



# Risk and Resilience in 2020

## The Cracks of the Changing World



# SYCAMORE ASSOCIATES

Turning and turning in the widening gyre  
The falcon cannot hear the falconer;  
Things fall apart; the centre cannot hold

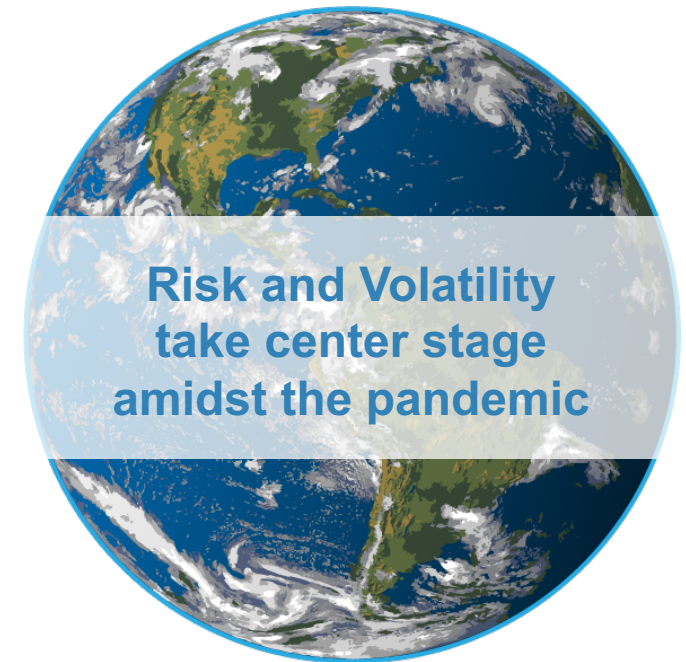
William Butler Yeats, *The Second Coming*



# Risk and Resilience: The Wild Ride in Capital Markets - Part 1

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- Discussion of interconnected risks in the face of the pandemic, and how corporates and institutions are coping
- Global events and actions are the backdrop
  - Things fall apart: a variety of solutions are brought forward
- Regulatory
- Fed and Fiscal actions/Global Regulators
- Financial institution risk appetites
  - Adjusting situationally, but clearly tighter
  - Limits and concentrations
  - Risk profiles adjusting to consider global climate risk and transition to low-carbon economy
- Practical cases:
  - COVID Carve Out “how-to” discussion
    - Case study







