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Default, Transition, and Recovery:

The European Speculative-Grade Default Rate Looks Set To Rise In 2019

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Key Takeaways

- The 12-month trailing default rate for speculative-grade European corporates could rise to about 2.6% through 2019, in our view, from 1.9% at end-2018. In this scenario, the default rate would remain below its average of 3.1% since 2002.
- Although bank lending conditions remain benign, recent risk aversion in capital markets has led to a significant widening in corporate credit spreads, which has historically been linked with a later rise in default rates.
- Certain aggregate measures of credit performance have also recently been deteriorating. For example, the proportion of speculative-grade issuers that we rate 'B-' or lower has been rising and is now high by recent standards, reading 18.3% at the end of 2018, up from 13.5% three years earlier.
- In addition, the negative ratings bias for speculative-grade European corporates increased to 15.3% at the end of 2018, from 12.5% in May.
- Segmentation by sector reveals some polarization. The retail/restaurants and health care sectors now have a speculative-grade negative bias above their long-term averages, in contrast with most other sectors.

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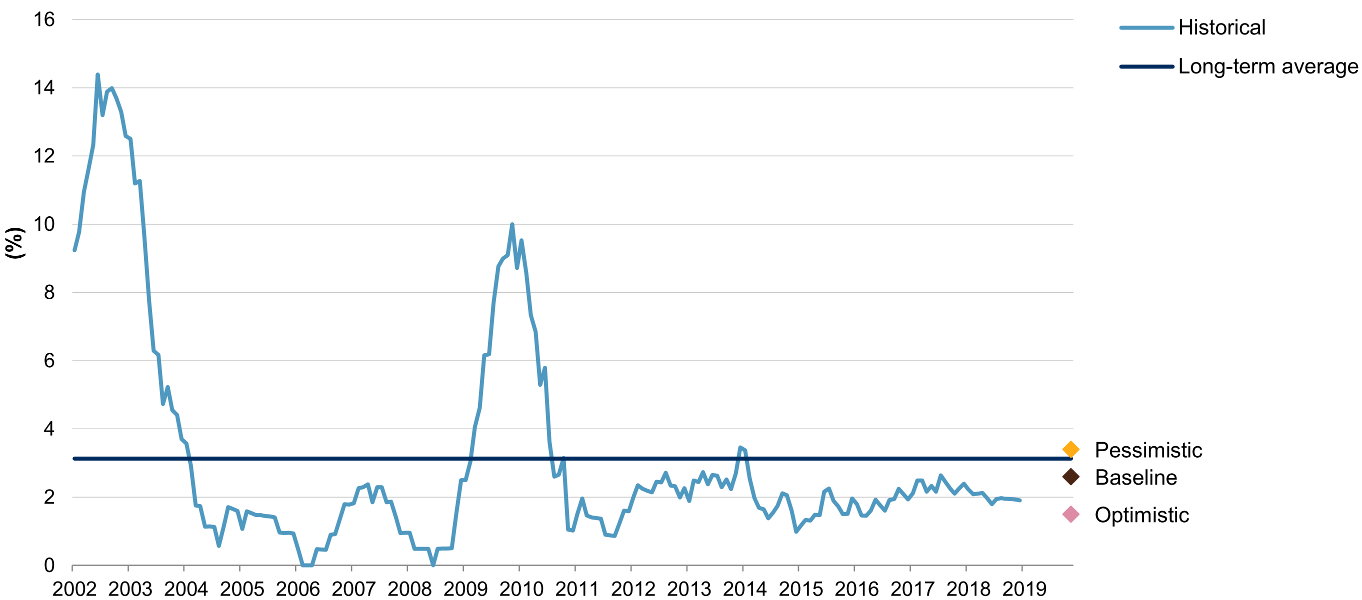
S&P Global Ratings expects the 12-month default rate for speculative-grade European financial and nonfinancial corporate issuers that we rate to rise to about 2.6% by the end of 2019 on the back of some tightening in credit conditions. This would be significantly up from the current level of 1.9%, representing a reversal in the gradual downward trend experienced since mid-2017, but would still leave the default rate still well below its long-term average of 3.1%.

