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The great migration

Evolving market conditions transform the credit rating landscape

J.P.Morgan

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1. Introduction

Over the last two decades, we have witnessed a massive migration of blue chip companies towards lower credit ratings. Statements like **“A is the new AA”** or **“BBB is the new A”** allude to the fact that many large firms, which would certainly have been AA rated 10 or 20 years ago, now operate within an A or BBB rating category. With the cost of debt still at historic lows, especially relative to the cost of equity, **many boards are currently debating whether they should embrace incremental leverage and the migration to a lower rating.**

Analysts often comment that the trend towards low-rated issuers arises from many smaller issuers or issuers from riskier industries now seeking a public rating. This may be true, but does not refute the finding that of the 169-rated firms in the S&P 500 20 years ago, 58% now have a lower rating, whereas only 28% have a higher rating. While some of these firms have suffered operationally as their competitive position deteriorated, they are all survivors, and many still command strong market shares and operate much bigger businesses. **The conclusion is irrefutable: Blue chip firms are migrating to lower ratings.**

In this report, we lay out the evidence for this migration, and then explore the factors driving it, which include the availability and affordability of credit, cost of capital considerations and investor behavior. We also analyze rating agency actions in light of the real economics underlying the great migration.

EXECUTIVE TAKEAWAY

With the migration of many blue chip companies towards lower credit ratings, the growing influence of activist shareholders and the ever-increasing focus on growth and capital returns, boards and senior decision-makers should evaluate the appropriateness of incremental leverage and the migration to a lower rating.

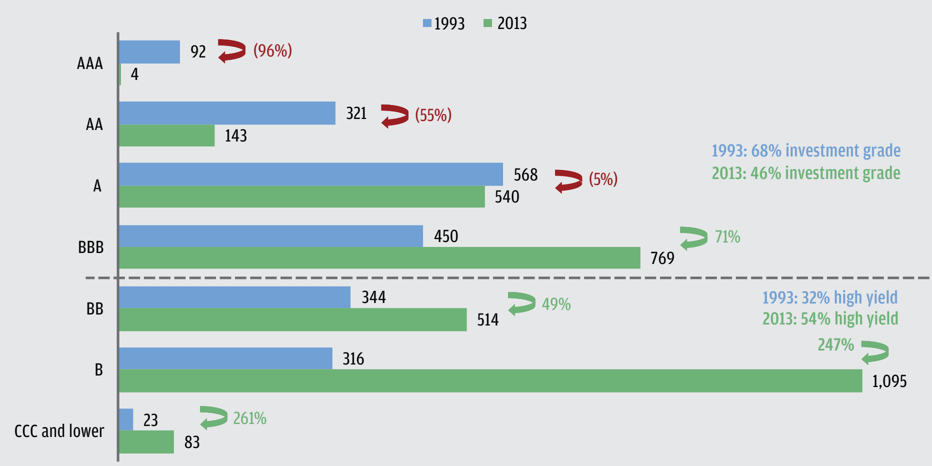
2. Compelling evidence supporting the assertion of a great migration

During financial policy conversations, we often hear that there are more lower-rated firms today than ever. Two decades ago, 68% of the issuers rated by S&P were in the BBB- category or higher (i.e., investment grade). Today, less than half of rated issuers maintain an investment grade rating (see Figure 1). Stunningly, the number of AAA-rated firms dropped by 96% and the number of AA-rated firms dropped by 55%. In contrast, B-rated issuers jumped by 247% becoming the single largest rating category, followed by BBB firms, which increased by 71%.

