Default, Transition, and Recovery:

The European Speculative-Grade Corporate Default Rate Could Reach 8% By September 2021

November 25, 2020

Key Takeaways

- We expect the European trailing-12-month speculative-grade corporate default rate to rise to 8% by September 2021 from 4.3% in September 2020. To reach this baseline forecast, 58 speculative-grade companies would need to default.
- In our optimistic scenario, we expect the default rate to fall to 3.5% by September 2021 (25 defaults), and in our pessimistic scenario, we expect the default rate to expand to 11% (80 defaults).
- Despite continued market optimism, recent positive news on vaccine development, and the economic recovery in the third quarter, new waves of infections and lockdowns provide risks to the baseline.
- Continued fiscal and monetary support could lessen defaults over the near term. However, given a still-high (though falling) proportion of 'CCC'/'C' rated issuers and the eventual removal of these supports, defaults may remain elevated for a protracted period.

RATINGS PERFORMANCE ANALYTICS

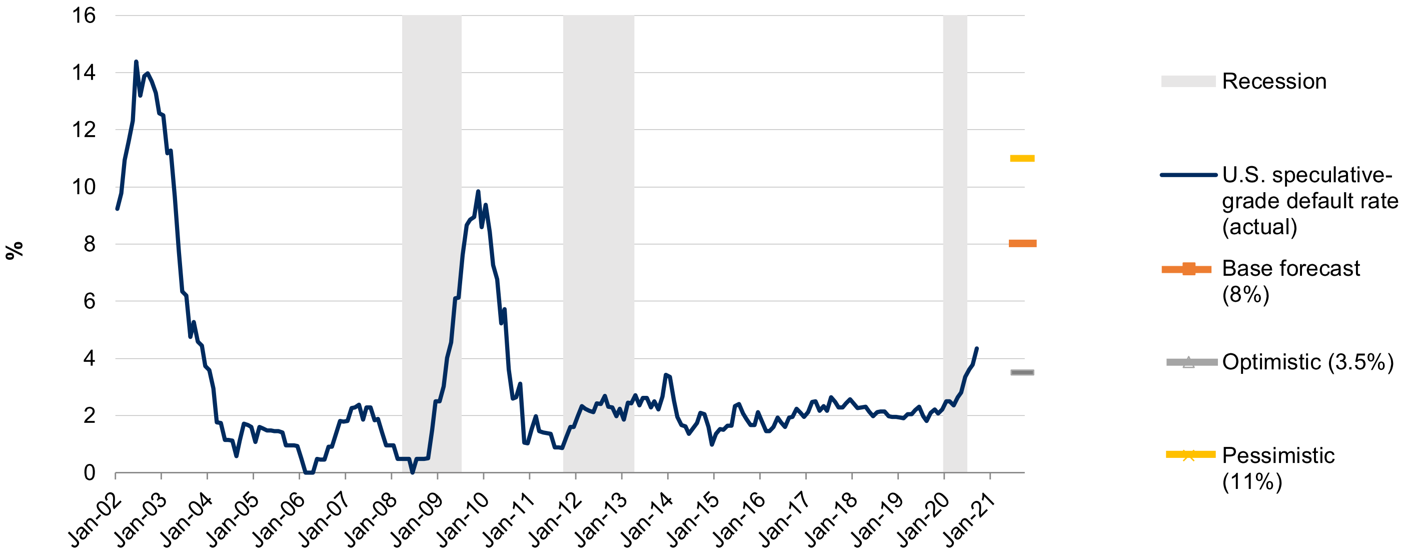
Nick W Kraemer, FRM
New York
+ 1 (212) 438 1698
nick.kraemer
@spglobal.com

Kirsten R Mccabe
New York
+ 1 (212) 438 3196
kirsten.mccabe
@spglobal.com

Paul Watters, CFA
London
+ 44 20 7176 3542
paul.watters
@spglobal.com

Chart 1

U.S. Trailing-12-Month Speculative-Grade Default Rate And September 2021 Forecast



Shaded areas are periods of recession as defined by the Center for Economic Policy Research. Sources: S&P Global Ratings Research and CreditPro. Data as of Sept. 30, 2020.

S&P Global Ratings Research expects the European trailing-12-month speculative-grade corporate default rate to increase to 8% by September 2021 from 4.3% as of September 2020 (see chart 1).

S&P Global economists currently expect the European economy to finish 2020 down 7.4%, with a rebound of 6.1% in 2021. That said, second waves of COVID-19 infections has led to another round of lockdowns in many countries, which will challenge the near-term recovery path. Still, the recovery in the third quarter generally came in stronger than many initially expected, and this could again happen when the current lockdowns ease. As important counterpoints, the European Central Bank (ECB), Bank of England, and most national governments have been providing historically large support mechanisms. It is our economists' belief that aggressive fiscal policies' impact would be greater under current conditions of lower demand and negative interest rates. We anticipate fiscal supports will be extended further into 2021.

In our pessimistic scenario, we forecast the default rate will rise to 11%. In this scenario, we account for the potential for slower economic activity as a result of recent lockdowns alongside ebbing fiscal support. Additionally, there is always the potential for subsequent "waves" of infections/lockdowns later on. This would make the subsequent recovery slower than S&P Global economists' current base case and expose many of the lowest-rated firms' weak credit positions, which would challenge their solvency. Such a scenario would result in a longer period of suppressed consumer spending, negligible business investment, and a longer period of higher unemployment or underemployment. This could result in higher default rates for 'CCC/C' rated issuers than has been seen historically in prior cycles, alongside greater potential for increased defaults from issuers currently possessing even higher ratings.

