North America Corporate Credit Outlook Mid-Year 2019

Pockets Of Risk Emerge
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July 25, 2019

Key Takeaways

- **Headwinds hurting growth.** Uncertainty lingers as trade-related headwinds persist, giving way to likely slower GDP growth for the rest of the year. Corporate capex spending growth has slumped in response.

- **Defaults to rise modestly.** S&P Global expects the speculative grade default rate to increase to 2.7% by March 2020, which would remain below its level from March 2018.

- **Fed about-turn has brought respite to market conditions.** Following a turbulent fourth quarter for leverage finance market conditions have improved. This is primarily a response to the Fed’s about turn towards an easing bias, countering deteriorating fundamentals.

Cash flow headwinds are pressuring credit quality

While S&P Global Ratings sees increased credit concerns for borrowers in the U.S., we expect ratings to be broadly stable in the near term. Credit risk remains focused on consumer products, retail, pharmaceuticals, and health care services. We expect headwinds for earnings and cash flow, given the; a) continued uncertainty around trade, b) anticipated slower growth in the U.S., c) weakening economies abroad, d) higher labor and input costs, and e) the dollar’s strength.

Credit risk has increased, with downgrades, defaults, and the negative bias (borrowers with a negative outlook or on CreditWatch Negative) up slightly. In terms of our sector outlooks, we lowered consumer durables to ‘negative’ and forest products to ‘stable to negative’. Both sectors face weaker demand in the U.S. and China, and softness in the U.S. housing market. The consumer durables sector continues to be pressured by rising labor and other input costs, including the impact of steel and aluminum tariffs.

We see a downturn in the economy/credit cycle, asset market/risk repricing, geopolitical turmoil, and escalation in trade conflicts as the main risks. Though the U.S.–China tariff dispute has had minimal direct impact to date, if the dispute further escalates and/or begins to erode confidence and tighten financial conditions, the negative economic and credit effects will be more damaging. The decline in average credit quality and the growth in leveraged loans and speculative-grade bonds outstanding could amplify credit stresses, resulting in higher defaults especially in a protracted capital market dislocation or credit downturn.

We see more downside risk if U.S.–China tensions intensify further. Among sectors, autos, capital goods, consumer products, retail, and technology could see more pressure in such a scenario. These sectors have relatively high input-cost exposure to China, and/or a limited ability to pass on costs to consumers, and/or more vulnerability to retaliation.

Escalating trade tensions have heightened fears that economic conditions in the U.S. have worsened, with signs that businesses are curbing investment. North American corporate capital spending has seen a dramatic slowdown, with spending growth slumping from 9% last year to a projected 2% this year (see S&P Global Corporate Capex Survey: Curbed Enthusiasm, June 19, 2019). Against this backdrop, it’s likely the Federal Reserve has not only paused in its monetary-policy tightening cycle but will lower benchmark borrowing costs. While most indicators of financing conditions remain largely supportive, the lending backdrop has become cloudier, hinting at a slight turn in the credit cycle.

Tensions in the Middle East, particularly regarding Iran and events in the Strait of Hormuz, have added to some of the global uncertainties. While we do not believe a long-term shut down of the Strait would be permitted, further escalations could continue to increase oil prices. The U.S. oil and...
gas sector continues to suffer from lack of investor appeal given its poor returns over the last several years, with yields remaining under pressure. This comes at a time when the oil and gas sector is confronting an increase in debt maturities over the coming years.

**Top Risks**

### Top North-America Risks

#### Geopolitical and trade disputes cloud world growth

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<tr>
<th>Risk level*</th>
<th>Very low</th>
<th>Moderate</th>
<th>Elevated</th>
<th>Very high</th>
<th>Risk trend**</th>
<th>Improving</th>
<th>Unchanged</th>
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The world’s multilateral trade framework has been shaken by key-country unilateral policy changes. U.S.-China friction has broadened from tariffs to technology. Middle East tensions pose a risk to energy markets. Such prolonged global tensions impact investment sentiment and long-term growth. The U.S. removal of tariffs on steel and aluminum imports from Mexico and Canada, and Mexico’s ratification of the U.S.-Mexico-Canada Agreement (USMCA) eases some uncertainty around trade relations in the region. The Canadian government introduced implementing legislation, but it plans to follow the U.S. ratification process closely—and any amendments proposed by U.S. Congress—before putting the deal to a final vote in Canada’s parliament.

#### Mature credit cycle and volatile liquidity

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The Fed’s dovish policy bias is supporting liquidity and extending a mature credit cycle. Still, the build-up in nonfinancial corporate debt and leveraged lending in the U.S. and elsewhere is a source of instability. Risk aversion and measures of financial stress are inching up again after easing from 2018’s extreme levels. Demand for safe assets is rising and wider credit spreads are crimping financing conditions, but volatility remains relatively subdued compared with late 2018 levels, which severely restricted borrowers’ access to capital markets’ sources of funding.

#### Cybersecurity threats to business activity

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Increasing technological dependency and global interconnectedness means cyber-risk poses a systemic threat and significant single-entity risk. Companies face the risk of criminal, proxy, and direct state-sponsored cyber-attacks.

#### Housing imbalances remain a threat for Canada even as credit growth slows

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The cumulative impact of rising interest rates since mid-2017 plus macroprudential policy tightening—notably, tougher federal government mortgage qualification rules for homebuyers—are contributing to a faster deceleration in house prices for Canada, and household credit growth is slowing more quickly versus other advanced economies. Although consumer debt service burdens are easing with the slower accumulation in new debt, and a pick-up in income growth is also supporting debt servicing capacity, elevated house price-to-income multiples and stretched housing affordability remain a threat to financial stability. The Bank of Canada’s recent shift to a dovish policy will support steady debt-service ratios for consumers.

Sources: S&P Global Ratings.

* Risk levels may be classified as very low, moderate, elevated, high, or very high, and are evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically these risks are not factored into our base case rating assumptions unless the risk level is very high.

** Risk trend reflects our current view on whether the risk level could increase or decrease over the next 12 months.
U.S. Macroeconomic Outlook

We continue to expect growth in the U.S. economy to decelerate without slipping into recession. With the Fed's and other central banks' shift to a more dovish stance, we expect continued supportive financing conditions, although not as rosy as at the same time last year or the year before. Global risks are growing, and it is likely markets are over-optimistic.

As signs of slumping global economic growth become more pronounced, the U.S. may soon suffer the effects. While most of the "soft" data gauging the health of the world's biggest economy have bounced back from a December-January hiccup, intensifying trade-related headwinds are beginning to affect private-sector investments. In this light, GDP growth will likely slow over the rest of the year, with real quarterly expansion slipping under 2% as fiscal stimulus wanes and increasing protectionism weigh on conditions.

S&P Global Ratings now forecasts full-year GDP growth of 2.5% this year and just 1.8% next year. We expect headline unemployment to drift higher next year, with core inflation rising to 2.0% after a preemptive interest-rate cut by the Fed stabilizes the inflation outlook.

Of the 10 leading indicators of near-term U.S. economic growth that S&P Global Ratings' economics team looks at in our monthly Business Cycle Barometer, five are positive, three neutral, and two negative. Escalating trade tensions have heightened fears that economic conditions have worsened, with signs that businesses have tightened their purse-strings. Deceptively strong first-quarter growth was largely driven by an inventory build-up and net export strength as businesses tried to get ahead of protectionist trade actions.

We expect weakening growth momentum and a benign inflation outlook will prompt the Fed to lower interest rates this year. The Fed is in agreement, according to its latest summary of economic projections, with one rate cut of 25 basis points (bps) penciled into policy makers' median estimate in 2020. Financial markets, meanwhile, are betting on multiple cuts in the benchmark federal funds rate—perhaps starting with 25 bps at the central bank's July meeting.

This would come just after the economic expansion became the longest in the country's history, now exceeding 10 years. How long it will last is a matter of debate, but it has been a remarkable run—one that we think will continue for at least the next 12 months.

Still, the risks of recession have risen. Using our proprietary augmented term spread model, our quantitative assessment of recession risk in the next 12 months is now at 26%. Our overall qualitative recession risk is at 25%-30%. It was 20%-25% in May.

The escalation of trade disputes remains the largest downside risk to our forecast. Increased tariffs have yet to manifest as steep increases in overall consumer goods prices—although prices on certain products have risen, and we see the potential for more. Still, the Fed would likely see any increase in inflation caused by tariffs as temporary. Either way, core inflation remains well below the central bank's target of 2%. With the short-term benchmark rate historically low, at 2.25%-2.50%, the Fed may want to move sooner and more quickly than it has in the past to prevent a tumble, given that it doesn't have a lot of room to maneuver.