Figure 1

BBB is the new A

U.S. S&P issuer rating distibutions[1]



Source: Standard & Poor's; 2013 data as of Q2 2013

[1] Universe includes all U.S.-rated issuers by Standard & Poor's

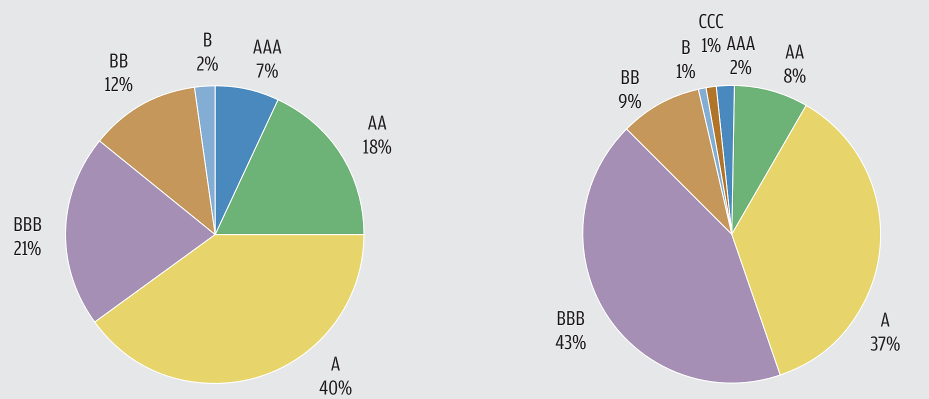
Common arguments for today's lower credit ratings include the shift in industry mix (e.g., more tech-focused firms), more highly leveraged private equity portfolio firms and investor preference for smaller "pure-play" firms. Examining the impact of evolving market conditions on credit ratings requires us to **focus on the same firms over time.** In this light, we examined the evolution of credit ratings for 169-rated S&P 500 companies over the last two decades. The firms eligible to be in this sample are rated companies currently in the S&P 500 that were also rated in 1993. Since firms that defaulted during this time period are eliminated from the sample, and those that survived are likely to have grown in scale, both factors lead us to expect higher ratings for these firms.

Surprisingly, we find that firms with strong ratings in 1993 tend to have significantly lower ratings today. As shown in Figure 2, **the fraction of firms with at least an AA rating declined from 25% to less than 10%.** Downgrades outpaced upgrades in most industries as well, with the noticeable exceptions of energy, information technology and REITs. Notably, we also find fewer non-investment grade companies today versus 1993, leading to a narrower rating distribution. The percentage of companies rated BBB more than doubled during this time period, from 21% to 43%. As such, any survivorship bias has worked to the opposite effect of the presumption: Survivors have lower ratings now than they did 20 years ago.

Figure 2

Rated S&P 500 firms have gravitated from A or better ratings to BBB ratings

1993 rating distribution[1] | Current rating distribution[1]



Source: Standard & Poor's
[1] Universe includes currently rated S&P 500 nonfinancials that also maintained a rating at S&P in 1993

Figure 3 illustrates how BBB has become a popular rating for once more highly rated firms in our sample. Of the 68 A-rated firms in 1993, 31 are now BBB. Similarly, nine of the AA-rated firms are now also BBB. In contrast, only three of the A-rated firms are now AA.

Figure 3

The great migration...firms are gravitating towards lower ratings

Current S&P credit rating[1]	1993 S&P credit rating[1]: AAA 11 firms	AA 31 firms	A 68 firms
AAA	2	1	–
AA	5	5	3
A	2	15	32
BBB	1	9	31
HY	1	1	2

Source: Standard & Poor's
[1] Universe includes currently rated S&P 500 nonfinancials that also maintained a rating at S&P in 1993

EXECUTIVE TAKEAWAY

One hundred and sixty nine S&P 500 firms were rated 20 years ago and are still rated today. These firms are now considerably larger but have gradually migrated toward lower ratings. Twenty years ago, 25% of these firms were AA- or higher. Today, less than 10% of these firms are AA- or higher. In contrast, the percentage of BBB firms jumped from 21% to 43%.

3. What is driving the great migration?

Debt markets with greater depth: Enterprises with lower investment grade ratings can now access borrowing markets not previously available—as highlighted in several recent record-breaking transactions. From Figure 4, one can see that issuance volumes in the BBB category historically tended to be quite a bit lower than in the A category. In recent years, however, BBB issuance levels have been nearly on par with A ratings issuance levels.

