Follow the Stars, Embrace the Angels

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Significant index transitions on the way

The last week has seen two very symbolic rating actions taking place in credit. Ford, the only of the Big-3 US automakers not to file for bankruptcy and not to receive government aid, became the first one to return to investment grade, after a seven-year stint in HY. Ford's size, at $25.8bn of US$ bonds, makes it the largest rising star in HY market's history in absolute dollar terms. Moving in the opposite direction, Nokia – which for a long time was a crown jewel of Finland's, if not European, economy – was downgraded to HY as its cellphone market dominance is being threatened by the likes of Apple and Samsung.

Follow the stars

Perhaps the most pressing question on the minds of HY investors related to these upcoming transitions is: when is a good time to rotate, before or after the formal index change takes place? Here, we are providing our readers with a historical track record of issuers moving in both directions – IG and HY – and adjusted for overall market performance.

On the rising star side, we found that these issuers are generating the bulk of their outperformance, generally between 60-70%, while still in HY, but it still pays for HY investors to hold on to these bonds in the first few months in IG as a much larger base of investors steps in and starts adding them to their portfolios. It makes the prime time to offload bonds into IG hands gradually over the first few months in that index.

Embrace the angels

The opposite is usually taking place among fallen angels. By the time a former IG name actually becomes a member of the HY index, it usually realizes most of its underperformance. The bottoming out process takes place in the next couple of months, as bonds transition from IG to HY holders, and an issuer tends to outperform both BB and BBB benchmarks afterwards to the tune of about 100bps. The bottom line here is that HY investors are usually paid to step in and take fallen angels off the hands of IG investors at deeply discounted prices, as the latter group is often forced to offload these bonds by their mandates.

Putting Ford and Nokia on the map

Finally, we are providing investors with a reference to current valuations in Ford, FMCC, and Nokia bonds and how those relate to historical performance in former fallen angels and rising stars. We are also estimating a propensity of former HY issuer to refinance their bonds once they make it to the IG space.

Largest rising stars

Ticker	Date	Face, US$bn	Pct of Index
F		25,800	2.5
AIG	Jan 11	10,041	1.0
TCOM	Apr 98	7,300	3.2
TYC	Jun 04	7,245	1.3
TWX	May 98	6,787	3.1
WCOM	Apr 98	3,685	1.6
NMK	Jun 99	3,150	1.2
CBS	Dec 98	2,355	1.0
VIA	Oct 98	2,350	0.9
LIL	Jun 98	2,172	1.0
CGP	Jan 97	1,900	1.0

Source: BofA Merrill Lynch Global Research

Largest fallen angels

Ticker	Date	Face, US$bn	Pct of Index
WCOM	May 02	23,719	5.9
S	May 08	16,823	2.3
QUS	May 02	14,386	3.6
GM	May 05	11,702	1.8
F	Aug 05	9,436	1.5
T	Aug 04	7,869	1.3
M	Apr 09	6,646	0.9
CTL	Apr 11	6,256	0.6
CCU	Nov 06	6,021	0.9
. . . . .			
NOKIA	May 12	3,800	3.7

Source: BofA Merrill Lynch Global Research

Refer to important disclosures on page 6 to 8. Link to Definitions on page 5.

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The last week has seen two very symbolic rating actions taking place in credit. Ford, the only of the Big-3 US automakers not to file for bankruptcy and not to receive government aid, became the first one to return to investment grade, after a seven-year stint in HY. Moving in the opposite direction, Nokia – which for a long time was a crown jewel of Finland's, if not European, economy – was downgraded to HY as its cellphone market dominance is being threatened by the likes of Apple and Samsung.

Specifically, Ford and FMCC were upgraded to IG by Fitch (BBB- from BB+) last Tuesday. Simultaneously, Fitch downgraded Nokia from BBB- to BB+, an action that was followed up on Friday morning by S&P, which cut its rating to BB+ as well.

Figure 1: Largest Rising Stars

Ticker	Date	Face, US$bn	Pct of Index
F		25,800	2.5
AIG	Jan 11	10,041	1.0
TCOM	Apr 98	7,300	3.2
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Source: BofA Merrill Lynch Global Research

For the time being, the other two agencies are keeping F/FMCC complex at BB1 level, which implies that this issuer remains in the HY index until one more upgrade takes place. Our index rules require an average of the three ratings to be IG for the transition to take place. At this point, two BB1s are pulling Ford's average into HY over a single BBB3. In case of Nokia, two downgrades to BB1 are sufficient for the transition to take place. However, the cut-off time for May index rebalancing has passed on April 25th, and therefore Nokia will remain in our IG indexes for the next month. The next rebalancing, which takes place on May 31st, will bring the issuer to our HY indexes.