Canada Macroeconomic Outlook

Canadian economic activity is rebounding after hitting a soft patch earlier in the year. Real GDP expanded 0.3% month-over-month in April adding to the 0.5% growth in March. Oil production resumed after temporary cuts by the Alberta government at the start of the year. Construction output grew by 0.2% month-over-month in April driven by an increase in residential and non-residential construction indicating a revival in fixed investment. Although durable goods production fell in April, output of non-durable goods was up 0.8% month-over-month led by an increase in the manufacture of food (1.3%), chemicals (1.2%) and petroleum and coal products (1.4%). Businesses added 421,100 workers to their payrolls in the 12 months to May 2019. Canada's unemployment rate edged up to 5.5% after sinking to a new record low of 5.4% the previous month. Employment slowed overall, but full-time job creation continued in June.

Although capacity pressures could lift business spending, sentiment remains tentative amid unresolved trade tensions and as global GDP slows, soft commodity prices could weigh on earnings.
and investment for natural resource producers. Strong job gains and income growth at the start of 2019 should fuel a rebound in consumer spending. But we don’t see a pick-up until the second quarter and heavy debt burdens will likely restrain the boost to GDP from household purchases. For now, it seems real GDP growth is likely to fall short. We’ve reduced our baseline assumptions and expect growth to average 1.2% in 2019, which is down from the 1.5% increase we were projecting for the year in our previous forecast update. In 2020, GDP growth is likely to move back up to 1.7%.

Slower growth in Europe and Asia will subdue exports, but Canada’s trade with the U.S. is likely to remain steady. Housing market imbalances remain a key vulnerability for Canada’s economy with elevated price-to-income multiples squeezing home affordability.

Trade tensions are shifting supply chains

Following the G-20 meeting between President Trump and President Xi Jinping in June, the U.S. shelved plans to place tariffs on the remaining imports from China that have not yet been subject to levies, and eased some export restrictions on Huawei. Negotiations have resumed but it’s difficult to see the U.S. and China quickly resolving differences on issues of enforcement and level playing field, among others, and reaching an agreement soon, if at all. The risk is that a re-escalation of this dispute will amplify pressure on profits and supply chain costs and lead to even more uncertainty.

So far, the negative credit impact of the conflict on corporate issuers has been modest, as companies have largely passed on the cost of tariffs to consumers and the dispute had largely been contained to retaliatory tariffs on intermediate inputs (see “As Tensions Escalate, U.S. Companies Try To Diversify Supply Chains Away From China,” June 24, 2019). A resilient U.S. economy also helped corporates weather the dispute, although this support is now shakier due to weaker growth prospects. Currency movements have also offset some of the tariff’s impact as the yuan weakened and the dollar strengthened overall. Moreover, the tariff costs may have been limited for some (especially before the May tariff rate hike from 10% to 25% on $200 billion of imports from China) as the tariffs applied to low-cost intermediate inputs, which represent a small portion of a company’s total expense.

But if the U.S. goes ahead and expands tariffs to all imports from China (including important consumer goods), it will become more difficult to continue passing on costs to consumers and companies may need to absorb a bigger share of the tariff costs. In addition, non-tariff actions can become more prevalent and their effects are more unpredictable, often targeting specific companies or sectors, and can directly affect revenues. The way tariffs work and affect companies is better understood, and it may be more challenging to respond to non-tariff measures. Some U.S. corporates have significant revenue exposure to China and are vulnerable to consumer boycotts or buying and selling restrictions.

Chart 1

Share of Revenues from China For Selected Companies

![Chart 1](image-url)
We think U.S. companies will continue to optimize their supply chains and divert away from China. However, this strategy is not costless. It's limited by near-term capacity constraints and will be more challenging for sectors that require skilled labor and high-value manufacturing. In particular, it is very difficult to replicate China's well-developed and integrated technology supply chain elsewhere. In addition, China itself is a large market for technology products and technology companies may want to continue manufacturing near it. All in all, companies have been able to mitigate the impact of past tariffs by passing on increased costs, diverting trade, and adjusting their supply chains. However, if the U.S.-China dispute further escalates, its costs will pile up, leaving less room for near-term mitigation strategies and, as a result, increasing its adverse credit effects.

**Leveraged Finance Outlook**

The protracted benign credit cycle and easy borrowing conditions have led to rising average debt leverage in the speculative-grade universe. Many smaller and weaker companies have come to market and speculative-grade firms more broadly have taken advantage of the accommodating credit market refinance to lower debt costs, refresh liquidity, revise loan terms, and push out debt maturities—all of which offer shelter in a slowdown, notwithstanding the rise in leverage and default risk. An outstretched runway to default also means greater erosion of enterprise value and more slimmed-down recovery prospects in a default scenario. While there are broader concerns on the leveraged lending front, one comforting facts is that collateralized loan obligations (CLOs), which hold the majority of syndicated bank debt, lock in capital commitments for a long period and proved to be a market stabilizer in the December 2018 sell-off, indicating some capacity to withstand price volatility.

**Leverage Trends**

Unsurprisingly, one of the late cycle characteristics is elevated leverage. For years now, the record-long economic expansion and low interest rate environment have encouraged rich valuations, with heavy borrowing supporting high merger and acquisition (M&A) activity in recent years. On a trailing-12-month basis, market statistics from LCD show overall leverage for large corporate entities—measured as total debt to EBITDA of new transactions—has picked up by half of a turn, rising to 5.4x in 2019 from 4.9x in 2007. While the increase in total debt leverage may seem modest in historical context, beneath the surface, the first-lien leverage is rising at a much faster pace over the same span, implying increasingly aggressive capital structures and, in many cases, one that consists exclusively of first-lien bank loans.
Further, LCD’s market statistics are based on adjusted EBITDA, which include management’s estimated cost savings and synergies. As such, the market statistics often underestimate the underlying leverage as EBITDA add-backs have become more common and larger over time. We’ve reflected this trend in our issuer credit ratings (ICR), which are a proxy for relative default risk, which show a substantial shift in distribution of ICRs towards lower end of our rating scale. However, we note that this shift also reflects an expansion of the rated universe in the U.S. from roughly 1,250 in December 2009 to more than 1,600 at the end of the first quarter of 2019, with a strong majority of new issuers in recent years being smaller, highly leveraged, and often owned by private equity sponsors.
Recovery Trends

Embedded in the decline in credit quality is the gradual weakening of recovery prospects, as measured by our recovery ratings as a proxy for future recovery rates in a default scenario. After the biggest slide in 2017, the average recovery estimate for first-lien new issues has largely stabilized in the mid-60% area. One common theme over recent years is that first-lien new issues continue to have the largest concentration of ‘3’ recovery rating (which indicate recovery of 50%-70% in an event of payment default). This is becoming increasingly apparent this year when 64% of new issuance by count are from that segment, the highest it’s been since we started tracking this data in 2014. For reference, the five-year average was 50%.

Chart 4
Average Recovery Estimate of First Lien New Issues, U.S. & Canada

Source: S&P Global Ratings

Chart 5
Recovery Rating Distribution of First Lien New Issues, U.S. & Canada

Source: S&P Global Ratings
'BBB' Corporate Debt In The Spotlight

The amount of debt that U.S. corporate borrowers are carrying on their balance sheets has reached an all-time high. Debt-to-EBITDA ratios have also climbed to record levels while EBITDA interest coverage metrics are lower than they were a few years ago. At the end of 2018, U.S. nonfinancial corporate debt that we rate in the 'BBB' category had grown to just under $3 trillion, up roughly 171% since 2007. To be sure, mergers and acquisitions (M&A) have created debt concentrations in certain sectors and companies. Median adjusted leverage in the 'BBB' category had increased to 2.2x in 2018 from 1.8x in 2007. While this is a large percentage increase, the overall level of leverage is still commensurate with the strength of the businesses in this rating category. In addition, this debt tends to be concentrated among the most stable sectors and issuers as the majority of 'BBB'-rated issuers had leverage of less than 3x in 2018.

As the amount of 'BBB' category debt swelled over the past decade, investors have become increasingly concerned that future downgrades could affect the credit markets and--particularly--that forced selling could test the ability of the speculative-grade market to absorb a large amount of long-dated "fallen angel" debt (i.e. debt downgraded to speculative grade from investment grade). In our view, this concern may be overstated. Our research shows that our ratings on U.S. nonfinancial corporate issuers in the 'BBB' category have generally held firm over the past 35-plus years, even during periods of economic stress. Based on a scenario analysis that extrapolates ratings performance during the financial crisis, the amount of potential 'BBB' fallen angel debt would be in line with past cycles when viewed as a percentage of the speculative-grade bond market. However, we recognize that every cycle is unique and that debt concentrations among certain issuers could pose increased risks relative to past cycles. Accordingly, in terms of market liquidity we believe the biggest risks will center around the timing of potential downgrades over a recessionary period and whether any large debtholders become fallen angels (see "When The Cycle Turns: 'BBB' Downgrade Risks May Be Overstated," Dec. 3, 2018).
M&A

Trade and geopolitical uncertainty has restrained the deal-making environment. Although announced transactions in the first half of 2019 ($800 billion worth that was boosted by mega-deals) are 20% higher than in the first half of last year, the number of deals was actually 20% lower (see chart 7). As it has been for a while, health care and technology were the most active sectors, followed by capital goods and energy. U.S.–China trade tensions continued to impact cross-border deals, amid tighter restrictions on incoming investments from China. While not large to begin with, M&A deals involving Chinese companies acquiring U.S. entities has practically dried up.