In our optimistic scenario, we forecast the default rate will fall to 3.5%. Once again, market signals are reflecting increasing optimism ahead and a declining default rate through next September. Current risk pricing in speculative-grade through both bond and leveraged loan spreads, a lower proportion of distressed leveraged loans relative to earlier stress in the second quarter, ample liquidity, and healthy issuance appear to support a declining default rate. Given the success thus far in the ECB's Pandemic Emergency Purchase Programme (PEPP)in providing needed liquidity, its recent extension and expansion, as well as the EU's fiscal pact to share debt and provide hundreds of billions in grants, market yields have fallen below where they would have been in the absence of these supports, encouraging many investors to move down the credit quality spectrum in search for yield.

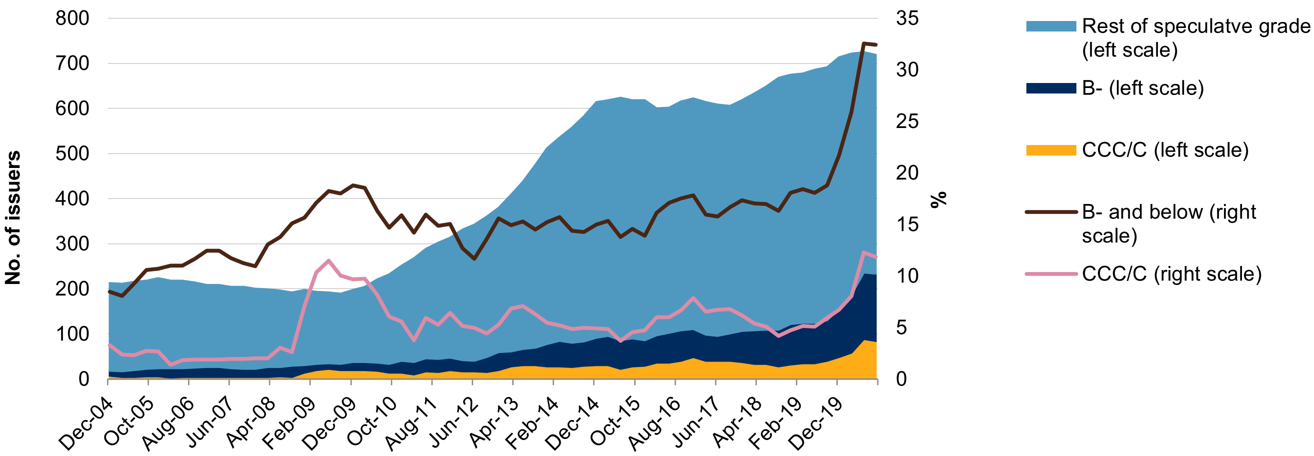
Base Case: Credit Metrics Still Reflect Heightened Stress

Historic levels of credit deterioration somewhat abated in the third quarter from the first and second quarters. The third quarter saw some economic recovery as lockdown measures lifted across many countries, leading to a bounce back in consumer activity. This was in part driven by fiscal and monetary policy support measures for businesses and individuals over the lockdown term. Within the European speculative-grade issuers, sectors most vulnerable to social distancing--such as retail/restaurants, consumer products, transportation, and media and entertainment--constitute a particularly large portion of the 'CCC/C' rated population (59%).

Large swaths of downgrades, particularly during the second quarter, have resulted in a high in the number of companies rated 'B-' and lower in June, at 32.6% (see chart 2). Within the issuers rated 'B-' or lower, those we rate 'CCC/C' fell to 11.8% in September, from 12.3% in June. Some of this reduction came from recent defaults in Europe in the third quarter, and all but one defaulter in 2020 was rated 'CCC/C' prior to default. In the year to date, 73% of all defaults with an active rating at the start of 2020 were rated 'CCC/C'.

Chart 2

Share Of Weakest Issuers Declines But Remains Elevated

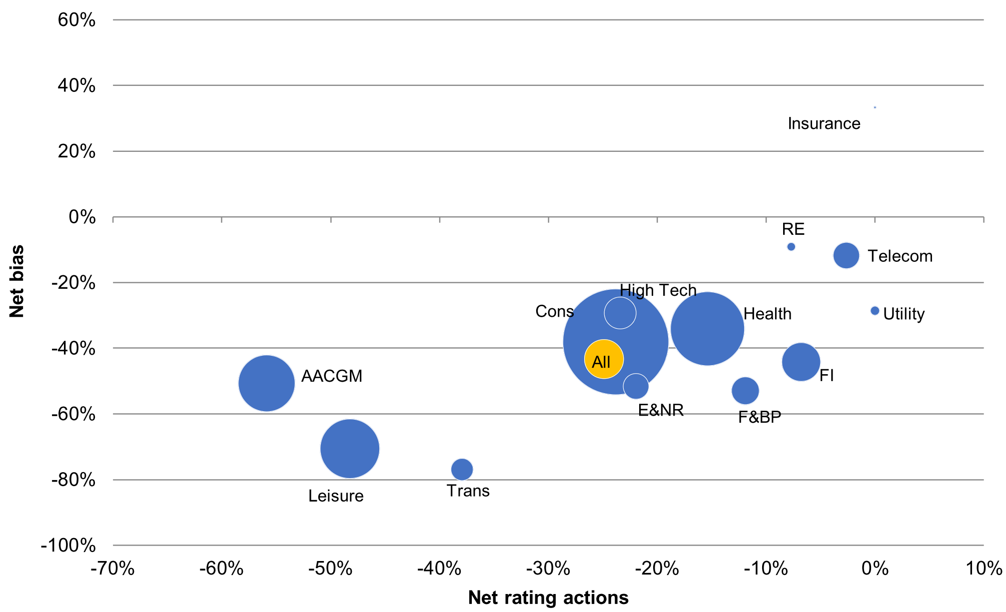


Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®. Data as of Sept. 30.