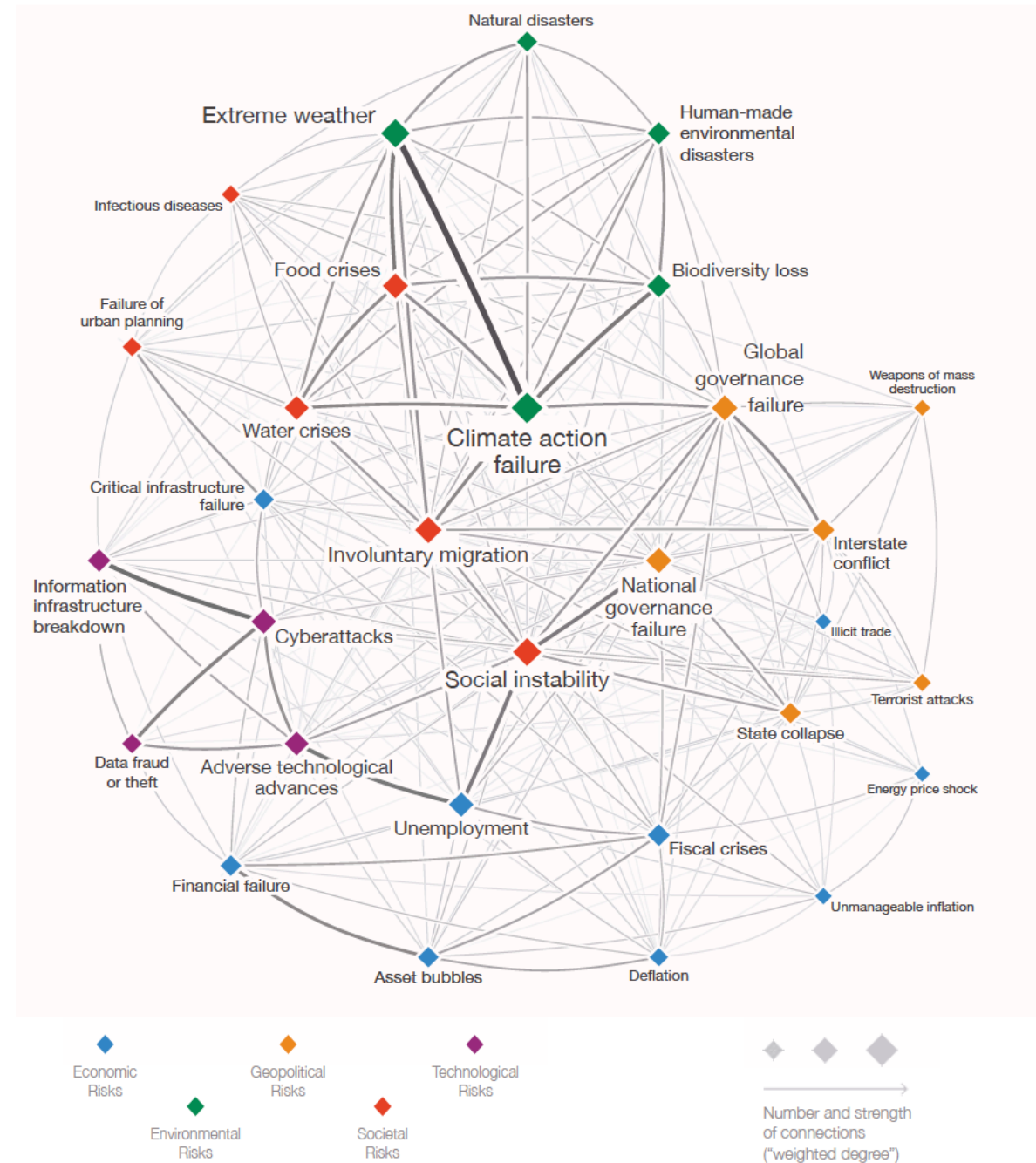
# The World Before Corona

- Fundamentally stable economically; US economy stable to strong
- Growth stable
- Banks well-capitalized broadly, although less so in Europe than in the US
- Employment strong, hiring up, capital spending lagging, but M&A up
- Still, the world faced risks.....



# The Global Risks Interconnections Map

World Economic Forum  
2020



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*Yesterday, all my troubles seemed  
so far away,*

*Now it seems as though they're  
here to stay....*

*There's a shadow hanging over me  
Oh, I believe in yesterday.*

*Lennon and McCartney*





# First: Things Fall Apart :

(supply and demand shock, different from 2008-9)

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## The global dislocation of business, society and economics has not been as broad since the Second World War

- Total global focus on the pandemic brings out geopolitical risks
  - as a variety of solutions are brought forward, disagreement among allies and risks to stability
  - China, US, Europe, Asia
- Global mechanisms fraught: WHO, United Nations
- The bright spots: global collaboration for science, research, and sharing of information to identify therapies and vaccines collaboratively versus in competition
- Health, governance, work force impairments
- **Supply chain dynamics get new focus globally and interconnections are revealed**



### Climate Awareness Rises

- Environments cleaner or not clean enough
- Linkage of climate change to infectious disease
- Growing urgency for action
- Investor concerns impact many markets

# Risk and Resilience: The US

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## Fed and Fiscal actions

- The entire 2008-9 playbook, plus more, unleashed quickly
- Fed actions stabilized markets
- Fiscal actions followed quickly, but..
- Unknown tenor of disruption plays a role: the cushion evaporates quickly
- Growing realization that “coming back”, “opening up” and other metaphors describe a completely unpredictable and altered reality
- Ratings agency implications for corporates looms... more on this later
- Is the wave of defaults to come a tsunami?
- Further fiscal stimulus languishes as economists warn on unemployment and end of stimulus payments



## Risk takes center stage amidst the pandemic:

- Investor concerns
- Ratings agency implications
- **Fiscal actions 13% of GDP so far, compared to 6% in 2009**