Chart 1

European Speculative-Grade Corporate Default Rate And Projections



Data as of Dec. 31, 2018. Source: S&P Global Fixed Income Research, S&P Global Market Intelligence's CreditPro®.

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Capital market volatility since the beginning of October 2018 has left credit spreads for speculative-grade European companies significantly wider than a year ago. Although it's not yet clear how long the recent trend of widening will persist, the end of quantitative easing and the prospect of tighter credit conditions suggest that the trough in the speculative-grade default rate for this credit cycle is now likely behind us.

Some ratings-based indicators also suggest rising aggregate default risk. Over the past 36 months, there has been a noticeable shift in the ratings distribution, which has become more concentrated toward lower rating levels within the speculative-grade range. Most of the shift has occurred at the 'B-' level, often resulting from financial underperformance relative to our expectations and leverage rising above our guided thresholds.

Some Signs That Financing Conditions Are Becoming More Difficult

The 12-month trailing default rate for speculative-grade European financial and nonfinancial corporates that we rate was 1.9% at end-2018, down from 2.4% a year earlier (see chart 1). Based on our expectations of some tightening in credit conditions for speculative-grade corporates, and stronger operational headwinds as economic growth slows, we anticipate that the default rate may have bottomed out and will increase by the end of 2019.

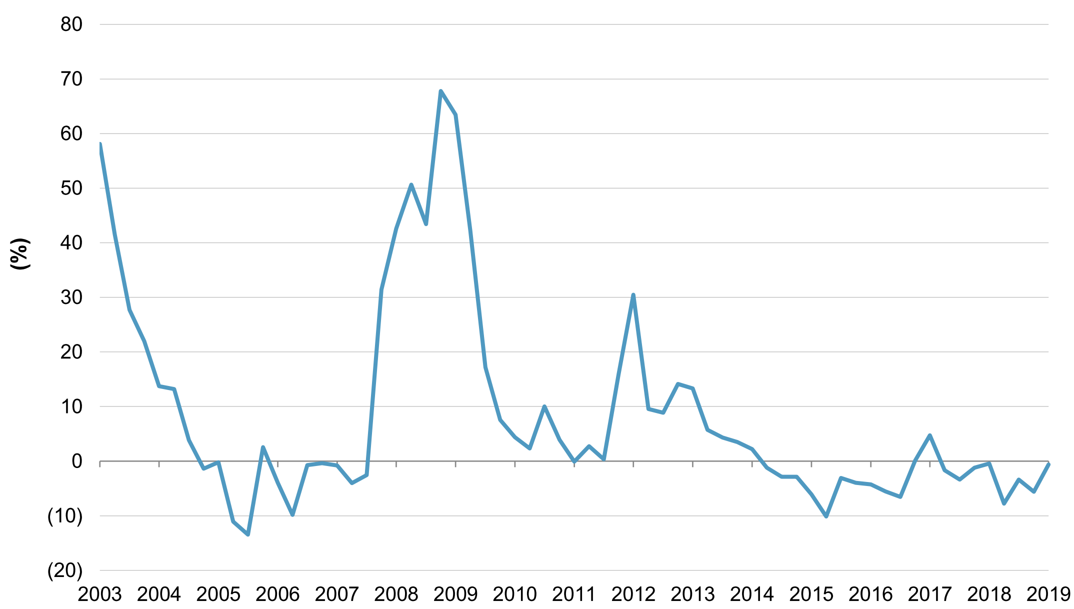
Specifically, we expect the 12-month trailing default rate for speculative-grade European financial and nonfinancial corporates could rise to about 2.6% in our baseline scenario, with 16 issuers defaulting. Under our optimistic scenario, the speculative-grade default rate would be 1.5% (nine issuers), while in our pessimistic scenario, the default rate would be 3.4% (21 issuers).

