FEATURE STORY

Gauging Credit Risk for 2024

BY BILL MAYER

The credit risk panel at SFNet's 79th Annual Convention focused on challenges such as consumer headwinds, the higher cost of capital, looming refinancing deadlines, and the prospect of more downgrades, bankruptcies and defaults. Overall, though, panelists were optimistic about credit appetite and the ability to negotiate risk through tighter deal structures and more in-depth borrower and sector analytics.

TITLED "CREDIT RISK IS FRONT AND CENTER," THE NOVEMBER 16 EVENT BROUGHT TOGETHER:

- **JOYE LYNN**
  Wells Fargo Capital Finance

- **COLEIGH MCKAY**
  Regions Bank

- **LOUIS NATALE**
  White Oak Commercial Finance

- **MEGAN NEUBURGER**
  Fitch Ratings

- **BILL MAYER**
  Tiger Capital Group

Ratings Trends

Megan Neuburger kicked off the discussion by highlighting trends in Fitch Rating's corporate, speculative grade-rated portfolio. In the first half of 2022, she said, ratings improvements were widespread due to the continuing pandemic recovery. But in the second half of 2022, credit performance among speculative-grade issuers in the portfolio began to deteriorate, relative to their investment-grade peers. As the Fed kicked off its tightening cycle, Neuburger explained, high-yield issuers had less financial flexibility and more floating-rate debt.

The percentage of issuers with a negative outlook or watch also started to creep up in this timeframe. Relative to historical levels, this number has now reached a "fairly high" 18 percent. "If you look back to those early borrowers in 2019, about 10 percent of this portfolio would typically be on a negative watch or outlook," Neuburger noted.

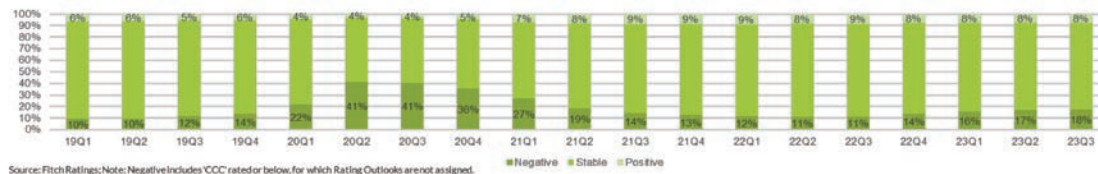
But context is everything. Given the previously high levels of liquidity and credit quality in lenders' portfolios, the current correction is more likely a return to normalcy for asset-based lending, in the view of Joye Lynn of Wells Fargo. "Our credit appetite still remains incredibly strong, albeit I'd say more disciplined," she said. "But we're doubling down on our underwriting standards. Our underwriting timeframe is taking a bit longer, not only on the collateral side, but also on the financial side."

In addition to downgrade/upgrade trends, Wells Fargo is paying close attention to borrowers' liquidity as well. Neuburger listened with interest to Lynn's remarks on credit appetite. "I was just really happy to hear that you're still leaning in, albeit with discipline," she said. "The refinancing environment is the other big thing we're watching with some of these issuers."

Fitch Ratings' Speculative Grade Rating Trends

Fitch Speculative Grade Rated U.S. Corporates Downgrades/Upgrades

Fitch Speculative Grade Rated U.S. Corporates Rating Outlook Distribution



Sectors and the Consumer

Credit risk is a moving target given the fluidity of the current macroeconomic environment. Louis Natale of White Oak pointed to a consistently important variable in the equation—consumer spending habits. Today's pullbacks, he said, could mean that "some consumer-facing companies will start experiencing issues." He also encouraged the audience to watch for the "trailing effects" of different marketplace shifts—for example, sluggish spending on cars and furniture causing problems for whole ecosystems of suppliers.

Neuburger provided a slide showing eight particular sectors—Fitch Ratings covers about 30 in all—with non-neutral outlooks. Global aerospace/defense was the sole sector with an "improving" outlook for 2024; the rest fell into the

Sectors with Deteriorating or Improving Outlooks: Fitch's Preliminary View for 2024

Region	Sector	Sector Outlook June 2023	Sector Outlook 2024
Global	Aerospace & Defense	Improving	Improving
Global	Shipping	Deteriorating	Deteriorating
North America	Building Products & Materials	Deteriorating	Deteriorating
North America	Utilities, Power & Gas	Deteriorating	Deteriorating
North America	Leverage Finance	Deteriorating	Deteriorating
North America	US Real Estate - Equity REITs	Deteriorating	Deteriorating
North America	US Retailing	Deteriorating	Deteriorating
North America	US Technology	Deteriorating	Deteriorating

Source: Fitch Ratings

"deteriorating" bucket. They included global shipping and, for the North American region:

- building products and materials
- utilities, power and gas
- leverage finance
- U.S. real estate, equity REITs
- U.S. retailing
- U.S. technology

These sectors represent about 20 percent of Fitch's total, Neuburger noted. "If we had looked at this chart in June of this year, we would have seen about 40 percent of sectors on deteriorating," she said. "So the picture has gotten a bit better."