Chart 7
U.S. Corporate M&A---Deal Value And Count

The Fed’s shift to a more accommodative stance coupled with buoyant equity markets are favorable backdrops for M&A, but any renewed market volatility could weigh on activity as seen in late 2018 and early this year. While there is an appetite for mega-deals, it’s unlikely that M&A will climb back to the highs in 2015-2016. After several years of aggressive M&A, some sectors (e.g. consumer nondurables, telecom) are digesting large acquisitions and/or seeking to reduce leverage. High purchase multiples may also deter some transactions. In general, we see moderate M&A (as well as divestitures) in the second half as companies continue to “purchase revenue growth” and pursue greater cost efficiencies — especially in response to disruptive trends. One sector where we could see more deals is pharmaceuticals, which is confronting increased pricing pressures, challenges to growth, and a pipeline that needs to be further bolstered. Meanwhile, private equity is also active in energy, leisure, and health care services. We expect M&A to continue to drive credit risk.

Chart 8
US Corporate M&A: Deal Value By Sector (2019 1H)
Issuance has lagged in the first half of 2019 when compared to 2018, in part because of lower M&A volumes and lower levels of debt-funded shareholder-friendly activities. With overseas cash unlocked through the recent passage of the Tax Cuts and Jobs act of 2017, issuers, especially those in the investment-grade space have not needed to rely as heavily on the debt capital markets in order to fund some of their shareholder-returns, such as share buybacks and dividends.

While total issuance and investment-grade issuance lag, high-yield issuance is actually up nearly 19% year over year. After a rough end to 2018 for corporate credit, high-yield issuance and spreads have rebounded nicely in the first half of 2019, helped in part by fairly healthy economic data and a more dovish Fed policy stance. As it stands now, if the current pace of issuance continues in the high-yield market, we could possibly see issuance return to 2017 levels.

Chart 9
Total Bond Issuance

Source: LCD, an offering of S&P Global Market Intelligence.

Levered Loan Issuance Trend

Following the unexpected nosedive in late 2018, the U.S. leveraged loan market bounced back significantly in early 2019, led by a pricing rebound in the secondary market. However, it is far from making a full comeback. In the first half of 2019, the market wrestled with uncertainties on tariff and interest rates at the macro level. Against this backdrop, new issuance volume, including both pro rata and institutional loans, slid to $239 billion, down a substantial 37% from a year ago (see chart 10, data sourced from S&P Global’s Leveraged Commentary & Data (LCD)). Leverage loan issuance will likely remain subdued for most of the second half on account of investors steering towards fixed-rate debt in the anticipation Fed’s interest rate policy. We have seen that high-yield issuance is on the rise, and a non-trivial portion of it is made up of secured notes, indicating that high yield investors are still concerned about credit risk. In the first six months of 2019, about 30% of new transactions by volume are secured offerings, a substantial step up from the role they played in 2018 (20%).
Defaults and Rating Trends

Defaults And Downgrade Potential Slowly Rising… But From Low Levels

In March 2019, the U.S. trailing-12-month speculative-grade corporate default rate declined to 2.1%, its lowest level in almost four years. S&P Global Fixed Income Research expects this default rate to increase to 2.7% by March 2020, and even with this increase, the default rate would remain below its level from March 2018.

With oil prices remaining between $55-$60/bbl despite geopolitical tensions between the U.S. and Iran, coming alongside shifting consumer preferences, we expect the energy, natural resources, and consumer services sectors will remain at the forefront of defaults over the next 12 months.

In Canada, there have been three defaults from rated companies so far in 2019. Canada also continues to be exposed to commodity price volatility as the country has a higher concentration of companies in the energy and natural resources sector than the U.S.
Companies have benefited in recent years from steady economic growth, a boost from tax reform, and more recently an increasingly dovish stance by the Federal Reserve. Nonetheless, S&P Global Ratings forecasts that U.S. GDP growth will decline to 2.5% for full year 2019 (from 2.9% in 2018) and this economic slowdown, along with trade tensions and geopolitical concerns, is likely to weigh on corporate earnings growth. While interest rate cuts should help buoy corporate issuers for the remainder of the year, we expect this tailwind to issuance to be offset somewhat by slowing economic growth.

With economic growth slowing, particularly as the year moves along, downgrade potential for both investment- and spec-grade nonfinancial companies has been modestly rising this year. The negative bias (the percentage of ratings with negative outlooks or on CreditWatch with negative implications) increased by one percentage each for investment- and spec-grade nonfinancials. At 13%, the negative bias for investment-grade nonfinancials is back around its level from August 2018. Meanwhile, the speculative-grade nonfinancial negative bias of 21% is up to its highest level since December 2016 (for more information, please see Credit Trends: Auto Woes Weigh On U.S. Corporate Credit Quality, published July 16, 2019).

The auto sector experienced the sharpest increase in its negative bias in the second quarter, and six sectors, including oil and gas, aerospace and defense, automotive, utilities, healthcare, and telecommunications, currently have negative biases that are higher than their historical averages. The growing downgrade potential in these sectors has contributed to the modestly rising negative bias for nonfinancials.

Chart 12
**Downgrade Potential Is Rising For Investment And Speculative Grade Nonfinancial Companies**

Given the accommodative financing conditions available to companies through much of the current, post-financial-crisis credit cycle, U.S. companies are generally well-positioned with pending maturities. Speculative-grade nonfinancial companies in particular have pushed out their maturity wall to 2022 and beyond. In 2018, U.S. companies reduced the spec-grade debt set to mature in 2019 through 2023 by 14%.
Chart 13
U.S. Speculative-Grade Nonfinancial Corporate Maturity Wall

![Bar chart showing U.S. Speculative-Grade Nonfinancial Corporate Maturity Wall from 2019 to 2023.](chart)

Source: S&P Global Ratings

Note: Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings on the respective report date. Foreign currencies are converted to USD on the respective report period date.

Research Contributor: Jake Crooks

Related Research

- Credit Trends: Auto Woes Weigh On U.S. Corporate Credit Quality, July 16, 2019
- With Some Lingering Risks, The U.S. Speculative-Grade Corporate Default Rate Is Set To Rise To 2.7% By March 2020, June 3, 2019
- U.S. Refinancing Study--$4.64 Trillion Of Rated Corporate Debt Is Scheduled To Mature Through 2023, Feb. 15, 2019

This report does not constitute a rating action
Industry Top Trends Update

Aerospace and Defense

737 MAX grounding creating uncertainty

What’s changed?

737 MAX grounding. Impact on Boeing and the supply chain has been manageable so far but if the grounding goes past the fall or Boeing cuts production further, smaller suppliers could start to see strains on earnings, cash flow, and liquidity.

Aircraft orders weak. The first of half of 2019 has seen very few aircraft orders, with the recent Paris Air Show seeing the fewest orders in more than five years. However, strong backlogs still support planned production levels.

Defense budget uncertainty. The president’s military spending request for fiscal 2020 shows solid growth but disagreements with Congress could result in a lower amount or no budget at all to start the year.

What to look for

Return of 737 MAX to the air. The timing of the certification of the software update is still unknown and may vary by country. Once Boeing resumes deliveries, and gets paid for the aircraft, it could take many months to deliver the aircraft already built and then increase production.

Slowing global air traffic. A weakening global economy has resulted in air traffic below long-term trends for the last few months, although an actual decline is highly unlikely. Air cargo is also being impacted by the trade war.

More M&A? A number of large deals in the past 12-18 months, including the recent plans by United Technologies and Raytheon to merge, could prompt more tie-ups. Impact on credit quality will depend on financing and benefits to the combined competitive position.

What are the key credit drivers?

Fallout from MAX grounding. Although we believe the financial damage to Boeing will be largely temporary, there could be long-term impacts on the company’s competitive position. The impact on suppliers will depend on their exposure to the program, what production rate Boeing and tier 1 suppliers maintain, and their current financial condition.

Evolving OEM/supplier relationship. Boeing’s drive to reduce costs, increase its presence in the aftermarket, and bring back certain components in-house is likely to affect the profitability of suppliers over time. It’s also one of the drivers of supplier consolidation.

Financial policy a key factor for larger companies. Share repurchases have moderated somewhat, but shareholder returns remain a key constraint on ratings for larger A&D companies.

Latest Related Research

- The Financial Impact On Boeing Co. From 737 MAX Grounding Is Modest So Far, But The Worst Is Still To Come, April 24, 2019
- Boeing Co.’s 737 MAX Production Cut Should Reduce Cash Impact From Grounding; Ratings Unchanged, April 8, 2019
- Boeing Ratings Not Affected By Second Crash Of 737-8, March 11, 2019
North American Corporate Credit Mid-Year Outlook 2019

Industry Top Trends Update

Autos

Negative rating bias intensifies but not cycle-related for now

What’s changed?

Sales/production levels are unlikely to recover soon. General macroeconomic and industry factors will continue to pressure sales and earnings in 2019.

