Packaged food companies' credit quality resilient compared with food service firms during the Covid-19 pandemic

by Li Mengyan

The Covid-19 pandemic is altering people's food choices and dining behaviours. Food service companies including restaurants, bars and catering firms, which rely heavily on out-of-home activities, have seen drastic fall in their business. For example in the US, food and drinking places sales has plunged 23% in March and seated diners have dropped considerably since late March compared with last year. In striking contrast, packaged food companies, including food packaged manufacturers and firms producing packaged food such as instant noodle and frozen pizza, are seeing business spike during the pandemic. The unprecedented restaurant closures and long-term lockdown has shifted consumers' purchasing patterns, increasing the demand for packaged food products. The credit quality during the pandemic and the credit outlook of packaged food manufacturers show more resilience compared with food companies with services exposure.

Generally, food industry is resilient in economic downturns since food is a basic necessity with inelastic demand. When looking at the recent US stock market performance as an example, while the food industry indeed outperforms the overall market, the packaged food sector is doing even better. As shown in Figure 1b, the S&P Food Products Industry index has declined 6.1% and S&P 500 Packaged Foods & Meats index is down 4.4% from January to May, far less than the 11.9% decline for the S&P 500 index during the same period. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) also shows similar pattern in Figure 1a. The food industry's Agg PD is lower than that of all industries in the globe. When zooming into food industry specifically, the Agg PD of food service companies doubled from 13bps to over 25bps after March, when WHO announced a global pandemic, and then dropped to around 20bps but remains elevated than the pre-pandemic level. However, packaged food companies are more resilient, as its Agg PD only increased slightly from 9bps to 13bps before declining back to its previous level.

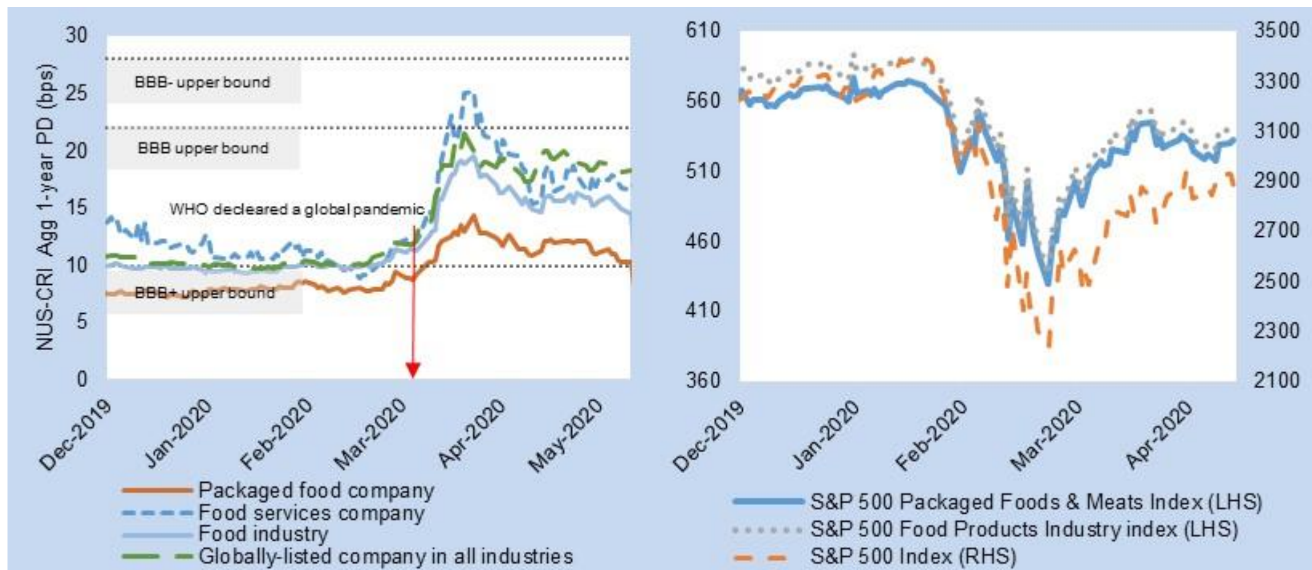

Figure 1a: NUS-CRI Aggregate 1-year PD for globally listed packaged food company, food service Company, food industry and company in all industries from Dec 2019 to May 2020 bounded by NUS-CRI Probability of Default implied Ratings Version 2.0 (PDiR2.0[1]); Figure 2b: S&P Food Products Industry index, S&P 500 Packaged Foods & Meats index (LHS) and S&P 500 index. (RHS) from Dec 2019 to May 2020. *Source: NUS-CRI, Bloomberg.*