With respect to U.S. retailing, the half-full view is that Teflon U.S. consumers will keep on supporting retailers' cyclical business models. On the other hand, Neuburger said, "you're still paying a lot more for that basket of goods and services today than you were in 2020 or 2021. At a certain point, the consumer is going to show weakness."

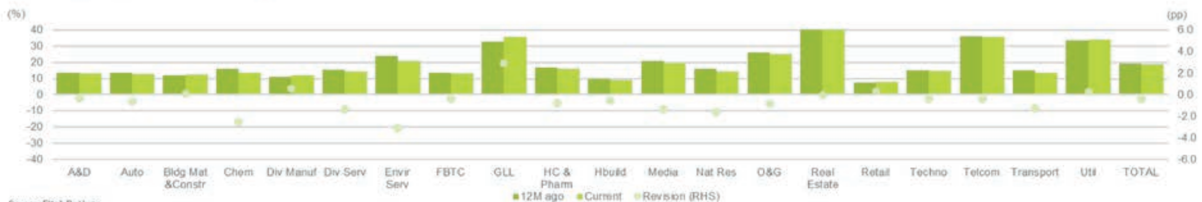
[NOTE: In a Dec. 1 non-rating action commentary, Fitch said it "expects 2024 U.S. retail volumes to decline at a low single-digit rate, particularly in discretionary categories." It cited factors such as:

- moderating consumer health and sentiment
- reduced consumer savings
- rising consumer debt levels
- climbing interest rates, and
- the cumulative impact of recent inflation.]

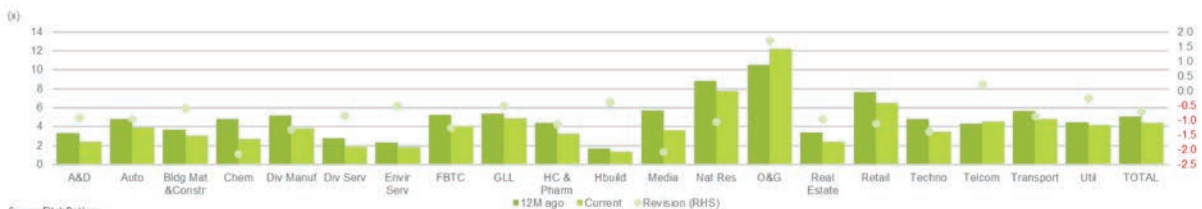
Meanwhile, noted Coleigh McKay of Regions Bank, the healthcare industry continues to struggle with persistent labor and wage pressures, especially those associated with doctors and nurses. Lenders also should pay close attention to leverage and cap ex trends among borrowers in technology,

Fitch Speculative Grade Issuer Forecast Evolution

Fitch Aggregate EBITDA margin 2024 Forecast Evolution



Fitch Aggregate Interest Cover 2024 Forecast Evolution (EBITDA/Cash Interest Paid)



media and telecom, he said, giving the example of telecoms spending heavily to rollout rural broadband. “The current environment is going to separate the really good operators versus the ones that are just muddling through,” McKay said.

He also called attention to the rate-sensitivity of commercial real estate, where some borrowers are headed for a refinancing wall. “Office and multifamily are going to be having some issues going forward, so we’re probably not going to see a lot of leaning in there,” McKay said. “Housing and building is going to be driven by how well the consumer holds up. It’s one of those wait-and-see areas.”

Credit Metrics

Midway through the presentation, Neuburger showed a slide with forecast evolutions (current vs. 12 months ago) for high-yield, speculative-grade issuers. One chart focused on aggregate EBITDA margin, the other on aggregate interest cover (EBITDA/cash interest paid). “From a forecast perspective, things are getting incrementally worse for these high-yield issuers, but not terribly so,” she told the audience. “The picture looks a bit worse from a coverage perspective than from a margin perspective, which is not surprising given that this is a high-yield population.”

Many of the issuers have a substantial amount of variable-rate debt in their capital structures. Fitch’s forecast at the time of the event called for one additional Fed hike this year, with no additional rate cuts until the middle of 2024. The ratings agency, according to that forecast, expects the Fed to keep the policy rate in restrictive territory for several years to come, creating additional challenges for issuers with maturing, fixed-rate debt. “They’re going to need to refinance,” Neuburger noted.

Against this backdrop, some banks have ramped up their provisions as though they were getting ready for an impending storm. While panelists were sanguine about credit appetite, they described pivoting to better assess and adjust to risk. Metrics and analytics have come to the fore.

“One thing that none of us have experienced in a really long time is a rising-interest-rate environment,” Natale said. “Today, the level of analysis you’re going to do on your existing portfolio, or when you’re bringing in a new transaction, is going to be heavily weighted toward interest-rate sensitivity.”