Some sectors experienced speculative-grade net downgrade rates of 38% or more in the 12 months ending in September, with many also showing a net negative bias in excess of the overall speculative-grade total of 43%. By these two measures, the most stressed sectors include those most vulnerable to economic lockdowns and social distancing: leisure time/media, transportation, and aerospace/automotive/capital goods/metals. Meanwhile, other sectors, such as health care, telecommunications, and high tech/computers/office equipment are seeing less credit stress than the overall speculative-grade population.

Chart 3

Credit Stress Sees Divergence Between Sectors Through The Third Quarter



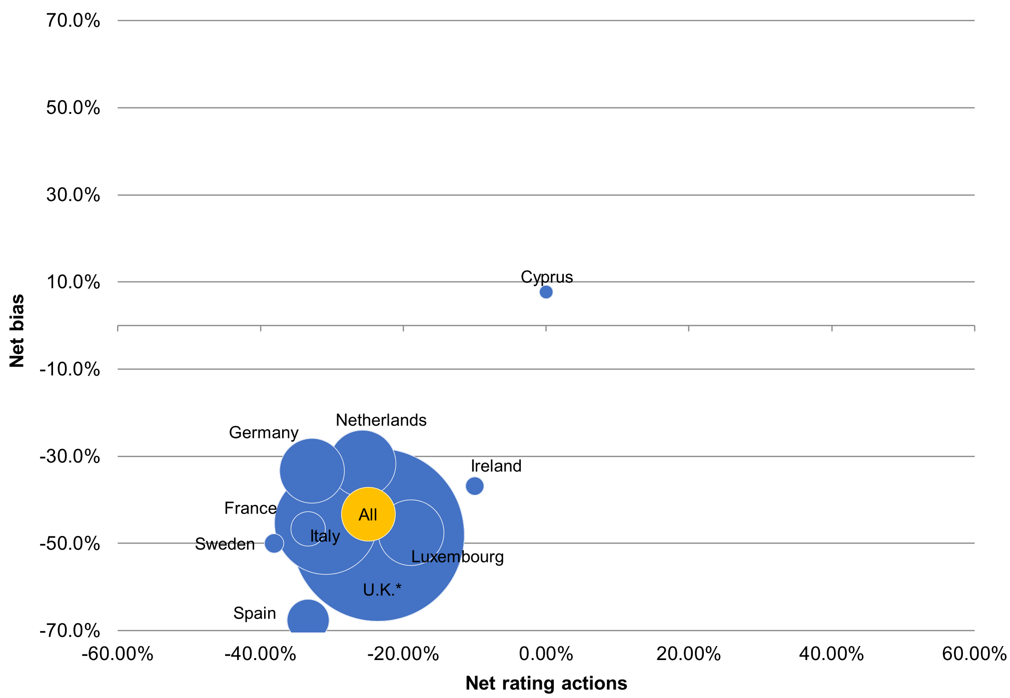
Speculative-grade firms only. AACGM--Aerospace, automotive, capital goods, and metal. Cons--Consumer/service. E&NR--Energy and natural resources. FI--Financial institutions. F&BP--Forest and building products/homebuilders. Health--Health care/chemicals. High Tech--High tech/computers/office equipment. Leisure--Leisure time/media. RE--Real estate. Telecom--Telecommunications. Trans--Transportation.

Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

In contrast to credit stress across sectors, country level results appear far more uniform (see chart 4). Given the global impact of the coronavirus, this should not be surprising. That said, conditions in the U.K. are likely to have a larger relative impact on European issuers we rate given the large proportion of companies we rate from that country (25.5% of the total). Overall, most countries saw an improvement in the third quarter; however, existing risks and historically high net negative bias raise the possibility for further deterioration in the near term.

Chart 4

Negative Momentum Is Fairly Consistent Across Major Countries



*Includes British Virgin Islands, Gibraltar, Guernsey, Isle of Man, and Jersey. Speculative-grade firms only.
Sources: S&P Global Ratings Researc and S&P Global Market Intelligence's CreditPro®.

