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#bbbubble

The Lowdown on the Lowest Rated BBBs

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Large capital structure BBBs continue to be a focus of investor concern on both the investment grade and high yield sides. While these concerns are understandable given some of the headline numbers, we believe they are overstated. Our view on fallen angel volumes remains fairly benign for now – rising stars have outpaced fallen angels in eight out of the past nine years, a trend that we expect to continue in 2019 (see *Angels Flirt but Won't Fall*).

As discussed in *Big BBBs Won't Break Bad*, we believe several factors alleviate the risk posed by the growth in BBB debt. Within the BBB bucket, the rating distribution has not deteriorated, and sector weights are skewed toward non-cyclical industries, which, all else equal, are better positioned to withstand a slowdown in growth. Furthermore, many of the highly leveraged companies have large capital structures and access to several levers to defend their investment grade ratings. In *Big BBBs Won't Break Bad*, we assess the thirteen non-bank BBB issuers that, if fallen, would represent more than 2% of the High Yield Index and conclude that the risk of downgrade to high yield remains very low for these credits.

Our benign view on fallen angel volumes is also supported by our relatively constructive US economic outlook. Barclays US Economics does not expect a recession in the US this year or next. However, credit markets have enjoyed a period of very low BBB downgrade rates, a trend that will likely reverse in the next recession. Consequently, for investors with a more bearish view of the US economic backdrop, we highlight companies that could be vulnerable to ratings pressure should growth weaken. As a start, we filter for bonds that would fall into the US High Yield Index if they were downgraded to BB (therefore, we include 144As but exclude emerging market issuers) and meet one of the following requirements:

- One downgrade away from High Yield Index rating: This segment includes BBB- bonds with three ratings, one of which is high yield, and BBB- bonds with fewer than three ratings. A one-notch downgrade for these companies would move them into the High Yield Index.
- Underweight rated by Barclays' fundamental analysts, negative outlook from at least one rating agency, or on watch for downgrade by at least one rating agency.[1]

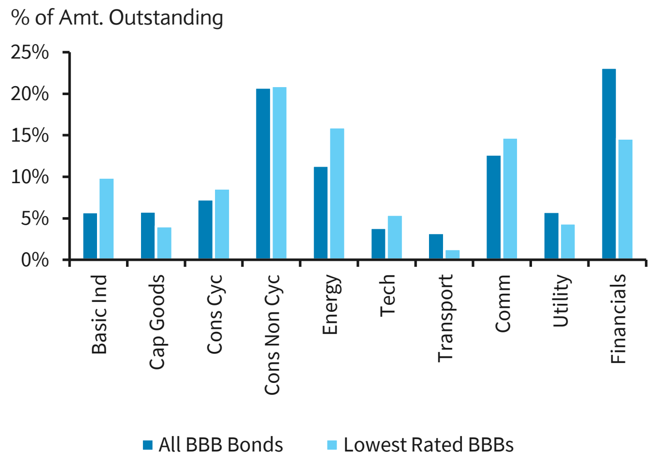
About $450bn of BBB debt meets the criteria. While that constitutes a significant portion of the BBB universe, we note that the above is a quantitative screen that attempts to identify credits that are mechanically the closest to being downgraded to high yield. Obviously, most of these companies will maintain their investment grade status through a cycle, but we think this provides a good starting point for identifying potential fallen angel candidates.

For the largest issuers on this list, our investment grade and high yield analysts provide fundamental commentary on the rating vulnerability of the credits to a weak macro backdrop, their ability to operate as high yield companies, comps in the High Yield Index, and potential downside in case of a downgrade to high yield. We note that one problem with our screen is that there is often a lag between rating agency action and company fundamentals. For example, many energy issuers are included because of the energy down cycle in 2014-16, as agency ratings do not yet reflect the balance sheet improvements since then.

[1] We have excluded bonds for which the negative outlook or watch for downgrade is provided by a rating agency that has a BBB-flat or better rating on the bond. Watch for downgrade is referred to as "CreditWatch negative" at S&P, "review for downgrade" at Moody's, and "ratings watch negative" at Fitch.

FIGURE 1

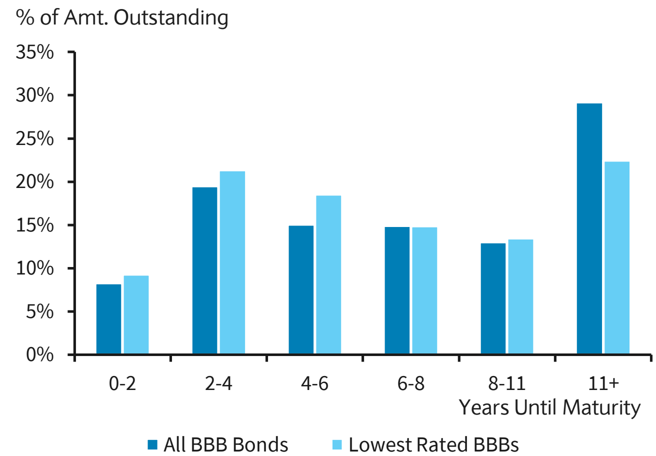
Bonds in the Screen Are Skewed toward Energy and Basic Industries…



Note: All BBB includes bonds in the US Credit Corporate and US 144A Indices.
Source: Bloomberg Barclays Live

FIGURE 2

…As Well as Shorter Duration



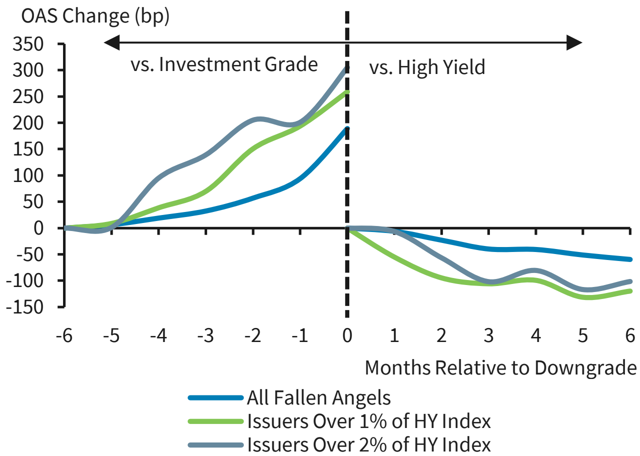
Note: All BBB includes bonds in the US Credit Corporate and US 144A Indices.
Source: Bloomberg Barclays Live

When we look at the bonds in this screen, we note certain characteristics relative to the broader BBB market (inclusive of 144As).