Recent volatility in financial markets has indicated shifting investor appetite affecting both speculative-grade bonds and leveraged loans, with lenders reappraising risk pricing as well as terms and conditions. With the U.S. Federal Reserve continuing to normalize monetary policy and the European authorities setting out in the same direction, we believe recent market dislocations represent a more significant change in financing conditions than in the first quarter of 2016.

On some measures, conditions for bank lending to European corporates remain benign. The European Central Bank (ECB) appears committed to maintaining favorable liquidity conditions over the long term, providing full allotment in its short-term and three-month refinancing operations, for example. While banks' borrowings under the ECB's extraordinary "targeted longer-term refinancing operations" (TLTROs) are set to mature from mid-2020, it's possible that the ECB could develop a new scheme to offer term funding if some banks (for example in Italy) would otherwise struggle to refinance. For now, strong competition among banks is ensuring that lending terms and conditions remain borrower-friendly. Indeed, according to the ECB's regular bank lending survey, credit conditions for corporates have recently still been on a net loosening trend, which supports corporate fundraising and refinancing of existing debt (see chart 2).

Chart 2

Eurozone Bank Lending Survey, Net Balance Of Credit Conditions



Note: Bank lending survey measure refers to net proportion of respondents reporting a tightening versus loosening in credit conditions for firms. Source: ECB.
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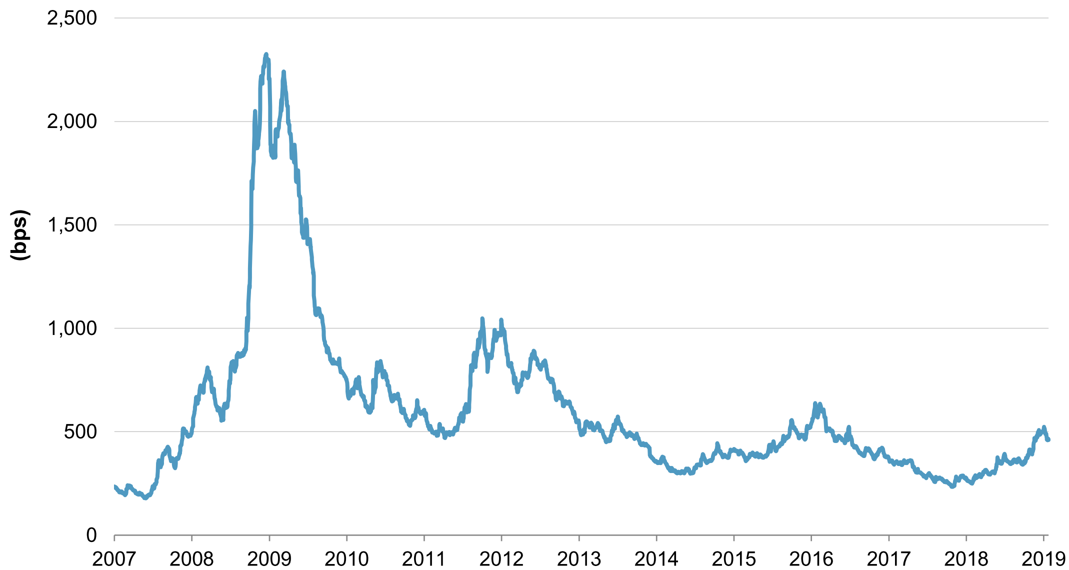
However, this may not translate into easier financing conditions for riskier borrowers, and the latest ECB survey suggested that even as average loan margins tightened in the fourth quarter of 2018, those on riskier loans widened. Conditions in the corporate speculative-grade bond market have certainly taken a turn for the worse since the beginning of October. The end of net purchases under the ECB's quantitative easing program at the end of 2018 coincided with a global repricing of risk in financial markets that has particularly affected leveraged finance. Some aggregate measures of speculative-grade corporate spreads have recently widened at a pace not seen in almost three years (see chart 3).