Figure 4

There are more issuers and broader markets at BBB ratings

Source: J.P. Morgan; 2013 data as of October 2013

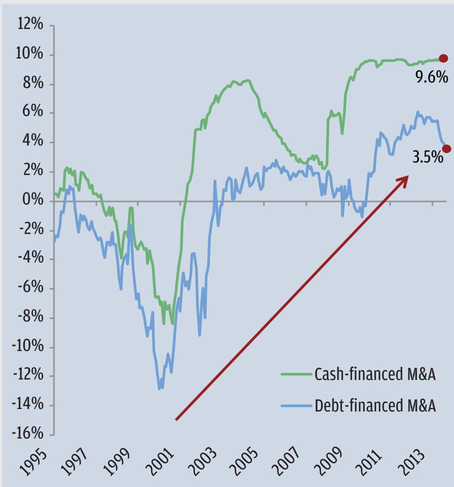
Historic low rates, especially relative to the cost of equity: With debt costs so low[1]—both on an absolute basis and especially relative to the cost of equity—some firms have taken advantage of this unique moment in the capital markets to make a "once in a lifetime" capital structure shift via recapitalization or acquisition. In Figure 5, we show the accretion of executing an M&A transaction or a stock buyback using balance sheet cash or debt financing. Despite a strong equity market performance and higher cost of debt relative to last year's lows, the EPS accretion is still close to historic highs. Some firms seeking to boost growth levered up their balance sheet to acquire their own stock or complete strategic acquisitions. **However, the bigger question is why more firms have not taken advantage of this historic disconnection between debt and equity.**

[1] For more information, please see "When rates take off…Corporate finance implications of rapidly rising interest rates" at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_WhenRatesTakeOff.pdf

Figure 5

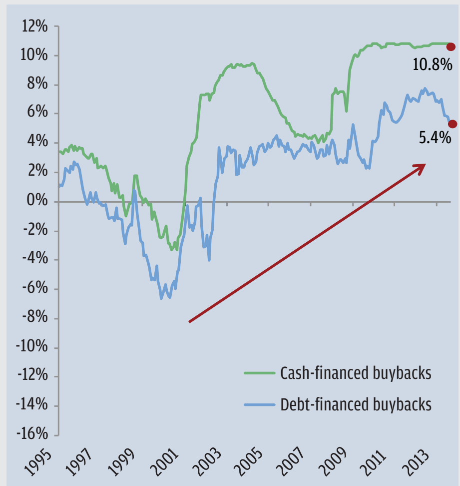
EPS accretion from acquisitions and buybacks is at near record highs

Illustrative EPS accretion of acquisitions for S&P 500 companies



Source: Bloomberg and FactSet as of 11/29/13
Note: Assumes buyback size of 10% of market capitalization and a 35% marginal tax rate; assumes Bloomberg fair market value index cost of debt for BBB-rated issuer; assumes three-month LIBOR as interest earned on cash

Illustrative EPS accretion of buybacks for S&P 500 companies



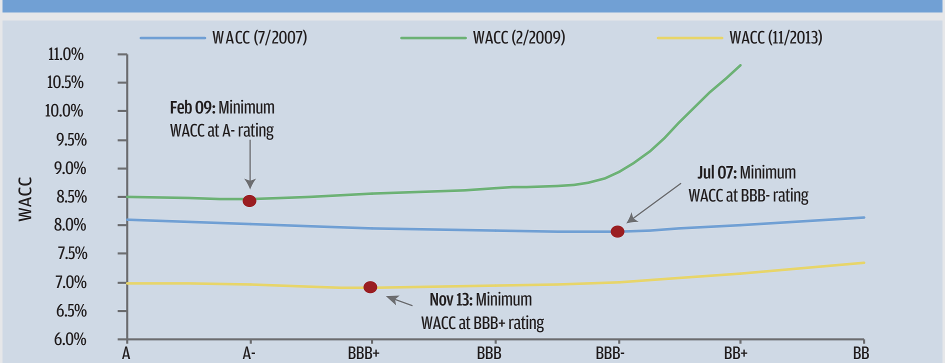
Source: Bloomberg and FactSet as of 11/29/13
Note: Assumes acquisition of 10% of market capitalization, historical repurchase premiums for cash consideration deals and a 35% marginal tax rate; assumes Bloomberg fair market value index cost of debt for BBB-rated issuer; assumes three-month LIBOR as interest earned on cash; assumes no synergies from the transaction