- **Sector:** The sector distribution could be a source of risk, as it is weighted more toward cyclical industries than the broader BBB universe (Figure 1). Conversely, financials and capital goods are underrepresented.
- **Duration:** The bonds in the screen are oriented more toward shorter duration than the broad BBB universe, with less long-dated issuance (Figure 2). This should be at least somewhat supportive of valuations in the case of heightened downgrades, given that we have previously found that fallen angels with shorter maturities tend to underperform investment grade less than longer-maturity fallen angels before a downgrade. In addition, shorter-dated bonds tend to outperform the High Yield Index more than longer-dated bonds after downgrades (*Large Angels Fall Harder but Bounce Higher*).
- **Price:** We believe that the price skew of this cohort should provide some support in regard to downgrade risk. The bonds from this screen have a slightly greater weight in lower price buckets than the broader BBB market. Specifically, 56% are priced below par, compared with slightly more than 52% for all BBBs. Similar to shorter-maturity buckets, we have found that lower-priced bonds tend to "bounce" after a downgrade by outperforming the High Yield Index as a whole, likely because of support for the lowest-priced bonds due to the upside/downside skew of returns.

FIGURE 3

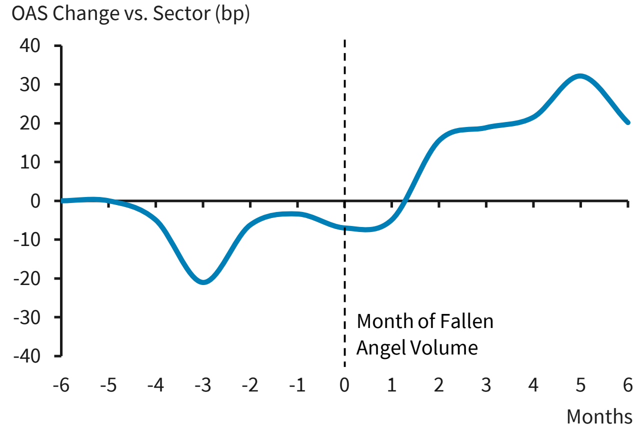
Fallen Angels Tend to Outperform the High Yield Index after Downgrade



Source: Bloomberg Barclays Research

FIGURE 4

Performance of Largest High Yield Issuer Relative to the Sector When a Large Fallen Angel Enters the Sector



Note: Large fallen angel defined as an issuer with at least $10bn of fallen angel volumes in a given month. Source: Bloomberg Barclays Research

Historic Fallen Angel Performance

On average, we have found that fallen angel bonds tend to underperform the Investment Grade Index in the six months prior to downgrade and outperform the High Yield Index in the six months following a downgrade. As seen in Figure 3 and outlined in *Large Angels Fall Harder but Bounce Higher*, this performance is magnified for the largest cap structures, with bonds from fallen angels that make up at least 1% of the High Yield Index underperforming investment grade more before the downgrade but outperforming high yield more after the downgrade. This performance difference can likely be attributed to forced selling from investment grade-benchmarked managers and forced buying from high yield-benchmarked managers – as the largest fallen angels cause the biggest ripples in terms of index weighting for both markets.

When we look at the performance of legacy high yield names, we find that they tend to underperform when a large fallen angel enters their high yield sector. Figure 4 shows that the largest high yield issuer in a specific sector tends to underperform the High Yield Index by more than 30bp in the five months after a large fallen angel enters that sector.

Fundamental Commentary on the Largest of These Issuers

Although our fallen angel outlook for 2019 is benign, investors with a more bearish view should look at the largest names in this screen for potential trading opportunities – in regard to both the fallen angels themselves and the largest high yield issuers in their specific sectors. Thirteen issuers in the screen have at least $5bn of bonds outstanding. Our fundamental analyst team has provided in-depth analysis of these names with specific focus on trading levels, business operation implications, and high yield comparable issuers if they were to become fallen angels.

Restricted - Internal

FIGURE 5
Select Large Issuers in our Quantitative Screen

Company	Ticker	Sector	Amt. of BBB- Debt That is Eligible for the US High Yield Index ($ bn)	Vulnerability to Worsening Economic Backdrop	Potential Widening if Downgraded
Allergan	AGN	Pharmaceuticals	18.3	Low	80-90bp
Becton Dickinson	BDX	Healthcare	13.0	Low	50-75bp
Deutsche Bank	DB	Financials	16.4	Medium	100-200bp*
Hess	HES	Independent	5.4	High	25-50bp
Marathon Oil	MRO	Independent	5.3	High	0-25bp
Mylan	MYL	Pharmaceuticals	9.2	Low	50-75bp
Newell Brands	NWL	Consumer Products	5.6	High	50-75bp
Noble Energy	NBL	Independent	5.5	High	50-75bp
Plains All American	PAA	Midstream	7.8	Medium	0-25bp
Synchrony Bank	SYF	Financials	6.0	Medium	50-75bp
Viacom	VIA	Media Entertainment	7.0	Medium	60-100bp
Williams Cos	WMB	Midstream	17.5	Low	50-75bp
Zimmer Biomet	ZBH	Healthcare	5.6	Medium	30-50bp

Note: This list is the output of a screen of names based on parameters outlined above with at least $5bn of High Yield Index-eligible debt outstanding. Risk of downgrade and potential spread effects if downgraded are estimates based on fundamental analysis. Potential widening if downgraded is for senior debt only.
* Because of a lack of high yield comparables, spread range for DB reflects widening of senior debt to current DB LT2 levels. Source: Bloomberg Barclays Indicies, Barclays Research

Investment grade consumer products covered by Priya Ohri-Gupta. High yield consumer products covered by Hale Holden.