Deepening negative rating bias. The percentage of ratings with negative outlooks or on CreditWatch with negative implications increased in Q2 driven by pressures in the aftermarket, rising commodity costs, and firm-specific underperformance. Moreover, operational missteps have plagued some tier-1 auto suppliers.

Geopolitical issues have intensified. U.S. profit margins for most automakers will hold steady in 2019 as manufacturers reduce costs, sharpen incentive discipline, and focus on selling higher-profit trucks. But, with China trade relations in question, a rebound in sales or profits in 2020 seems unlikely.

What to look for

Profit margin declines. Though we expect product mix trends to favor higher-margin trucks, the softer outlook for auto sales and production could produce negative earnings surprises for some issuers.

Discipline related to financial policies. Credit metrics for several auto suppliers have weakened somewhat. We will be watching their stance on aggressive expansion, M&A, and share buybacks.

Labor cost pressures could dent long-term profitability. Automakers will look to maintain cost flexibility with the United Auto workers (UAW).

What are the key credit drivers?

Recession. With increased overall odds of a recession 12 months out, declining used vehicle prices, and ongoing geopolitical risks, U.S. automakers face a tough road ahead.

Trade-related risks. Tariffs on imports, or a potential re-emergence of Mexican tariff threats, would weaken automotive demand as most of these costs will be passed on to consumers.

Proactive steps to combat lower profitability. Effective of cost-cutting will be crucial to offset elevated pricing pressure and volume softness, as will cost-sharing of expenses for autonomous and electrification-related technologies.

Latest Related Research

- The U.S. Auto Industry’s Historic Sales Run Will Taper Off Over The Next 12-24 Mont Rating Bias Could Intensify Somewhat, Jul 16, 2019
- In Europe’s Auto Market It’s All About Curbing CO2 Emissions, June 17, 2019
- ESG Industry Report Card: Autos And Auto Parts, May 13, 2019
- Worldwide Auto Sales Will Slump More Than Expected In 2019, May 6, 2019
- Trump’s Tariffs Could Hurt EU Carmakers--Not The Economy, March 26, 2019
- The Future Is Electric: Auto Suppliers And The Emergence Of EVs, Feb. 21, 2019
- 10-Year Retrospective: Changes In U.S. Auto ABS In The Decade Since The Great Re 15, 2019

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Industry Top Trends Update

Building Materials

Credit quality stable despite tariffs and slow start to 2019

What’s changed?

After a slow start, demand is improving. Unusually cold and wet weather and slow housing starts reduced demand for building materials in the first quarter. But weather has improved and construction trends appear to have strengthened. We expect the full year results to be close to 2018 levels, with flat to slightly increased demand and slightly lower overall profitability for most issuers.

The more recent round of tariffs will cause modest margin compression for some issuers. Some building products producers that import from China (toolmakers, plumbing products, HVAC parts) have taken pricing actions to offset the increased costs. But these will take time (two to four quarters) to have an offsetting impact.

Commodity costs will be a tailwind in 2019 as inflation in material costs have subsided. Transportation and labor costs continue to be a headwind. Price increases will blunt some of the impact of tariffs.

What to look for

Outlooks are overwhelmingly stable. Fundamentals in the space point to stable sales and earnings. We see little prospect of upgrades as investment-grade and ‘BB’ names are not likely to deleverage from current levels. Highly leveraged private equity-owned names are using excess funds on small acquisitions and dividends as opposed to reducing debt.

The sector is better positioned to absorb a downturn than at the start of the Great Recession. Investment-grade and ‘BB’ names are larger, more diverse, and more cost-efficient than in the last downturn. Most are not as leveraged, and debt maturities are pushed way out and liquidity is ample. The ‘B’ category is mostly leveraged in the 5x-7x range and has been slow to de-lever while markets are favorable, increasing the risk of excessive leverage if the market turns down.

Acquisition activity, while up from last year, is still muted due to high multiples. Some companies have increased share repurchases but have not incurred new debt to do so. Private equity acquisitions and new issuer activity has slowed considerably, but smaller bolt-on acquisitions are still being done.

What are the key credit drivers?

Construction markets are still reasonably healthy. While new home construction got off to a very slow start in 2019, recent trends indicate that 1.2 million-1.3 million homes could still be built this year. Repair and remodeling has shown growth driven by consumer confidence and low unemployment, while nonresidential and infrastructure spending are flat to slightly up. If markets hold up, we expect 1%-2% volume growth, and 3%-5% pricing growth, but overall margins flat to slightly down due to tariffs and other cost pressures.

Growth and operating performance may have peaked for the sector. Housing starts are constrained at current levels and other building sectors are slow-growth. Labor, transportation, tariffs, and other cost pressures are making any further margin improvement difficult. Still, the slow anemic recovery of the past ten years may still have some legs as we see little that would cause a construction downturn absent a recession.
Industry Top Trends Update

Capital Goods

Macroeconomic uncertainty softens growth prospects

What’s changed?

A more uncertain operating environment. We expect slowing revenue growth in 2019 and 2020 as a weaker macroeconomic outlook, including U.S.-China trade tensions, dampens investment spending. The PMI Index, while still in expansionary territory, has slowed for past three months to 51.7 as of June 2019.

Riskier end-market exposure. Agricultural sector fundamentals are softening due to trade tensions with China and resulting shifts in trade routes in the short term. The auto and electronics sectors are also more vulnerable to trade tensions and supply chain changes.

Acquisitions to enhance portfolio have generally pressured ratings. Recent acquisitions by 3M, Parker-Hannifin, and others have used debt for funding. Capital goods issuers are looking to increase profits in more favorable end markets such as consumer goods and health care, or enhance their products' value propositions.

What to look for

Earnings pressure from slowing revenue and cost headwinds. As revenue growth slows, we think the issuers’ ability to pass on cost increases could diminish.

Exposure to China and weaker end markets (autos, electronics, and commodities).

Changes in supply chain and a potential impact on cost structure. Some capital goods issuers are moving production plants out of China into other locations, which could have a meaningful impact on logistics and costs.

What are the key credit drivers?

A negative ratings bias. 14% of ratings in the sector carry a negative outlook. Downgrades have outpaced upgrades by 2 to 1 so far in 2019.

Aggressive financial policies. Debt-funded M&A could pressure ratings.

The trend of deconglomeration. With large diversified industrial issuers spinning off or selling noncore businesses, their scale, scope, and diversity could weaken, and lower ratings could follow.

Liquidity constraints for weaker issuers. For issuers in the lower end of the ratings spectrum, shortfalls in operating performance or tightening liquidity (including narrow covenant cushion) could drive downgrades.

Latest Related Research

- ESG Report Card: Capital Goods, June 3 2019
Industry Top Trends Update

Chemicals

Rating actions likely to remain mixed through 2019

What’s changed?

Higher risk of a U.S. recession. We have raised the odds of a recession in the U.S. over the next 12 months to 25% to 30%.

U.S. agriculture market challenges. Severe weather in the first half led to weaker-than-expected performance among U.S. agricultural chemical companies. The wet spring shortened the planting season, and we believe the bushels of corn produced in 2019 will be moderately below 2018 levels. Additionally, ongoing trade tensions with China have weighed on soybean prices.

What to look for

Capacity changes in the U.S. and China. New capacity in the U.S. Gulf Coast for olefins and polyolefins will contribute to weakening prices and margins. Meanwhile, China’s push to improve its environmental footprint could impact its domestic capacity and benefit some U.S.-based chemicals producers.

Increased focus on ESG. Companies will increase their disclosure of ESG topics, in part on their own accord to address rising investor interest, but in some cases driven by activists or regulators.

Activist investor pressure. Companies sitting on a hoard of cash, an underleveraged balance sheet, or a portfolio ripe for rationalization, have been popular targets by activists. While rating activity regarding activists in 2019 has thus far been muted, we expect a greater potential for negative rating actions triggered by activist ownership and agitation.

What are the key credit drivers?

Mixed rating actions through the balance of 2019. Thus far, positive rating actions outpace negative ones, driven by a mix of improved operating performance, prudent financial policies, and being acquired by a higher rated entity. Negative actions have primarily been at the lower end of the ratings spectrum and driven by increasing liquidity and refinancing risk.

M&A likely to remain a key theme. Companies will continue to supplement slowing organic growth with acquisitions, particularly while interest rates are low; and will continue to divest noncore businesses and focus on a company’s core competencies.

Trade with China. The ongoing trade war with China, the world’s largest chemicals consumer, could hurt global chemical prices. Additionally, tariffs on key raw materials could squeeze EBITDA margins and impact demand.

Latest Related Research

- Is Targeting U.S. Chemical Companies A Successful Formula For Activist Investors?, June 25, 2019
- ESG Industry Report Card: Chemicals, June 3, 2019
- The Potential For Speculative-Grade/Investment-Grade Crossovers In The North American Chemical Sector In 2019, January 16, 2019
Industry Top Trends Update

Consumer Products

Liquidity and weak growth prospects underpin negative bias

What’s changed?