Hedging around interest rates can be challenging even in a working capital facility, Natale noted. “You always need to have a certain amount of outstanding to do that,” he said. In today’s brave new world, one approach would be to encourage the borrower on, say, a $10 million to $50 million facility to “lock in a portion of the interest rate, so that you at least know what it looks like from a cash-flow perspective.”

“As long as I have two of those three, I’m good,” she said. “When you’re only reliant on one, that’s when you can get yourself in trouble.” Natale then suggested a fourth pillar—the management team. “You want them to be able to execute,” he said. “There’s an expectation in the ABL world that there will be defaults. The question is the severity of it. Where does it really lie in starting off?”

Upsides of a Downcycle

Lynn encouraged the audience to remember that, when lending throughout the business cycle, opportunities can emerge. “When the client needs you much more than you need them, that’s really when those best relationships can be formed,” she said. Indeed, finding skillful ways to assist stressed sectors is already helping Wells Fargo develop new business.

The lender has intensified its interest-rate analysis, both on the floating-rate side but also with respect to high-yield maturities. These factors came into play recently when a borrower came to Lynn and her team with what looked like, in her words, “a fantastic acquisition opportunity.”

Aware of the need to focus on distribution risk, she took a step back. “I started asking, ‘Well, where are those high-yield notes trading that the client has today and that are going to come due and need to be refinanced in the next 18 to 24 months?’”

The answer changed the calculus: Those refis were “going to wipe out all of their free cash flow … We probably would have been fine on the ABL side, by the way, but the client really didn’t understand the refinancing risk on the notes that they were going to incur if they took on the additional debt, on

top of needing to refi their existing notes given the significant discount the debt was trading at."

The lender flipped the dialogue, encouraging the client to preserve liquidity and cash and pay down some of those notes rather than put its business on the line with a costly and risky acquisition.

In the banking context, McKay seconded Lynn's focus on the importance of forging closer ties during challenging times. "We're constantly looking for a broader, deeper relationship," he said. "Whether that's capital markets activity or treasury-management or cash-management." These ancillary solutions, he explained, enable banks to generate full-relationship returns. "It's where a lot of banks are spending most of their focus," McKay said.

Default Dynamics

While borrowers are rapidly adjusting to the new normal, the panelists were clear-eyed about default risk moving forward. As McKay flatly stated, "We're going to see more defaults."

Fitch is forecasting about a 3.25 percent default rate on both bonds and loans for 2023, down from a 5 percent forecasted default rate at the beginning of 2023 for both asset classes, Neuburger noted.

In this environment, Lynn said, Wells Fargo is focusing harder on providing stretched availability and taking distribution risk, tightening up on in-transit inventory, and is more likely to put reserves in at the outset at closing. McKay encouraged the audience to pay closer attention to middle-market borrowers that are broadly syndicated and covenant-light. "They could slide further before they trip any covenant," he explained. "In many cases, we expect recoveries to be worse in those situations. There isn't the ability to come back to the table and try to right-size that particular borrower."

On the lower middle-market side, deals tend to be structured slightly differently due to smaller baskets and EBITDA definitions that may not be as complex. These borrowers could potentially trip covenants sooner, Lynn noted, giving the lender "more creative flexibility and options on how we help address and find solutions for those defaults."

She cautioned that flexibility in the documents associated with larger, syndicated or sponsor-backed deals can translate into higher risk, pointing specifically to situations in which baskets are significantly higher than EBITDA and borrowers "can then reallocate amongst the baskets in any given month, depending on how the company is doing. We're trying to tighten up on some of those EBITDA add-backs."

Lynn encouraged the audience to look for at least two of three pillars when evaluating credit risk associated with a borrower/deal:

- the company's ability to sustain cash-flow performance
- the strength, liquidity and marketability of the embedded collateral and
- the ability to put in a favorable loan structure

"As long as I have two of those three, I'm good," she said. "When you're only reliant on one, that's when you can get yourself in trouble." Natale then suggested a fourth pillar—the management team. "You want them to be able to execute," he said. "There's an expectation in the ABL world that there will be defaults. The question is the severity of it. Where does it really lie in starting off?"

For 2024, Fitch is forecasting defaults of 3.5 to 4 percent for leveraged loan defaults, and 5 to 5.5 percent for high-yield defaults, up from 2023 default forecasts of 3 to 3.5 percent. For 2025, Fitch is forecasting a 2 to 3 percent default rate for both the leveraged loan and high-yield market, as default activity is expected to slow following elevated defaults in 2023-2024, and amid improving macro conditions including lower Fed rates.

This represents a scenario in which consumers are resilient enough to support the economy without fueling inflation and further rate hikes. "To my mind," Neuburger concluded, "that is probably one of the most salient risks for this group of issuers today."

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