

Moody's Credit Trends Webinar, January 22, 2019

# Rising corporate leverage and risks to credit markets

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# Agenda

1. US growth outlook and rising corporate leverage
2. Corporate credit landscape: investment grade and speculative grade issuers
3. Credit implications for banks and asset managers

# Key messages

1

**Global credit conditions to weaken this year;** US economic growth will slow, uncertain Fed rate path and trade tensions pose risks to the downside; volatility returns to leveraged finance markets

2

**Growth and distribution of corporate debt signal future credit stress;** however, corporate credit fundamentals – by rating level – today are similar to those pre-crisis

3

**Favorable credit conditions have supported US banks' commercial and industrial (C&I) lending in recent years;** supply of funding to leveraged finance markets has shifted somewhat to the non-banking sector

1

US growth outlook  
and rising corporate  
leverage

# Global growth to decelerate amid tightening global liquidity and continued trade tensions



**Economic growth will decelerate across most advanced and emerging market economies**



**Gradual quantitative tightening by major central banks will continue to have large spillover effects outside the reserve currency**

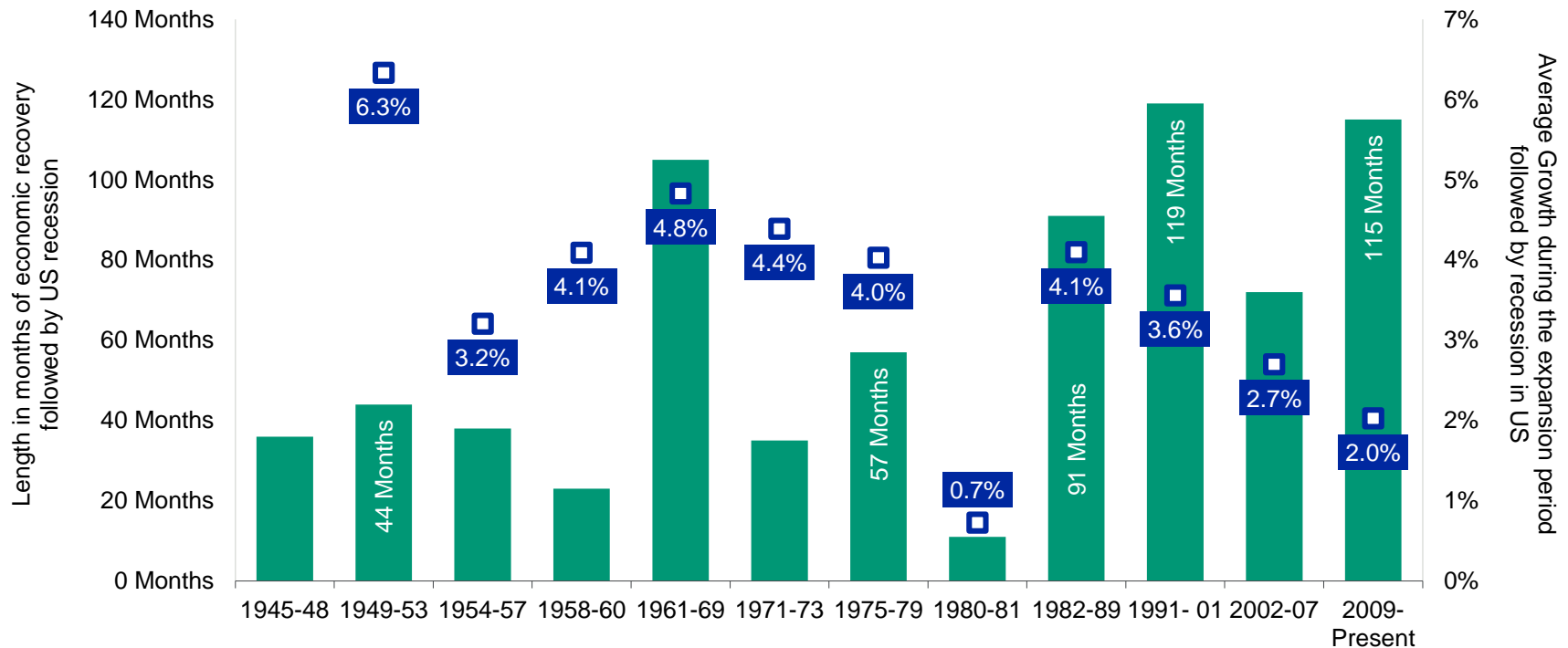


**US-China trade and geopolitical tensions will swing between periods of conflict and compromise**

Latest Global Macroeconomic Outlook for G-20 Countries, 2019-20 (November 2018 Update): [Global growth to decelerate amid tightening global liquidity and elevated trade tensions](#), November 8, 2018

# The current US expansion will likely continue into 2019 to become the longest recorded

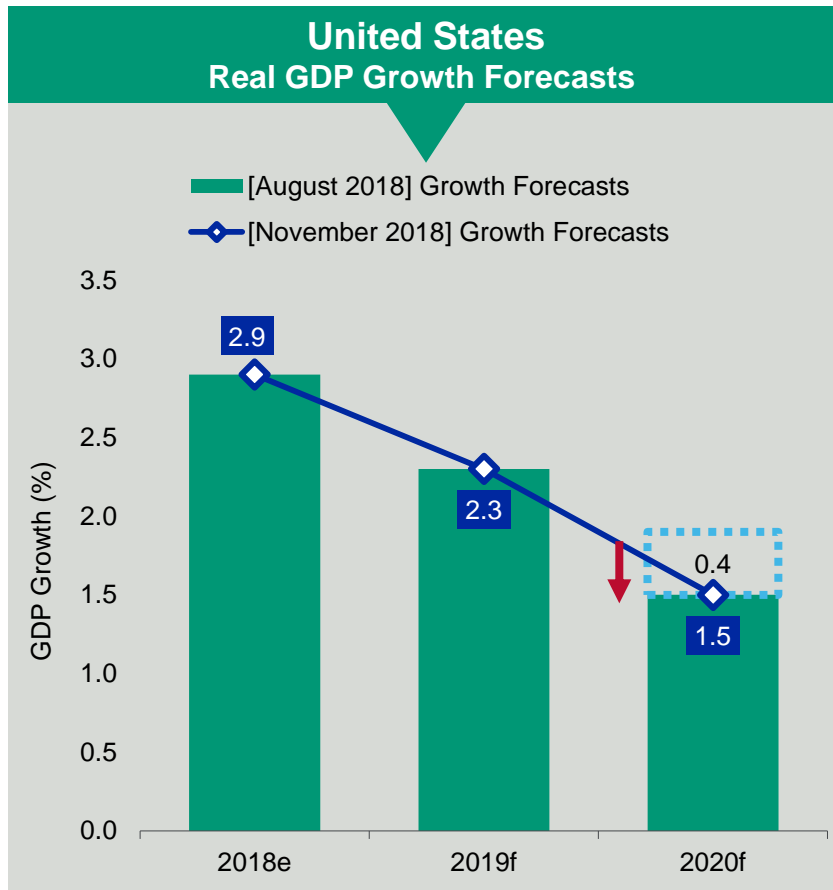
- » Our baseline assumes that the Fed will carefully calibrate monetary policy to deliberately dampen growth and elongate the current expansion by preventing excessive inflationary pressures from taking root