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Consumer Products

Newell Brands (NWL)

Business Model Implications

As noted in more detail in *A Longer Road to Staying IG*, the path for Newell to remain investment grade is even tougher in light of recent guidance provided by the company. While management recently affirmed its commitment to maintain its "leverage ratios…and investment grade status," the company was lowered to BB+/Stable by Fitch just days prior to that commentary. In addition to the Fitch rating, the credit presently has low-BBB ratings with negative outlooks at both Moody's and S&P.

If the company were to be downgraded out of investment grade, we do not believe there would be any operational effect on its business model – beyond the elements discussed below, we also note that Newell's management has indicated that the rating would not have an effect on the working capital initiatives under way. In addition, Jarden (which the company bought in early 2016) operated well with single-B or BB ratings prior to its acquisition. We think the primary risk is the potential for a layering transaction of the existing unsecured notes should the company choose to refinance upcoming maturities with a high yield covenant package and higher associated coupon rates, although even this is not a near-term concern.

Refi risk/interest expense step-up: Refinancing risk is less of a concern given the debt paydown actions pursued by the company already. It has a manageable maturity schedule through 2022 (with less than $450mn in maturities annually), but has sizable maturities in 2023, totaling $2.05bn. Although NWL has coupon steps in $4.8bn of its debt (or about three-quarters of its bonds assuming that the March 2019s are paid at maturity), this has been reduced to $2.2bn through recent tender activity and could potentially decrease further as additional asset sale proceeds are deployed toward debt reduction.

Commercial paper use: Newell also made limited use of the commercial paper (CP) market in 2017 and 2018, with the exception of 1Q18, when it used $700mn of CP to meet seasonal needs (the company typically uses CP in 1Q, which it brings to $0 at the end of 4Q, but this was not the case in 1Q17 because the company used proceeds realized from asset sales). Management has highlighted that that it could meet seasonal cash flow needs using other sources, such as bank debt/revolvers.

High Yield Comparisons

If NWL were to be downgraded to high yield, it would account for about 26% of the consumer products subsector, making it the largest issuer. Given the high yield market's comfort with Jarden, which traded consistently at the tight end of our consumer coverage, recent divestitures, including Pure Fishing and Jostens, have been supported in the leveraged loan market. Assuming BB ratings, it could be a “must own” for index-weighted accounts if it can deliver on its plans for margin improvement for the core business and cash flow improvement related to working capital initiatives. In addition, there are only a handful of BB consumer product credits, with the majority falling in the B ratings category. Given the ratings distribution and assuming only a one- or two-notch downgrade for NWL, this suggests that levels could trade at the tighter end of our fair value range.

If Newell falls to high yield, we believe the market would use Spectrum 2025s (currently trading at a g-spread of 359bp), Tempur Sealy 2026s (291bp g-spread), Central Garden 2028s (355bp g-spread), and Energizer 2026s (361bp g-spread) as its relative value peer set. Currently, NWL 2026s are trading at $94, or a g-spread of 264bp – we think that NWL could trade at about 300bp, or a 50bp premium to the peer group and, at the wide end, would be closer to in line with the peer set, at 350bp. The Newell 2036s are trading at 375bp, or $88, while the 2046s are at 347bp, or $87. We believe downside for the 2036s and 2046s could be about $85 should the company be downgraded out of investment grade.

One significant dynamic is the coupon steps present in roughly three-quarters of Newell’s bonds. These steps are worth 25bp per agency (for each of Moody's and S&P) per notch below investment grade. The presence of the steps should help mitigate downside risk in the case of downgrade.

Energy

Investment grade energy covered by Harry Mateer. High yield energy covered by Paul Chambers.

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Hess Corp (HES)

Business Model Implications

Should Hess be downgraded out of investment grade, we do not believe there would be any operational effects on its model other than slightly higher letters of credit (LCs) that might be required for transport contracts with midstream companies. This could be a modest draw on liquidity, but Hess characterizes the effects as “not material.” Moreover, with $2.6bn of cash, $4bn of revolver availability (due January 2021), and a long runway before its first bond maturities are due ($300mn due in 2024), HES seems well positioned with no near-term concerns. As a result, we do not see any financing risk.

As an offset, Hess is outspending cash flow in 2019 while it funds its share of costs at the offshore Guyana mega-project (Exxon is the operator), and management has guided for a free cash flow inflection only in 2020. As a result, if oil prices weaken materially, Hess’s cash balance could decline more significantly in 2019, with limited capex flexibility in the next several quarters. Overall, we think that HES would be able to operate as a high yield issuer, although management has a stated target of maintaining investment grade ratings. Hess already has a high yield (Ba1) rating at Moody’s and is rated BBB- by S&P and Fitch, with the latter maintaining a negative outlook. Given the Moody’s rating, it would take only one additional downgrade to move Hess into the High Yield Index.