In 2019, food service companies and packaged food companies issued debt at a steady pace as shown in Figure 3a. While starting from 2020, both sectors have issued record amount of debt, taking advantage of the low interest rate to enhance liquidity and roll over existing debts. The massive issuance of debt has increased the average Debt/EBITDA ratio for food service companies in Q1 2020, while the ratio for packaged food companies hold steady (Figure 3b). Moreover, packaged food companies are able to enjoy lower borrowing costs than food service companies. Over 65% of the bonds issued in Q1 and over 90% of bonds issued in April and May by packaged food companies are investment grade rated by S&P or Moody's. The average yield for bond issued by packaged food firms is 2.43%, lower than that for bond issued by food service companies, which sets at 3.42%. This might explain the relative advantage on credit quality of packaged food companies compared with food service companies.

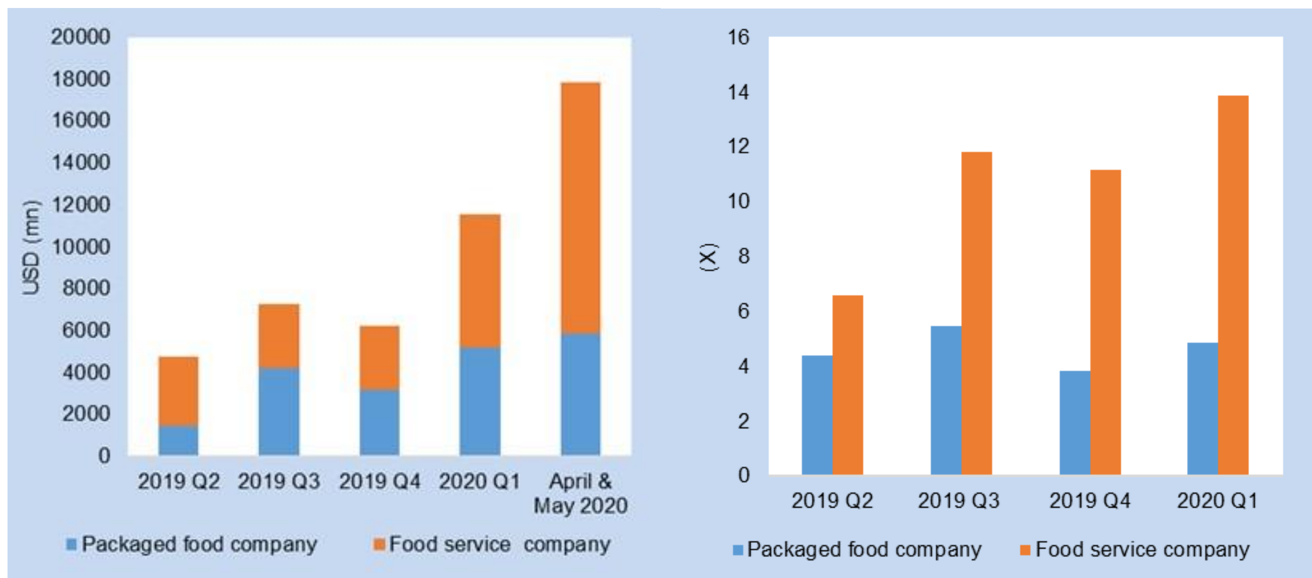

Figure 2a: The amount of bond issued by packaged food companies and by food service companies by quarter; Figure 2b: Average Debt/EBITDA of packaged food companies and food service companies by quarter. *Source: Bloomberg.*

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

Apart from that, packaged food companies' business nature also helps to maintain resilience amid the current crisis. For food service companies, their credit quality deterioration is mainly due to low revenue and higher labour cost caused by the heightened safety requirements. Restaurants, cafés and bars are shut down. Some of them turn to takeaway and delivery to survive, but those food service providers still need to face the high commission of delivery platform due to the high labour cost. In stark contrast, the demand for packaged food products has surged during the lockdown, and the global food-at-home sales is estimated to rise 14% in 2020. For example, General Mills Inc. has seen its sales of US retail stores surging 45% and 32% in March and April, respectively. Ingredion Incorporated, an ingredients supplier, has reported strong financial results in Q1 2020 and forecasted a robust demand for ingredients found in traditional packaged food products in 2020. In addition, the production line for packaged food is less susceptible to virus-related interruptions than food service companies, since most of the packaged food plants are heavily automated, and workers are naturally separated when operating large pieces of processing and packaging machinery.