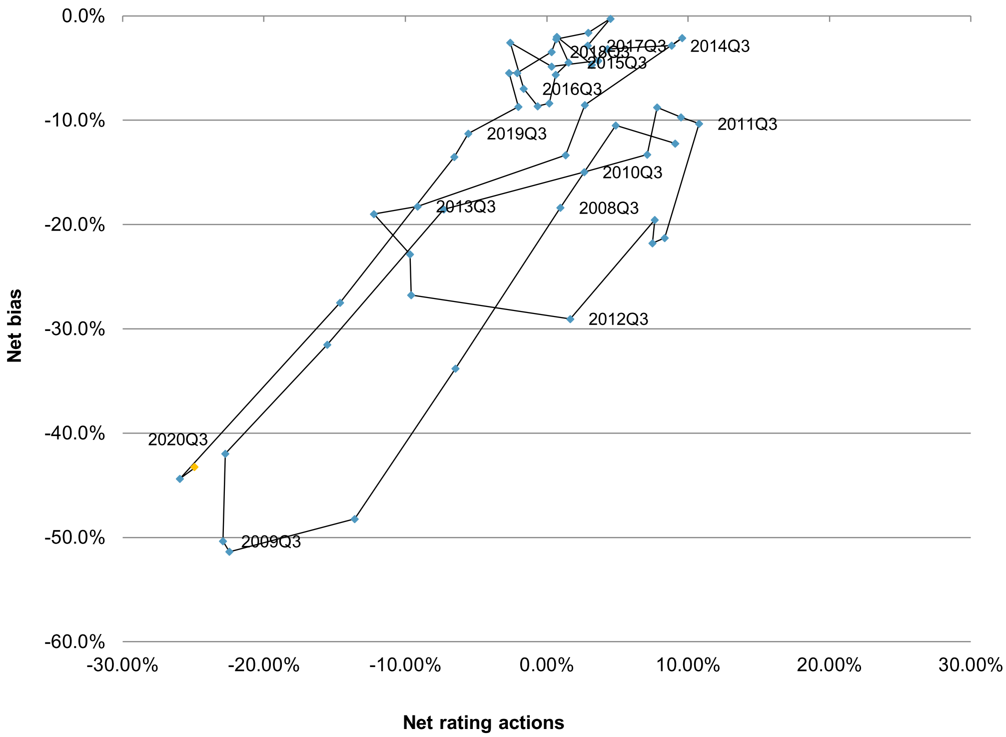
Deterioration in revenue generation across many firms due to COVID-19-imposed lockdowns led to widespread stress in the first half the year. Subsequently, the pace of downgrades increased rapidly over the course of March and April, leading to some of the highest downgrade rates since the 2008-2009 recession. While the pace of downgrades did slow somewhat over the summer months, downgrades increased once again in September, particularly among sectors more vulnerable to the reinstatement of lockdown measures.

That said, the 12 months ending September 2020 has resulted a moderate easing of credit deterioration (see chart 5). When looking at net rating actions, the negative 25% reading in the 12 months ended Sept. 30, 2020, was a slight improvement from the negative 26% reading in the 12 months ended June. Still, this is one of the weakest 12-month periods for Europe. The net negative bias also remains high (43%), with only four prior quarters registering larger net negative readings, and three of those were all during 2009 amid the financial crisis.

History shows that the rate of downgrades and net negative bias improve a few quarters prior to the peak default rate. That said, if this pattern holds, the depth of deterioration displayed through the last quarter would suggest there are still more defaults to come.

Chart 5

Speculative-Grade Credit Holds Steady In The Third Quarter

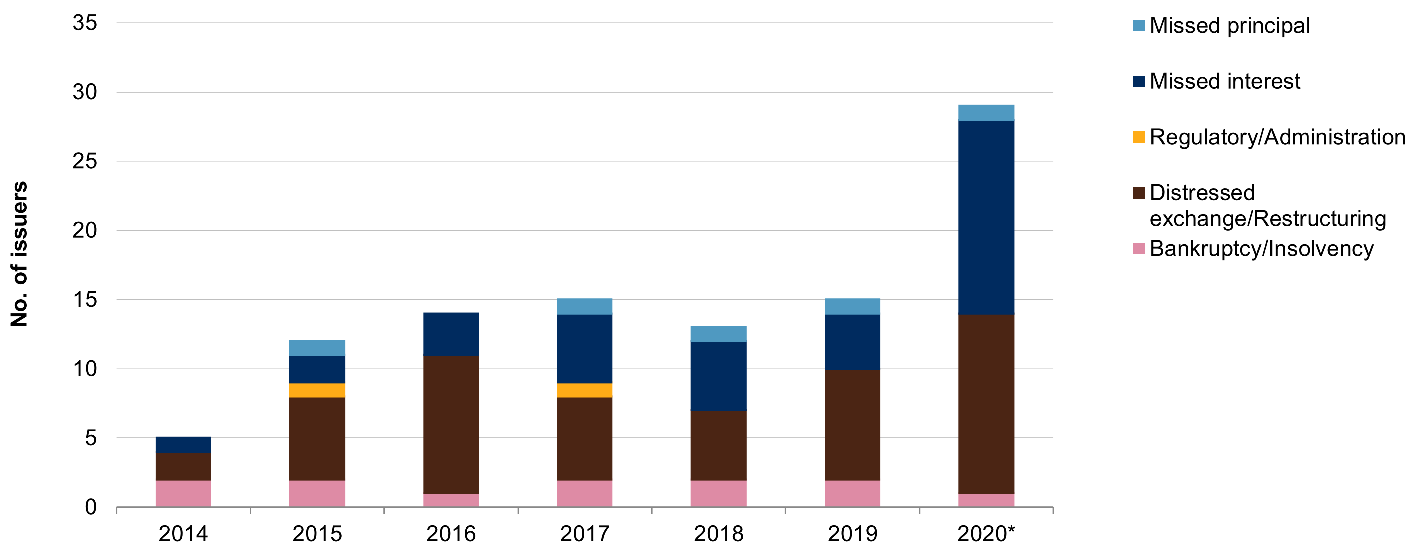


Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

Through the first three quarter of 2020, nearly all of the defaults were due to missed interest payments or distressed exchanges, which is in line with our prior expectations (see chart 6). Bankruptcies in Europe are generally rare by comparison to the U.S. However, much of this is due to stricter bankruptcy laws in Europe. Through September, 93% of 2020 defaults were the result of either missed interest payments or distressed exchanges. With 29 defaults in the first nine months of the year, 2020's total has already easily claimed the spot as the highest annual default tally in Europe, eclipsing the prior record of 22 in 2009.

Chart 6

2020 Sets A New Annual High For Defaults



*Through Sept. 30. Source: S&P Global Ratings Research; S&P Global Market Intelligence's CreditPro®

Through the 12 months ended Sept. 30, the speculative-grade default rate reached 4.34%. This was the result of 30 defaults over the period beginning Oct. 1, 2019, and the highest default rate since the 12 months ending June 2010. This is above our long-term average default rate (since January 2002) of 3.1%, and proportionately well above the 2.1% average default rate over the protracted period of a relatively stable default rate from 2011.