Ratings outlook. Rating trends have become more negative--largely at the low-end of the speculative-grade rating categories--reflecting refinancing risk, constrained liquidity, unsustainable capital structures, and poor operating performance.

Favorable pricing. Branded goods companies have been successful at passing on inflation to the consumer. Household products and personal care companies have better pricing power and less cost pressures than packaged goods.

M&A has slowed. After elevated transformational M&A in 2017 and 2018, companies have been integrating acquisitions, divesting noncore assets, paying down debt, and making small bolt-on acquisitions.

What to look for

Deleveraging trends in the ‘BBB’ category. ‘BBB’ rated companies that undertook large M&A in 2017 and 2018 are meeting our deleveraging targets.

Private label taking share. Retailers are increasing private label offerings. Meanwhile, the price gap between branded goods and private label has widened because private label has not tried to recoup inflation.

Slowing economic growth. Currently things look good for the consumer--employment, wages, and household net worth are all positive. But we expect U.S. GDP to slow this year and next, which could make it more difficult for companies to accelerate volume growth and sustain price increases.

What are the key credit drivers?

Financial Policies. Given the acquisition activity and debt-financed dividends to equity sponsors, financial policies are key factors affecting credit quality.

Remaining Relevant. Consumers are more fickle and the pace of change has increased because of technology. Companies are remaining relevant through innovation, repositioning, and renovating portfolios, and divesting noncore assets.

Margin Expansion. Better pricing, ongoing cost-cutting, and acquisition synergies should enable companies to grow EBITDA faster than sales over the next year. But slower economic growth puts this at risk.

Latest Related Research

– ESG Industry Report Card: Consumer Products And Agribusiness, May 21, 2019
– U.S. Combustible Cigarette Volume Decline Expected To Accelerate, April 22, 2019
Health Care

Companies shuffle hands as pricing pressure rises

What’s changed?

Increasing M&A Activity. Pharmaceutical companies are seeking to bolster their pipelines while healthcare services companies seek to enhance their competitive positions as uncertainty in industry rises.

Ratings Deterioration Is Broader Based. There have been 16 downgrades versus only six upgrades thus far in 2019. The mix has also become broader based—including more investment-grade and pharma industry actions.

Payor Mergers Heating Up. Major mergers among payors will accelerate the move toward value-based care and change the health care industry paradigm.

What to look for

Developments on the payor front, further pricing pressure. With the recent mergers of payors, such as CVS/Aetna, it will be interesting to see the newly enlarged managed care companies exert their leverage.

Legislative developments. We will soon be entering a presidential election year, so the number of proposals on health care will likely increase. Proposals such as Medicare For All bear watching for potential industry vulnerabilities.

Headline risk. Opioid-related litigation, talcum powder, generic drug price collusion, and Texas v. Azar (Affordable Care Act), to name a few, have had limited ratings impact thus far but we are monitoring them closely.

What are the key credit drivers?

Financial policy. How willing are health care companies to leverage themselves to improve their product pipelines, diversify their service offerings, or increase their market share or geographic footprint?

Competitive positioning/EBITDA margins. The industry is shifting patients to lower-cost, value-based health care, which poses a challenge to service providers to stay competitive and profitable.

Pharma pipeline quality. Depth and diversity in the product pipeline are key to competing in the increasingly uncertain pharmaceutical market. With growing pricing pressure, pharma ratings will depend on the success of the product.

Latest Related Research

– How Business Strength Varies Across the Top 15 Branded Pharmaceutical Companies, June 10, 2019
– When The Cycle Turns: Health Care Subsectors Ranked By Vulnerability To Economic Downturn, April 29, 2019
– Health Care Washington Watch: Which Government Proposals May Affect Ratings?, April 18, 2019
Homebuilders and Developers
Credit quality trends up as the cyclical market peaks

What’s changed?


U.S. homebuilder credit looks resilient to a modest slowdown. The slowdown in sales shows the resilience of homebuilder balance sheets. Homebuilders have benefited from the 7-8 year uptick of the housing market, but have funded growth and shareholder returns with record levels of debt.

Costs and price pressure constrain margins. Labor and land costs have risen, constraining credit metrics thus far in 2019. We expect slightly lower gross margins for the remainder of the year as these pressures persist.

What to look for

Free cash flow gives issuers some options. For homebuilders, boosting free cash flow for debt reduction would support credit measures amid potentially weaker earnings. Share repurchases will also be a factor.

Higher prices hit affordability and volumes, but are key to homebuilder margins. Price support will maintain margins amid persistent cost pressures like rising land and labor costs. Productivity will be difficult to sustain with turnover and a demographic shift in available skills.

Employment supports housing activity, but interest rates can hit prices. As long as the U.S. economy continues to create jobs and boost wages, demand for first-time and move-up homes should persist. That said, higher mortgage rates in late 2018 provided a good indication of the industry’s sensitivity to affordability.

What are the key credit drivers?

The next downturn probably won’t look like the last downturn. Fundamental improvements in market positions and pricing power should combine favorably with less exuberant growth recently to protect homebuilders from a sharp decline in home sales in the event of a downturn. Housing starts remain below trend and below the level of household formation, which likely indicates far less speculative housing activity at the current peak.

Financial policies could drive rating upside. Several issuers face choices between investing in land and lots near a multiyear cyclical peak, returning cash to long-suffering shareholders, or shoring up the balance sheet with cash or debt reduction.

Price risks likely overwhelm volume downside. The steady upward march of home prices against a backdrop of fairly steady volumes could expose U.S. homebuilders to a margin shock if they lower prices or increase incentives to sustain unit sales.

Latest Related Research

- PulteGroup Inc. Outlook Revised To Positive On Continued Deleveraging, Ratings Affirmed. June 12, 2019
- MDC Holdings Inc. Outlook Revised To Positive On Improved Credit Metrics Due To Increasing Revenue And Profitability. June 11, 2019
Hotels, Gaming, and Leisure

Leveraging transactions, rising cycle risk are key exposures

What’s changed?

Hotel margin pressure may get worse. RevPAR in the U.S. is slowing more than we anticipated six months ago, and is up just over 1% year-to-date, which is at the low end of our 1%-3% forecast for 2019. Wage and other cost inflation is on the rise, pressuring margin for hotel owners, which bear the burden of hotel costs.

VIP weakness drives lower Macau growth. We lowered our Macau gaming revenue growth forecast to 0%-4% from 4%-8% because of more severe declines in VIP gaming revenue than we expected. Mass market growth continues to be strong.

Cruise lines face some choppy waters. An unexpected policy change limiting travel to Cuba, as well as voyage disruptions for some brands, could pressure yields in 2019. Geopolitical and economic headwinds, and capacity increases are also hampering European bookings.

What to look for

Leveraging transactions. M&A and LBOs funded by private equity and strategic buyers is increasing, driven by a desire for scale and real estate and by other business separations or acquisitions that result in assets available for purchase. Gaming and lodging, and sports and recreation sectors are most impacted in 2019, as discrete assets become available and if they fit well with other asset portfolios.

Rising recession risk. Our economist recently raised the probability of recession over the next 12 months to 25%-30%, reflecting trade tensions and fading fiscal stimulus. Discretionary sectors like leisure fall farther than the economy in a recession and rebound faster in a recovery.

Gaming operators pursue Japan licenses. We expect competition for Japan’s integrated casino resort licenses to heat up, as operators pursue what could be a large gaming market. However, we believe 2020 is the earliest Japan would begin awarding licenses.

What are the key credit drivers?

Leveraging M&A. The recent trend in ratings activity since 2018 has been negative, driven mostly by leveraging M&A and other transactions, and company-specific operating underperformance.

Consumer discretionary spending. About 70% of ratings outlooks remain stable, primarily because consumer discretionary spending is holding up in a still-good economy, and many issuers’ leverage remain inside downgrade thresholds.

Gaming real estate sales. Continued gaming real estate sales reduce companies’ operating leverage and will drive cash flow volatility if gaming revenue weakens and promotional spending increases.

Latest Related Research

- ESG Industry Report Card: Leisure, May 21, 2019
- Could A 2019 Slowdown in U.S. Lodging Turn Into a 2020 Downturn, Feb. 19, 2019

Outlook Distribution

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Rating Distribution

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Seasonally Strongest Quarter as a Percentage of Annual EBITDA (stock comp adjusted)
Industry Top Trends Update

Media and Entertainment

Preparing for key over-the-top (OTT) service launches

What’s changed?

Disney’s acquisition of Twenty First Century Fox. Disney finally closed the acquisition in March. Besides getting majority control of Hulu, Disney acquired key 21CF assets, including its studio and extensive film and TV library, which will bolster Disney’s direct-to-consumer (DTC) strategy.

Disney gets operational control of Hulu. Disney bought AT&T’s stake and gave Comcast a put option. Hulu, with its depth and scale of content, can serve as Disney’s general entertainment subscription video on demand (SVOD) service, in direct competition with Netflix.

Viacom acquires Pluto TV. This gives Viacom a scaled advertising-based video on demand (AVOD) platform. AVOD could represent an alternative to the SVOD strategy for those media companies with weaker IP.