High Yield Comparisons

For HES, comps would be BB-rated names such as Antero (AR), Diamondback (FANG), Murphy Oil (MUR), Aker (DETNOR), Hilcorp (HILCRP), QEP, Range (RRC), Southwestern (SWN), Seven Generations (VIICN) and possibly high-quality B+ rated names such as PDC Energy (PDCE), WPX, and Whiting Petroleum (WLL). For HES, based on the Street's 2019 net leverage estimate of 2.3x, compared with its BB-rated peer average of 1.7x and its current OAS of 276bp, we see 25-50bp in yield risk if it were to be classified as high yield. Of note, given the scarcity of oil-biased BB-rated E&P producers in high yield, investor appetite might be high, and this scarcity value could keep the credit relatively tight. In addition, the size of Hess could make it more attractive than current BB-rated high yield E&P companies.

Noble Energy (NBL)

Business Model Implications

Similar to Hess, should Noble (NBL) be downgraded to high yield, we think that the only operating effect would be slightly higher LC requirements for various contractual commitments, such as transportation. In terms of liquidity, Noble finished 2018 with $708mn of cash and $4bn available under its revolving credit facility (2023 maturity). The company has a $1bn maturity in 2021, which we expect to be refinanced. In our opinion, with management guiding for a significant improvement in free cash flow beginning in 2020, when NBL's Leviathan offshore project ramps up, the 2021 maturity should be manageable. As with Hess, Noble's management has a target of maintaining investment grade ratings, but we think the company would face few operating or financial constraints if it were to fall to high yield. The company currently has low-BBB ratings at Moody's and Fitch, but with a positive outlook at the latter, and a mid-BBB rating at S&P. In order to move into the High Yield Index, at least two agencies would need to lower Noble.

High Yield Comparisons

For NBL, comps would be BB-rated tickers such as AR, FANG, MUR, DETNOR, HILCRP, QEP, RRC, SWN, VIICN, and possibly high-quality B+ rated names like PDCE, WPX, and WLL. For NBL based on the Street's 2019 net leverage estimate of 2.4x, compared with its BB-rated peer average of 1.7x and its current OAS of 265bp, which is roughly 32bp tight of our BB-rated E&Ps, we see 50-75bp in yield risk if it were to be classified as high yield. Of note given the scarcity of oil-biased BB-rated E&P producers in high yield, investor appetite might be high, and this scarcity value could keep NBL relatively tight. In addition, the size of Noble's asset base could make it more attractive than current BB-rated high yield E&P companies.

Marathon Oil (MRO)

Business Model Implications

If Marathon were to be downgraded to high yield, the company could be required to post LCs to backstop some of its contractual obligations, along with higher fees on its revolving credit facility, leading to a slight reduction in liquidity. Unlike Hess and Noble, Marathon expects to be free cash flow positive in 2019, and the company's credit ratings have some upward momentum at Moody's (Ba1 with a positive outlook) and S&P (BBB- with a positive outlook), while Fitch rates the company mid-BBB. MRO has a $600mn maturity in 2020 and another $1bn coming due in late 2022, but given the company's expectation for positive free cash flow, $1.5bn of cash on hand, and $3.4bn of revolver availability (2022 maturity), we think that management will be able to pay down or refinance the maturities unless oil prices move materially lower (MRO has guided for a $45/bbl WTI free cash flow breakeven). Marathon recently announced the sale of its remaining UK assets for $140mn, which will further bolster the company's liquidity.

High Yield Comparisons

For MRO, comps would be BB-rated tickers such as AR, FANG, MUR, DETNOR, HILCRP, QEP, RRC, SWN, VIICN, and possibly high-quality B+ rated names such as PDCE, WPX, and WLL For MRO, based on the Street's 2019 net leverage estimate of 1.3x, compared with its BB-rated peer average of 1.7x and its current OAS of 181bp, which is roughly 116bp tight of our BB-rated E&Ps, we see 0-25bp in yield risk if it were to be classified as high yield. As noted for Hess and Noble, we think that the relative scarcity of oil-biased E&P paper in the BB ratings category could keep Marathon's spreads from gapping wider. We also think that MRO will benefit from its relative size advantage compared with many of the other high yield E&P credits.

Williams Cos (WMB)

Business Model Implications

If downgraded to high yield, Williams could be required to post collateral for the benefit of some of its counterparties, although we think that the company's liquidity of $4.5bn ($168mn of cash and $4.3bn of revolver availability) at year-end 2018 would accommodate potentially increased LC requirements. From an operating standpoint, we see few risks to WMB's interstate natural gas transportation and gathering and processing midstream operations, although we anticipate that FERC regulatory oversight would limit the amount of incremental leverage that could be placed on Williams's pipeline opcos (Transco and Northwest Pipeline).

Barclays Credit Research estimates year-end 2019 leverage of 4.7x (consistent with management guidance), but the company's leverage target is 4.2x, and WMB has stated that it may look to sell assets in order to accelerate its deleveraging progress. With investment grade ratings at all three agencies, it would take two downgrades to shift WMB into high yield. At present, the company has a Baa3 rating at Moody's (stable outlook), mid-BBB rating at S&P (negative outlook), and a BBB- rating at Fitch (but with a positive outlook). Management targets maintaining investment grade ratings. Given the fairly limited quarter-to-quarter cash flow volatility of Williams's asset base, we think that WMB would be able to refinance maturities and fund growth spending as a high yield issuer, but the company has historically operated with negative free cash flow, as growth capex (plus dividends) has been larger than operating cash flow.

As a key risk if WMB were to fall to high yield, we note that Williams has significant annual bond maturities, with $2.1bn due in 2020, $0.9bn in 2021, and $2bn in 2022, which might require management to pull back on growth capex in order to retain more cash flow if the high yield primary market offered limited access.

