Questions That Matter

Corporates | A Long Cycle Of Defaults And Debt Restructuring?

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We expect default rates, including debt restructurings, to increase to 9% in the U.S. in next 12 month, while Europe might rise to 8% and remain elevated for longer.

How this will shape 2021

Credit vulnerabilities are growing. The severity of the COVID-19-induced economic shock triggered downgrades among the weakest rungs of speculative-grade corporates, creating vulnerability in those sectors hit hardest by the pandemic: 39.4% and 32.5% of speculative-grade companies were rated 'B-' or lower in the U.S. and Europe as of Oct. 31, 2020.

Will financial markets and credit metrics continue to diverge? Revenues are flagging just when debt is increasing for many sectors. This has created a dichotomy between market-implied default prospects and our central view based on credit fundamentals. The disconnect can be explained by the sizable liquidity facilities the Fed and the ECB created this year that, while primarily targeted at investment-grade corporates, have indirectly benefited speculative-grade issuers as well. With government benchmark yields at historical lows and market liquidity restored, many investors are moving to riskier credit in search of yield.

We expect that distressed exchanges (largely composed of consensual restructurings) will continue to be the largest contributor to rated defaults in Europe

What we think and why

The most defaults are in sectors hardest hit by lockdowns. We forecast a rise in our default rate to 9% in the U.S. and 8% in Europe over the next year. Most defaults will occur in those sectors hardest hit by social-distancing and health concerns, such as media and entertainment, transportation, and retail and restaurants. The oil and gas sector also exhibits some vulnerability, particularly in the U.S. for shale producers.

Companies are now more sensitive to higher rates and tightening credit conditions as a result of higher debt and weaker earnings

Forbearance will string out defaults in Europe. Widespread official funding programs and the suspension of important insolvency regulations are dampening defaults in Europe for now. This could drag out defaults longer relative to the U.S. past a 12-month horizon.

Debt restructurings will drive the most defaults in Europe. Distressed exchanges (largely consensual restructurings) will continue to push up rated defaults in Europe. Almost one-half of European rated defaults since 2009 have been distressed exchanges; senior lenders want to avoid formal, lengthy insolvency processes so they can maximize post-default recoveries.

Weak underwriting standards are undermining recoveries. In Europe, the proportion of covenant-lite institutional loans remains around 93% in 2020, the same as in 2019. The U.S. equivalent has been above 80% since 2018 and stands at 84% in 2020. This is detrimental to recovery prospects. In the U.S., covenant-lite first-lien term loans recover about 68%, just over 10% less than covenanted deals on average. In Europe, the equivalent recovery rate could be even lower at 58%.

Yet, markets expect a rosy outcome. In contrast to our base case, our optimistic scenarios factor in market indicators that we have observed throughout the pandemic, which have been signaling reduced default risk ahead. Currently, our optimistic U.S. and European scenarios both point to only a 3.5% default rate through next September.

Read More

The U.S. Speculative-Grade Corporate Default Rate Could Rise To 9% By September 2021, Nov. 23, 2020

The European Speculative-Grade Corporate Default Rate Could Reach 8% By September 2021, Nov. 25, 2020

European Corporate Support Schemes: A Long Unwinding Road, Nov. 25, 2020

What could go wrong

Credit conditions could tighten. While favorable financing conditions continue to enable most U.S. companies to refinance and term out debt, more vulnerable companies are not in the same position. They are now more sensitive to higher rates and tightening credit conditions because they have increased debt and their earnings have weakened after the dislocation caused by the pandemic. Firms with 'CCC/C' ratings are particularly vulnerable, and their numbers hit record-high proportions of our speculative-grade populations in both regions earlier this year.

Additional COVID-19 waves could lead to more lockdowns. Countries are in the middle of second waves of increased coronavirus infections, which may not subside but resurge in the months ahead —prompting renewed lockdowns. This contributes to our current pessimistic scenarios, which call for a 12% default rate in the U.S. and 11% in Europe through September 2021.

The pandemic could continue to dominate. In Europe, any delays in immunizing the population could force the authorities to extend emergency support measures, delaying the inevitable restructurings required to strengthen balance sheets.

Governments could pull fiscal support or not deliver enough. The extension of fiscal support is not a given. This is more the case in the U.S. as the incoming Biden Administration may likely face a split Congress. However, the path is not completely clear in Europe either, as some disagreements on the EU's €750 billion recovery fund could delay initial disbursements until the end of 2021.

Chart 12

Europe Expected To Lag U.S. Default Cycle in 2021

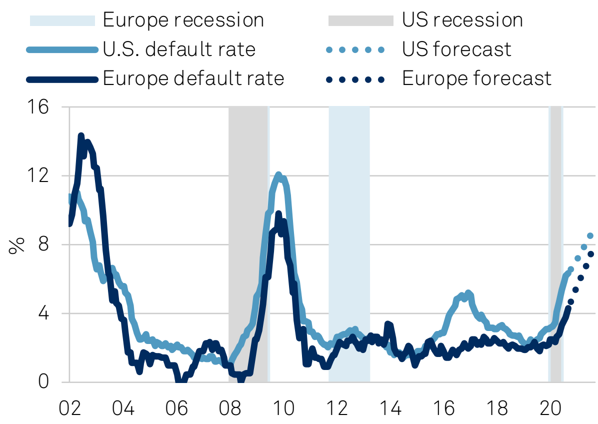
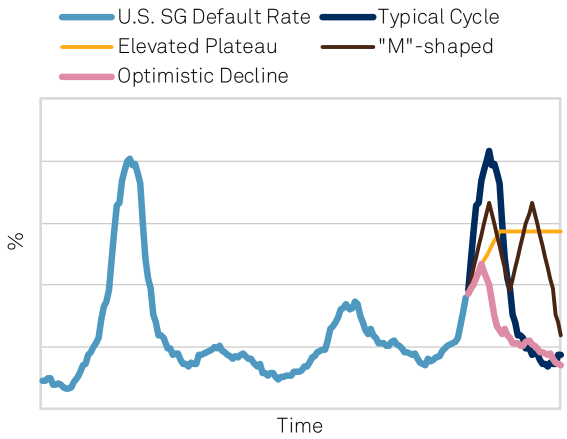


Chart 13

Unusual Stressor (And Responses) Could Produce Unusual Results



Source: S&P Global Ratings.

This report is an extract from the S&P Global Ratings report, "Global Credit Outlook 2021: Back On Track?"

This report does not constitute a rating action

S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

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