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Despite initial recovery from COVID-19, credit outlook is deteriorating for UK domiciled firms

by Raghav Mathur

- **Credit outlook for UK domiciled firms is worsening due to the increased possibility of a No-Deal Brexit and resurgence of COVID-19 cases.**
- **An analysis by the UK government indicated that the UK's manufacturing and financial services sectors will be particularly hit hard by the increased costs of adapting to No-Deal Brexit.**

The United Kingdom (UK) has been battered by the effects of the COVID-19 pandemic. The UK economy entered a recession after its GDP plunged by a record of 20.4% in the second quarter of 2020, following a 2.2% contraction in the first quarter of this year. Though the economy has seen signs of initial recovery post lockdown, the UK now faces the 'double-trouble' of dealing with a second-wave of coronavirus cases, while simultaneously managing the likely scenario of a No-Deal Brexit. Credit outlook for companies domiciled in the UK has worsened, primarily driven by the lack of domestic consumer confidence as further restrictions are put in place by the UK government and as increased chances of a No-Deal Brexit negatively impacts revenue and profitability prospects of UK domiciled firms.

Fiscal stimulus from the UK Government and monetary stimulus from the Bank of England (BoE) have played an important role in the quick recovery of UK domiciled firms' credit quality. As demonstrated by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) shown in Figure 1a, the Agg PD fell from 45.2bps to 27.1bps between March and April 2020. A plethora of stimulus packages provided by the UK government enabled companies to take on more loans to meet short-term cash flow obligations while simultaneously preventing mass retrenchment in the labor market. Though overall demand in the economy contracted during the pandemic, the pace of contractions in consumer spending was slower in June compared to April partly because of the UK government furlough schemes which are due to expire at the end of October 2020. This ensured that recovery in sales was quicker as unemployment figures remained low and stable during the pandemic. Meanwhile, the impact of BoE's expansionary monetary policy on UK domiciled firms' credit quality has largely been positive. The BoE reduced and maintained the bank rate at 0.1% since March 2020 and increased its holding of UK government and non-financial investment grade corporate bonds by GBP 200bn. This policy decision, combined with the positive effects of the Federal Reserve's stimulus on restoring confidence in the global capital markets, helped accelerate the initial recovery in credit quality.