High Yield Comparisons

For WMB, comps such as Targa (NGLS), Enlink (ENLK), DCP, and NuStar (NSUS) would apply. All four of these high midstream names have BB ratings (composite). For WMB, based on the Street's 2019 net leverage estimate of 4.6x, compared with the high yield midstream peer average (NGLS, DCP, ENLK, NSUS) of 4.4x and its current OAS of 156bp, which is roughly 118bp tight of its potential BB-rated high yield midstream peers, we see 50-75bp in yield risk if it were to be classified as high yield. As an offset, we think that Williams's interstate natural gas pipeline assets are a positive differentiator compared with the gathering and processing-oriented high yield comp set.

Plains All American (PAA)

Business Model Implications

Plains All American (PAA) operates a crude oil and natural gas liquids infrastructure network that includes transportation, storage, and marketing operations. Of the partnership's primary businesses, the Supply & Logistics marketing segment requires significant access to capital and could be negatively affected if the company were to move into the High Yield Index. PAA was downgraded to Ba1 by Moody's in August 2017, but the company maintained low-BBB ratings at S&P and Fitch, which kept the partnership in the Investment Grade Index.

In order to deleverage the balance during the past couple years, PAA cut its distribution, sold assets, and de-risked its marketing operations (by adding hedges and curtailing certain activities). As a result, with EBITDA growing as new projects come online and PAA's free cash flow deficit reduced significantly, Plains's leverage has improved. In addition, although we think that PAA's marketing business would be negatively affected by any further credit rating deterioration, management has guided for a much smaller EBITDA contribution from the Supply & Logistics segment in 2020, which we think lessens the overall business risk associated with high yield.

PAA has $1bn of debt maturities in the next 12 months that we expect to be refinanced, and management has signaled that it may seek to increase the distribution after achieving its debt reduction targets. The partnership has a target of eventually regaining mid-BBB credit ratings and has announced that it is reviewing its current leverage target of 3.5-4.0x long-term debt/EBITDA.

High Yield Comparisons

As with WMB, we think that PAA would be compared in high yield with credits such as such as NGLS, ENLK, DCP, and NSUS. All four of those high yield midstream names have BB ratings (composite). For PAA, based on the Street's 2019 net leverage estimate of 3.7x, compared with the high yield midstream peer average of 4.4x and its current OAS of 197bp, which is roughly 77bp tight of its potential BB-rated high yield midstream peers, we see 0-25bp in yield risk if it were to be classified as high yield.

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Financials

Deutsche Bank (DB)

Business Model Implications

Please see *European Credit Alpha: All doved up* and *Global Banks: Ten Themes for 2019* for detailed comments on regarding Deutsche Bank (DB), specifically in regard to fallen angel potential. While it is not our base case, there is a non-negligible risk that Deutsche Bank (DB) will be downgraded in 2019. Deutsche Bank has a very large capital structure, and the implications for the Investment Grade Index, as well as for the bank, are significant. The primary concern refers to the non-preferred senior ratings, which are BBB- equivalent at S&P and Moody's.

Moody's and S&P link their downgrade risks primarily to the failure to implement the strategic plan. We think that both agencies are tolerant to some slippage below the 2019 targets, although interpreting just how much is difficult, which in turn increases the nervousness of market participants. That said, the agencies are not likely to take a further downgrade decision lightly, given the potential consequences to the bank's client relationships, especially if capital and liquidity positions remain robust at the same time, which we expect will continue to be a priority for bank management. Perhaps the bigger concern is the wider problem of a weakened franchise and competitive position, something we see evidence of already and that will require years to fix, if there is a way back to an adequate position. Negative headlines about the bank's conduct could reinforce the negative sentiment and exacerbate weak profitability.

With regard to timing, our base case is that the rating agencies will wait for FY 2019 results to make their decisions to give the bank time to fulfil its 2019 strategic objectives. However, if it becomes apparent before end-2019 that these objectives will not be achieved and/or other headlines materialize that significantly affect the bank's financial condition (eg, a litigation fine), we do not rule out the agencies' acting during 2H19. In that case, S&P might add an intermediate stage action, with a negative outlook or a review for downgrade before actually cutting ratings.

High Yield Comparisons

The size of DB's capital structure alone is a significant overhang to the market, given its low investment grade ratings and uncertain fundamental trajectory. A downgrade of DB would be a material index event, given that the issuer would represent more than one-third of the US high yield banking sector. This technical aspect would be exacerbated by the fact that DB is a financial issuer and many high yield funds have a mandate or a benchmark that excludes financials. Based on EPFR data, we estimate that about 25% of high yield mutual funds are benchmarked to high yield ex-financials, which would further reduce the pool of capital that is available to absorb any selling from investment grade mandates.

Current trading levels suggest that a significant further widening would be required to make DB's senior non-preferred bonds appealing to high yield managers and to compensate them for taking potentially off-benchmark positions in a financial issuer. More generally, the willingness of high yield managers to take senior risk in a large bank has not been tested in this size before and is a significant "known unknown" for European credit markets.

Synchrony Bank (SYF)

Business Model Implications

SYF is a consumer finance company that primarily offers private label credit cards through partners, including retailers. In 2018, the company announced that a large retailer partner – Walmart – would not renew its contract, which accounted for about 13% of the company's receivables. This prompted negative outlooks from the two agencies that rate SYF's bonds – S&P and Fitch (SYF does not have a Moody's rating). With negative outlooks on both of SYF's BBB- ratings, the risk of a downgrade to high yield was elevated.

Following these outlook actions, there was heightened market concern that other large contacts could be at risk of non-renewing. Nonetheless, while still on negative outlook, the company successfully renewed/extended contacts with key partners including Sam's Club and Amazon. SYF also reached an agreement to sell its legacy Walmart receivables to Capital One. These actions stabilized the company's competitive position and prompted S&P and Fitch to revise their outlooks on SYF's BBB- ratings back to stable.

