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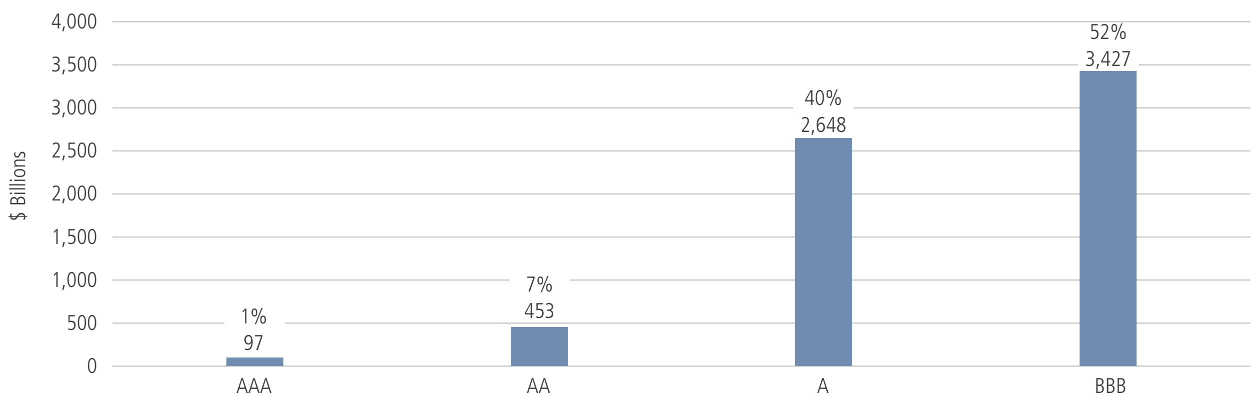
The State of BBBs: Here to Stay

A significant, if misunderstood, market segment continues to offer attractive investment opportunity.

BBB rated corporate bonds remain a large, important force in the investment grade credit markets, and we believe the investment performance of this category will likely be an important driver of overall market performance this year. Previously, we argued that concerns around a wave of BBB downgrades materially disrupting the market were overstated. Consistent with that view, we continue to find attractive investment opportunities in the sector. We provide details on conditions among BBBs in this bulletin.

BBBs REMAIN A MAJOR FORCE

Dollar Value, Percentage of Investment Grade Credit Universe



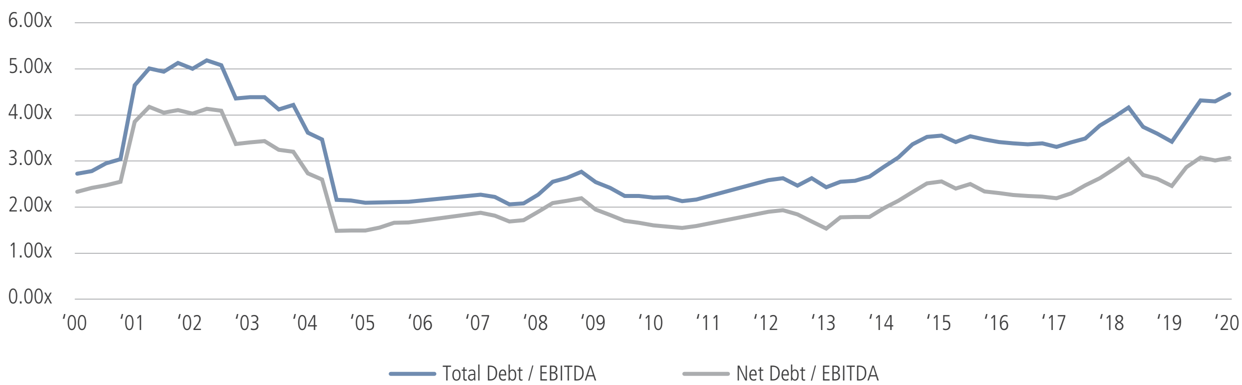
Source: Bloomberg. Data as of March 31, 2021.

The BBB market has grown just over 15% since the beginning of 2020. BBB industrials are also growing, and now approach 60% of the index, excluding financials.

BBB Fundamentals Appear Likely to Improve

After a period of strengthening, the fundamentals underlying BBBs, like the rest of the investment grade corporate universe, deteriorated over the course of 2020. BBB leverage increased over a turn from the beginning of 2020 to around 4.5 times EBITDA, primarily driven by last year's earnings declines. Net leverage has increased but is more tempered, as companies have increased cash balances. We expect fundamentals to improve as profitability recovers and debt growth subsides, with many of the large BBB issuers focused on debt reduction in the coming quarters. As we expected, most BBB companies were not passive in the face of deteriorating credit metrics driven by the pandemic. Instead, many moderated their returns to shareholders and took proactive steps to support their balance sheet, and renewed existing commitments to repair them, albeit in several cases at a slower pace than expected prior to the crisis.