However, although the credit quality of packaged food companies has been barely affected and food service companies is not significantly affected by the widespread Covid-19 as reflected by Agg PD, uncertainty remains and there still exists considerable credit risk for both sectors. As tracked by the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) based on the information available in May 2020 (Figure 3b), the food service companies and packaged food companies both see its credit quality deteriorating in the future. One possible explanation for the current negative credit outlook is that food service companies might suffer from high price level, high labour cost and shortage of food in the long-term, even after the gradual opening-up of outdoor activities and businesses. For packaged food companies, they are now facing mounting illness at plants and in supply chains, and they might see declining demand of packaged food products and higher cost of food amid higher unemployment and depress disposable income that could persist to 2021. Compared with Forward PD based on information available in Dec 2019 (Figure 3a), the gap between the Forward PD of packaged food company and of food service company currently is wider than the pre-pandemic level, which also demonstrates the resilience of packaged food company's credit quality during the Covid-19 outbreak.

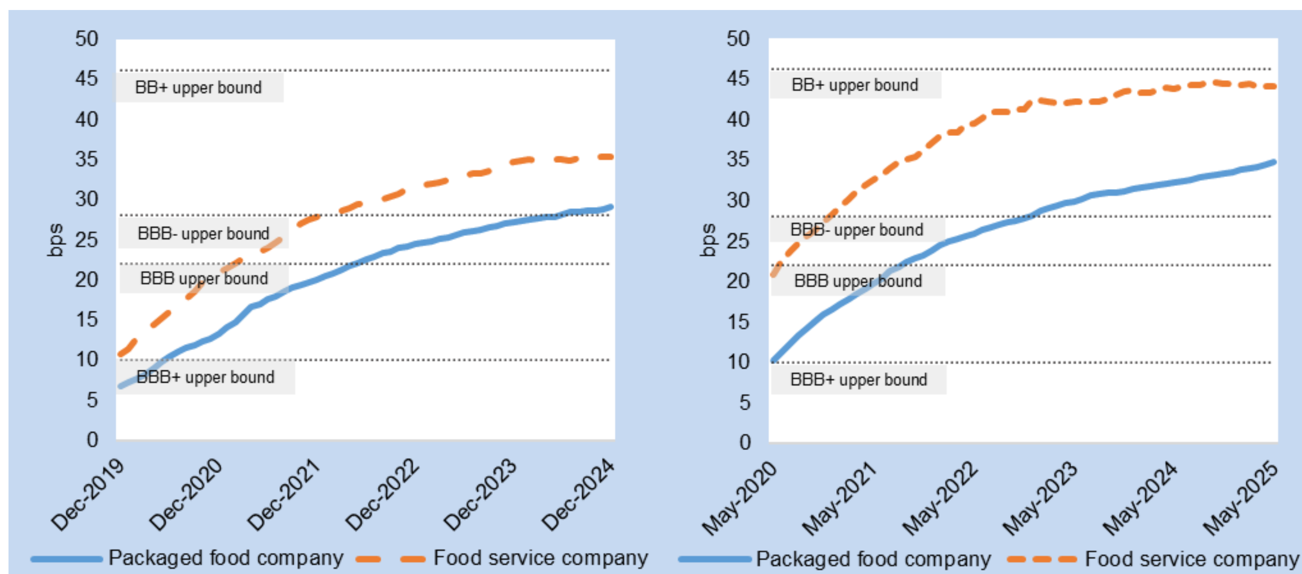

Figure 3a&3b: NUS-CRI Aggregate Forward 1-year PD of globally listed packaged food companies and food service companies based on information available in Dec 2019 and May 2020, respectively. *Source: NUSCRI*

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

Credit News

Japan banks see bad-loan costs at decade-high USD 10bn

May 15. For years, Japanese banks relied on low credit costs to sustain their earnings in the low interest rate environment. In the year ending March 2021, total costs at Mitsubishi UFJ Financial Group Inc., Sumitomo Mitsui Financial Group Inc. and Mizuho Financial Group Inc. will double to USD 10bn while combined net income is projected to fall to USD 12bn, the lowest in a decade. Moreover, after the equity markets plunged, corporate shares the banks held also dropped in value. The shares of the three banks also tumbled 29%. The profit outlook of these banks is bleak and retrenchment of workers loom. Fortunately, all lenders will maintain dividend payments for the current fiscal year and Japan is beginning to reopen parts of its economy as the COVID-19 situation improved. It is expected that the economy will bottom out by the end of the third quarter and there may be a strong loan demand in the short run to meet the liquidity needs of corporates to reopen. However, the demand may not be long term given the small spending appetite of companies during Japan's forecasted deep recession and a 21.5% plunge in GDP. (Bloomberg)