We believe that SYF's ratings are stable and see low risk of a downgrade to high yield this year. Over the medium term, asset quality trends will likely become a more important factor for ratings as the US business cycle matures. Although Barclays' view is that a recession is unlikely this year, below, we discuss the implications of potential high yield ratings for SYF. In general, we think that high yield ratings would not materially affect SYF's relationships with its borrowers or private label partners. Depositors would continue to benefit from FDIC protections and Fed oversight of the overall enterprise.

High Yield Comparisons

High yield ratings are not optimal for fincos, but they do not introduce existential risk. Ally Financial and CIT Group are examples of fincos with predominantly online deposits that have operated successfully with high yield ratings since the financial crisis. This has been the case largely because ALLY and CIT have grown their deposit funding over time, thereby reducing their reliance on unsecured debt, which have funding costs that are more sensitive to ratings. SYF already has a high mix of deposit funding (73% of the total), with unsecured debt accounting for only 11% of total funding at YE18 and 16% attributable to ABS. High yield ratings could increase the cost of SYF's unsecured funding, resulting in a manageable drag on the company's earnings and returns, in our view. The company generated a healthy ROA of 2.8% and ROE of 19.4% in 2018.

ALLY and CIT are the best natural high yield comps for SYF. ALLY 4.625% 2025s (170bp) and CIT 5.25% 2025s (177bp) already trade 60-80bp inside of SYF 4.5% 2025s (g+231bp) despite having lower ratings. We attribute this to the high likelihood that ALLY and CIT will move into to the Investment Grade Index in 2019 and the lack of idiosyncratic risks that have weighed on SYF's valuations.

Among other high yield financial peers, Springleaf/OneMain (AMGFIN, Ba3/BB-) is a comp because its customer profile (middle/low end of the credit spectrum) is similar to SYF's. That said, AMGFIN's reliance on brick-and-mortar branches and lack of deposit funding contrasts with SYF's online focus and status as a federally regulated depository institution. We view SYF as a higher-tier credit than AMGFIN given its status as a regulated bank and its ability to source funding from deposits. As a result, we think that SYF should trade at least 50bp through AMGFIN. The AMGFIN 24/25s curve is steep at about 50bp, with its 6.125% 2024s quoted g+325bp and 6.875% 2025s quoted g+378bp, mid-market. Using the average of about +350-360bp, we think that SYF 2025s as a high yield credit could be valued at around g+300bp, implying about 50-60bp of widening from current levels.

If SYF were to become a fallen angel, it would be the sixth-largest constituent, at 5%, of the high yield financials index. Given its size, we would expect some support from index-weighted accounts upon a downgrade, but do not foresee a meaningful spread effect for other high yield financials.

Investment grade healthcare and pharmaceuticals covered by Brittany Chen. High yield healthcare and pharmaceuticals covered by Rishi Parekh.

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Healthcare and Pharmaceuticals

Allergan (AGN)

Business Model Implications

With 3x leverage, approximately 18% free cash flow/debt (after dividends but before share repurchases), and bonds trading inside of the investment grade pharmaceutical index (duration adjusted), we do not believe the market is anticipating a downgrade to high yield. That said, it is possible that aggressive corporate action, such as a spin or leveraging acquisition, could place this assumption at risk. While management seems committed to maintaining investment grade rating and achieving its 2.5x net leverage target by year-end 2020, the covenants do not prohibit the company from pursuing various leveraging or credit-unfriendly events. We believe that certain scenarios could lead to debt penalties, which might dissuade management from considering such actions.

The company faces roughly $800mn in maturities in 2019, $4.7bn in 2020, and $2.5bn in 2021. A downgrade would only affect the company's cost of capital and not prohibit it from addressing these maturities. Depending on what hypothetical event might trigger a downgrade, we believe the company would have ample options to issue secured debt or debt with subsidiary guarantees. We also assume that AGN has options to address near-term debt through leveraged spins.

Fourth-quarter 2018 revenue declined 5.7%, to $4.1bn, ahead of the Street's $4bn estimate. Growth came from Botox, Vraylar, Juvederm, and Lo Loestrin. The company's 2019 revenue guidance, which was below Street expectations, reflects loss of exclusivity of Restasis in March 2019 and recalled products. During the call, management announced that it would scrap the previously announced sale of its Women's Health division while proceeding with a transaction for Infectious Diseases. The company also reiterated its focus on maximizing shareholder value among key capital allocation priorities (which include debt reduction) and a commitment to investment grade ratings (2.5x net leverage target by year-end 2020). For a full review of AGN's recent results, please see *Allergan plc (AGN), Amgen Inc (AMGN), Pfizer Inc (PFE) 4Q18: What You Need to Know*.

High Yield Comparisons

If there are legitimate concerns of a downgrade, AGN has the greatest risk of underperformance relative to Mylan (MYL) based on current levels and on the assumption that it might take a material credit negative event for a 3x leveraged, approximately18% FCF/debt credit to fall to high yield. Following a downgrade, AGN and Bausch (BHCCN) would represent roughly 38% and 34%, respectively, of the high yield pharmaceuticals index. If AGN (currently trading around 140bp) is downgraded to BB, we assume that the notes would trade to MYL levels (roughly 220bp) and would expect the notes to settle around BB index spreads (currently 240bp).

Mylan (MYL)

Business Model Implications

2018 was a challenging year for MYL. Operational underperformance (for details, see *Mylan NV (MYL) Déjà vu: Caution: Tread Lightly*) was exacerbated by delays in securing FDA approval for generic Advair and Restasis, which drove investor concerns about an imminent downgrade at one or more agencies (currently low-BBB at all three). Mylan saw some reprieve when the FDA finally green-lighted its application of Advair in January 2019. While consensus expectations have come down for FY 2019, concerns about a near-term downgrade have largely abated.

