Rating	Research Commentary
Constellation Brands Inc	STZ	Food & Beverage	3,350	154	BA1	During its annual investor day, Constellation changed its leverage target to 3.5x (from 3.0-4.0x), a threshold previously communicated by ratings agencies for upgrade to IG ratings. Subsequently, Moody's put Constellation on watch for upgrade review (90 day reviewing period), and on Friday, S&P officially moved STZ to IG ratings. We expect Moody's and Fitch to move Constellation to investment grade ratings in the next three months, despite concerns about trade tariffs related to a Trump presidency. On a relative value basis, we believe Constellation will eventually trade to Molson Coors's level, if not through, given a higher growth trajectory and lower leverage.
Dollar Tree	DLTR	Retail	3,542	233	BA2/ BA3	We expect Dollar Tree to continue its rapid deleveraging in the next 12-24 months. S&P has noted that it would give DLTR investment grade ratings if leverage falls below 3x and projected a timeline of 1-3 years. Moody's (Ba2 positive) believes DLTR could prepay another $1bn in term loan in the next 12 months and would upgrade DLTR if leverage falls below 4x and interest coverage is higher than 3.25x. We believe DLTR could do both in the next 12 months, with a clearer path to IG, based on our projected leverage of mid-2x by the end of FY17. We expect DLTR to look closely at the refinancing option, given the relative high coupon of existing debt. Despite a recent traffic challenge in the dollar channel, we believe DLTR could refinance at a much lower rate.
Brocade Communications Systems	BRCD	Technology	300	248	BA1	We believe that upward ratings momentum can extend to the outstanding BRCD 4.625s of 2023 in the High Yield Index, in light of Avago's announced acquisition of Brocade. S&P revised Avago's BB+ ratings outlook to Positive from Stable on August 2, 2016 (with a potential upgrade over next year), reflecting the company's deleveraging and expectations for revenue growth, which were unaffected by its plan to acquire Brocade. Moody's maintained its Ba1 Positive rating following the announced acquisition while indicating it is credit negative and could delay deleveraging and an upgrade to IG for up to a year.

Issuer	Ticker	Sector	Par ($mn)	OAS (bp)	Index Rating	Research Commentary
Kinross Gold Corp	KCN	Metals & Mining	1,250	339	BA1	After becoming a fallen angel earlier in 2016, when S&P lowered its rating to BB+, we estimate that KCN should be able to meet S&P's upgrade threshold for leverage of "well below" 2.0x (which we interpret at below 1.5x) if the price of gold averages $1,200/oz or higher in 2017. Our expectation is that an upgrade back to BBB- is unlikely before 1H17 at the earliest, however, as we think the agency will want to monitor the progress of the company's operations and the price of gold.
FirstEnergy Transmission	FE	Electric Utilities	2,001	593	BA2/ BA3	Fitch upgraded its outlook on FirstEnergy Corp (HoldCo) to BBB-/stable on November 11, resulting in the migration of $3bn of its senior unsecured debt to the IG Index. The OpCo does not possess a Fitch rating, but has indicated that it will look into this possibility. If it is successful in securing investment grade status from Fitch, the OpCo could also emerge as a rising star in 2017.
Toll Brothers Finance Corp	TOL	Building	2,020	225	BA1	Toll Brothers should hold in strong versus high-quality peers as it continues its track record as a consistent operator on a path toward investment grade. Over the course of the housing cycle, we think the builder's exposure to a luxury-weighted buyer base could be a source of strength versus entry level-focused competitors, particularly amid the transition to a more restrictive monetary policy environment. While we continue to view Toll as one of two operators with crossover potential (DHI made the first transition), we are skeptical of an imminent upgrade with the current level of leverage. With net homebuilding debt/ capitalization currently ~2pts lower than the 47% level at closing of the Shapell trade, we continue to believe that a reduction toward pre-Shapell leverage (34%) will be critical for the credit to return to investment grade. Further, we think the combination of City Living and attractive California assets is a uniquely positive mix factor that should support margins through the cycle. While City Living remains small relative to the core single-family detached homebuilding business (only 8% of LTM homebuilding revenue and 3% of LTM closings), this segment carries premium margins (~10pts higher than traditional homebuilding) and should be an incremental source of profits as high/mid-rise projects are delivered in the NYC metro area through 2017.
Masco Corp	MAS	Building	2,896	205	BA1	Masco bonds offer fair risk compensation for a split-rated Ba2/BBB diversified building materials credit with 1.5x net leverage and positive ratings momentum, in our view. Although we expect constrained Cabinet revenue from the exit of the direct-to-builder business, along with inefficiency overhangs in Windows and incremental SG&A investments to support product expansion (Kraftmaid/Behr), we are comfortable with low to mid-single digit growth for a business with 30% run-rate contribution margins, FCF generation of about $500mn, balanced capital allocation, and a path to investment grade. We remain constructive on the company's strong liquidity position ($1.2bn on balance sheet), proactive debt pay-down, continued execution on cost control, exposure to pent-up R&R demand (83% of mix), and operating leverage through the cycle.