Sources: Haver Analytics, St. Louis Federal Reserve Database, Moody's Investors Service

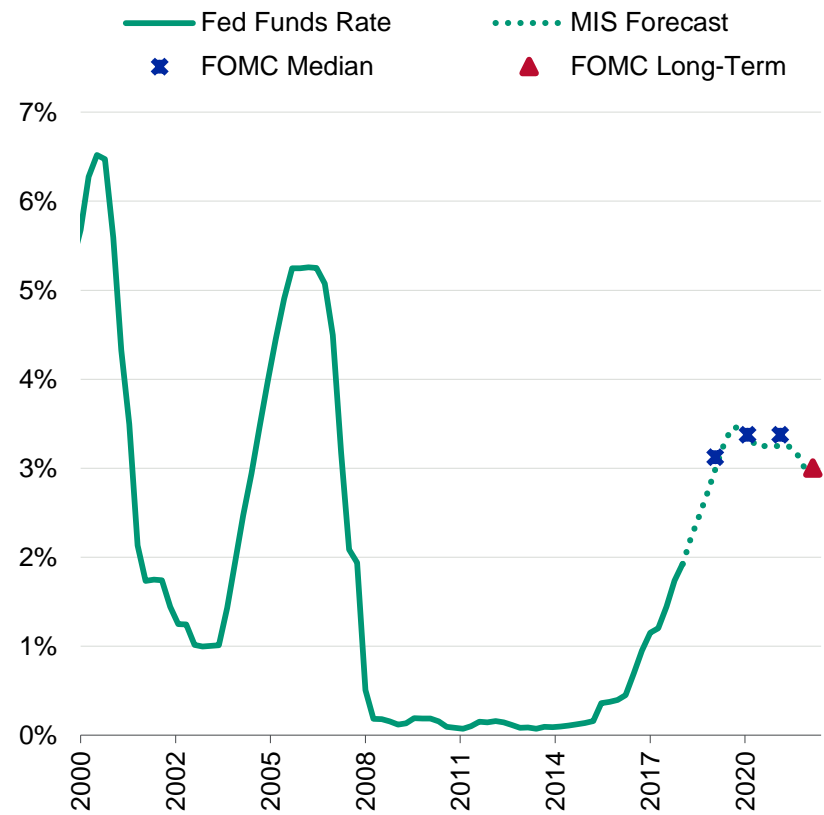


# US growth outlook: Weaker momentum ahead



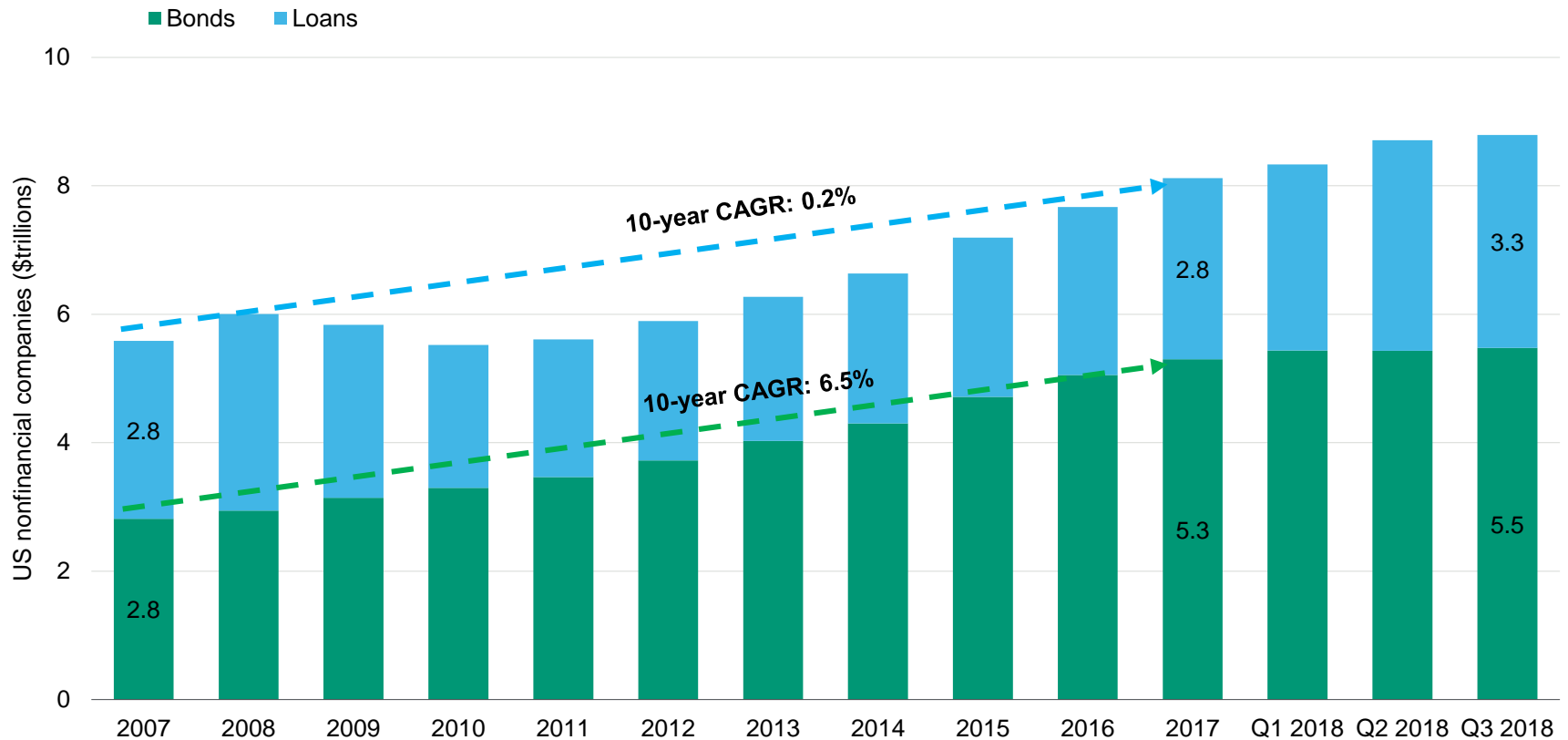
Sources: Moody's Investors Service, Haver Analytics