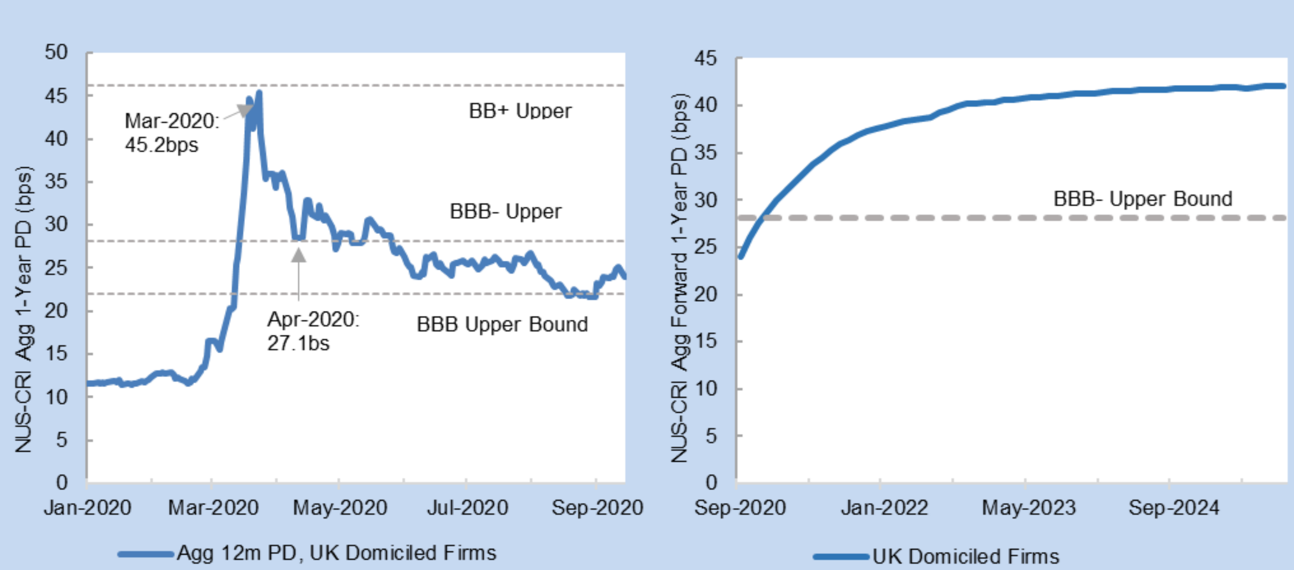

Figure 1a (LHS): NUS-CRI Agg 1-year PD UK Domiciled companies when referenced to PDiR2.0 bounds[1]. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD of UK Domiciled companies when referenced to PDiR2.0 bounds. *Source: NUS-CRI*

However, the resurgence of the second wave of COVID-19 cases has compelled the UK government to impose further social restrictions, affecting the economic activity in the country. According to the September Composite Output index, business activity decreased with the index falling from 58.8 in August to 55.1 in this month. This is expected to reduce even further in October and November as initial restrictions are extended for the next six months, affecting the revenue of firms domiciled in the UK. As such, the UK government has increased its focus on providing further stimulus such as the revised furlough program which is set to replace the current government job package at the end of October. Simultaneously, the BoE has appropriated additional 'firepower' by promising further quantitative easing when necessary, which would aid in reducing the overall pressure felt on the economy due to virus resurgences. Though not as comprehensive as previous stimulus, these policies could help UK domiciled firms in terms of lower redundancies, demand recovery and financing opportunities.

As shown by the NUS-CRI Aggregate (median) Forward 1-Year PD (Forward PD[2]) in Figure 1b above, UK domiciled firms will likely face further deterioration in their credit profile in the next few years. In addition to the challenging operating environment, companies domiciled in the UK have increased their debt levels during the pandemic to deal with working capital obligations and to fund cash flow deficits. UK corporates entered the pandemic with relatively healthy balance sheets. However, with more than 40% of companies domiciled in the UK taking on extra debt with lower earnings during the pandemic, the average Total Debt/EBITDA ratio increased from 2.8 in 2019 to 4.8 in H1 2020. On average, firms taking on additional debt has raised concerns regarding the emergence of 'zombie' companies in the UK as companies increasingly face insufficient cash flows to meet debt repayment obligations. This effectively raises the probability of default in the future as showcased above by the Forward PD. The emergence of zombie firms is also a concern for the credit quality of other companies domiciled in the UK as zombie firms absorb crucial financing, thereby possibly depraving healthier firms from viable financing opportunities.

Unfortunately for UK companies, they are not only facing the adverse impact of the pandemic but also Brexit. The situation got even more challenging with the increased likelihood of a No-Deal Brexit post the UK's introduction of the Internal Market Bill at the start of this month. It means more challenges and uncertainty for companies that have been preparing for the transition. The severity of the impact of a No-Deal Brexit on credit outlook is not homogenous across sectors and industries. Specifically, the UK government's analysis

[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.

[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.

demonstrates that the impact of a No-Deal Brexit on the manufacturing[3] and the financial services sector's revenue and profitability are negative due to the higher costs of doing cross-border operations under new regulations and customs rules. Tariff and non-tariff barriers will increase trade costs for manufacturing firms by 9% to 17%. On the other hand, the impact on the UK domiciled financial services firms' credit quality is not as drastic as that on manufacturing firms. Major financial services firms have already started setting up their EU-authorized subsidiaries and moving necessary human resources to address 'Passporting'[4] issues.