Source: Bloomberg Barclays Indices, Barclays Research

Fallen Angel Outlook

As expected, commodity price weakness has driven the bulk of fallen angel volumes year-to-date, with more than $60bn of energy- and metals-based issuers downgraded from investment grade to high yield (Figure 8). In aggregate, about $80bn has been downgraded to high yield, with volumes tracking the lower end of our forecast for $85-95bn by year-end (*Stemming the Tide*, May 27, 2016). Most of these downgrades occurred in February and early March, soon after oil reached a low point of $26/bbl on February 11. Oil has since recovered, trading near $43/bbl, and there have been no energy-based downgrades since March.

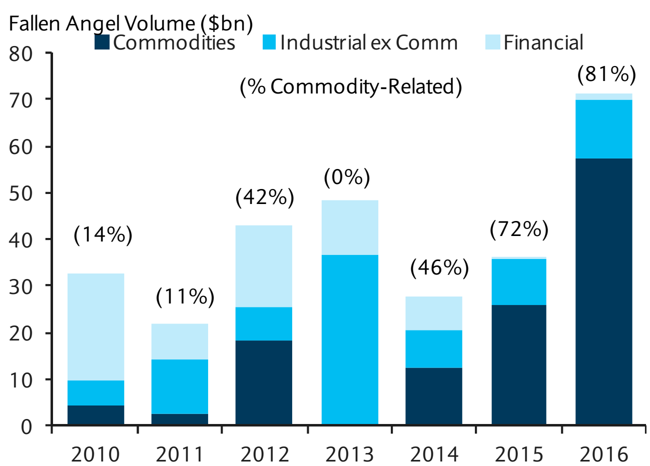
As we highlighted in *Angels More Energetic than Stars*, November 13, 2015, fallen angels tend to underperform the index by 5-10% in the 12 months before leaving investment grade, but outperform the index once transferred to high yield (by 2- 3pts). Entering the year, we wrote that the potential for a large volume of downgrades concentrated in a specific sector could put more technical pressure on these names, given the sheer size of volume that would need to be absorbed by the high yield market. This initially appeared to be the case, as names underperformed by closer to 15-20% as they left the Investment Grade Index in February and March. However, commodity-based fallen angels have been among the best performers in high yield, with nearly 30% of excess return year-to-date (Figure 9).

This is in large part due to the rally in oil, which is up 75% since mid-February and has allayed at least the most extreme fears of many investors. While all commodity credits have performed well, fallen angel credits have outperformed similarly rated (but non-fallen angel) commodity credits by about 7% year-to-date. In our view, this is a reflection of the fact that the commodity issuers with the most downgrade risk were trading excessively wide; improvement in the commodity price environment since then has caused spreads to converge. Indeed, year-to-date fallen angel issuers were trading about 115bp wide of other BB-rated commodity credits in March and are now trading only 40bp back. Ultimately, the fallen angel issuers appear to have a higher sensitivity to oil prices, for moves in either direction; thus, we think a modest spread pickup is merited for these names.