Cost of capital optimization: Many firms have focused on optimizing their cost of capital. In most market environments, the cost of capital is minimized around a BBB rating, as we show in Figure 6. The cost of capital benefits of a BBB rating relative to an A rating are, however, relatively small. When they lever up for an acquisition or when their rating takes a hit because of operational issues, many firms falling from an A or AA rating take solace in the knowledge that their lower rating is attended by a lower cost of capital. They also are often not willing to accept the costs of climbing back up the rating spectrum.

Figure 6

In most markets environments firms optimize their cost of capital at a BBB level

Historical cost of capital curves for a generic firm



Source: Bloomberg, J.P. Morgan
Note: Assumes beta of 1 at each point in time, 10-year U.S. Treasury (risk-free) rates, average 10-year bond yields across ratings from Bloomberg, market risk premiums of 5.0% (Jul 2007), 9.0% (Feb 2009) and 6.5% (Nov 2013)

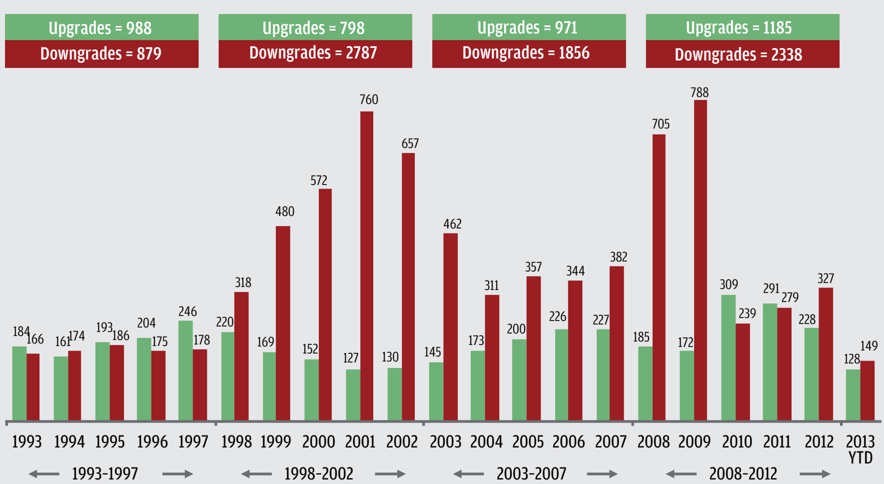
Investor behavior: Investors are applauding firms that use debt to return capital to shareholders or to finance strategic acquisitions. Given the low-rate environment, this phenomenon has only strengthened, with investors rewarding acquirers on large transactions soon after announcement for the first time in decades. Hedge fund activists also command more capital and influence than ever before.[2] Recently, we have even seen some of the largest firms bow to activist demands to take on leverage and return capital to shareholders.

Rating agency response: In Figure 7, we show the number of upgrades and downgrades amongst rated issuers since the end of 1993. In all but two years since 1998, downgrades outpaced upgrades and in some years downgrades outpaced upgrades by a ratio of almost 6-to-1. Although downgrades were more prevalent during recessions, they often outpaced upgrades, even in good years. Overall, the number of downgrades outpaced the number of upgrades by a ratio of 2-to-1 over the last two decades.