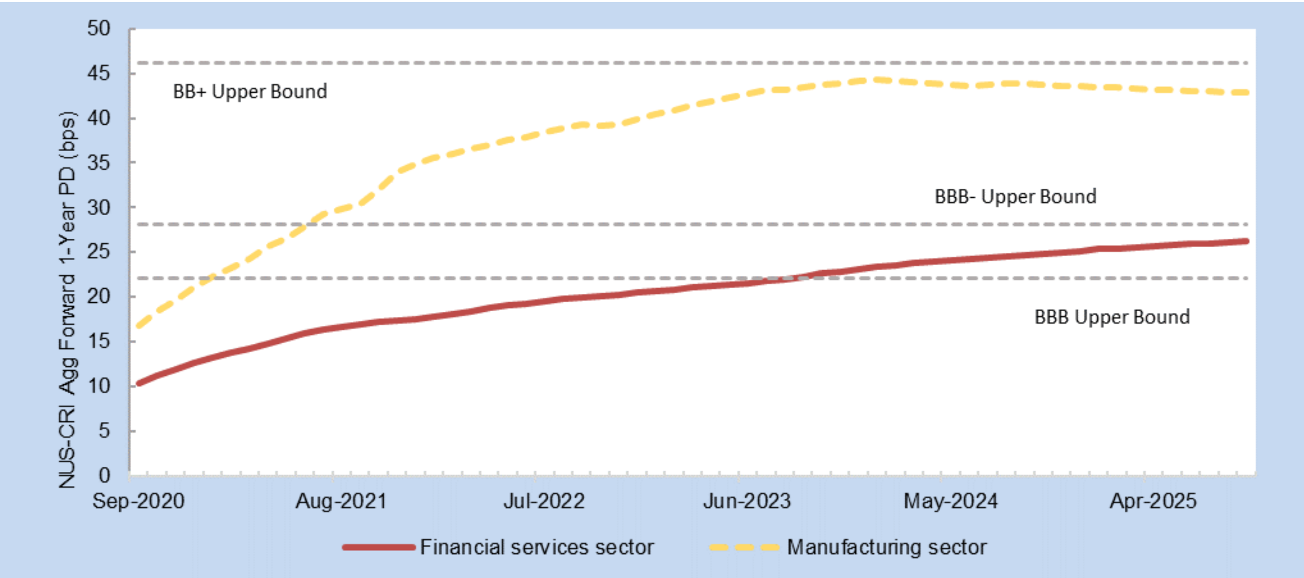

Figure 2: NUS-CRI Agg Forward 1-year PD of UK domiciled manufacturing and financial services companies when referenced to PDiR2.0 bounds. *Source: NUS-CRI*

Overall, it is not surprising to see the negative credit trends in the Forward PD (see Figure 2) for UK manufacturing and financial services firms, with the former more impacted than the latter. Given all of these factors, the timing and speed of the recovery will likely hinge on the short-term outcome of Brexit and worldwide vaccine developments.

[3] Manufacturing firms include firms from the following industries: Automotive, Textiles, Pharmaceuticals, Aero & Defense
[4] Passporting allows financial services firms, which have gained authority in one-member state of the EU, to conduct business throughout the EU without the need of additional authorization

Credit News

Sustainable-bond market boosted by Europe's top institutions

Sep 25. Two of the most powerful institutions in Europe, the European Central Bank (ECB) and the European Commission, have thrown their weight behind the market for environmentally friendly bonds. The ECB has started buying sustainability-linked corporate bonds as part of its quantitative easing-program and accepts them as collateral for loans to commercial banks, starting next year. Meanwhile, the European Commission stated it would fund a third of its coronavirus recovery fund spending with green debt, turning it into the world's largest issuer of such debt. While the money raised from the green bond sale is earmarked for environmental projects, the coupon rate for sustainability-linked bonds is linked to certain metrics of a company's environmental impacts. Historically, market participants have given priority to growth over stringency, which has led to the allegation of greenwashing. Although the EU's entry can improve the sustainable-debt market transparency, the risk of greenwashing may remain a problem. (WSJ)

Rise of the zombies? Europe faces insolvency balancing act

Sep 25. Despite falling into its deepest recession in modern history, the number of bankruptcies across the European economy has fallen sharply as government subsidies and a temporary loosening of insolvency rules have kept companies afloat. In the first half of 2020, countries such as Britain, France and Spain saw insolvencies fall by an estimated 20-40% year-on-year. There is a real difficulty distinguishing zombie firms from healthy firms that are in temporary trouble and this could interfere with the self-cleaning process of the market. As governments phase out support schemes, there is expected to be a sharp rise in insolvencies globally. However, it is likely that any increase in insolvencies will be much lower in Europe compared to elsewhere. (Reuters)