## US Fed Funds Rate



# US corporate loans and bonds outstanding have grown steadily since financial crisis

## US non-financial corporate bonds and loans (\$ trillions)

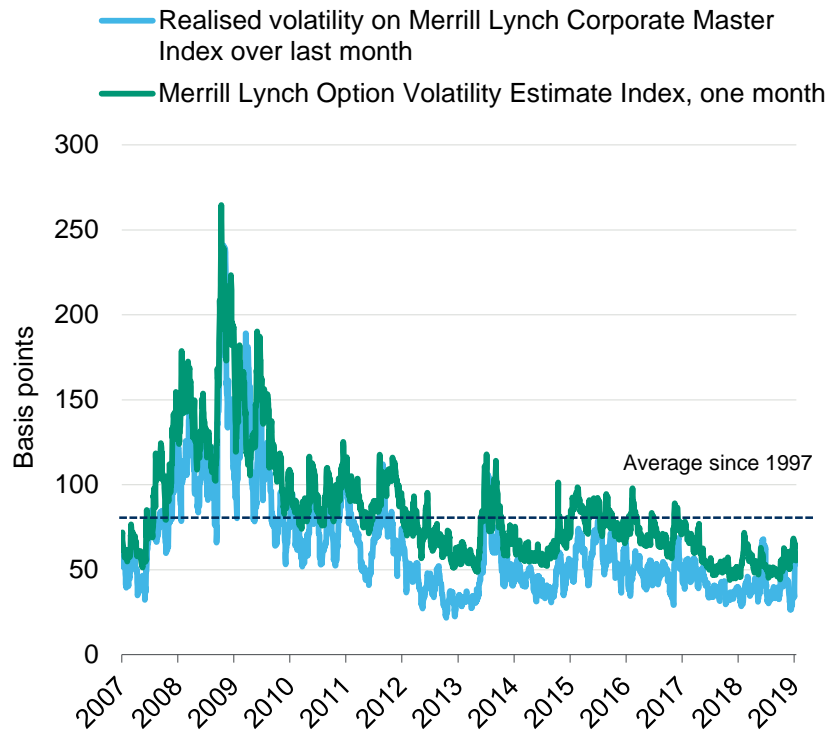


Sources: Haver Analytics, Federal Reserve US Flow of Funds, Moody's Investors Service



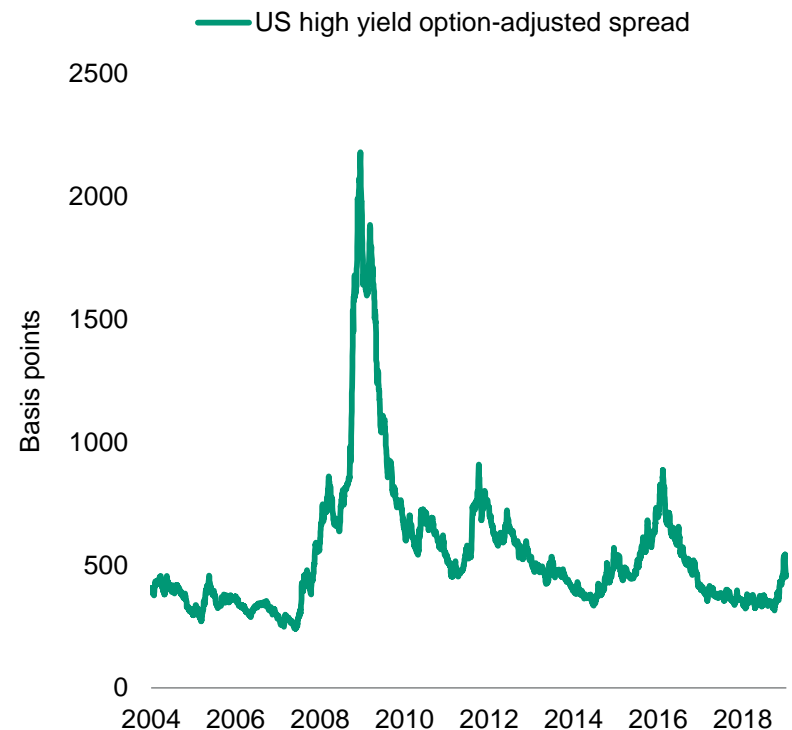
# Bond market volatility returning but still below long-term average

## Bond market volatility has increased but remains subdued



Last data captured on 14 January 2019  
Sources: Haver Analytics, Moody's Investors Service

## High-yield corporate spreads have widened



Last data captured on 14 January 2019  
Sources: Haver Analytics, Moody's Investors Service

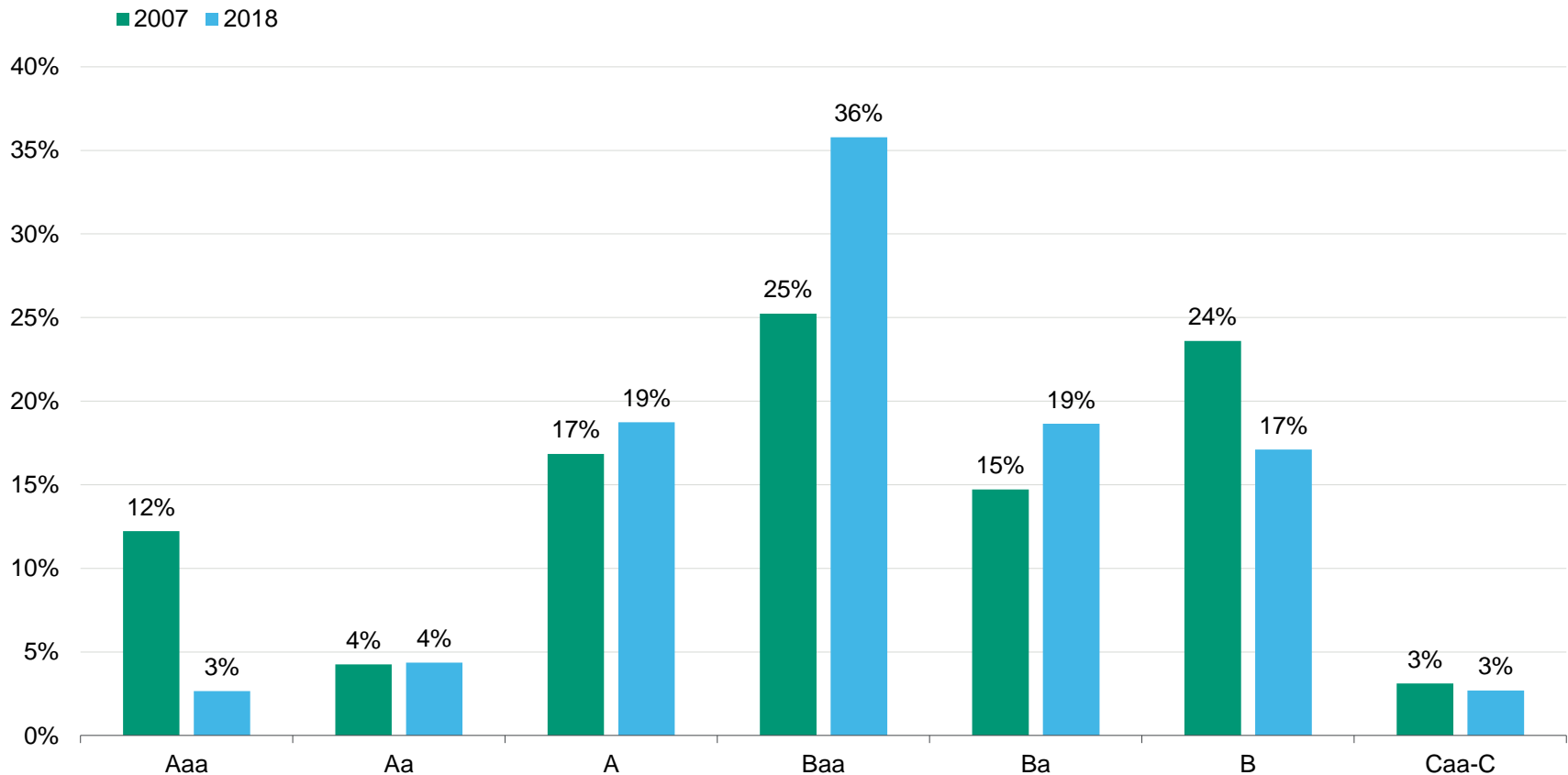
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Corporate credit  
landscape