Optimistic Scenario: Market Sentiment Reflects A Falling Default Rate

Fixed-income markets are reflecting a much more modest default outcome over the next 12 months than the underlying credit fundamentals imply. March through May was particularly difficult for speculative-grade issuers in Europe, as primary debt markets were all but closed to them through most of that period. However, issuance has come back to life since June (see chart 7). Through September, combined high-yield bond and leveraged loan issuance totaled €157.6 billion, up 4.4% from the same point in 2019 and only about €4 billion short of the 2018 year-to-date total.

Chart 7

Debt Issuance Holds Steady After Slow Start To 2020

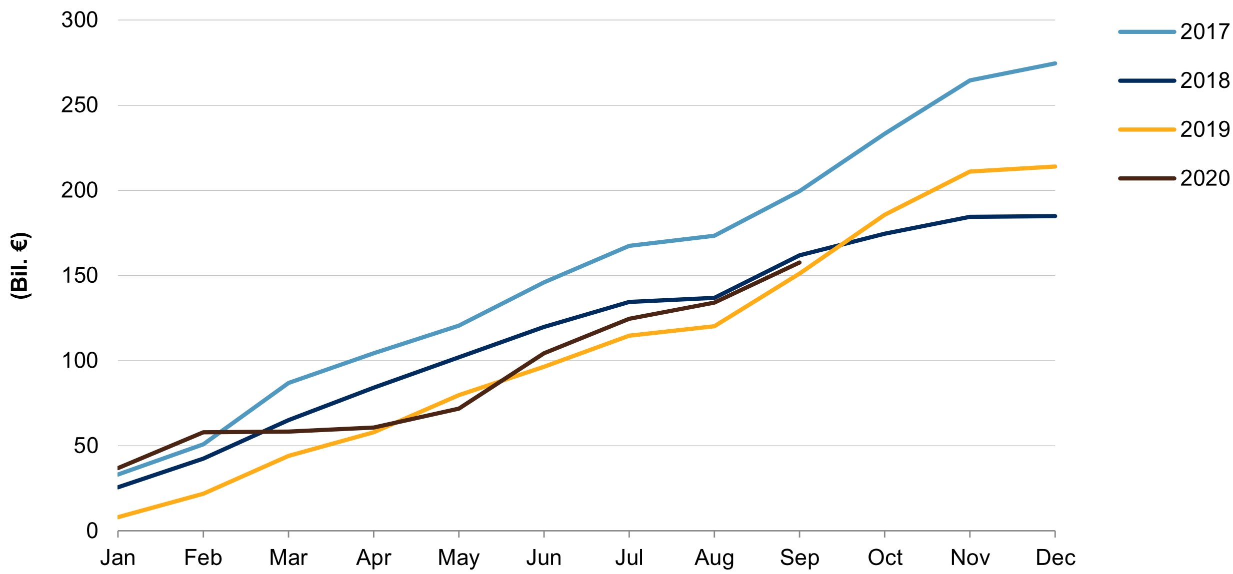


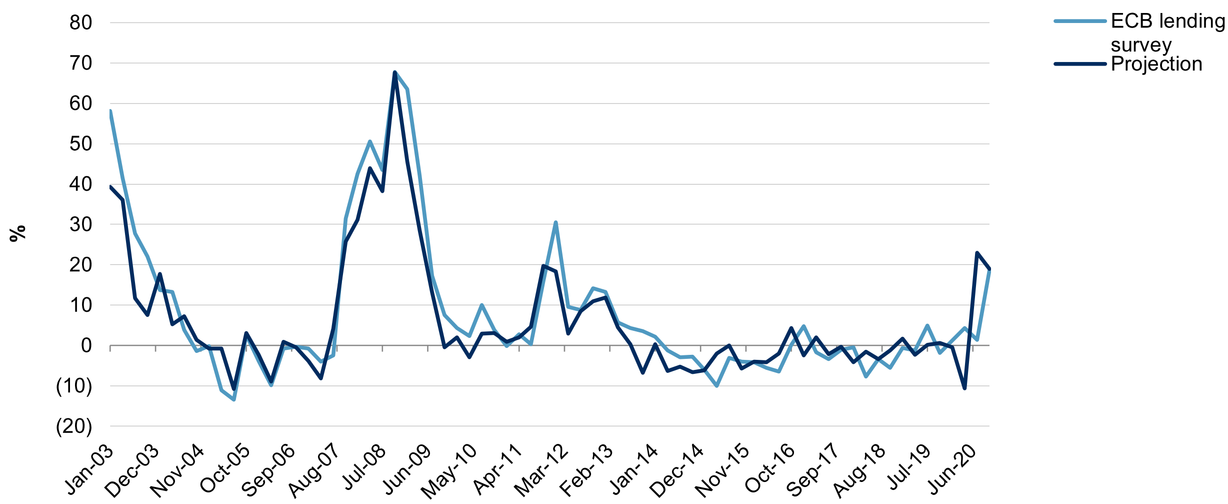
Chart displays combined speculative-grade bond and leveraged loan issuance. Data through Sept. 30, 2020.
Sources: S&P Global Ratings Research, Thomson Financial, and LCD, an offering of S&P Global Market Intelligence.