Chart 3

European High-Yield Index, Option-Adjusted Spreads



bps--basis points. Source: ICE BofAML Euro High Yield Index, Federal Reserve Bank of St. Louis.

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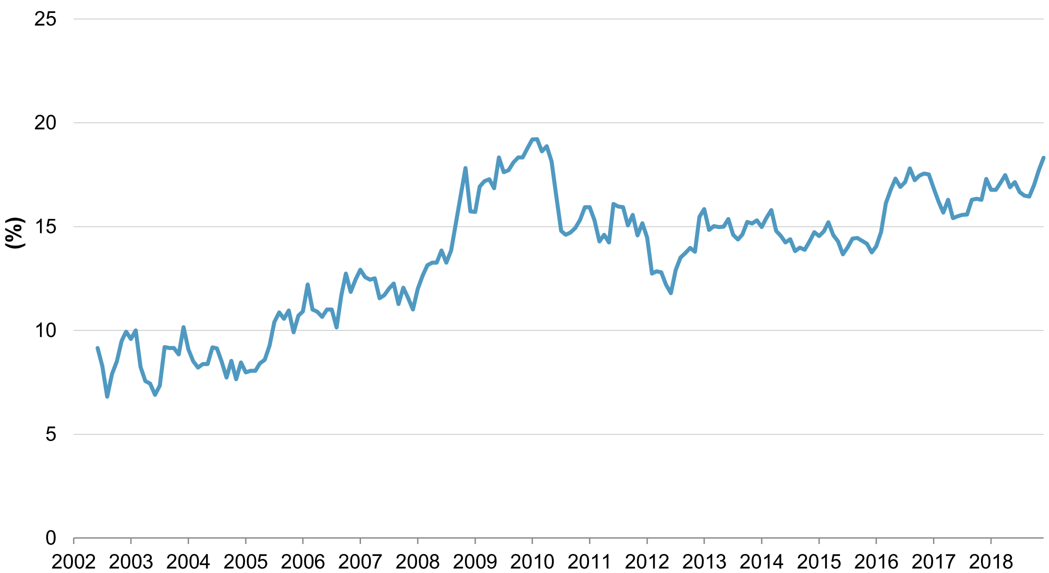
This is one factor underpinning our view that default rates could edge higher by the end of 2019. Over the past 20 years, there has been a strong correlation between credit spread widening and subsequent rises in the speculative-grade default rate. Although it's not yet clear how long the recent spread widening will persist, the end of quantitative easing and the prospect of tighter credit conditions suggest that the trough in the speculative-grade default rate is now likely behind us for this cycle.

A Rising Concentration Of Lower Ratings May Indicate A Higher Default Rate

Another potential indicator of changing credit risk across the portfolio of speculative-grade European corporates we rate is the evolving ratings distribution. Over the past 36 months, we have broadly seen an increase in the concentration of ratings at lower levels, likely indicating higher credit risk on average. For example, between end-2015 and end-2018, the proportion of speculative-grade issuers rated 'B-' or lower rose to 18.3% from 13.8% (see chart 4).

Chart 4

Proportion Of Speculative-Grade European Corporate Issuers Rated 'B-' And Lower



Data as of Dec. 31, 2018. Source: S&P Global Fixed Income Research, S&P Global Market Intelligence's CreditPro®.