With less commodity-related pressure, downgrades slowed substantially after March and have been driven primarily by idiosyncratic factors. Since April, seven companies have fallen to high yield: Gap Inc (GPS), FirstEnergy Solutions Corp/Allegheny Energy Supply (FE), EMC Corp (now DELL), CF Industries (CF), Och-Ziff Finance (OZM), Brinker International (EAT),

FIGURE 8

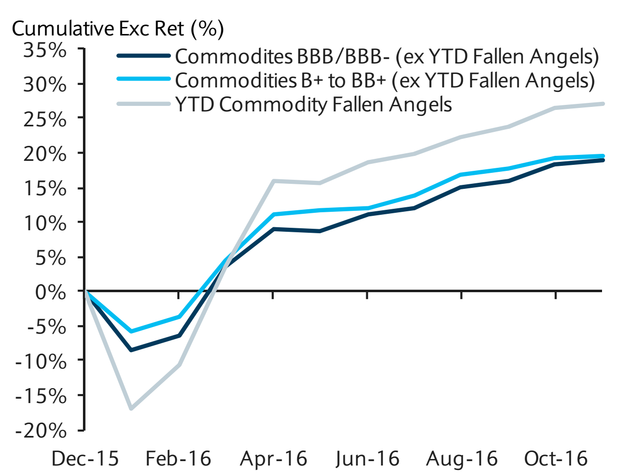
Fallen Angel Volumes Were Driven by Declining Commodity Prices, Once Again, in 2016



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 9

Fallen Angels Have Outperformed Otherwise Comparable Commodity-Based Securities Year-to-Date



Source: Bloomberg Barclays Indices, Barclays Research

and CDK Global (CDK), for a total of $15bn of debt. In most cases, company-specific fundamental factors drove the downgrade; in the case of EMC, for example, it was the merger with Dell. If oil remains stable next year, as expected, we believe that fallen angels will be driven primarily by company-specific factors, with the potential for debt-fueled M&A activity to continue to drive downgrades for certain issuers.

2017 Fallen Angel Projection

As Figure 1 shows, fallen angel volumes tend to be relatively binary from year to year. Generally, "high downgrade volume" years tend to coincide with a large macroeconomic and sector-specific shock: telecoms in 2001-02, autos in 2005, financials in 2008-09, and, finally, commodity weakness this year. Outside of these years, fallen angel volumes tend to be marginal, driven by idiosyncratic factors related to specific issuers.

Therefore, unlike last year, when we forecast a large amount of fallen angels concentrated within commodity-based industries, given the sharp drop in oil and metals prices, our base case is that next year will fall under the "low volume" category. While there is always the risk that an unforeseen shock will lead to weakness in a specific sector, we believe that the potential for fiscal stimulus under a Trump presidency, as well as moderate but stable economic fundamentals both domestically and abroad, should be supportive of a low volume year. Since the crisis, slightly less than 1% of the index in "low volume" years has fallen to high yield, which would equate to $45bn in fallen angel volumes for 2017. While the par amount seems high by post-crisis standards, this mainly reflects the rapid growth in the size of the index over the past three years.

There are potential risks for higher volumes, however. There is elevated uncertainty surrounding the policy agenda in a Trump presidency, which could cause a sector-specific shock. Furthermore, we expect debt-fueled M&A activity to remain robust, which may put ratings pressure on particularly aggressive acquirers in the investment grade market.

Figure 10 highlights the companies that we believe have the highest likelihood of being downgraded to the US High Yield Index in 2017. Ultimately, we believe very few issuers are clear fallen angel candidates (ie, have a greater than 50% likelihood of being downgraded to high yield). Other than NBR, YRICN, and LXK, which we view as high likelihood candidates, the companies appear more likely to remain investment grade than to fall to high yield within the next 12 months. However, some subset likely will end up in high yield.