While total of new debt issued this year has marginally increased relative to 2019, lending conditions on corporate loans tightened sharply in the third quarter (see chart 8). In the most recent ECB bank lending survey from the third quarter, lending conditions tightening considerably (net 18.6% on all enterprises by size). Looking to the forward projections for the fourth quarter (19%), we expect tightened lending conditions to continue.

Banks indicated that the main driver of tighter conditions was banks' risk perceptions related to the deterioration in the general economy and firm-specific situations. Conversely, they reported that market financing conditions and balance sheet conditions had an easing impact.

Chart 8

ECB Bank Lending Survey And Future Expectations

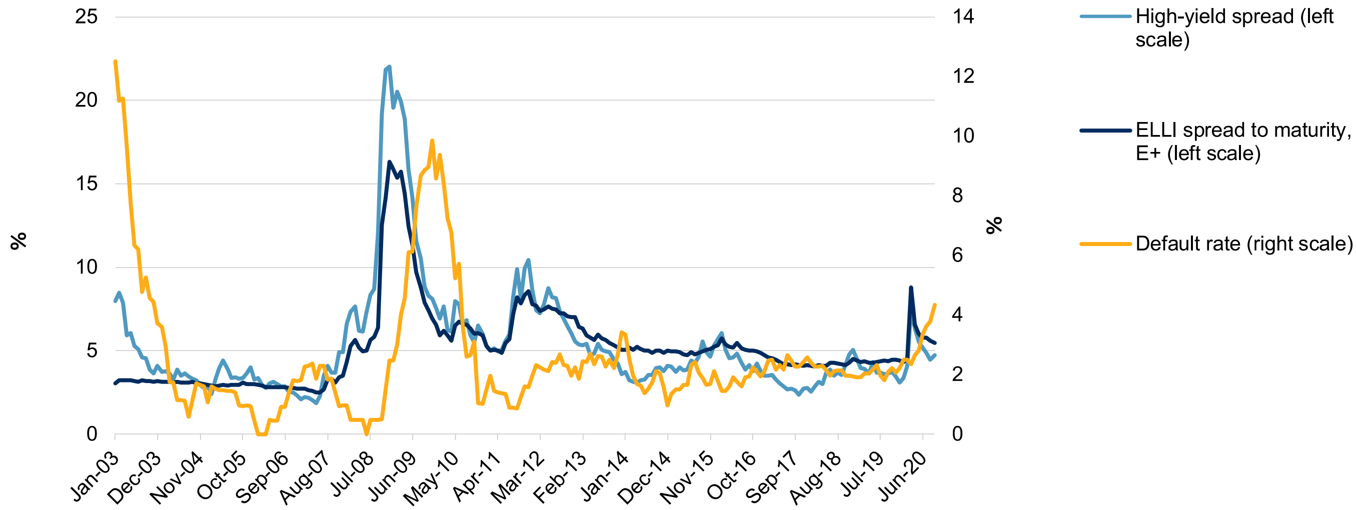


Sources: S&P Global Ratings Research and ECB.

Meanwhile, market pricing for lower-rated borrowers continue to reflect a more favorable environment (see chart 9). Spreads on both high-yield bonds and leveraged loans jumped quickly in March and April, only to retract nearly as quickly in May and June. Spreads on high-yield bonds have continued to fall in the third quarter, albeit at a slower pace than in the second quarter. Leveraged loan spreads did rise marginally in the third quarter; however, they remain well below where they were in March and April. The relative risk of holding corporate debt can be a major contributor to future defaults because firms face pressure if they are unable to refinance maturing debt. In broad terms, these speculative-grade spreads have been good indicators of future defaults based on a roughly one-year lead time. That said, at current spread levels, our baseline default rate forecast of 8% is well above what the historical trend would suggest.

Chart 9

Market Pricing Portends A Falling Default Rate



Sources: ICE Benchmark Administration Limited (IBA), ICE BofAML Euro High Yield Index Option-Adjusted Spread, retrieved from FRED, Federal Reserve Bank of St. Louis; S&P Global Ratings Research; and S&P Global Market Intelligence's CreditPro®.

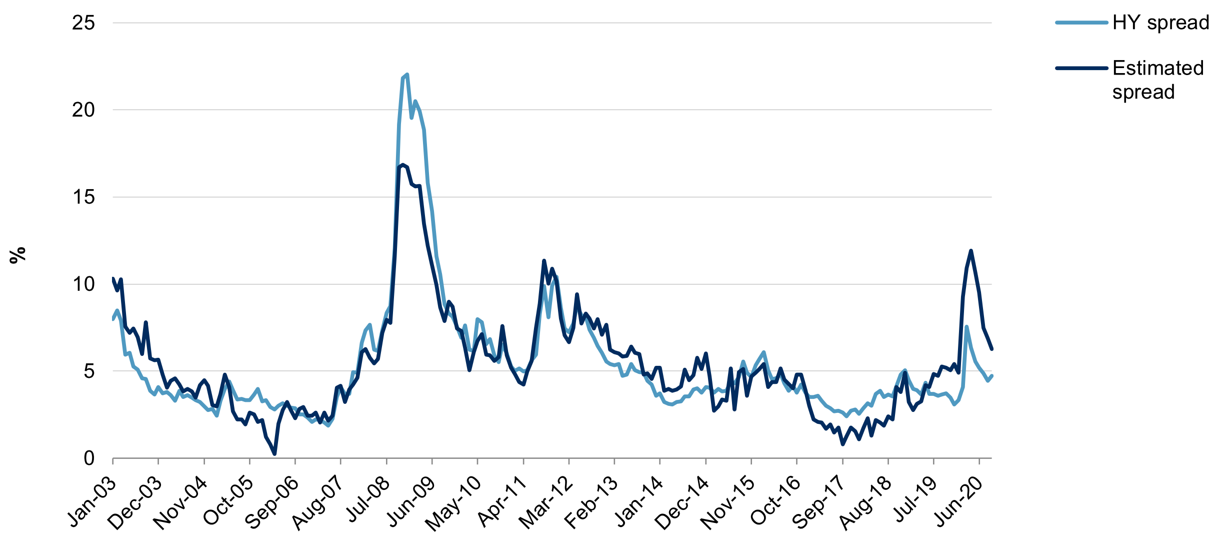
Markets Remain More Optimistic Than Fundamentals