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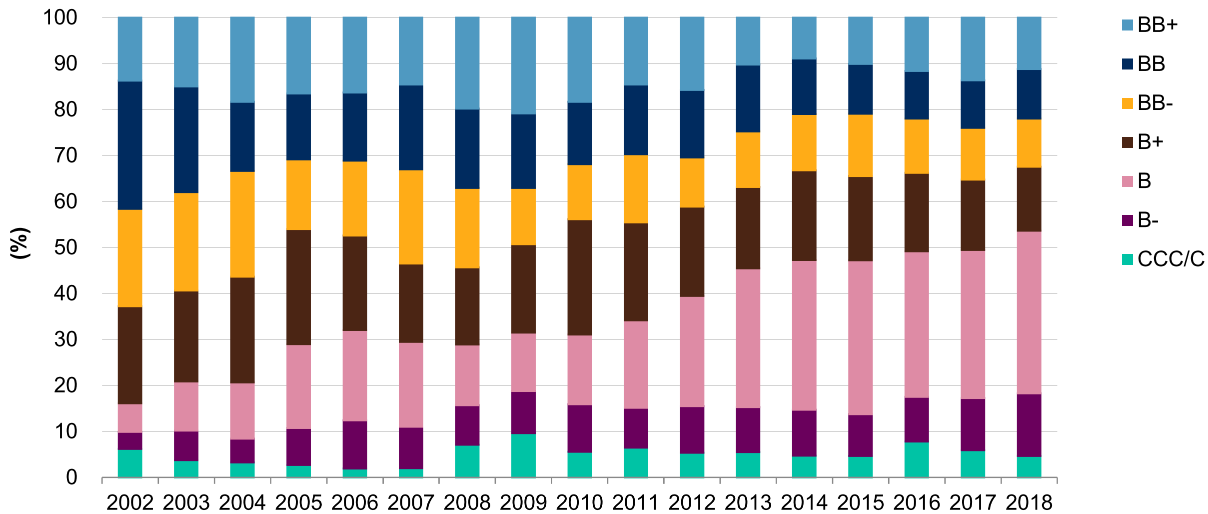
Considering the wider range of speculative-grade ratings, the distribution has generally shifted toward lower ratings (see chart 5). In absolute terms, the number of issuers we rate 'B' and below has more than quadrupled over the past eight years, rising to 369 (or 54% of speculative-grade ratings) as of end-2018 from just 77 (31%) at end-2010.

Chart 5

Ratings Distribution Of Speculative-Grade European Corporate Issuers



Data as of Dec. 31, 2018. Data at end of stated period. Source: S&P Global Fixed Income Research, S&P Global Market Intelligence's CreditPro®.

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The changing ratings distribution over this period was largely due to new issuers joining the pool of speculative-grade ratings, rather than solely due to the deteriorating credit quality of previously rated issuers. However, regardless of the cause, such a structural shift in the ratings distribution would likely increase the aggregate speculative-grade default rate in a credit downturn, all else being equal, because realized default rates are typically higher for lower rating levels.

Another consideration in our forecast for the speculative-grade default rate is the negative ratings bias, which we define as the proportion of outstanding ratings with a negative outlook or on CreditWatch with negative implications. The negative bias for speculative-grade European corporate issuers was 15.3% at the end of 2018, up from the recent low of 12.5% in May. For issuers at the lower end of the speculative-grade spectrum (rated 'B-' or lower), the negative bias rose to 27.7% at end-2018, from 23.2% in May. This marks a reversal of the broad downward trend observed since mid-2016, although these measures of potential credit stress are still well below their historical averages (see chart 6).