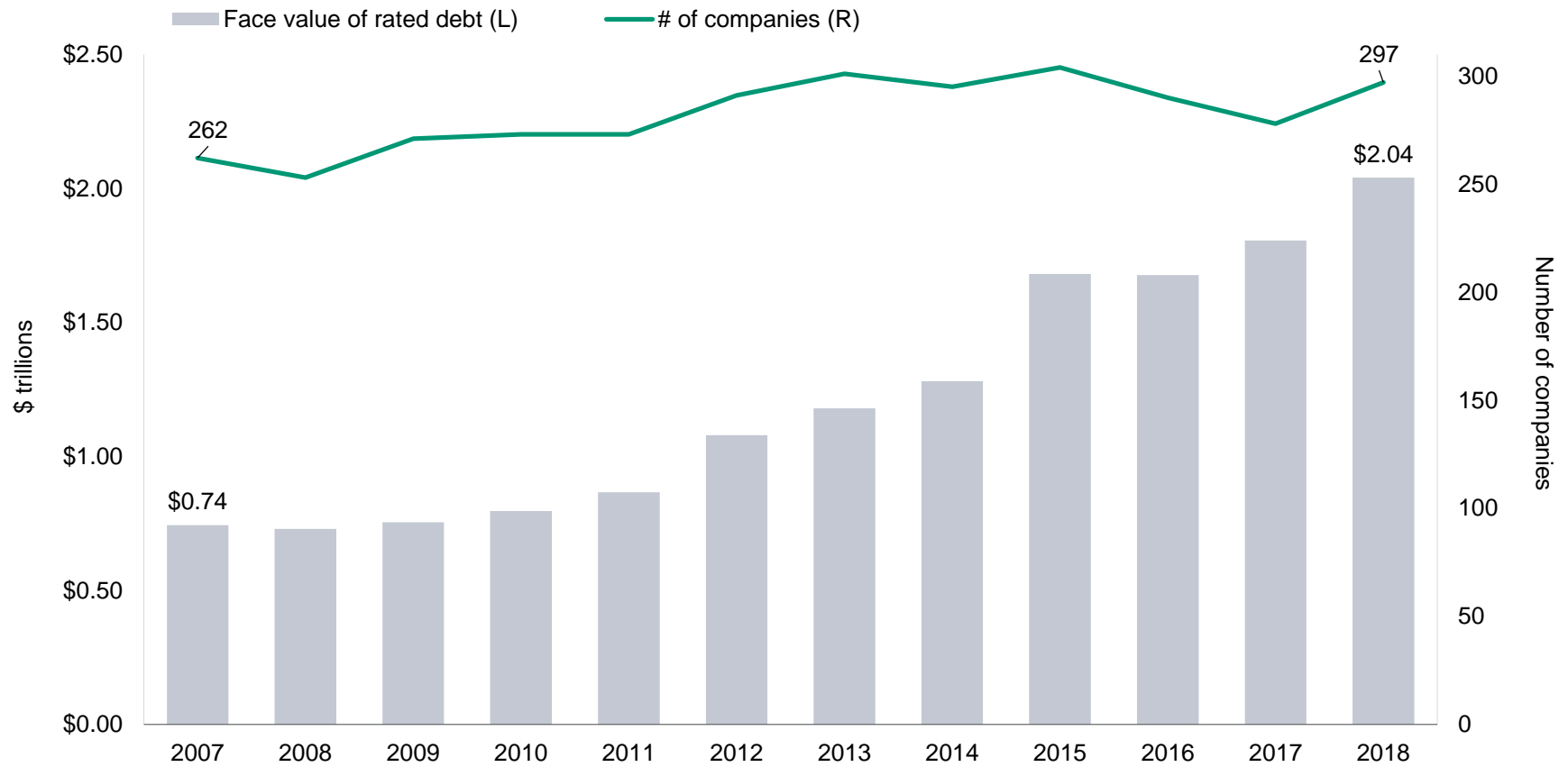
Investment grade

# Baa-rated debt now more than one-third of all nonfinancial companies' rated debt



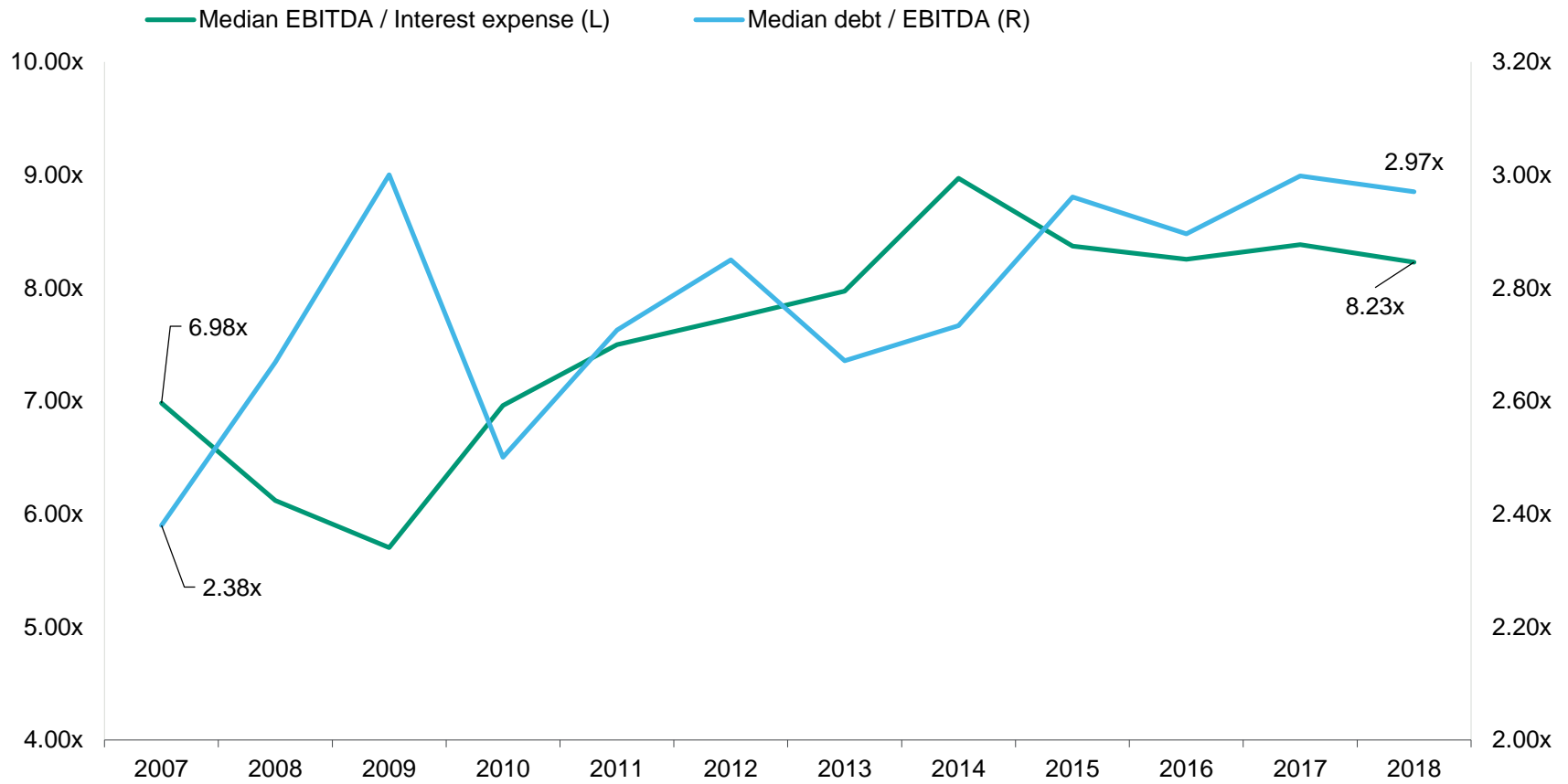
Source: Moody's Investors Service

# Rated debt of Baa non-financial companies has almost tripled since 2007



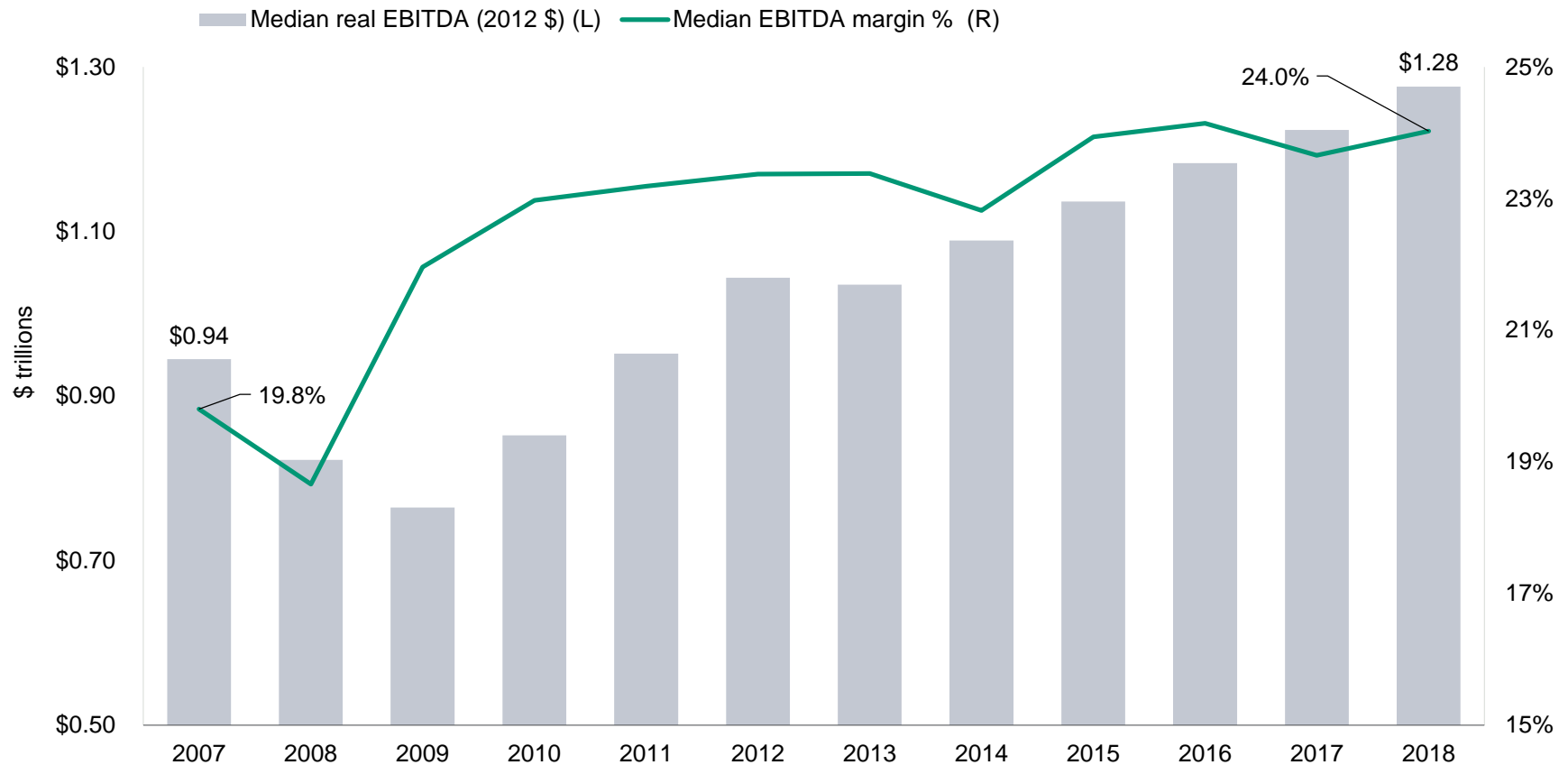
Source: Moody's Investors Service

# Higher coverage offsets Baa leverage



Source: Moody's Investors Service

# Baa-rated companies are larger and more profitable

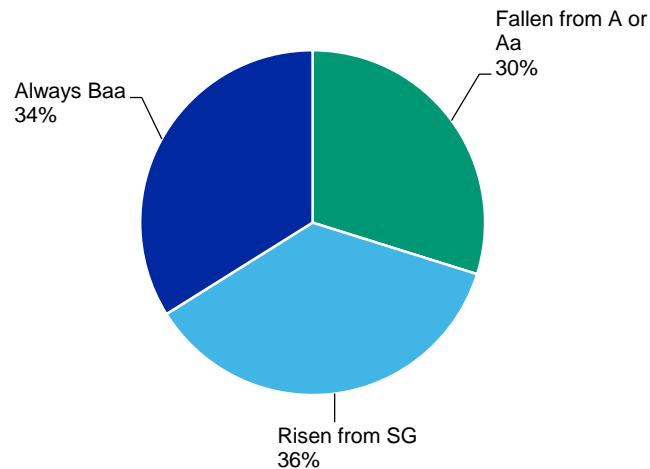


Source: Moody's Investors Service

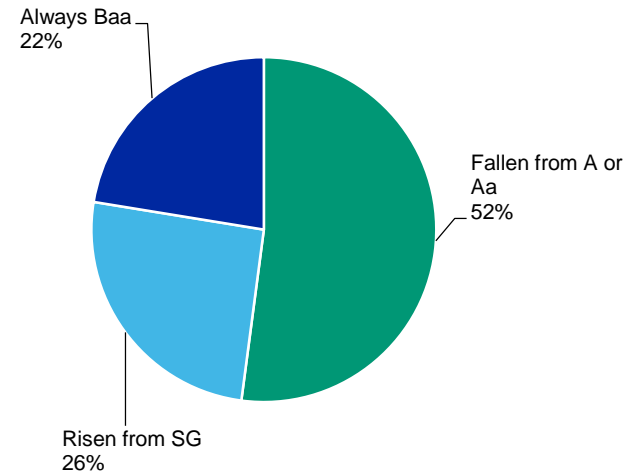


# Downgrades from A or Aa - contribution to growth of Baa debt

**By company**



**By debt**



Source: Moody's Investors Service