FIGURE 10

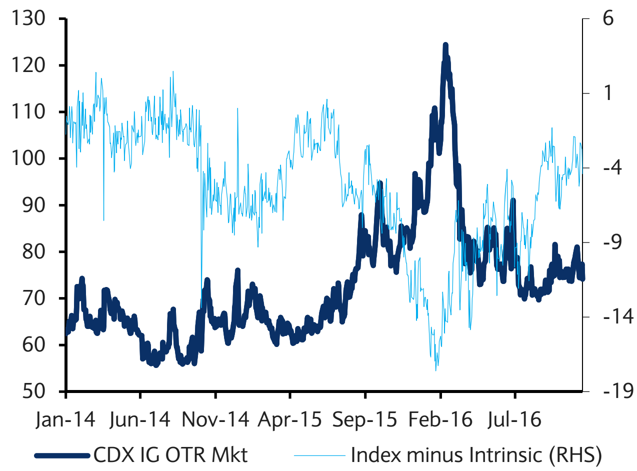
2017 Fallen Angel Candidates

Issuer	Ticker	Sector	Par ($mn)	OAS (bp)	Index Rating	Research Commentary
Yamana Gold Inc	YRICN	Metals & Mining	500	276	BAA3	We think that YRICN is weakly positioned in the Investment Grade Index, with Moody's at a negative outlook on its Baa3 rating and S&P already at BB+. The company's potential monetization of a stake in Brio Gold would be positive, as proceeds are expected to be used for net debt reduction, but execution risk remains, and we are not convinced that this alone would eliminate the ratings risk.
Nabors Industries	NBR	Oil Field Services	3,026	309	BAA3	Management continues to hold its current course and is relying on product differentiation and cost reductions to navigate the downturn. Ultimately, however, it will take increased activity and higher fleet utilization to put upward pressure on dayrates and drive a reduction in leverage, in our view. In line with management's guidance, we see little improvement to credit metrics over the next 12 months and think that ratings are vulnerable to downgrade at S&P, with FFO to debt failing to reach the agency's threshold of 20%.
Motorola Solutions Inc	MSI	Technology	3,096	213	BAA3	Motorola sits on the edge of investment grade ratings, Baa3/BBB-/BBB, with negative outlooks at Moody's and Fitch. While management has stated the importance of retaining investment grade ratings, the agencies remain skeptical whether the company's credit profile meets the requirements of an investment grade company, given high leverage and continued shareholder returns. Nonetheless, fundamental analyst Sandeep Gupta is Market Weight rated on the credit and views near-term downgrades as less likely than the bond valuations reflect. He believes the company has several pipeline revenue opportunities that can help the company de-leverage below 3.0x (a level with which rating agencies would be much more comfortable) over the next couple of years.
Lexmark Intl Inc	LXK	Technology	700	224	BAA3	After announcing it will be acquired by a consortium led by Apex Technologies and PAG Asia Capital (a private equity firm), Lexmark's credit ratings (Baa3/BBB-/BBB-) were put on review to be downgraded at all three agencies. If the outstanding debt is redeemed in the recapitalization process, Moody's has said it will remove its ratings on the company. If the outstanding debt remains, however, the company would likely be downgraded to high yield as a result of aggressive financial policies and weakening fundamentals. The acquisition is expected to close before the end of 2016, after it receives clearance from the Committee on Foreign Investment in the US.
Viacom Inc	VIA	Media/ Entertain-ment	12,076	185	BAA3	Analyst Sandeep Gupta remains Overweight rated on Viacom (Baa3/BBB-(neg)/BBB (neg)), as his base case continues to be that the company will merge with CBS, with the combined entity likely receiving mid-BBB ratings. Nonetheless, the credit remains on negative outlook at Fitch and S&P, meaning a downgrade to high yield is not impossible, especially if a merger with CBS does not materialize.
Discovery Communica tions	DISCA	Media/ Entertain-ment	6,300	192	BAA3	While Discovery has recently reiterated its commitment to investment grade credit ratings, the company remains on the fringe of ratings, with only two one-notch downgrades needed to move the credit into the High Yield Index. Our fundamental analysts remain Underweight rated on the credit, as they believe secular media industry pressures and a declining share price (DISCA down ~40% from peak stock price in 2013) may drive the company to prioritize shareholder returns and strategic M&A over investment grade ratings. The company has, however, recently recommitted to investment grade ratings, which reduces, but does not eliminate, the probability of a ratings downgrade to high yield.
Fibria	FIBRBZ	Paper	600	329	BAA3	Fibria is the largest market pulp company in the world. It is a producer of eucalyptus pulp, which is at five-year lows. Fibria recently announced that it is undergoing a large expansion program, which is expected to put additional pressure on credit metrics. S&P recently placed the credit on Negative Outlook, with the agency stating that a downgrade is possible in the near term if FIBRBZ's leverage exceeds 3.5x by YE17 and does not come below 3.0x in FY 18. S&P expects FIBRBZ's leverage to reach 3.7x-3.9x by YE 17, or above 4.0x if pulp prices stay at current levels.
Sherwin-	SHW/VAL	Chemicals	1,800/1,55	110/165	A3/	Moody's has hinted at the possibility of high yield ratings should the