Ford complex currently has $25.8bn of US$ bonds outstanding, with $20.7bn issued by FMCC and $4.6bn by Ford Motor Co[1]. In addition there is also C$2bn, €1.4bn, and £0.65bn of bonds issued by international subsidiaries. Nokia has $1.5bn and €1.75bn of bonds outstands.

Figure 2: Largest Fallen Angels

Ticker	Date	Face, US$bn	Pct of Index
WCOM	May 02	23,719	5.9
S	May 08	16,823	2.3
QUS	May 02	14,386	3.6
GM	May 05	11,702	1.8
F	Aug 05	9,436	1.5
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Source: BofA Merrill Lynch Global Research

Ford's size makes it the largest rising star in HY market's history in absolute dollar terms (Figure 1). However, the pre-telecom-bubble era produced two upgrades, exceeding current Ford's size expressed on a percent of index size basis: TCI Communications upgraded in April 1998 and Time Warner Cable upgraded in May 1998. Nokia's downgrade, while relatively meaningful by itself, doesn't rank too high compared to some previous fallen angels (Figure 2). The record here is still being held by WorldCom with $23.7bn of bonds in 2002. By the way, Ford, on its way to HY in 2005, had only $9.4bn of bonds outstanding.

Follow the stars

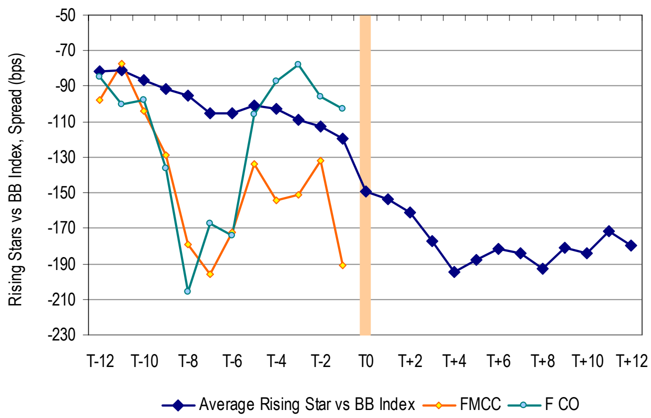
Perhaps the most pressing question on the minds of HY investors related to these upcoming transitions is: when is a good time to rotate, before or after the formal index change takes place? Below, we provide a set of charts that could hopefully provide some guidance in this respect. In Figures 3 and 4 below, we are calculating "average rising star" spread over BB and BBB indexes respectively, calculated over time around transition. By average rising star here we mean historical average of spread differences of each previous rising star over $1bn in size, calculated over the BB and BBB index spreads at that time. The timeframe is chosen as 12 months prior and 12 month after the transition, with point T0 (highlighted with vertical bar) representing the actual date of index change. For example, if Time Warner Cable was upgraded to IG in May 1998, we would calculate average spreads of all of its bonds for the period May 1997 to transition, and then from transition to May 1999. BB and BBB index spreads used as

[1] Additional $500mn of US$ bonds are issued by Ford Holdings.

benchmarks are from those same periods as well. Our sample consists of 34 rising star issuers, each having face value of bonds upgraded exceeding $1bn.

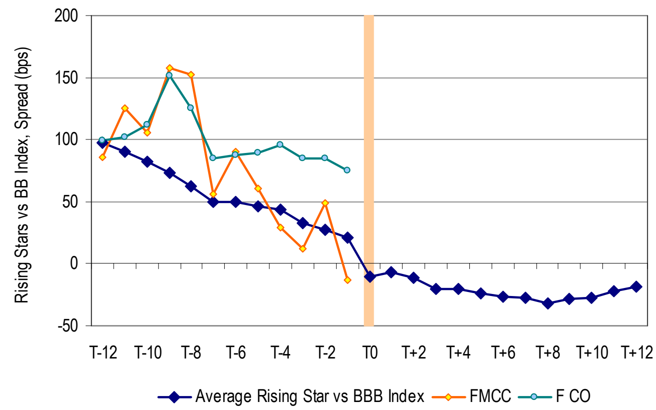
The way to read this chart is that on average, rising stars are trading 80bps through BB index and 100bp over BBB index one year before the transition. The single largest monthly gain takes place, not surprisingly, during the last month prior to transition, when rising stars tighten by an average of 30bps against both BBs and BBBs. On the day of index change, denoted as T0, rising stars trade on average 150bp through BBs and 10bp through BBBs. Once in IG, rising stars usually continue to outperform both indexes, tightening further by an average of 40bps against BBs and 30bps against BBBs. The outperformance usually exhausts itself after 3-4 months in IG.