# 20 Largest Baa-rated companies make up 45% of Baa debt

Company	Industry	Rating	Outlook	Long-term reported debt (in \$ mlns)	Highest prior rating
AT&T Inc.	Telecommunications	Baa2	STA	\$183,418	Aa3
Verizon Communications Inc.	Telecommunications	Baa1	STA	\$112,942	A1
General Electric Company	Heavy Machinery	Baa1	STA	\$64,631	Aaa
CVS Health	Retail	Baa2	NEG	\$62,886	A2
United Technologies Corporation	Aerospace / Defense	Baa1	STA	\$38,367	A2
Kinder Morgan Inc.	Energy, Oil & Gas - Midstream	Baa2	STA	\$37,605	Baa3
AbbVie Inc.	Pharmaceutical	Baa2	STA	\$37,506	Baa1
Amgen Inc.	Pharmaceutical	Baa1	STA	\$34,427	A2
McDonald's Corporation	Restaurants	Baa1	STA	\$31,895	Aa2
Kraft Heinz Foods Company	Consumer Packaged Goods	Baa3	POS	\$31,403	Baa2
Ford Motor Company	Auto Manufacturer	Baa3	NEG	\$27,342	A1
Enterprise Products Operating, LLC	Energy, Oil & Gas - Midstream	Baa1	STA	\$25,914	Baa1
Allergan, Inc.	Pharmaceutical	Baa3	STA	\$23,583	A3
Abbott Laboratories	Medical Product & Device	Baa1	POS	\$23,347	Aa1
Union Pacific Corporation	Surface Transportation and Logistics	Baa1	STA	\$22,411	A3
Williams Companies, Inc. (The)	Energy, Oil & Gas - Midstream	Baa3	STA	\$21,442	Baa2
Celgene Corporation	Pharmaceutical	Baa2	RUR- UP	\$20,350	Baa2
PPL Corporation	Regulated Electric and Gas Utilities	Baa2	STA	\$20,254	Baa2
Mondelez International, Inc.	Consumer Packaged Goods	Baa1	STA	\$19,920	A2
Dow Chemical Company (The)	Chemical	Baa2	STA	\$19,690	A1

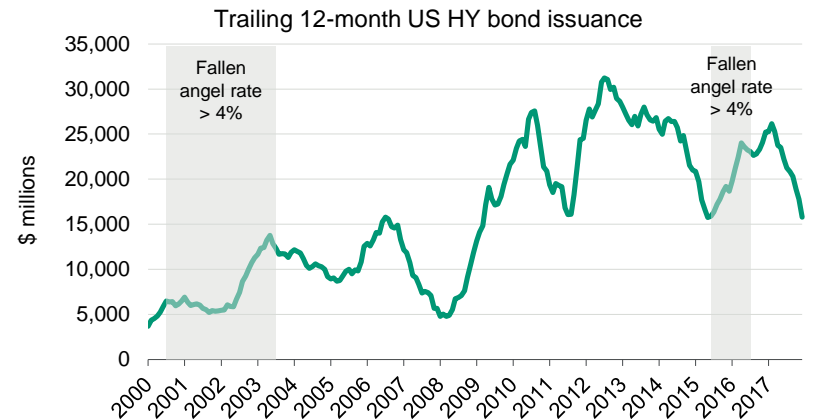
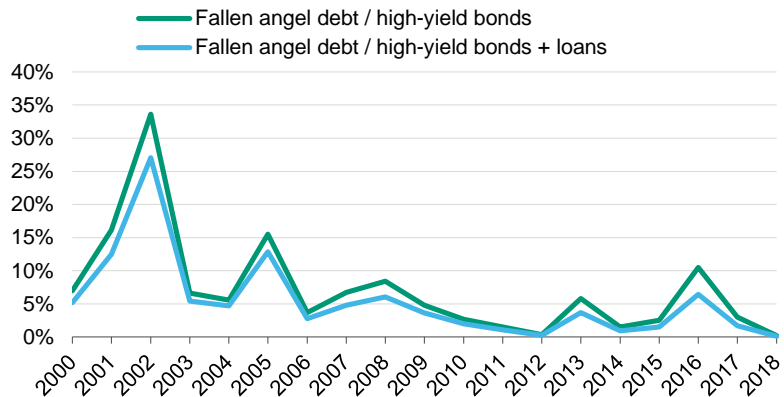
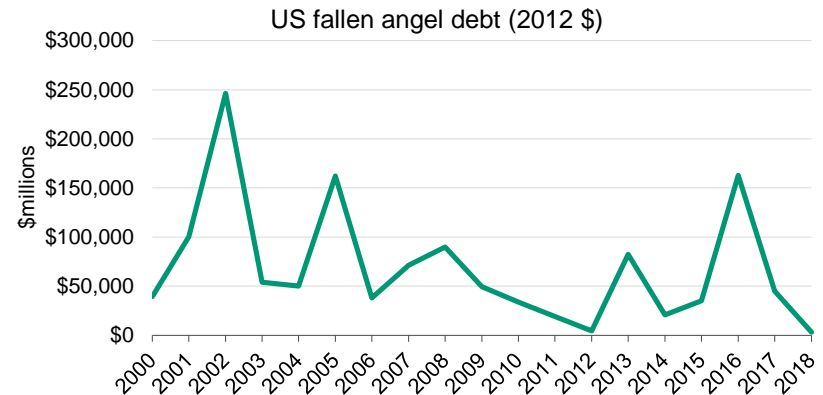
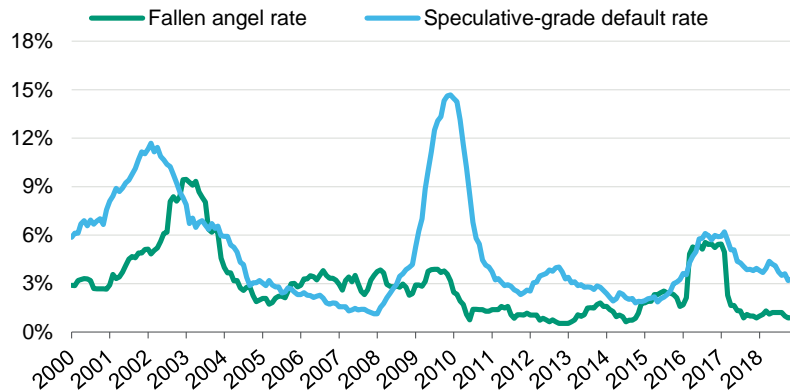
Source: Moody's Investors Service