Issuer	Ticker	Sector	Par ($mn)	OAS (bp)	Index Rating	Research Commentary
Williams/ Valspar			0		BAA2	transaction be fully debt financed. SHW has not provided plans for refinancing the $9.3bn bridge loan, as the transaction remains under regulatory review.
Methanex Corp	MXCN	Chemicals	1,200	304	BAA3	Already a crossover name (Baa3/BB+/BBB- Neg/Neg/Sta), Methanex is the most likely fallen angel in high grade chemicals. Although methanol pricing has improved recently, leverage remains elevated, and Moody's rating could be at risk should the pricing environment remain pressured through 2017.
Other Potential Tech Downgrades	PBI, STX, SYMC, XRX	Technology			BAA3	One of the key trends in the tech sector has been the disruption driven by digital technologies, and PBI, STX, SYMC, XRX have been at the receiving end of it. These companies have offered products and services that are seeing secular declines in demand or substitution by better/cheaper technologies. During the past two years, PBI has made several acquisitions that have increased leverage. Similarly, Seagate has made leveraging acquisitions amid deteriorating demand for its legacy hard drive products, which has been negative for the company's credit ratings. Symantec has made a combination of acquisitions and divestitures, while returning a significant portion of its cash to shareholders, resulting in higher leverage levels and pressuring the ratings. Xerox is also undergoing a transition, whereby the company is splitting itself into document and outsourcing businesses. The resulting size of the document company and the ongoing pressure on revenues have kept the ratings agencies on edge, with some probability of a downgrade to high yield should fundamentals worsen.

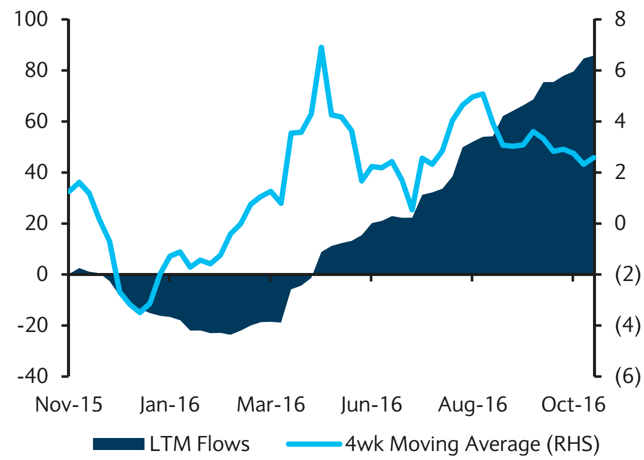
Source: Bloomberg Barclays Indices, Barclays Research

CDX.IG OTR Market versus Intrinsic (bp)