Figure 3: Rising stars vs BBs (T0 = transition date)



Source: BofA Merrill Lynch Global Research

Figure 4: Rising stars vs BBBs (T0 = transition date)



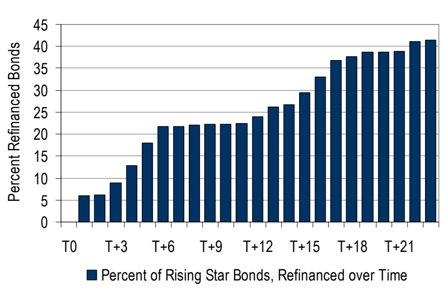
Source: BofA Merrill Lynch Global Research

Most importantly, investors need to remember that rising stars are generating bulk of their outperformance, generally between 60-70%, while still in HY, but it still pays for HY investors to hold on to these bonds in the first few months in IG as a much larger base of investors steps in and starts adding them to their portfolios. It makes the prime time to offload bonds into IG hands gradually over the first few months in that index.

Putting Ford on the map

We are also showing the current Ford and FMCC relative spread levels on both of these charts. Of course, the timing of actual transition is still unknown, and it may take place as soon as next month or drag on for a while. The purpose of these charts is not to predict timing of transition, but rather to show relative valuations, if such a transition were to take place in the near term. As such, FMCC bonds are already trading very tight against both BBs and BBBs, basically standing less than 10 bps away from where an average rising star outperformance exhausted itself historically. In case of Ford Motor Co, spreads still remain relatively wide, suggesting that the market hasn't fully priced in the potential for transition to IG yet.

Figure 5: Refi volumes among rising stars



Source: BofA Merrill Lynch Global Research

Out with the old, in with the new

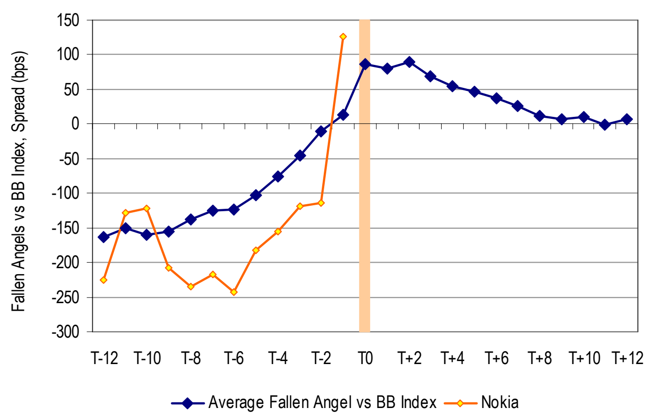
As soon as former HY issuers establish themselves in IG, the first thing they do is focus on refinancing old high-coupon, covenant-heavy and collateral-consuming debt with new IG paper that often carries none of the above. We have used the same sample of previous large rising star issuers to track the percent of their total bond debt outstanding, issued since the time of upgrade (T0) over subsequent two years (Figure 5). On average, these issuers make an initial rush to refinance in the first six month of IG life (~20% of total), followed by a second wave in year two, when the cumulative refi volume exceeds 40% of all bonds outstanding. The ability to refinance at a faster pace is usually constrained by the call schedule of existing bonds.

Embrace the angels

We are showing similar charts, related to fallen angel transitions from IG to HY on Figures 6 and 7 below, representing relative valuations against BBs and BBBs respectively. All calculations here are down in exactly the same way as described above, except for removal of immediate IG defaults, a.k.a. falling knives – former IG issuers that go straight to default with a short stop-over in HY. Historically, there are very few IG defaults like this, and they tend to be associated with accounting fraud (Enron, WorldCom, Qwest), litigation (Owens Corning, Armstrong), or financial crisis (Lehman, WaMu, Icelandic banks). We defined falling knives as those with less than 6 months in HY and removed them from our sample. Otherwise, our sample is very comprehensive, consisting of 78 fallen angel issuers, each with bond face value over $1bn.