Similar to what we've been observing in the U.S. since the onset of the coronavirus pandemic, it is possible bond investors continue to be more optimistic than the underlying economy and financial markets suggest. Using a model based on broad measures of financial market sentiment, economic activity, and liquidity, we estimate that at the end of September, the speculative-grade bond spread in Europe was about 155 basis points (bps) below where our model would suggest (see chart 10).

The average monthly gap between the actual and estimated spread has been 352 bps since January. This divergence, taken into consideration with the European economic outlook and the fundamental credit backdrop for speculative-grade issuers, raises doubt that risk is adequately priced into markets, despite the estimated spread and the actual spread both trending sharply downward since the end of April.

Chart 10

Spreads Gap Remains But Narrows Considerably



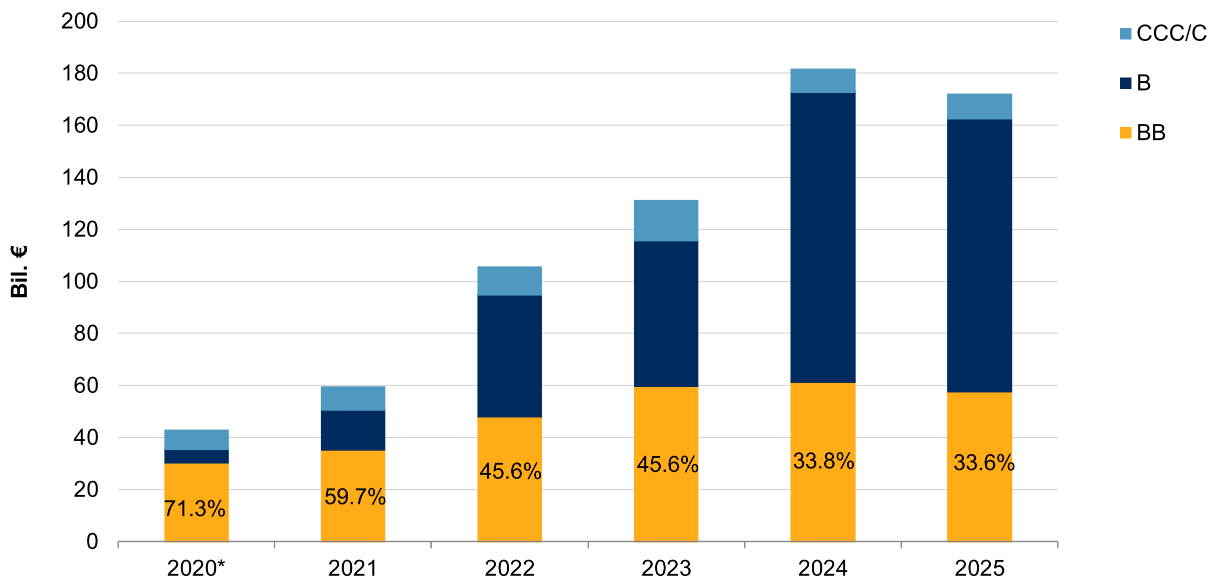
Sources: ICE Benchmark Administration Limited (IBA), ICE BofAML Euro High Yield Index Option-Adjusted Spread, retrieved from FRED, Federal Reserve Bank of St. Louis, and S&P Global Ratings Research.

However, just as the nature of the current stress caused by the coronavirus is particularly unusual and difficult to predict, so too are the potential upsides to the current situation. Markets have not only been reacting positively to central bank facilities and fiscal assistance programs, but also to a steady stream of positive developments on the vaccine front. Given the knowledge and experience gained through the first wave of infections, which could limit the depth of new lockdowns, coupled with the potential of a vaccine by mid-year 2021, there is potential for less economic deterioration than in the second quarter.

Generally, upcoming maturities among European speculative-grade debt appear manageable through 2021 (see chart 11). We estimate that roughly €102 billion in speculative-grade bond and loan debt is coming due between the fourth quarter of 2020 and all of 2021, with 'BB' rated debt comprising the majority in both years. That said, there could still be some refinancing risk within the 'CCC/C' segment, which has about €15.6 billion due in 2020 and 2021, but with only €4.05 billion in bond issuance this year through September.

Chart 11

Speculative-Grade Maturities Through 2025



*Fourth-quarter only. Data as of Oct. 1, 2020. Includes bonds, loans, and revolving credit facilities. Percentages in chart reflect proportion of annual totals that are rated 'BB'. Source: S&P Global Ratings Research.

Pessimistic Scenario: Downside Risks Are Still Considerable

In our pessimistic scenario, we anticipate the default rate could reach 11% (80 defaults) by September 2021. Here, we incorporate an ineffective or delayed response to the second wave of the virus and an increased caseload through the end of 2020 continuing into mid-year 2021 leading to slower economic recovery or a contraction in activity. Real-time measures of economic activity show that service sectors are still lagging behind manufacturing. In fact, the manufacturing purchasing managers' index (PMI) has entered in expansionary territory as of September 2020, while the services PMI has returned to contractionary. While the unemployment rate has remained low (compared to the U.S.), much of this muted rise in unemployment is also due to more workers leaving the labor force.