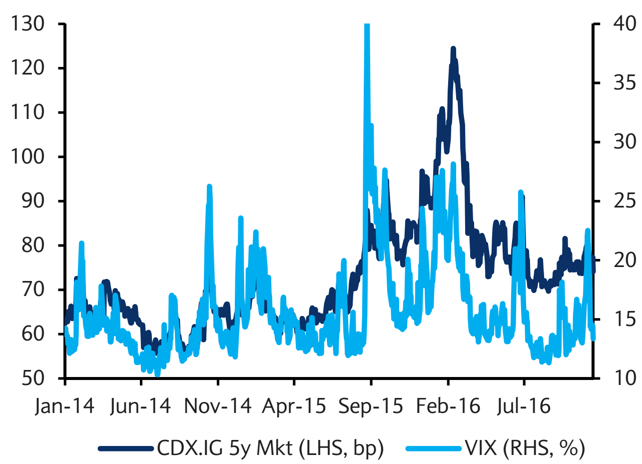
Source: Barclays Research

Investment Grade Fund Flows ($bn)



Source: Lipper/Thomson Reuters, Barclays Research

CDX.IG versus VIX

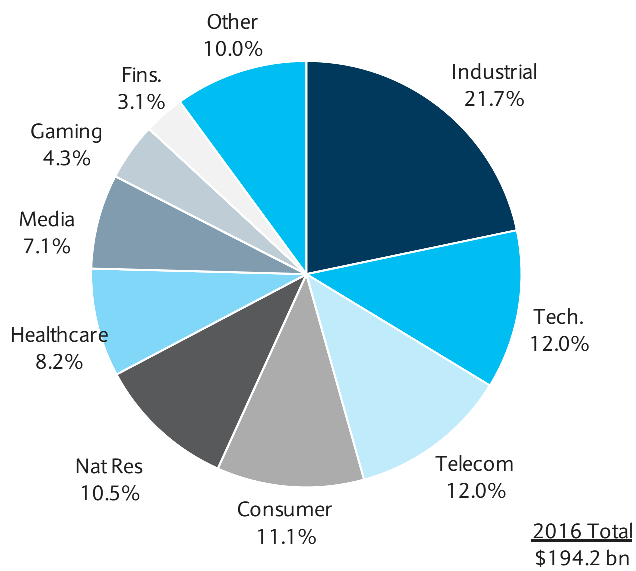


Source: Markit, Barclays Research

CDS-Cash Basis (bp)

Note: Basis defined as CDX.IG spread – Corporate Libor OAS.
Source: Bloomberg Barclays Indices, Barclays Research

2016 High Yield Supply by Sector



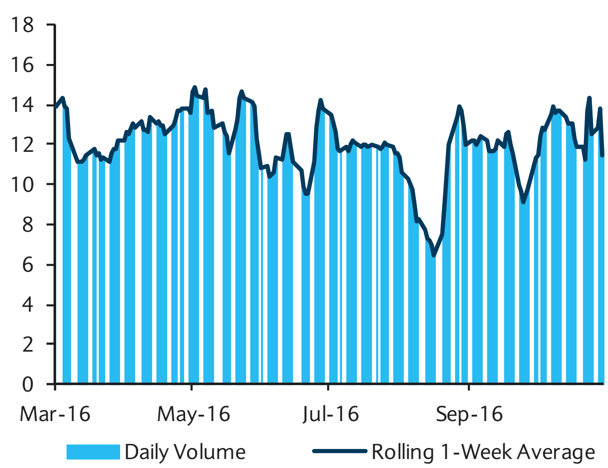
Source: Barclays Research

Top On-the-Run CDX Index Names by Weekly CDS Volume

	Notional Outstanding ($bn)		Volume – Week Ending 11/11/16 ($mn)
	Gross	Net	Gross
Hertz	4.4	0.7	223.4
Community Health	3.3	0.4	204.6
MBIA Insurance	16.3	0.8	115.0
U.S. Steel	5.8	0.7	113.7
Windstream	3.1	0.6	102.2
Navient	8.4	0.6	93.8
JC Penney	9.5	0.7	92.0
AK Steel	3.7	0.4	88.4
American Axle	3.3	0.4	86.0
Tenet Healthcare	4.1	0.5	82.9