INDUSTRIAL BBB CORPORATE LEVERAGE INCREASED DURING THE PANDEMIC

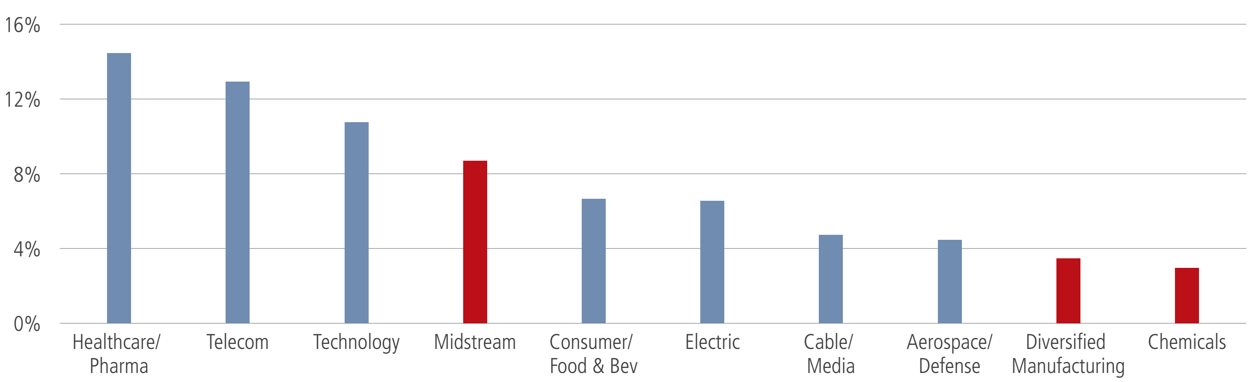


Source: Bloomberg. S&P 500 ex-financials.

Durability and Deleveraging

In the past, we highlighted the durability of the BBB category and the strong cash flow characteristics of several larger, less cyclical BBB sectors dominating the category relative to previous credit cycles. This theme rings true when examining where the growth in BBBs came from over the course of 2020. From the start of 2020, half came from the Technology and Telecom space with the remaining in Aerospace and Defense, Health Care, Capital Goods and Utilities. Generally, we view these sectors as less cyclical and more resilient during times of economic stress, with more resilient cash flow. An examination of the changes in the top 10 BBB sectors shows how downgrades have diminished the importance of Energy, Autos and Food and Beverage while Aerospace and Defense, and Chemicals now screen in the top 10. Technology has moved up in importance, past Consumer/Food and Beverage, and Midstream. These changes have been driven by large individual issuers, but overall have resulted in a slightly less cyclical mix of sectors that make up the largest share of the BBB category.

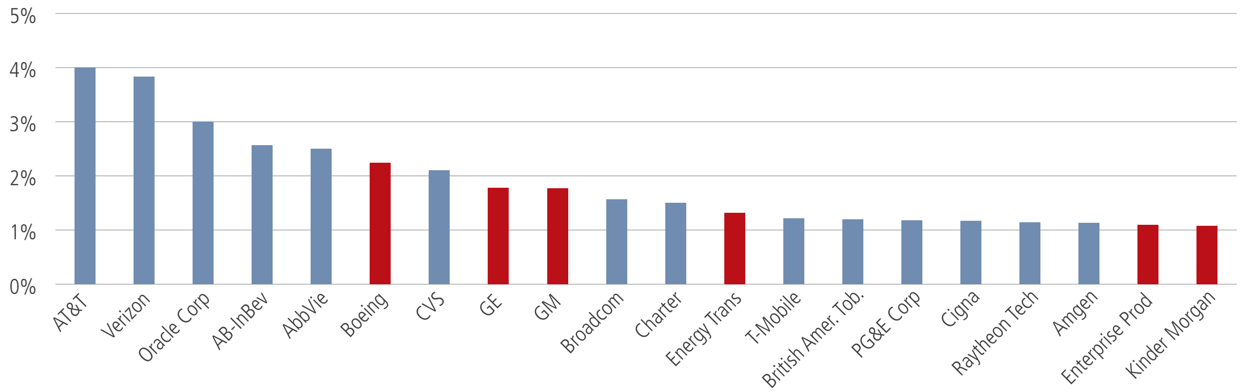
TOP SECTORS IN THE BBB CATEGORY ON MARCH 31, 2021 (% BBB MARKET VALUE)



Source: Bloomberg Index Services. Red denotes more cyclical categories.