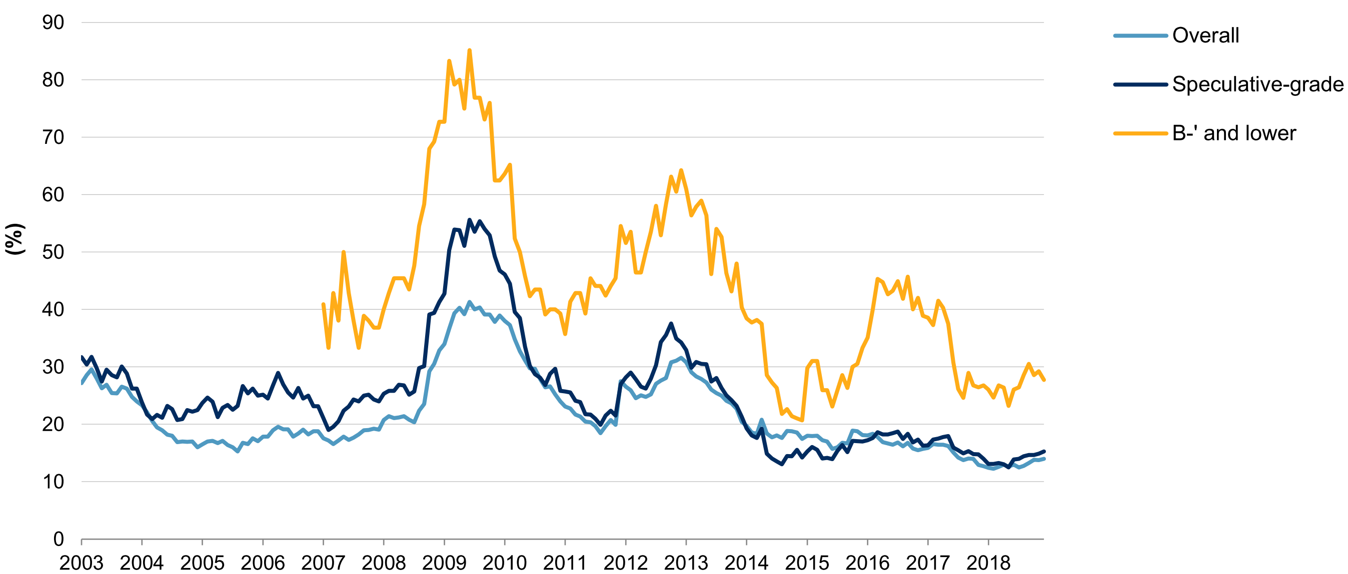
Downgrade risk is an important factor on the path to default for more vulnerable, highly leveraged, entities. It will be interesting to see how this plays out over the next default cycle, given the introduction of new accounting standards (notably International Financial Reporting Standard 9) and the recent prevalence of "covenant-lite" leveraged loans. We think that bank lenders providing leveraged loans will be less supportive of vulnerable companies during the next credit downturn as the risk-return trade-off has become less attractive, for two reasons.

First, under IFRS 9--which took effect in January 2018--banks have started provisioning on the basis of expected credit loss. For performing loans this means provisioning just for 12 months. However, when a credit becomes stressed and is classified as underperforming (or "stage 2"), required provisions increase significantly to cover the full expected credit loss over the lifetime of the loan. The second reason is that the great majority of term loans are now so-called "covenant-lite" and, even though institutional investors have grown in dominance, European banks still participate in 17% of term loan primary volumes, according to data from S&P Global Market Intelligence's Leveraged Commentary & Data (LCD) offering. This reduces the ability of lenders to receive amendment fees and reset margins. And for revolving credit facilities, while financial maintenance covenants still prevail, their effectiveness is reduced in many cases due to the use of carve-outs, high covenant triggers, and equity cures, among other devices.

In our view, these changes mean that bank lenders will have less incentive to remain committed to vulnerable credits in the event of a downward transition in credit quality. This could encourage distressed sales to other investors and be detrimental to the liquidity position of the company, with the consequence that, over time, the level of default risk will be higher.

Chart 6

European Corporate Negative Ratings Bias



Source: S&P Global Fixed Income Research.