Cost of European junk bond insurance set for biggest weekly jump since March

Sep 25. The cost of insuring European junk bonds against default was on track for its biggest weekly jump since the height of the coronavirus market sell-off in March. This is on the back of new restrictions in Europe to contain the rapid spread of new coronavirus cases raising concerns over the economic recovery. The iTraxx Europe Crossover index, which measures the cost of insuring defaults on a basket of underlying junk bonds, rose 73bps to close at 369bps, the highest level since early August. With fiscal and central bank support, and interest rates set to stay lower for longer, default rates are expected to be lower than the estimate at the start of the pandemic. This could see investors move to an overweight position in high yield as risk premiums increase. (Reuters)

Investors flee US junk bond funds as concern for the economy grows

Sep 25. US high-yield bond funds have seen the biggest weekly outflow since March as investors pulled USD 4.86bn from funds as they fret over the sustainability of the US economic recovery. Due to concerns over the persistent economic effects of the virus and the mounting fears of a contentious US presidential election, investors scale back their exposure to the riskiest companies in the debt market. The US Federal Reserve (Fed) Chairman Jay Powell has said that the US economic recovery will hinge in a large part on more fiscal stimulus. The Fed has been buying corporate bonds and high-yield ETFs since May, leading to high-yield bond issuance surging over that time as companies took advantage of the rampant investor demand to load up on new borrowings. (FT)

Swedish corporate bond market is dysfunctional, says central bank

Sep 24. According to Sweden's central bank, the Swedish corporate bond market is immature, illiquid and dysfunctional. Asset manager BlackRock was recently commissioned to write a report on the functioning of the market and the possible design of the bond-buying program the central bank wanted to conduct to support the economy. However, the report could not be published as it raised several concerns that would undermine the scheme. Many Swedish bond funds, most invested in high-yield debt, were suspended in March as the COVID-19 pandemic put global markets under severe stress. The Riksbank is aiming to buy up to SEK 10bn (USD 1.1bn) in investment-grade rated corporate debt by June next year, a small part of its overall SEK 500bn quantitative easing program. It is currently deciding if they should proceed as there are concerns over the market impact of the program. (FT)

American Airlines secures USD 5.5bn Treasury loan, could tap more (Reuters)

Evergrande bond trading halted on reports of crash crunch (FT)

Red flag waves as demand wanes at Southeast Asia bond auctions (Bloomberg)

Regulatory Updates

China expands investment scope for foreign investors under combined scheme

Sep 25. China has officially combined two major inbound investment schemes and broadening the scope for foreign institutional investment to ease foreign access to its capital markets. The finalized rules, which combine the Qualified Foreign Institutional Investor (QFII) scheme and RQFII, would not only channel foreign capital into Chinese stocks and bonds but also expand investment scope under the combined scheme. As trade and diplomatic ties with the US remain strained, China's reforms and opening up of its capital markets are part of its efforts to promote the global use of the yuan currency. Besides lowering the threshold for overseas applicants and simplifying the vetting process, the rules also give foreign institutions access to derivatives. An analyst from UBS stated that this move will encourage more medium and long-term funds to enter the Chinese market directly. (Reuters)

Australia banks surge as lending laws eased to boost economy

Sep 25. Australia will make it easier for banks to approve mortgages and small-business loans to help the economy recover from its first recession in almost 30 years. Banks will now be able to rely on income and spending information provided by borrowers when assessing loan applications, rather than doing their lengthy verification. These changes ended a decade of increased regulations for the banks. The onus of responsibility is now shifting to the borrower instead of the bank to address the excessive built-up risk aversion that has restricted the flow of credit. This comes as part of the country's broader regulation-busting package aimed to help the economy rebound from the coronavirus-induced recession. (Bloomberg)

Colombia central bank cuts rate to 1.75%, IMF increases flexible credit line (Reuters)

Turkey tightens monetary policy further after surprise rate hike (Bloomberg)

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