What to look for

OTT launches. Over the next year, Disney, Warner Media, and NBCU will launch SVOD offerings into an already crowded DTC universe. We expect companies will experiment for the right combination of branding, content, and pricing.

Another round of M&A. Following two years of major M&A, we expect additional consolidation in 2019 and 2020 as the remaining “free radicals” seek to partner with or to be acquired by other media companies. Additionally, larger media companies may acquire film/TV libraries to bolster their SVOD offerings.

Video content bubble. The content bubble shows no signs of ending as all SVOD services will need original content in order to grow subscribers. Production costs will continue to escalate due to both scarcity of resources and more elaborate and higher quality production. While its measurement will become more obscure, returns on individual pieces of content will very likely decline.

What are the key credit drivers?

Success of OTT launches. While the industry will be quick to pick winners and losers, we believe it will be years before we can truly judge the success of these SVOD and AVOD platforms.

Increasing pressure on credit ratings. We anticipate declining earnings and cash flow for most media companies, reflecting increased investments in exclusive content (original programming and sports rights) and the loss of syndication and licensing revenues, until DTC services reach scale and begin generating positive cash flow. Longer term, margins and cash flow are unlikely to rebound, meaning leverage thresholds would need to be reset or credit ratings lowered.

Latest Related Research

- The U.S. Ad Market Is Healthy With Growth Expected In 2019, But Current Trends Are Fragile, July 12, 2019
- How Does S&P Global Ratings Calculate Leverage For U.S. Diversified Media Companies? (2019 Update), June 20, 2019
- The Future Of Retransmission Revenue For Broadcast Television, June 6, 2019

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### Merchant Power

#### Load-to-generation matching strategy gains traction

**What’s changed?**

**The sustainability of retail load to wholesale generation matching.** Despite strong margins, competition is limited for incumbent players and cash flow conversion is high.

**The PJM market is oversupplied.** Slightly weaker demand forecast and incremental transmission weigh negatively on most of the PJM interconnection zone. While retirements have accelerated, so have additions—about 15.5 GW of capacity cleared in the 2018-2022 timeframe relative to 13 GW that we expect to see retire.

**The ERCOT market’s reserve margin widened** due to expectation of higher solar and wind installations. Yet, growth appears strong and the steep power curve backwardation post-2021 could still lift. Near-term prices are affected by mildness of weather.

**What to look for**

**Energy price reforms in PJM.** FERC has approved PJM’s proposal to allow fast-start resources to set locational marginal pricing (LMP). While likely on a slower timeline, the operating reserve demand curve proposal could still be approved. Combined with a proposal to allow baseload inflexible units to set LMP, these measures could result in a $3.5-$4/MWh lift to energy prices in PJM.

**Wind generation installations after 2020.** Years 2019 and 2020 are likely to be strong as orders are placed ahead of construction deadline. Key drivers for post-2020 are state renewable targets, corporate power purchase agreements, coal/nuclear closures, and cost curve declines (decline in the cost of electricity is significant).

**State legislative proposals to procure clean capacity for utilities in PJM.** States like Illinois and Pennsylvania have proposed House and Senate bills that would support procuring clean capacity. If approved, this would impact PJM’s capacity construct substantially.

**What are the key credit drivers?**

**The ability to ratably hedge economic generation.** In the short to medium term, ratable hedging predictability allows a company time to adjust its capital structure.

**Ability to match retail load to wholesale generation.** In the long term, this appears a sustainable strategy and growth model.

**The ability to diversify across markets.** Markets like ERCOT and California show strength (market prices have strengthened even as utility counterparty risks exists). While PJM’s energy markets could strengthen, our capacity price expectations are bearish.

**Latest Related Research**

- Unregulated Power: S&P Global Ratings’ Evolving View Of Retail Power, May 14, 2019

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**Outlook Distribution**

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Industry Top Trends Update

Metals and Mining

U.S. tariffs don’t help as steel and aluminum profits crater

What’s changed?

Supply-demand imbalances cloud visibility. Supply constraints in iron ore are raising earnings for miners at the expense of steel producers amid weaker steel demand. A similar margin squeeze is on aluminum producers, facing high alumina input costs and low primary aluminum prices.

U.S. tariffs have done little for steel and aluminum. Windfall earnings were fleeting in 2018, reflecting a cyclical rebound in prices. Integrated steelmakers are investing heavily to improve competitiveness, yielding negative cash flows, while mini-mill competitors expand output and extend their cost advantage.

Miners plot their next moves after cleaning up balance sheets. Good cash flow in 2018 provides options for investment or shareholder returns. We expect mining companies will use ample cash balances to bolster reserve lives amid steady demand, but these multiyear investments are increasingly difficult and risky.

What to look for

Competitive positions are being recast in the gold sector. We believe recent M&A among gold miners will trigger a reshuffling of assets among issuers. Large producers will try to improve efficiency by selling assets to smaller companies, which have difficulty replacing reserves to sustain production.

Lower U.S. dollar and interest rates support metal prices, if China holds up. Gold miners should get a boost as prices respond favorably to geopolitical risks and lower U.S. interest rates. Producers of base metals like copper and nickel could also get a boost, but only if demand from China holds up through trade friction.

Imports and inventories signal weakness. Steel imports into the U.S. are down 7%-8% year-to-date in 2019 and LME aluminum inventories appear remarkably tight, but prices for both metals have dropped 20%-30% over that same period.

What are the key credit drivers?

Big plans for steelmakers. Steel and aluminum producers in the U.S. face deteriorating cash flow with which to fund defining investments. Follow-through on large projects will determine near-term financial performance and the long-term sustainability of competitive positions.

Miners partner to develop reserves. The continual need to replenish reserves is pushing miners into partnerships to reduce risk or improve operational efficiency.

Thermal coal producers harvest cash and prune assets. Thermal coal producers will reinvest minimally to sustain operations. Bankruptcies and defaults will likely persist as most assets eventually hit a demand wall when power-plant customers switch to natural gas, with returns to shareholders as long as cash flows enable.

Latest Related Research

– Global Trade At A Crossroads: Section 232 Tariffs Leave Dents In U.S. Aluminum Credit Quality, April 1, 2019
– Research Update: U.S. Steel Corp. Outlook Revised To Stable From Positive On Higher Capex And Share Buybacks; Ratings Affirmed , May 30, 2019
– Teck Resources Ltd. Upgraded To 'BBB-' From 'BB+' On Conservative Leverage; Outlook Stable, March 21, 2019

Outlook Distribution

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Sector Forecasts (2019)

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Industry Top Trends Update
Midstream Energy
Stable outlook, but emerging risks could present challenges

What’s changed?

Influence of private money is creating uncertainty for credit quality and ratings. Private equity firms and infrastructure funds have filled funding gaps, resulting in more complex organizational structures and higher financial leverage.

Risk-sharing on large projects. Capital spending is down and midstream companies are looking to share the risk on large pipeline projects with strategic and financial players. Excess cash flow has improved, allowing companies to self-fund the equity portion of organic growth, a trend we expect to continue.

Possible take-private transactions could pressure ratings. IFM Global Infrastructure Fund’s acquisition of Buckeye Partners L.P. and intention to partly fund the transaction with debt will likely have ratings implications, and raises broader questions on take-private trends in the industry.

What to look for

Capital allocation for significant excess cash flow. We will be watching capital deployment, share buybacks, distribution growth, and debt reduction. We believe allocation decisions could be the difference between stronger credit profiles and less financial flexibility over time.

M&A opportunities and selective asset divestitures. We believe the next step in the midstream industry lifecycle is asset rationalization. Proceeds from asset sales have reduced debt and funded growth projects, which supported credit quality.

Increased regulatory or environmental risks. Permitting delays and heightened social opposition to new pipelines in some cases has impacted timing and construction costs. As a result, the pipeline already in the ground is more valuable.

What are the key credit drivers?

Leverage and excess cash flow trends. We expect debt to EBITDA to improve for investment-grade issuers with an average ratio of about 4x, and to be somewhat flat for speculative grade issuers at about 4.5x. We forecast excess cash flow to grow across the industry, which is generally supportive of credit quality.

Financial discipline and future strategy. Balancing capital spending, shareholder needs, and growth strategies will be key differentiators.

Scale, scope, and diversification. Increased scale and geographic and asset diversification is becoming a more important credit driver as companies look to compete in high growth areas or for access to export markets along the U.S. Gulf Coast. We believe larger asset footprints provide more optionality for customers and are more likely to attract strategic partners.

Latest Related Research

- ESG Industry Report Card, June 3, 2019
- Issuer Ranking: North American Midstream Companies, Strongest To Weakest, May 2, 2019
Industry Top Trends Update

Oil and Gas

OPEC cuts crude production while shale output grows

What’s changed?

Crude has been volatile and needs OPEC support; gas prices weaker. Crude prices have wavered, but OPEC’s resolve to support oil prices with production cuts has not. Without cuts, oil prices would be much lower considering the continued growth of U.S. shale production, particularly in the Permian. Natural Gas prices have slumped.