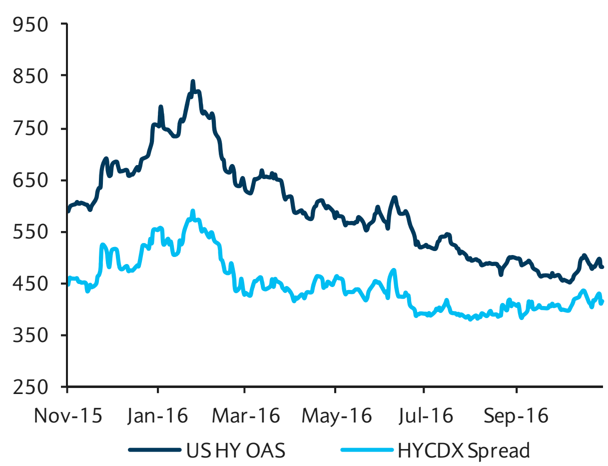
Source: DTCC

High Yield Average Institutional Trade Volume ($bn)



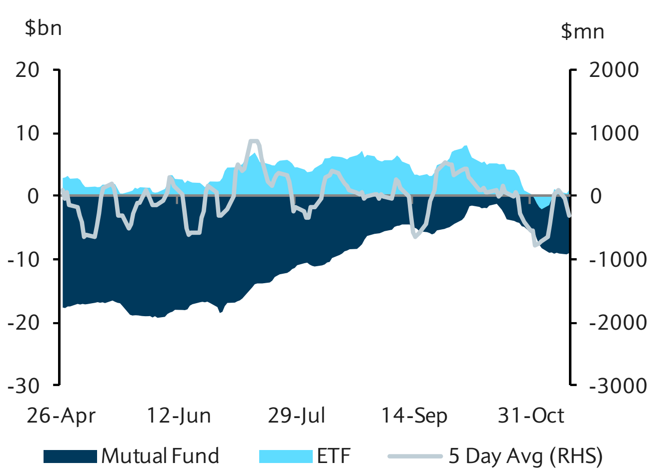
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

On-the-Run HYCDX versus US High Yield Index (bp)



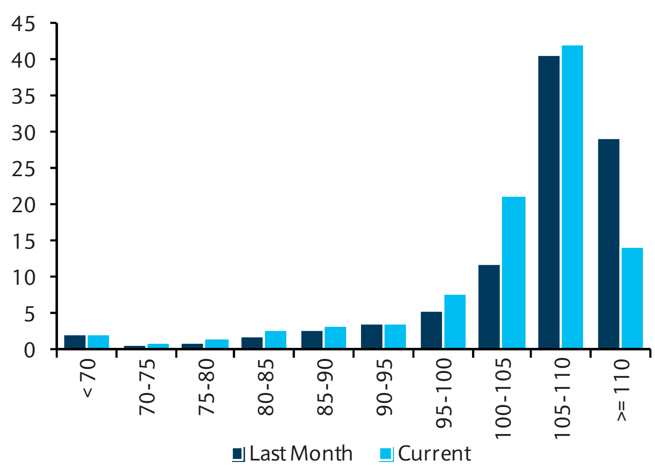
Source: Bloomberg Barclays Indices, Barclays Research

Flows to High Yield Mutual Funds and ETFs



Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



Source: Bloomberg Barclays Indices, Barclays Research

Analyst Certification

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Market Weight (MW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be in line with the six-month expected excess return of the relevant sector.
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Market Weight (MW): The analyst expects the six-month total returns of the issuer's rand-denominated fixed rate notes or floating rate notes (as applicable) to be in line with the six-month expected total returns the South African Credit Fixed Market Index (CFIX95) or the South African Credit Floating Market Index (CFL020), respectively..
Underweight (UW): The analyst expects the six-month total returns of the issuer's rand-denominated fixed rate notes or floating rate notes (as applicable) to be below the six-month expected total returns the South African Credit Fixed Market Index (CFIX95) or the South African Credit Floating Market Index (CFL020), respectively..
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Underweight (UW):
The analyst expects the three-month excess return of the country's index eligible bonds to be less than the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
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