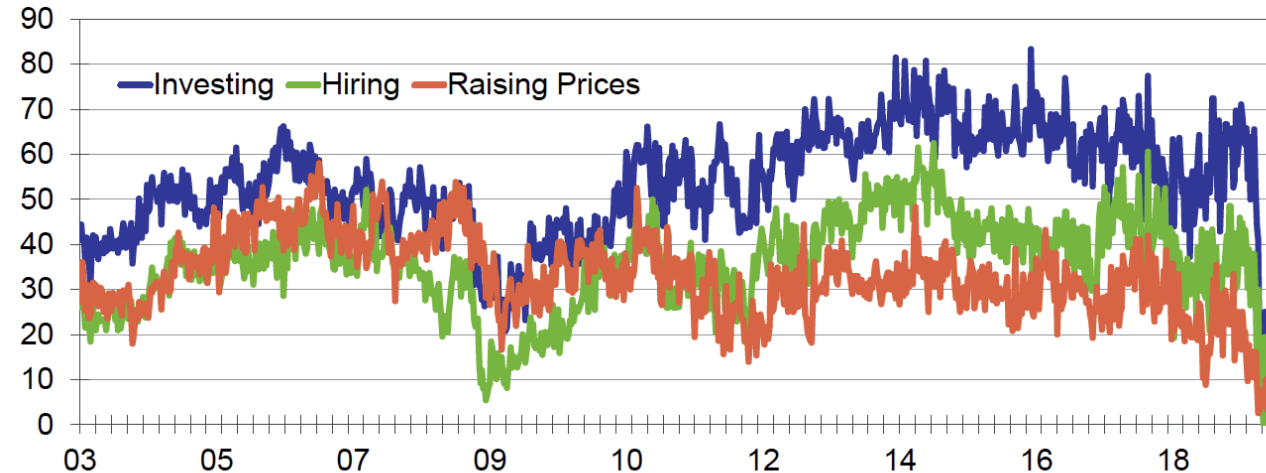


# Risk and Resilience: The Markets in 2020

## The Economy is not the Stock Market

### Businesses are Shell-Shocked

% of respondents to Moody's Analytics global business survey that are ...



Source: Moody's Analytics



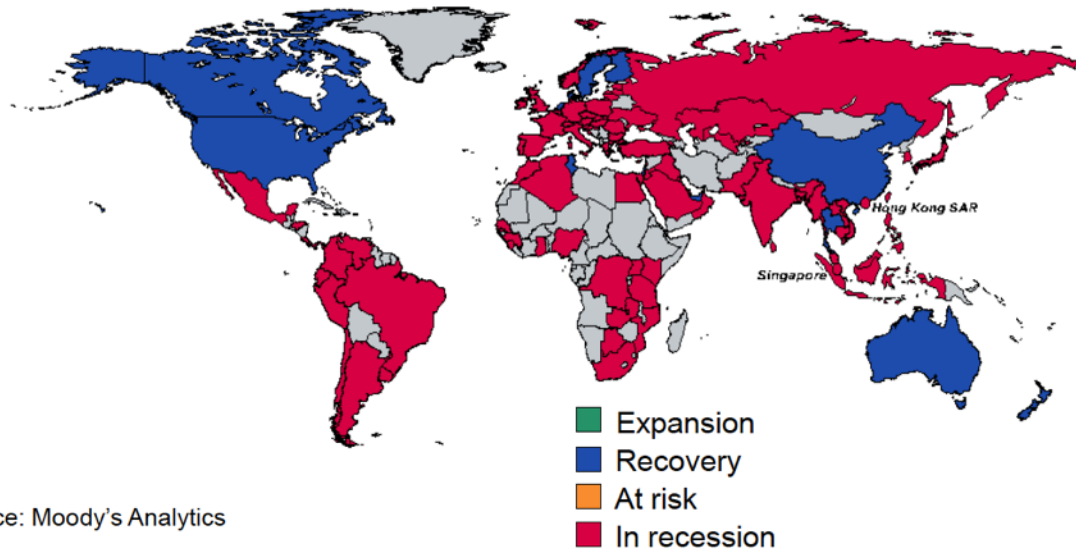
**Visibility is low:  
when will business  
levels stabilize?**