Figure 7

Downgrades have outpaced upgrades by a ratio of 2-to-1

S&P domestic issuers upgrades and downgrades



Source: Standard & Poor's; 2013 data as of Q2 2013

Do weakening operational and leverage metrics explain the downward ratings migration? We again look to the credit ratings for the 169-rated companies currently in the S&P 500 that were also rated in 1993. In Figure 8, we can see that firms in this sample were downgraded from AA to A or from A to BBB despite an increase of three to four times in size (controlling for inflation) and relatively similar profit margins over this period. Changes in leverage can partially explain the downgrades, especially when looking at the impact of underfunded pensions on adjusted leverage.

[2] For more information, please see "Uncorking M&A The 2013 Vintage: Investors increasingly reward synergistic transactions" at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_MA.pdf and "Action speaks louder than words: Investors reward proactive strategies" at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_ActionSpeaksLouder.pdf

Figure 8

Firms that were downgraded did not weaken from an operational standpoint

Operational metrics

Median	AA to A	Stayed A	A to BBB	Stayed BBB
1993 Debt/EBITDA	1.3x	1.5x	1.5x	2.4x
1993 EBITDA Margin	13.3%	12.5%	17.0%	19.2%
1993 Total EBITDA[1]	$1,067mm	$540mm	$458mm	$518mm
LTM Debt/EBITDA	1.5x	1.6x	2.3x	2.0x
LTM Debt + Pension/ EBITDA[2]	2.3x	1.7x	2.6x	2.0x
LTM EBITDA Margin	18.2%	15.6%	14.8%	21.8%
LTM Total EBITDA	$3,207mm	$3,660mm	$1,706mm	$2,073mm
Count	15	32	31	20

Source: FactSet; Universe includes currently rated S&P 500 nonfinancials that also maintained a rating at S&P in 1993
[1] 1993 EBITDA CPI inflation adjusted for 2012 dollars
[2] Adjusted for after-tax pension and OPEB underfunding according to S&P's methodology

Another worthy observation is the magnitude of downgrades versus upgrades. Out of the 47 upgrades in our sample, 40% were of only one notch (e.g., from BBB- to BBB), relative to 28% of downgrades. Conversely, 31% of the 98 downgrades in our sample were of at least four notches, significantly more than the 21% of upgrades. This trend demonstrates the higher likelihood of a severe downgrade over the last two decades.

EXECUTIVE TAKEAWAY

The great migration was not driven by a single cause, but rather by a combination of factors that eventually led highly rated firms toward lower ratings. Firms that find an attractive strategic acquisition, or view their stock as undervalued, may decide to use newly available and historically cheap debt to buy their or somebody else's stock while accepting a ratings decline. Greater focus on cost of capital optimization and investor demands has also led firms to increase leverage.

4. Key takeaways

Here are the key takeaways for boards evaluating the costs and benefits of stronger ratings.

- **Today's unique interest rate environment:** Firms have many opportunities to optimize their balance sheets, particularly when a firm's stock is undervalued or when strategic M&A opportunities arise. The persistent low cost of debt—particularly relative to the high cost of equity—continues to offer a unique "arbitrage" opportunity available to companies willing to use debt to fund share repurchases or strategic acquisitions.
- **Financial flexibility at current ratings:** Lower ratings with similar leverage means —for many firms—more capacity for incremental debt without risking a downgrade.
- **An investment grade rating pays off:** Despite the market depth and attractive pricing currently available to high-yield issuers, investment grade markets remain the deepest and provide the most predictable source of debt capital. Coupled with the advantages of low cost of capital through the cycle, access to the broadest set of markets (e.g., commercial paper) and the less tangible reputational benefits of higher ratings, investment grade ratings remain in favor among the world's largest and most established enterprises.
- **Activist pressure:** The pressure from activist investors to optimize the balance sheet will accelerate, especially—but not only—for firms that have underperformed. With activists managing record amounts of capital, and getting results, even the largest and highest-rated firms should evaluate their capital structure decisions through the lens of a potential activist investor.

EXECUTIVE TAKEAWAY

Despite recent memories of the financial crisis, the great migration will likely continue, as the low- and non-investment grade markets continue to grow and develop.

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