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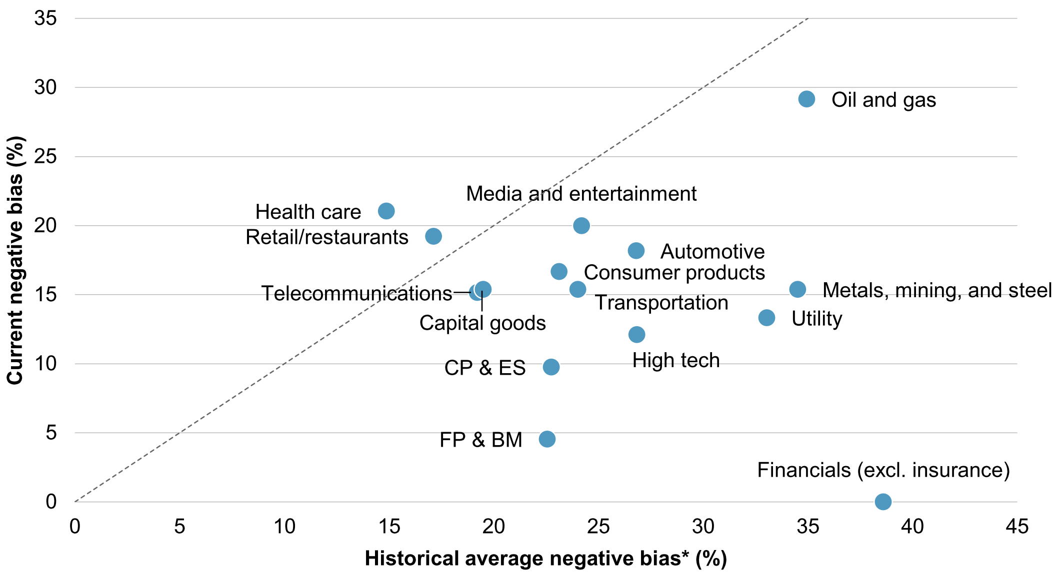
While the aggregate speculative-grade negative ratings bias remains low and has only recently begun to increase, segmenting by sector reveals some polarization and areas of greater relative weakness. For example, the health care and retail/restaurant sectors have negative bias figures that exceed their historical averages (see chart 7).

Chart 7

Speculative-Grade European Corporate Negative Ratings
By sector



*Historical averages from 2002 to end-2018. Data as of Dec. 31, 2018. CP & ES--Chemicals, packaging & environmental services. FP & BM--Forest products & building materials. Source: S&P Global Fixed Income Research.

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The Economic Landscape Is Still Supportive, Despite Decelerating Growth

Our default rate projection considers various macroeconomic indicators, and European growth trends continue to support a below-average default rate, in our view. Although eurozone GDP growth is decelerating, this is from a 10-year high of 2.5% in 2017. We expect the 2018 figure to come in at 1.9%, with a further drop to 1.6% through 2019. We expect continued stronger relative performance in Spain and The Netherlands (both at 2.6%), while Italy (0.7%) lags significantly behind.

However, risks to growth are tilted to the downside. In particular, the eventual outcome of the U.K.'s Brexit process could have a significant bearing on economic prospects, with a "no deal" scenario likely to be highly disruptive for trade and businesses. As a base case, we expect that U.K. economic growth will be 1.3% in 2019, although this is contingent on a deal being struck with the EU (see our related research, "Countdown To Brexit: No Deal Moving Into Sight," published Oct. 30, 2018). Through 2019 there are further risks related to tensions over the Italian budget and trade relations between the U.S. and the EU.

Appendix: Scope And Approach

This study covers both financial and nonfinancial speculative-grade corporate issuers (those with a rating of 'BB+' or lower).

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 corporates 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.

Related Research

- Global Weakest Links And Default Rates: Oil And Gas Weakest Links Increase As A Year Of Turbulent Oil Prices Comes To A Close, Jan. 15, 2019
- Economic Research: Global Economic Outlook 2019: Autumn Is Coming, Dec. 12, 2018
- Countdown To Brexit: No Deal Moving Into Sight, Oct. 30, 2018
- 2017 Annual European Corporate Default Study And Rating Transitions, Sept. 5, 2018
- 2017 Annual Global Corporate Default Study And Rating Transitions, April 5, 2018
- Weakest Links Are Nearly Ten Times More Likely To Transition To Default Than Speculative-Grade Entities, Feb. 27, 2013

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