# Highly leveraged Baa companies reflect acquisitions

Company	Industry	Rating	Outlook	Debt/EBITDA	Long-term reported debt (in \$ mils)	Moody's target debt/EBITDA	Moody's target date	Moody's size score	Moody's business profile score	Comments
Campbell Soup Company	Consumer Packaged Goods	Baa2	NEG	5.94x	\$8,001	<4x	2020	A	A	Snyder's-Lance acquisition, poor performance / execution
Keurig Dr Pepper	Soft Beverage	Baa2	NEG	5.50x	\$14,984	3.5x	2020	A	Baa	Keurig Green Mountain, Dr Pepper Snapple merger
Conagra Brands, Inc.	Consumer Packaged Goods	Baa3	STA	5.50x	\$3,541	<4.5x	2020	A	Baa	Pinnacle Foods acquisition
Symantec Corporation	Software	Baa3	RUR	4.95x	\$5,039	3x	2019	Baa	Baa	Acquisitions / divestitures, Audit Committee investigation
General Mills, Inc.	Consumer Packaged Goods	Baa2	STA	4.92x	\$14,199	<4x	2020	A	Baa	Blue Buffalo Pet Products acquisition
McCormick & Company, Incorporated	Consumer Packaged Goods	Baa2	STA	4.73x	\$4,345	<4x	2020	Baa	A	Acquisition of Reckitt Benckiser's food division
International Flavors & Fragrances, Inc.	Chemical	Baa3	STA	4.70x	\$4,377	3.5x	2020	Ba	A	Frutarom acquisition
CVS Health	Retail	Baa2	NEG	4.50x	\$62,886	3.5x	2020	Aaa	Aa/A	Aetna acquisition
Coca-Cola Bottling Co. Consolidated	Soft Beverage	Baa2	STA	4.48x	\$1,231	3.5x	2019	Baa	Baa	Franchise territory acquisitions
Mondelez International, Inc.	Consumer Packaged Goods	Baa1	STA	4.54x	\$15,253	3.5x	2019	A	Aaa/Aa	Restructuring activities, share buybacks
Molson Coors Brewing Company	Alcoholic Beverage	Baa3	STA	4.45x	\$10,560	<4x	2019	Baa	Baa	MillerCoors joint venture acquisition
Northrop Grumman Corporation	Aerospace / Defense	Baa2	STA	4.29x	\$14,406	3.5x	2020	Aa	A	Orbital ATK acquisition
Bunge Limited	Trading Companies	Baa3	STA	4.27x	\$5,243	<3x (net)	2018	Baa	Baa	Weak performance
Whirlpool Corporation	Consumer Durables	Baa1	STA	4.25x	\$5,028	<3x	2019	Aa	Baa	Bridge debt funding with asset sales proceeds expected
Newell Brands	Consumer Durables	Baa3	NEG	4.24x	\$9,613	<4x	2018	Baa	A/Baa	Soft operating performance, Jarden acquisition
United Technologies Corporation	Aerospace / Defense	Baa1	STA	4.24x	\$38,367	<3.5x	2020	Aaa	A/Baa	Rockwell Collins acquisition
Kraft Heinz Foods Company	Consumer Packaged Goods	Baa2	POS	4.18x	\$31,403	3.9x	2019	A	A	Aggressive financial policy
General Electric Company	Manufacturing	Baa1	STA	4.15x	\$64,631	<3.0x	2020	Aaa	Aa	Power business performance, prior aggressive financial policy
PerkinElmer, Inc.	Medical Product & Device	Baa3	STA	4.15x	\$1,903	3x	2019	Ba	Baa/Ba	EUROIMMUN acquisition
Kellogg Company	Consumer Packaged Goods	Baa2	STA	4.03x	\$8,721	<4x	2019	Baa	Baa	RXBAR acquisition

Source: Moody's Investors Service

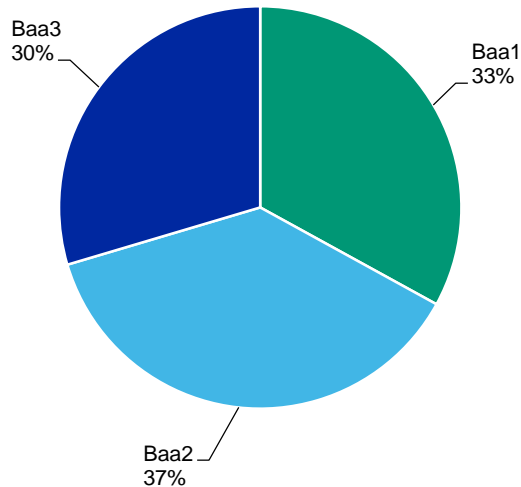
# Mitigants to risk of fallen angel debt and high-yield bond market disruption



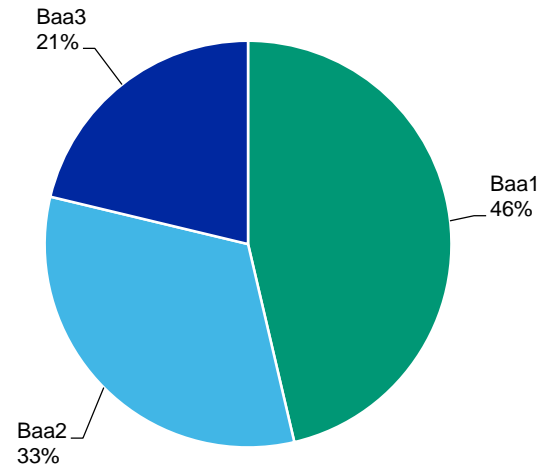
Sources: Moody's Investors Service; Dealogic