A check-in on the largest BBB issuers reveals diverging business and credit trends, with certain issuers remaining in balance sheet repair mode and others experiencing stalled deleveraging after debt-financed M&A in years past. For example, Anheuser Busch InBev continues to grapple with stubbornly high leverage, as the negative impacts from COVID offset some of its balance sheet- and cash flow-supportive actions taken over the last several years. CVS also fits within the stalled deleveraging category, and while its debt has come down on an absolute basis, the pace of reduction has been slow. On the flipside, GE remains committed to using over $30 billion in deal proceeds from the sale of its aircraft leasing business to reduce debt in the coming quarters.

TOP 20 ISSUERS IN THE BBB CATEGORY ON MARCH 31, 2021 (% BBB MARKET VALUE)



Source: Bloomberg Index Services. Red denotes more cyclical categories.

BBB Market Growth Tied to Idiosyncratic Risks and M&A Activity

While BBBs grew in size over the course of 2020, in part due to companies in COVID-impacted sectors shoring up liquidity, a larger portion of the net increase came from idiosyncratic situations and M&A transactions related to the largest BBB issuers.

In terms of idiosyncratic situations, Oracle and Boeing were the two largest new entrants into the BBB category as they both were downgraded from single-A ratings. Oracle's move was self-inflicted as the company decided to use debt to fund shareholder returns at the expense of its balance sheet. Management decided to implement more aggressive financial policy given the opportunity to use leverage to repurchase shares at a time when interest rates are low, and the stock is undervalued, per the company's opinion. Boeing had been facing idiosyncratic business challenges which were only exacerbated by COVID pressures that contributed to its deteriorating credit profile. However, the company remains in repair mode with a focus on strengthening liquidity and prioritizing debt reduction. Willingness to tactically trade BBB risk was a key contributor to 2020 performance and we expect this theme to remain in place in the coming quarters.

The other key contributor to growth in BBBs has been related to M&A activity. In some cases, the migration to the BBB category has been from adding debt and operating with higher leverage. For example, in the Health Care sector, Gilead's $21 billion acquisition of Immunomedics resulted in higher leverage and a downgrade from single-A. In other cases, new BBB rated capital structures have emerged in conjunction with asset reshufflings associated with other transactions. Carrier Global was a new BBB entity formed when it spun off from United Technologies, which was involved with its own merger with Raytheon. As is more common in the Telecom, Cable and Media space, some of the M&A-related growth in BBBs has been a function of issuing secured debt that is investment grade despite a non-investment grade parent rating. The T-Mobile and Sprint combination has resulted in the company issuing over $30 billion of secured debt in the investment grade market.

Rising Stars Less Material to Market Growth, for Now

We can't talk about BBBs without addressing fallen angels. A large portion of the reduction in the BBB category last year was driven by a few of the large capital structures: Kraft Heinz, Occidental Petroleum and Ford. Together, these three issuers accounted for over $80 billion in par value of fallen angels in 2020. Rising stars have been an offset to some of the fallen angel activity, but these capital structures are smaller in size and less material drivers of overall BBB growth in aggregate. For perspective, Lennar was one of the largest rising stars last year, bringing just under $5 billion of debt into the BBB market. We will continue to monitor rising star candidates over the next 12 – 18 months as it is likely that some of these large capital structures will migrate back to investment grade, presenting attractive investment opportunities.

Keeping an Eye on BBB Risks in the Dynamic Post-Pandemic Environment

As a new credit cycle takes shape, we continue to emphasize both sector and issuer analysis and refrain from painting all BBBs with the same broad brush. While we think self-inflicted downgrades to BBB to fund shareholder returns like Oracle's are the exception not the rule, we are keen to continuously evaluate corporate behavior to pick up on clues that the tide is changing toward a more aggressive approach. M&A activity has picked up, but impacts have been manageable from a credit perspective due to conservative financing structures, often involving equity. This could change quickly, but it is not our base case. Anticipating the next single-A companies that may be inclined to move their capital structures to the BBB "sweet spot," identifying slow deleveraging stories before the market prices them as such, and anticipating balance sheet repair successes will be key to successfully navigating the investment grade credit universe in the months to come.

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