Banks refusing to lend prompt USD 62bn Indian rescue deal

May 15. India's lenders are accepting penalty rates to keep a record USD 92bn a day with the Reserve Bank of India and have shunned a central bank program aimed at credit-starved firms, choosing safety as the coronavirus pandemic cripples economic activity. Banks' risk aversion has forced the government to offer USD 62bn in credit lines and cash injections to the smaller firms. According to an economist at the brokerage Anand Rathi, however, the government program may have limited effect as it could only help less than a tenth of India's 63mn smaller firms. With banks still unwilling to take the risk of lending, the protracted liquidity squeeze could still lead to as many as 20mn more job losses. (Bloomberg)

Pandemic poses big risk to collateralised loans market

May 13. The collateralised loans obligations (CLOs) are securities backed by loans taken out by highly leveraged companies, typically non-investment grade credit rating. Many companies are struggling to survive in the current pandemic and the credit rating agencies have downgraded and issued negative outlooks on some leveraged loans included in the CLOs. Hence, this badly affects the credit quality of CLO loan portfolios. The Financial Stability Board has estimated that the leveraged loan market was worth USD 1.4tn to USD 3.2tn in 2018, with just a few global banks in the United States and European Union accounting for 86% of CLOs issued. Rating agencies will continue to monitor and perform stress-testing stimulations to provide CLO ratings that appropriately reflects the credit risk. (Reuters)

Investors struggle to hear signals from bond markets

May 12. Some fixed income investors said in successfully staving off a more pronounced financial crisis, the Fed has further distorted markets. Over the past two months, the Feb has snapped up roughly USD 1.5tn of Treasuries and another USD 600bn or so of agency mortgage-backed securities as part of its pledge to buy an unlimited quantity of government debt. Treasury yields have touched their historic lows since March, and the result is that, for market participants, the once-reliable signals are not reliable, as they are being manufactured by the Feb to keep financial conditions easy. (FT)

Deutsche grabs capital from rekindled bank bond market

May 12. Deutsche Bank took advantage of investors' renewed demand for financial institutions' higher risk debt and sold EUR 1.25bn of new bonds that work as its capital buffers on Monday. Both Deutsche Bank and Royal Bank of Scotland in the UK raised the new tier 2 debt, which was a riskier class of bank debt after the heightened Coronavirus situation hit additional tier 1 (AT1) bonds in March badly. The resumption of new capital deals from European banks shows signs that the demand for high risk debt has returned. Since 2019, Deutsche Bank is undergoing a revamp to shrink its underperforming investment bank and cull its workforce

as it braces for its sixth consecutive loss-making year. The type of bonds issued by the bank may not count towards its common equity tier 1 ratio (a key benchmark of balance sheet strength) but will definitely be used to support business growth and improve balance sheet flexibility. (FT)

End of virus panic mode revives slumbering green-bond market (Bloomberg)

Credit rating 'fallen angel' danger at record high: S&P Global (Reuters)

Moody's warns of sharp pick-up in emerging market corporate debt defaults (FT)

Regulatory Updates

Federal Reserve warns of potential strains on US banks

May 16. In its semi-annual report on financial stability, the Fed pointed out a litany of vulnerabilities and risks to the current financial system including high corporate debt levels and excessive concentration among hedge funds. It warned that the decline in the revenues of highly leveraged business borrowers had brought about a widespread repricing of credit risk, and a slower pace of high-yield corporate bonds issuance and leveraged loans origination. It also warned of the concentration of hedge funds, because distress at a few large hedge funds with high leverage can have outsized effects. To deleverage, they may sell a large amount of assets, which may have contributed to the poor liquidity conditions in financial markets. (FT)

India unveils major credit line for small businesses, lenders

May 13. India's government aims to release a fiscal package to help the economy which is hit by the impact of the coronavirus. Therefore, it plans to offer about USD 60bn of loan guarantees for small businesses, shadow banks and power companies. Additionally, two debt and equity funds amounting to over USD 9bn will be set up to support stressed business. Real estate companies will be able to claim relief to regulatory penalties that are caused by coronavirus-driven delays of project completion. However, no relief is announced so far for all the migrant workers who have lost their jobs since the national lockdown. In April, the unemployment rate rose by 14.8% to 23.5% from the previous month. (Reuters)

Fed corporate bond program starts with a fizzle as total assets near USD 7tn (Reuters)

Federal Reserve will begin purchasing exchange-traded funds (Reuters)

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