Drillers and oilfield services still under pressure. A fundamental shift has occurred in the oil field services space that we believe has been caused by permanent upstream efficiencies and restraining capex to live within cash flow.

Refining margins likely to strengthen in 2H 2019. First-half 2019 margins have been depressed and below our base-case view. IMO 2020 will lead to low sulfur fuel oil blends and diesel cracks for complex refineries recovering, especially in the U.S., in the second half and into 2020.

What to look for

Will OPEC+ continue to support prices? Compliance with cuts has been over 100%. The recent 9-month extension of production cuts will remain important to underpin crude prices, absent tightening supply-demand balances.

Permian Basin production growth. With pipelines being added, the region should have enough take-out capacity to support production growth over the next several years. Questions remain: Can producers grow while maintaining positive free cash flow and funding shareholder returns.

Restructuring risk. Smaller and lower rated oilfield services and E&P companies may lower their fixed costs, namely interest, by restructuring financial obligations or buying back debt below par.

What are the key credit drivers?

Oil/gas prices. At current oil prices, most E&P companies, especially those in the Permian, will deliver cash flow metrics in line for the rating. For heavy weighted natural gas producers, we expect low natural gas prices to result in lower production and weaker metrics.

Financial discipline. For majors and shale players alike, effective capex spending and contained shareholder returns and M&A are key.

Capital market access. It has been a while since we have seen a deep-speculative-grade company issue unsecured debt. The sector yields are trading very wide relative to the rest of other industries. This is noteworthy when considering the sector debt maturities begin to increase over the next couple of years.

Latest Related Research

- Another Brick In The Wall For The U.S. Oil And Gas Industry As Debt Maturities Build Through 2024, July 18, 2019
- Surging Distress In Oil & Gas Sector May Foreshadow A Second Reckoning, July 12, 2019
- ESG Industry Report Card: Oil And Gas, June 3, 2019
Industry Top Trends Update

Real Estate

Late cycle sees growing negative bias

What’s changed?

Low interest rates help REITs maintain low costs of capital. Increasing headwinds for the U.S. economy will likely push the Fed to lower interest rates this year.

Returning to the capital markets. U.S. rated REITs raised approximately 57% more capital for the year-to-date period ended May 21 than during the same period in 2018. Several issuers also added commercial paper programs.

Negative rating actions have outpaced positive actions. While we expect the pace of positive actions to subside amid somewhat softening REIT fundamentals, the majority of rated REITs are well positioned for steady revenue and profit growth.

What to look for

Nimbleness in adapting to secular changes and the impact of disruptors. While the stress on retailers is abating somewhat, there are still challenges, particularly for ‘B’ mall operators. Another potential disruptor is the rapid growth of co-working concepts within the office sector, such as Wework Co.

Development pipelines for office, multifamily, and industrial REITs. REITs have resorted to growing through development as pricing on high quality assets remains expensive. We will monitor progress in completion and funding.

Rising leverage. Some well positioned companies may seize growth opportunities and stretch leverage metrics, while others may invest more in capital expenditures. That said, many rated REITs have deleveraged in recent quarters and have built some balance sheet capacity. However, most have not revised financial policies and are probably saving some dry powder to acquire assets when (and if) cap rates rise.

What are the key credit drivers?

NOI growth. We expect stable but decelerating NOI growth will support ratings, limiting downgrades for most.

Financial policies. More aggressive financial policies to fund acquisitions or development with a greater portion of debt could pressure ratings, as well as continued pressured from tenant risk, particularly in the retail or office sector.

Industry fundamentals. Only 4% of our ratings have positive outlooks, while 8% had negative outlooks. While negative rating actions outpaced positive ones thus far in 2019, 87% of the ratings had stable outlooks as of July 17, 2019. We expect ratings upside to be limited given slowing fundamentals and little apparent interest in further deleveraging.

Latest Related Research

- ESG Industry Report Card: Real Estate And Homebuilders/Developers, Jun 3, 2019
- REITrends: Back In The Capital Markets And Largely Well Positioned For Opportunity, May 31, 2019
- Disruption In Real Estate: Co-Working Space Connects With An Untethered Workforce, April 11, 2019
- REITrends: U.S. REITs Remain Well-Positioned For 2019 Despite Less Favorable Macroeconomic Backdrop, March 11, 2019
- U.S. Retailers Will Need A Better Footing As Another Difficult Year Digs In, Feb 25, 2019
Regulated Utilities
Coal less appealing; California healing?

What’s changed?

Negative credit bias. A relatively high percentage—about 26%—of all North America utilities either have a negative outlook or are on CreditWatch with negative implications.

Weak financial measures. Following the 2018 tax reform, utility funds from operations (FFO) to debt has weakened, on average, by about 150 basis points.

California’s unprecedented challenges. The first half of 2019 was extraordinarily challenging for California’s utilities. Catastrophic wildfires and the lack of regulatory predictability led to the bankruptcy filing of PG&E and downgrades for the state’s other electric utilities.

What to look for

Sales slump. Conservation and increasing distributed generation have kept sales growth generally flat, and some companies have sought M&A as a remedy. Generally, this has resulted in weaker credit quality and negative outlooks.

Environmental risks. Utilities with significant coal generation face higher regulatory scrutiny and environmental risks. Coal ash recovery efforts highlight the environmental risks.

What are the key credit drivers?

Passage of California’s Assembly Bill 1054. This law may lead to a stabilization of credit quality for California’s regulated investor-owned electric utilities. Important near-term developments include the utility’s receiving a valid safety certification and the determination to participate in a newly created insurance fund.

Large capital projects. While capital spending remains robust at about $140 billion annually. The vast majority is intended for smaller, more manageable projects, but some large, longer-term capital projects face higher risks. Companies building new nuclear generation, liquefaction natural gas projects, and interstate pipelines have faced project delays and higher costs that could affect credit quality.

Safe operations. Increasing regulatory scrutiny and risks exist for utilities in the face of gas explosions, electrical blackouts, wildfires, and other severe service interruptions.

Latest Related Research

– Credit FAQ: The Looming California Wildfire Season Prompts An Examination Of Investor-Owned Utilities’ Risks, June 7, 2019
– U.S. And Canadian Regulatory Jurisdiction Updates And Insights, May 14, 2019
– For Canadian Utilities, Credit Quality Will Depend On Executing Key Strategies, April 11, 2019
Industry Top Trends Update

Retail and Restaurants

Winners emerging, weaker players closing up shop

What’s changed?

A growing divergence between stronger and weaker players. Stronger retailers including Kohl’s Corp, Macy’s, Albertson’s, and Hudson’s Bay are stabilizing sales and reducing debt. Large, well-positioned retailers will continue to take market share from struggling players.

Weaker players face significant challenges. Specialty retailers continue to see declining customer traffic and promotional pricing pressure, resulting in unsustainable capital structures or narrowing liquidity. We recently lowered the ratings on Ascena Retail Group, Belk and J.Crew Group into the 'CCC' category, reflecting a high risk of default in the near term.

High levels of default and distressed debt have not eased. Currently about 15% of rated issuers are in the 'CCC' category, and four have defaulted so far in 2019. We expect that pace to continue for the balance of the year.

What to look for

Margin pressure from rising tariffs. We are seeing particular pressure on home furnishing retailers, discounters, and art and craft players, among others.

Profit pressure from transformation from brick-and-mortar to omnichannel. Retailers are investing heavily in technology and warehouses to build out e-commerce infrastructure. This expensive endeavor is generating losses, even for the biggest retailers, which they are hoping to absorb in the near term.

The restaurant sector remains more resilient vs. retail. We’re seeing a higher level of M&A/leveraged buyouts, as well as new issuer activity. The rise of e-delivery could create more competition.

What are the key credit drivers?

Material or sudden drops in store traffic. Competitive pressure or slowing consumer spending could also pressure ratings.

Declining profitability due to cost headwinds. Higher wages or greater-than-planned promotions could hurt cash flow and exert pressure on ratings, particularly for speculative grade North American issuers given limited operating cushion.

Rising labor and freight costs in Canada are also pressuring margins, somewhat offset by modest inflation at grocery retailers.

Financial policy shifts. The appetite for material debt-funded acquisitions or share repurchases could also pressure ratings.

Latest Related Research

- ESG Industry Report Card: Retail, June 3 2019
- U.S. Retailers Will Need a Better Footing As Another Difficult Year Digs In, Feb. 25, 2019
- Credit FAQ: How Will CVS-Aetna Affect Retail and Health Care (And Vice Versa), Feb. 21, 2019
Industry Top Trends Update

Technology

Political risks and aggressive financial policies cloud outlook

What’s changed?

U.S.-China trade uncertainties are weighing on tech companies as certain products imported from China are now subject to 25% tariffs, up from 10% previously. Threats of tariffs on smartphones, servers, CPUs/GPUs, etc., and a ban on sales to Huawei by U.S. suppliers pose significant downside risk to the sector.