# Risk and Resilience: The Markets in 2020

## The Economy is not the Stock Market

### Global Recession Is Over...

Global business cycle status as of June 2020



Source: Moody's Analytics



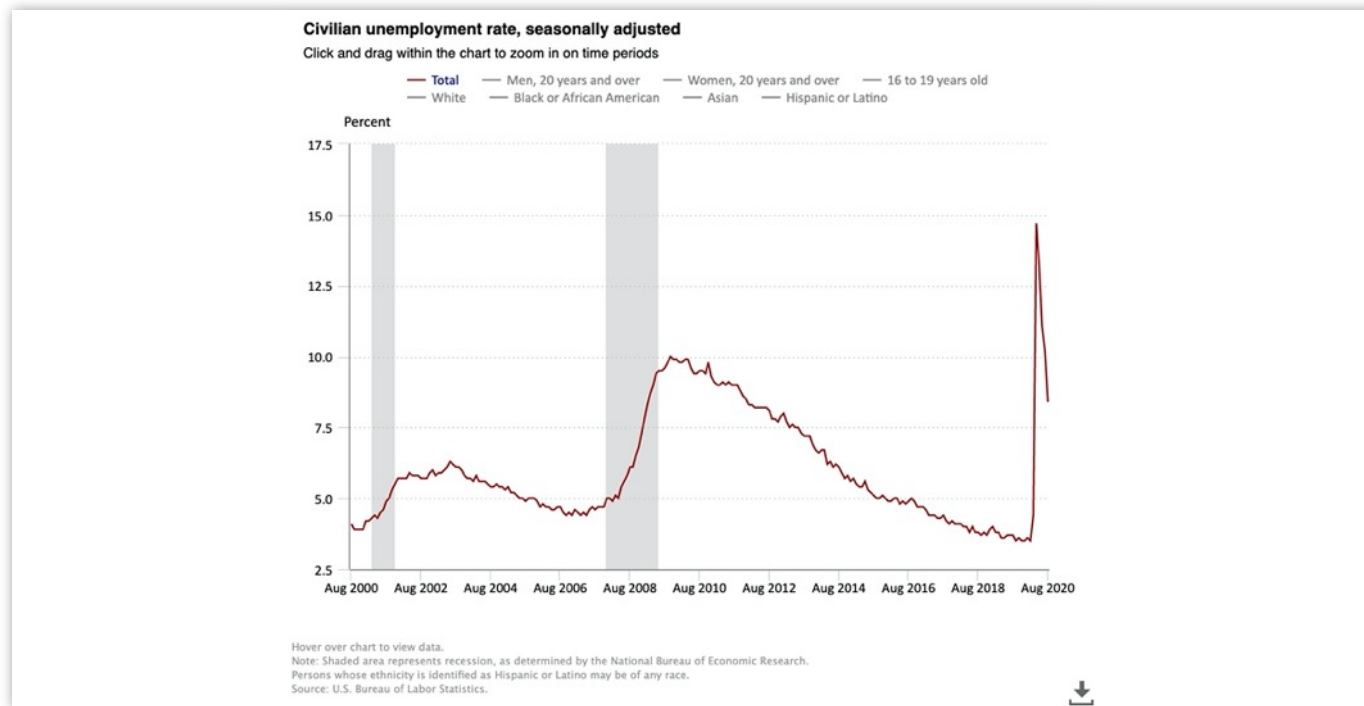
**Recoveries vary by region: possibility of rolling shutdowns lingers**

**BUT.....**



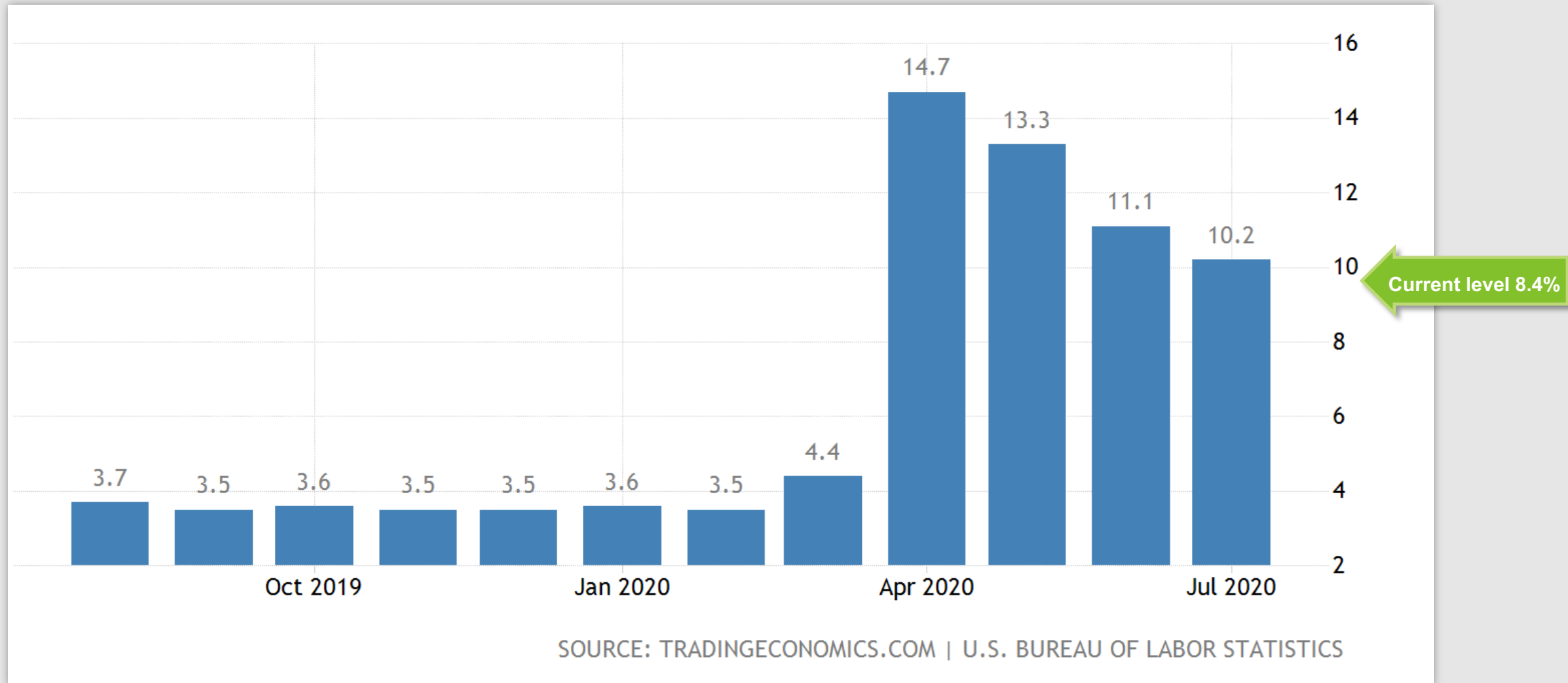
# The Markets in 2020: Risk and Resilience