There has been concern about a potential shift in MYL's financial policy as the result of the company's ongoing strategic review. Accordingly, we believe a sizable debt-financed acquisition could renew fears of a ratings downgrade. If a downgrade were to occur, we do not think that MYL would face material challenges in addressing its near-term maturities. We believe it would have options to issue both USD and EUR notes. While the cost of capital would increase, we would expect a strong emerging markets bid. We would also expect strong interest if ratings did not slip below BB. It is possible that the company might be able to issue pari passu paper (similar to what Teva did following its downgrade); if that were to prove prohibitively expensive, we believe Mylan would have ample options to issue either secured debt and/or unsecured debt with subsidiary guarantees. MYL utilizes a $1.65bn CP program and a $400mn receivables facility for general corporate purposes. In the event of a downgrade, we believe advance rates under its A/R facility might decline to levels similar to Teva, whose rates dropped from 85% to 65%.

High Yield Comparisons

The high yield pharmaceutical index ($31bn outstanding) is heavily weighted toward Bausch (BHCCN) at nearly 55% of the amount outstanding. If MYL were to fall into the index, weightings between the two credits would rebalance at approximately 24% (MYL) and 41% (BHCCN). We would expect BHC spreads to widen in the event of a MYL downgrade as investors reposition out of BHC; however, we would not expect the effect to be material considering that investors might consider exiting riskier positions to rebalance into MYL.

MYL 2028 notes ($94, OAS 265bp) trade nearly 130bp wide of BBB investment grade pharma (137bp), roughly 100bp wide of the IG BBB index, and nearly +150bp wide of the IG pharma index (110bp). We would expect MYL bonds to round-trip and experience nearly 50-75bp of widening leading into a downgrade and subsequently tighten as high yield investors rebalance their holdings. Although TEVA is not index-eligible, we would not expect MYL to trade wide of TEVA 2028 notes (OAS 374bp).

Zimmer Biomet (ZBH)

Business Model Implications

ZBH is in the final year of a turnaround period and continues to target a leverage profile of 3x or lower thereafter. Management has recently refocused its attention on achieving growth in 2020 and has communicated a willingness to consider using financial leverage to outpace the industry average of 2-3%. If the company achieves its deleveraging target in the near term, we believe the agencies should maintain their current ratings. However, if leverage does not fall below 3x because of weak sales, production issues, large debt-funded acquisitions, and/or increased shareholder returns, there could be a high probability of one or more downgrades. At the moment, we believe the company's credit profile offers little flexibility or room for error.

High Yield Comparisons

Following a hypothetical downgrade, ZBH USD notes would represent roughly 8% of the high yield healthcare index. Unlike BDX, MYL, and AGN, we would not expect ZBH to pressure existing high yield healthcare issuers' valuations materially if it were to fall into the index. Based on comps, we believe the 2025 notes could widen by 30-40bp. ZBH faces a $500mn maturity in 2019 and a $1.5bn maturity in 2020.

Becton Dickinson (BDX)

Business Model Implications

Following its acquisition of CR Bard, BDX's pro forma leverage spiked to approximately 5x and has since declined to around 4.6x. As recently as the company's fiscal 1Q19 earnings call on February 5, management reiterated its commitment to deleverage to around 3x over the next couple years while maintaining some wiggle room for tuck-in acquisitions. In November 2017, management indicated that its target leverage of around 3x should "equate" to a strong investment grade rating.

BDX is currently split-rated (Ba1/BBB/BBB-); A ratings downgrade from either Fitch or S&P could result from weaker free cash flow generation, loss of market share, weaker margins (Bard was expected to drive growth in higher-margin categories), reimbursement concerns, or a change in the company's acquisition strategy. On a yield per turn of leverage basis, BDX benchmark bonds trade tight to ZBH; thus, we believe a downgrade could cause spreads to widen by 50-75bp.

BDX faces sizable near-term maturities, with nearly $7bn coming due over the next three years. The weighted interest rate associated with these maturities is roughly 2.5%. Therefore, based on current valuations, we believe the company could seek to capitalize on its secured capacity to access capital at more attractrive pricing levels.

High Yield Comparisons

Following a hypothetical downgrade, BDX would represent 19% of the high yield healthcare index, thereby reducing THC's weighting from 19% to 16% and HCA's from 17% to 14%. We believe this would lead investors to rebalance their portfolio holdings by selling illiquid higher-quality credits such as Hologic (HOLX) or Hill-Rom (HRC) and buying BDX. We would also expect pressure on THC and HCA as investors reduce exposure to hospitals. However, we believe any HCA or THC spread widening would be temporary, as many investors have been waiting for better entry points in both credits.

Media Entertainment

Investment grade media entertainment covered by Sandeep Gupta. High yield media entertainment covered by Vincent Foley.

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Viacom (VIA)

Business Model Implications

We believe a loss of investment grade ratings at Viacom. would have a minimal effect on the company's operating profile. As the owner of Paramount studios, Viacom does frequently tap the commercial paper market, which it would not be able to do if downgraded to high yield (although there was no outstanding CP balance at the end of fiscal 1Q19). Aside from CP, the company's liquidity needs are supported by a $2.5bn revolver. As a high yield company, Viacom would face a higher cost of capital compared with its current low-BBB ratings. Viacom's maturity schedule is fairly well laddered, with just $310mn of debt coming due in 2019 and then $1.1bn in 2021. Its current cash balance of $534mn, revolver capacity of $2.5bn, and annual free cash flow generation of $1.6bn (Street consensus) would help mitigate its upcoming maturities and limit refinancing risk. In our view, the biggest concern about refinancing would be a likely high yield covenant package.