# Only 21% of Baa debt rated Baa3

**By company**



**By debt**



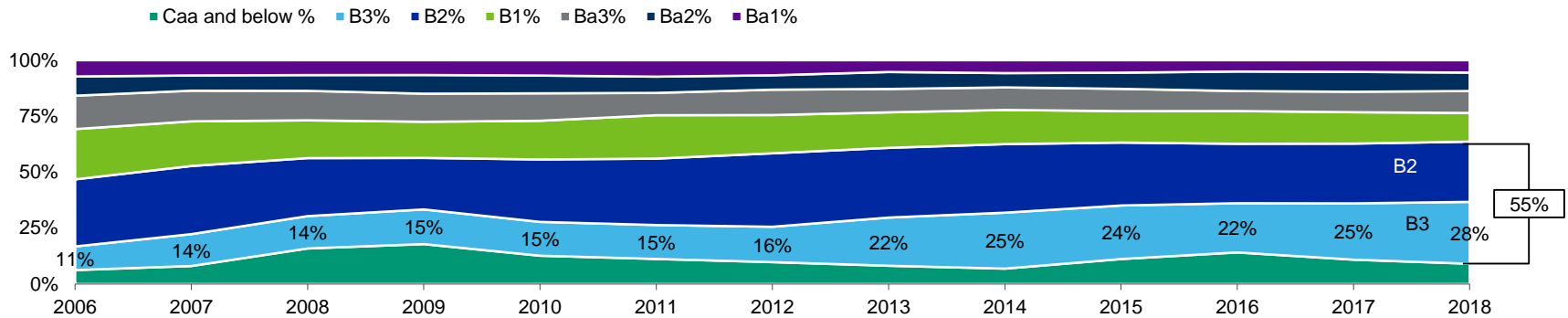
Source: Moody's Investors Service



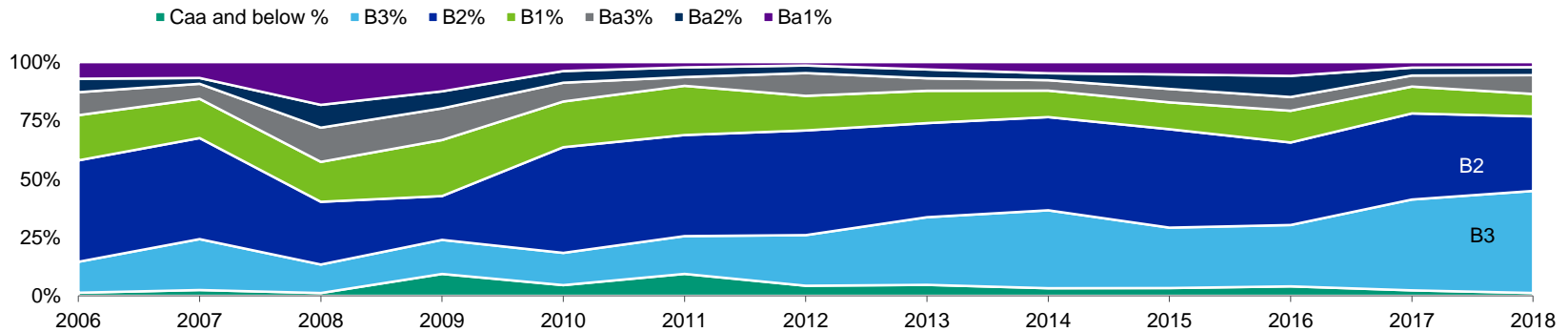
Speculative grade

# Rating distribution reflects weak credit quality

## Speculative-grade population already weaker than Great Recession depths



## Record share of low ratings on first-time issuers – Mostly leveraged loans



Source: Moody's Investors Service; CFRs of US corporate finance group - top chart is population; bottom chart is new issuers



# 3

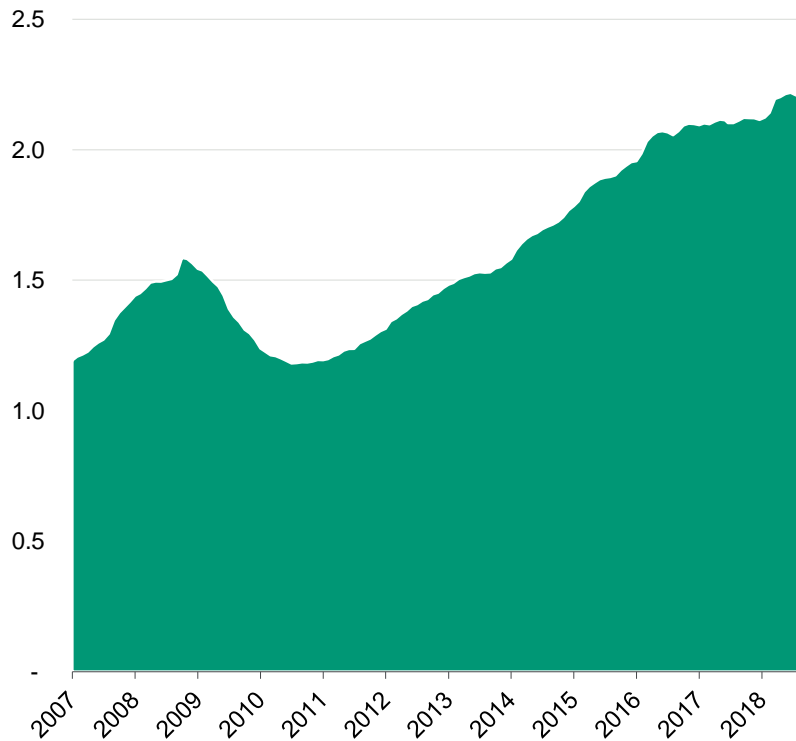
Credit implications for  
banks and asset  
managers



Banks

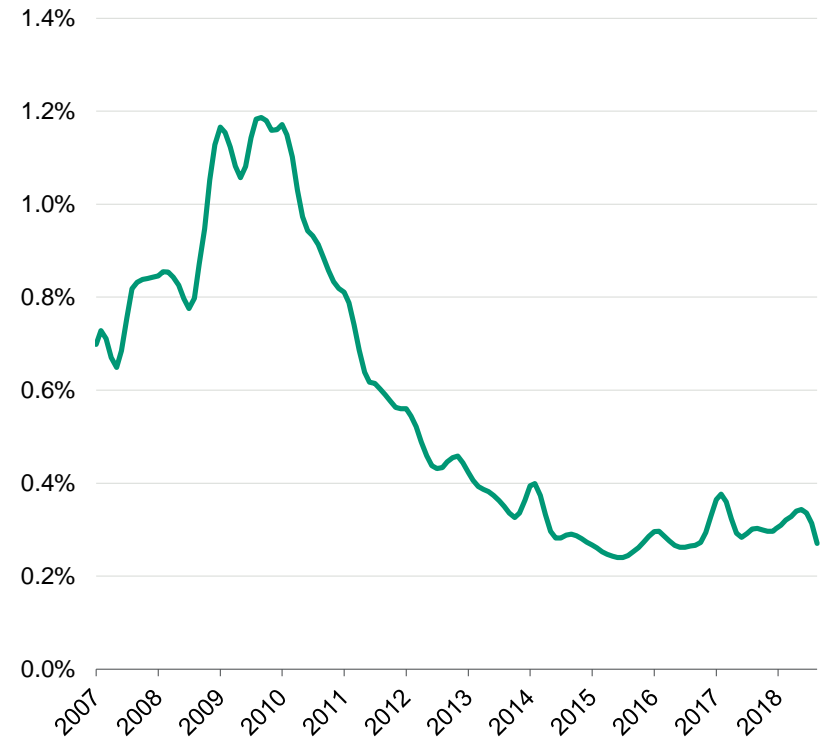
# US banks' C&I lending has continued to expand in recent years while loan performance has improved

**C&I loans (\$trillions)**



Sources: U.S. Board of Governors of the Federal Reserve System, Moody's Investors Service

**Total non-performing C&I loans as a percentage of total C&I loans**



Sources: U.S. Board of Governors of the Federal Reserve System, Moody's Investors Service

# Banks face a range of risks stemming from leveraged lending and related activities

## » **Credit losses from leveraged loans held in loan books**

- US regional banks' leveraged lending exposures are modest but growing
- We expect larger US banks to have similar exposures relative to capital

## » **Market and credit risk losses from CLOs held for trading/investment**

- US banks' CLO portfolios totaled \$92.3 billion as of the end of September 2018
  - › Equivalent to 1% of total assets and to median of 9% of tangible common equity

## » **Pipeline risk from leveraged loan syndication activity**

- Bank lead arranger may report mark-to-market losses on underwritten loans prior to distribution, which market flex and arranging fees may not be sufficient to absorb
- Pipeline limits are significantly lower and commitment sizes are more granular than pre-financial crisis



Non-banks

# Insurers / Asset Managers / Pension Funds

## » Insurers

- Exposure to leveraged lending rising at the margin; CLOs feature in more portfolios and more prominently
- While losses are a potential issue, ratings transition can cause similar short-term pain in the form of higher capital charges

## » Asset Managers

- Private debt funds, loan funds have grown in size but remain a small portion of industry assets
- Major risks: reputation, contagion

## » Pension Funds

- Also more involved

# Insurer investment risks are increasing at the margin

- » Some reaching for yield
- » More Baa, less Aaa-A
- » ABS/CLO exposure around 6% as of year end 2017
- » Speculative grade remained around 6%; with 4% at Ba, 2% at B, as of year end 2017



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