Elevated semiconductor inventory levels, especially in memory, as a result of trade uncertainties and lower demand from hyperscalers led us to reduce semiconductor market growth expectations to a mid-teens % decline in 2019, down from a 7% decline forecasted in February.

Weaker IT spending environment: We now expect overall IT spending growth to lag that of global GDP in 2019, versus our prior expectation for IT spending near global GDP forecasted in November 2018, due to lingering trade concerns, overall weakness in hardware sales, and a shrinking semiconductor market despite the resilient enterprise software environment.

What to look for

Trade truce or escalation? U.S. and China agreed to reopen trade talks, suspend new tariffs and the U.S. partially lifted the Huawei ban while trade discussions continue. A truce between the two countries will certainly lift business optimism. On the other hand, an escalation that leads to additional tariffs will worsen an already weak semiconductor market and hurt major OEMs, contract manufacturers, and parts suppliers.

Large-Scale M&As: Sizable M&A in the software and fintech areas were plentiful in 1H19. Favorable credit environment and significant financial sponsor dry powder could facilitate more tech M&A in the back half of the year.

Software eats the world? Traditional hardware vendors are being challenged by performance attribution to software rather hardware. Hardware companies, especially smaller ones with limited R&D budgets, could see their market share erode.

What are the key credit drivers?

Continued favorable credit conditions are conducive to debt-financed M&A, shareholder returns, and LBOs, which would further weaken credit metrics.

Ratcheting down aggressive financial policies: We believe it’s a question of when, not if, the economic cycle will turn. Companies that can withstand such a downturn, either through resiliency of their product portfolio or prudent balance sheet management, will be able to protect their creditworthiness while those who lack these protections could see downgrades.

Latest Related Research

- The Tech Scan: Why Credit Quality Is Faltering In The U.S. Tech Sector, July 8, 2019
- Bans On Huawei Will Hit Tech Harder Than Telecom, But Not Enough To Move The Ratings, June 12, 2019

S&P Global Ratings

July 25, 2019 32
Industry Top Trends Update

Telecommunications

Evolving competitive landscape

What’s changed?

Verizon outlook revised to positive. Solid service revenue trends in its wireless business, coupled with debt reduction from free operating cash flow and greater clarity on its long-term financial policy could result in an upgrade in 2020.

Sprint CreditWatch revised to developing. While the merger with T-Mobile is still on track, we could lower the rating on Sprint due to earnings pressure if the deal is rejected by U.S. regulators, depending on our view of likely support by SoftBank.

Video cord-cutting accelerating faster than we expected. Satellite TV providers Dish and DIRECTV lost 11% and about 6%-7% of traditional subscribers, respectively, in Q1’19, while cable operators benefitted from demand for high-speed internet.

What to look for

Outcome of T-Mobile’s acquisition of Sprint. If the deal is approved, a 3-player market could reduce the competitive intensity of the wireless industry, resulting in lower churn and some price stabilization longer-term. If the deal is blocked, competitive pressure could intensify, reversing some of the positive service revenue trends that operators are currently experiencing.

Spending on upcoming spectrum auctions. Overall, we expect Verizon will be more aggressive than AT&T, which is working through the integration of Warner Media while trying to navigate secular industry pressures in several business lines and manage a massive debt burden. There is also the potential for cable operators to purchase spectrum licenses. In Canada, bidding will be dependent on 3.5 GHz spectrum auction rules—whether there is a cap or set-asides.

The evolution of cable’s wireless strategy. In an era of unlimited data plans and rising data consumption, cable providers could become more aggressive in acquiring spectrum, forming partnerships, or negotiating deeper wholesale agreements, to drive better economics particularly in the event that 5G fixed wireless becomes more of a competitive threat.

What are the key credit drivers?

Shifting competitive dynamics. Converging technology, shifting consumer preferences and M&A will continue to shape the competitive landscape as the lines between cable and wireless begin to blur.

Capital allocation strategies. Verizon, AT&T, and Comcast’s deleveraging plans must be balanced with the need for long-term investment in the business. In contrast, many cable providers are using cash flow for shareholder returns to maintain leverage within targeted ranges in a growth environment.

Latest Related Research

– While AT&T And Verizon Focus On Leverage Improvement, Their Strategies Continue To Diverge, May 22, 2019
– Sprint Corp. CreditWatch Implications Revised To Developing; Secured Debt Rating Placed On CreditWatch Negative, May 22, 2019
Industry Top Trends Update

Transportation

Will rising risks derail transportation?

What’s changed?

**737 MAX grounding** is hurting many large U.S. and Canadian airlines, squeezing capacity, and adding to costs, though probably not enough to affect ratings.

**U.S. consumers keep spending but corporations are turning cautious.** Transportation sectors that serve the industrial sector, such as U.S. and Canadian railroads, are seeing softer demand, reflecting trade uncertainty and slowing GDP growth. But airlines continue to report healthy revenues.

**U.S.-Iran confrontation risks.** Although oil prices have been fairly stable so far, an escalation of tensions in the Persian Gulf could unsettle global energy markets.

What to look for

**Trade negotiations remain a wild card.** The on-again, off-again U.S.-China trade talks, threat of U.S. tariffs on auto imports from Europe, and more uncertain prospects for U.S. ratification of the USMCA are a drag on business confidence. And escalation would hurt most transportation sectors to some extent.

**Financial policy a key variable.** Large railroads and airlines have spent billions on share buybacks in recent years. Will they scale these back if earnings falter, as most managements claim they would?

**Fuel prices likely to become more volatile.** Even absent geopolitical risks, fuel prices are likely to spike by the fourth quarter as new global shipping fuel regulations kick in. Airlines are most at risk, as few hedge fuel.

What are the key credit drivers?

**As always, it’s the economy.** Slowing U.S. and Canadian economies are likely to cool demand; the only question is how much and how will companies respond.

**Fuel prices have differential impacts.** Some sectors, such as railroads, levy fuel surcharges under customer contracts, while others, such as airlines, seek to raise fares to offset more expensive fuel. So far, the consolidated U.S. airline industry has done so fairly well, but a softer economy could make that more challenging.

**Labor costs are ratcheting upwards.** Long-term shortages of some key employee groups (airline pilots and mechanics, truck drivers), low unemployment, and union bargaining leverage are pushing up pay, a concern when the cycle turns.

Latest Related Research

- Boeing 737 MAX Accidents Leave A Trail Of Uncertainty For Airlines And Aircraft Leasing Companies, March 14, 2019
- How Grounding Boeing 737 MAX Aircraft Could Affect Canadian Airlines’ Credit Quality, March 14, 2019
- Credit Conditions North America: Trade Tensions Cloud The Outlook, June 27, 2019

Outlook Distribution

- **17%** Negative
- **27%** Stable
- **6%** Positive

**Ratings Statistics (Last 12 months)**

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**Sector Forecasts (2019)**

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**EBITDA Margins**

- Package express
- Leasing
- Logistics
- Freight railroads
- Trucking
- Airlines
- Shipping
Industry Top Trends Update

Transportation Project Finance

Performance in line with expectation but new risks emerge

What’s changed?

**Not our stable outlook.** The only downgrade so far this year was driven by the downgrade of the construction counterparty.

**Increasing weather-related impacts.** While the traffic and revenue performance of North American toll roads was better than our expectation, the traffic in 2018 was weakened by weather events; e.g. Hurricane Florence impacted the traffic on Virginian toll roads.

What to look for

**Above-GDP revenue growth.** Traffic growth for North American roads remains below GDP growth driven by maturity of assets or strategy of sponsors. However, we expect revenue growth to be well above nominal GDP growth on account of above-inflation toll increases permitted under concession agreements.

**Limited but diverse activity.** With no major movement on the U.S. Infrastructure bill, we expect limited brownfield and greenfield transportation opportunities for the rest of 2019. However, we are seeing greater activity in airport, rail, and port segments.

**Increasing relevance of ESG.** Especially E-related factors impacting traffic and revenue performance of toll roads.

**Strong truck traffic performance** despite the concerns over economic slowdown.

What are the key credit drivers?

**Toll elasticity.** Ability of toll roads and parking garage operators to continue to pass on above-inflation-rate increases in toll or parking rates to users without higher than expected elasticity.

**Generally stable performance for availability-based projects.** However, as can be seen from the number of downgrade and negative outlook revisions, two credits were impacted by rating action on a construction firm.

**Contractors under pressure.** There has been higher risk transfer from the public sector to private entities (construction and operation contractors), which is pressuring the margin and balance sheet of these entities and thereby increasing the project’s credit risk profile.

**Technology disruption,** including the growth of ride-sharing and its impact on airports’ parking revenues and parking garage operators.

Latest Related Research

- Request For Comment: Methodology For Assessing Project Finance Debt Instruments With Deferrable Features, Such As Those Issued Under TIFIA, May 23, 2019
- Why The Transportation Sector Is On A Fast Track To Get Greener, May 10, 2019
- Relevant Measures Of Insurer Creditworthiness When A Transaction Relies On Credit Enhancement Or Collateral Support, Jan. 14, 2019