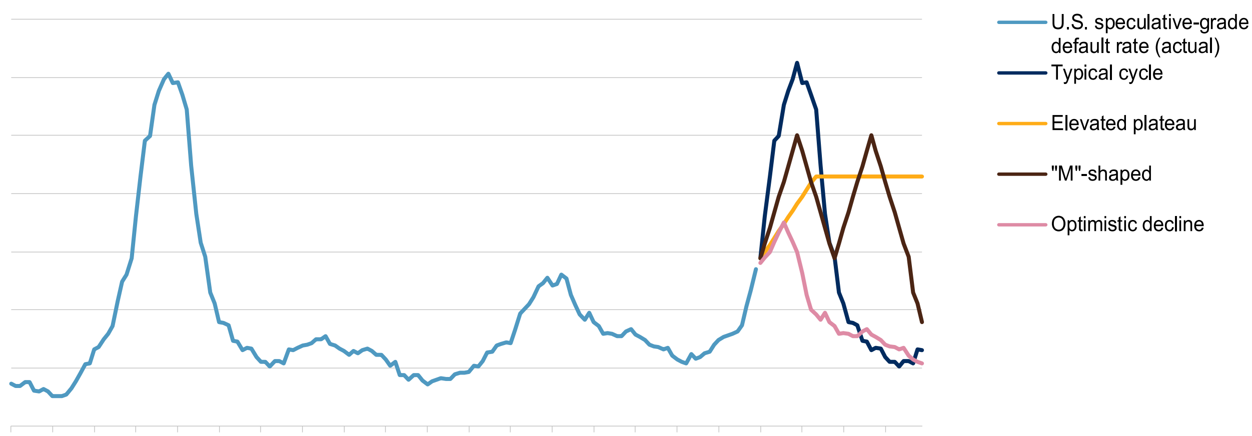
Multipronged fiscal support this year has helped reduce the usual pace of bankruptcy filings in many European countries, and has also helped to keep the region's unemployment rate below that of the U.S. There is a risk that these programs may be pulled back too quickly and expose high underlying levels of credit risk, which could lead to more defaults in the future. This would be a heightened risk if the positive impact of a widely available vaccine is not in place prior to a reduction in fiscal support. Our economists have also identified that fiscal stimulus is more powerful in situations where demand is suppressed and negative rates prevail--as is the case now. This implies that continued fiscal support would give a much needed boost to the economy.

Unprecedented Times Could Produce Unusual Results

Because of the many possibilities, it is perhaps more appropriate to think of these default forecasts as separate possible outcomes rather than simply a range. Given the nature of the virus, resulting containment measures, fiscal and monetary responses thus far, and the uncertain path ahead for all of these factors, it is also possible that regardless of which of these three outcomes is more accurate, defaults could follow a path resembling an elevated plateau or waves of heightened defaults, as opposed to the peak-and-trough cycles of the past (see chart 12).

Chart 12

Hypothetical Possibilities For Future Defaults In An Unusual Environment



Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

Regardless of the path of the economic recovery, corporations will carry much more debt in the years ahead. This will either have to be financed through even more debt or will require organic revenue to grow at a faster pace than in the past. If a more drawn-out recovery does occur, refinancing obligations may become more difficult to repay, particularly for the weakest borrowers.

How We Determine Our European Default Rate Forecast

Our European default rate forecast is based on current observations and on expectations of the likely path of the European economy and financial markets.

In addition to our baseline projection, we forecast the default rate in optimistic and pessimistic scenarios. We expect the default rate to finish at 3.5% in September 2021 (25 defaults in the trailing 12 months) in our optimistic scenario and 11% (80 defaults in the trailing 12 months) in our pessimistic scenario.

This study covers both financial and nonfinancial speculative-grade corporate issuers.

The scope and approach are consistent with our other ratings performance research publications globally--that is, our default and ratings transition studies. In this report, our default rate projection incorporates inputs from our economists that we also use to inform the analysis of our regional Credit Conditions Committees.

We determine our default rate forecast for speculative-grade European financial and nonfinancial companies based on a variety of quantitative and qualitative factors. The main components of the analysis are credit-related variables (for example, negative ratings bias and ratings distribution), the ECB bank lending survey, market-related variables (for example, corporate credit spreads and the slope of the yield curve), economic variables (for example, the unemployment rate), and financial variables (for example, corporate profits). For example, increases in the negative ratings bias and the unemployment rate are positively correlated with the speculative-grade default rate.

As the proportion of issuers with negative outlooks or ratings on CreditWatch with negative implications increases, or the unemployment rate rises, the default rate usually increases.

By geography, this report covers issuers incorporated in any of the 31 countries of the European Economic Area (EEA), Switzerland, or certain other territories, such as the Channel Islands. The full list of included countries is: Austria, Belgium, the British Virgin Islands, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Gibraltar, Greece, Guernsey, Hungary, Iceland, Ireland, the Isle of Man, Italy, Jersey, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Monaco, Montenegro, the Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, and the U.K.

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.

Related Research

- European Corporate Support Schemes: A Long Unwinding Road, Nov. 25, 2020
- The Case For Bold Fiscal Stimulus In The Eurozone, Nov. 17, 2020
- European Economic Snapshots: A Second COVID-19 Wave Is Dampening The Recovery, Oct. 14, 2020
- Credit Conditions Europe: Ill-Prepared For Winter, Sept. 29, 2020
- The Eurozone Is Healing From COVID-19, Sept. 24, 2020

This report does not constitute a rating action.