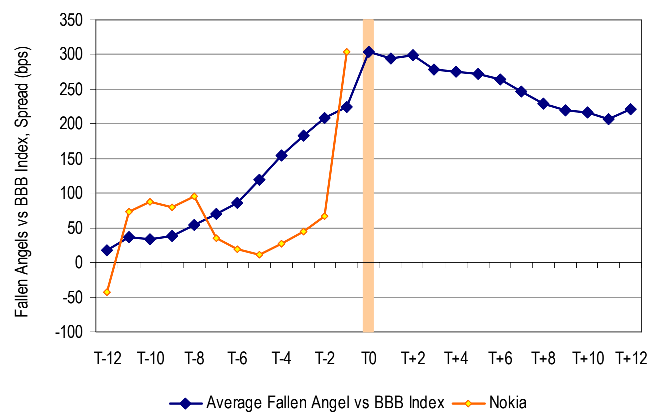
Once again, these charts are read in that same way, with average fallen angel starting its journey trading right on top of other BBBs and 160bp inside of BBs one year prior to transition, as the market has little reason to expect a downgrade. As the time goes on and gets inside of the last two quarters of IG life, the news make it into the marketplace, perhaps as a result of poor earnings reports during those two quarters, and valuations adjust very abruptly. The biggest move, again, takes place during the last month prior to downgrade, when bonds sell off by an average of 100bps against both benchmarks, and as it happens to be, reach their lowest point.

Figure 6: Fallen angels vs BBs (T0 = transition date)



Source: BofA Merrill Lynch Global Research

Figure 7: Fallen angels vs BBBs (T0 = transition date)



Source: BofA Merrill Lynch Global Research

By the time a fallen angel actually becomes a member of the HY index, it usually realizes most of its underperformance. The bottoming out process takes place in the next couple of months, as bonds transition from IG to HY holders, and an issuer tends to outperform both BB and BBB benchmarks afterwards to the tune of about 100bps. Of course, the word of caution here is that we removed falling knives from our sample, i.e. issuers that go straight from IG to default with a short stopover in HY. Fallen angels that may have defaulted after a six-month stint in HY are included in our sample. The bottom line here is that HY investors are usually paid to step in and take fallen angels off the hands of IG investors at deeply discounted prices, as the latter group is often forced to offload these bonds by their mandates.

The case of Nokia

Finally, the chart also shows current valuations of Nokia versus both benchmarks. In this case there is little uncertainty that the issuer is transitioning to HY next month, as described previously. At current valuations, Nokia bonds appear to fully reflect this prospect, based on historical experience of similar issuers. Our credit analyst covering the name, Terry Nguyen, highlights in a recent report credit metrics of this issuer, which at this point maintains a deeply negative net leverage, owing to its €10bn cash pile. Terry also highlights operational and competitive pressures Nokia faces going forward, and maintains an UW30 recommendation on this name.

Keep an eye on future stars and angels

Finally, our readers can access a full list of rising star and fallen angel candidates, defined as issuers on the cusp of crossover line, with watches/outlooks indicating the move in the direction that takes them over this line, under option 10 on our HYDL page in Bloomberg.

Link to Definitions

Credit

Click here for definitions of commonly used terms.

Additional Disclosures

BoA Merrill Lynch is currently acting as sell side Financial Adviser to Nokia Siemens Networks in the potential acquisition of its fixed line Broadband Access business by Adtran Inc, which was announced on the 12th December 2011.

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Overweight-70%	Up to 70% Overweight of investor's guidelines	Carry, plus some spread tightening expected
Overweight-30%	Up to 30% Overweight of investor's guidelines	Good carry, but little spread tightening expected
Underweight-30%	Down to 30% Underweight of investor's guidelines	Unattractive carry, but spreads unlikely to widen
Underweight-70%	Down to 70% Underweight of investor's guidelines	Expected spread underperformance
Underweight-100%	Down to 100% Underweight of investor's guidelines	Material spread widening expected

Time horizon – our recommendations have a 3 month trade horizon

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