Viacom would become the largest constituent of the high yield media index should it fall to below investment grade. The company currently has two subordinated note issues in the index (5.875% due 2057 and 6.25% due 2057) that together total about $1.3bn, or 2.9% of the media index. Pro forma for a downgrade to high yield, an additional 18 senior unsecured notes would be included in the HY media index for a total of around $8.9bn. Viacom would represent 17.4% of the HY media index, topping Netflix, which is currently the largest constituent ($7.8bn across eight securities, or 17.8% of the sector).

High Yield Comparisons

Assuming that Viacom had high-BB ratings, there are very few BB credits in the high yield media index, as the majority of the constituents are single-B rated, making the comp universe relatively limited. From an operational perspective, we would include AMC Networks and Lions Gate Entertainment, both of which develop and produce movies and original content for television and the big screen, similar to Viacom's business profile. To a lesser extent, we believe the TV broadcast universe could be used as relevant comps given the local content produced.

We would expect fairly meaningful widening across the Viacom curve upon a downgrade to high yield. However, we think the company would trade at a premium to its operational peers. We believe investors would likely use AMC Network's 5.0% due 2024 (Ba3/BB/NR) and Lions Gate Entertainment's 5.875% due 2024 (B2/B-/NR) as trading comps, although we recognize there is a multi-notch differential in ratings. Nevertheless, in terms of relative value, at roughly the five-year part of the curve, Viacom's 3.875% due 2024 trade at a g-spread of 145bp, more than 100bp inside AMC Network's 2024s (251bp) and 170bp better than Lions Gate's 2024s (315bp). Given the ratings differential, we do not think that Viacom's shorter-dated securities would trade as wide as AMC Network or Lions Gate. We view Charter Communications 5.875% due 2024, which trades at a g-spread of 195bp, as perhaps a better proxy for where Viacom's 2024s could trade upon a downgrade given the similarities in ratings. With an index weighting of more than 17%, Viacom would likely be a core media holding for many investors. That said, trading closer to Charter's 2024s would represent approximately 4pts and 60bp of downside.

Valuation comparables for Viacom's longer-dated securities, 2036-57, are far more difficult, as there are no securities within the high yield media index with a maturity longer than 2030. The longest-dated security in the index is Liberty Interactive (LINTA) 8.25% due 2030 (B2/BB-/BB), which trades at a price of $103, YTW of 7.8%, and g-spread of 510bp. Upon a downgrade to high yield, we believe a 6.0-6.5% yield would be closer to fair value for the Viacom 2036s, which would represent considerable downside from current levels.

Analyst Certification

We, Paul Chambers, Brittany Chen, Vincent Foley, Sandeep Gupta, Shobhit Gupta, Christy Hajiloizou, Hale Holden, Rizwan Hussain, Harry Mateer, Brian Monteleone, Priya Ohri-Gupta, CFA, Rishi Parekh, Scott Schachter and Peter Troisi, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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Materially Mentioned Issuers/Bonds

ALLERGAN FINANCE LLC, Underweight, A/CD/D/J/K/L/M/N
Representative Bond: AGN 3 1/4 10/01/22 (USD 98.63, 27-Feb-2019)

BECTON DICKINSON AND CO, A/CD/CE/D/J/K/L/M/N

DEUTSCHE BANK AG, Underweight, A/CD/CE/D/E/I/J/K/L/M/N/S
Representative Bond: DB 4 1/2 05/19/26 (EUR 102.72, 27-Feb-2019)

HESS CORP, Underweight, CD/CE/J
Representative Bond: HES 3 1/2 07/15/24 (USD 96.11, 27-Feb-2019)
Representative Bond: HES 7 1/8 03/15/33 (USD 112.98, 27-Feb-2019)

MARATHON OIL CORP, Market Weight, CD/CE/J
Representative Bond: MRO 3.85 06/01/25 (USD 98.85, 27-Feb-2019)

MYLAN NV, Underweight, CD/CE/J
Representative Bond: MYL 3 1/8 01/15/23 (USD 95.85, 27-Feb-2019)

NEWELL BRANDS INC, Underweight, CD/CE/D/J/K/L/M/N
Representative Bond: NWL 3.15 04/01/21 (USD 99.48, 27-Feb-2019)
Representative Bond: NWL 3.85 04/01/23 (USD 97.71, 27-Feb-2019)
Representative Bond: NWL 4.2 04/01/26 (USD 94.17, 27-Feb-2019)

NOBLE ENERGY INC, Underweight, CD/CE/D/J/K/L/M/N
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Representative Bond: NBL 3.9 11/15/24 (USD 98.84, 27-Feb-2019)

PLAINS ALL AMERICAN PIPELINE LP / PAA FINANCE CORP, Market Weight, CD/D/J/K/L/M
Representative Bond: PAA 2.85 01/31/23 (USD 96.22, 27-Feb-2019)

SYNCHRONY BANK, CD/D/E/J/L

VIACOM INC, Market Weight, CD/CE/J/K/M
Representative Bond: VIA 4 1/2 02/27/42 (USD 79.13, 27-Feb-2019)

WILLIAMS COS INC/THE, Market Weight, A/CD/CE/D/E/J/K/L/M
Representative Bond: WMB 5 3/4 06/24/44 (USD 105.67, 27-Feb-2019)

ZIMMER BIOMET HOLDINGS INC, CD/CE/D/E/J/K/L/M/N

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to exceed the six-month total return of the relevant index.

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High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be in line with the six-month excess return of the relevant index.
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Market Weight (MW):
The analyst expects the six-month excess return of the country's index eligible bonds to be in line with the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
Underweight (UW):
The analyst expects the six-month excess return of the country's index eligible bonds to be less than the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
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