## The Economy is not the Stock Market: Unemployment at records



**Unemployment in  
the US cannot be  
ignored**

# Unemployment Persists, Impacting Consumption





# Risk and Resilience: The Markets in 2020

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## The Next Question: What does the Recovery Look Like?

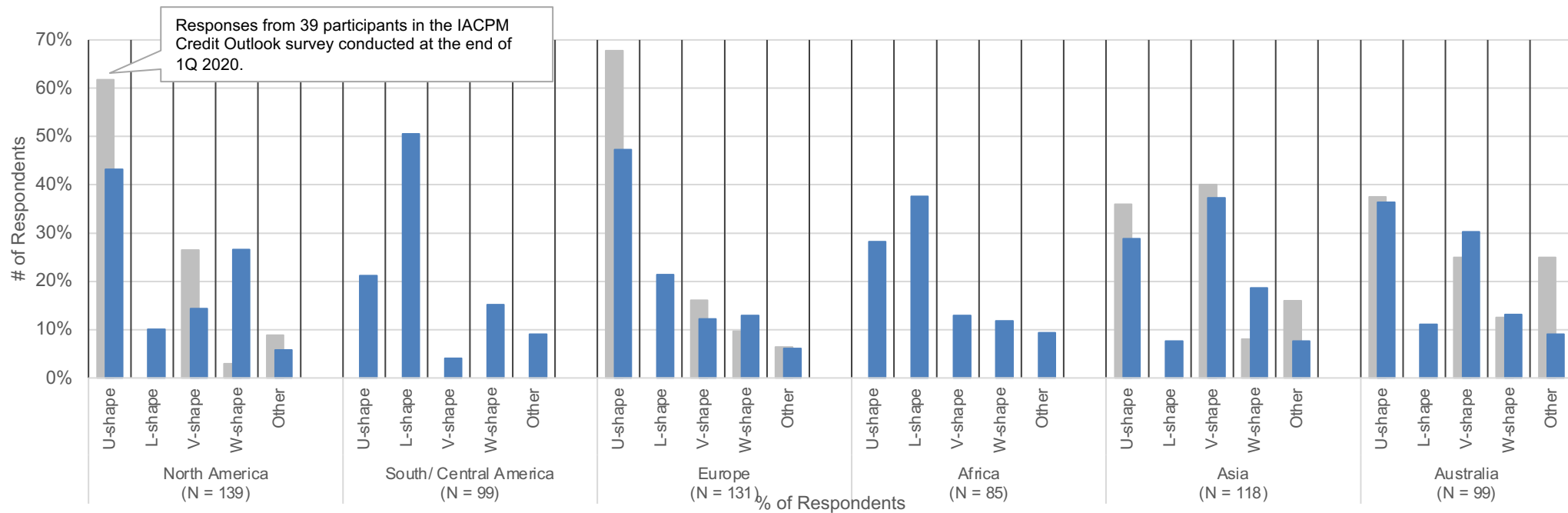
- Sector specifics
- What does that mean in and for the capital markets
- Covenants and amendments
- Recovery “shape” varies by geography and sector
- Recovery will take longer than expected
  - Results in the impacts that the debt markets are showing and will continue to show
  - Public versus private
  - Sector differences
  - Investment grade versus non-investment grade



**Recoveries vary by region: possibility of rolling shutdowns lingers**

# Expectations for Recovery “Shape”

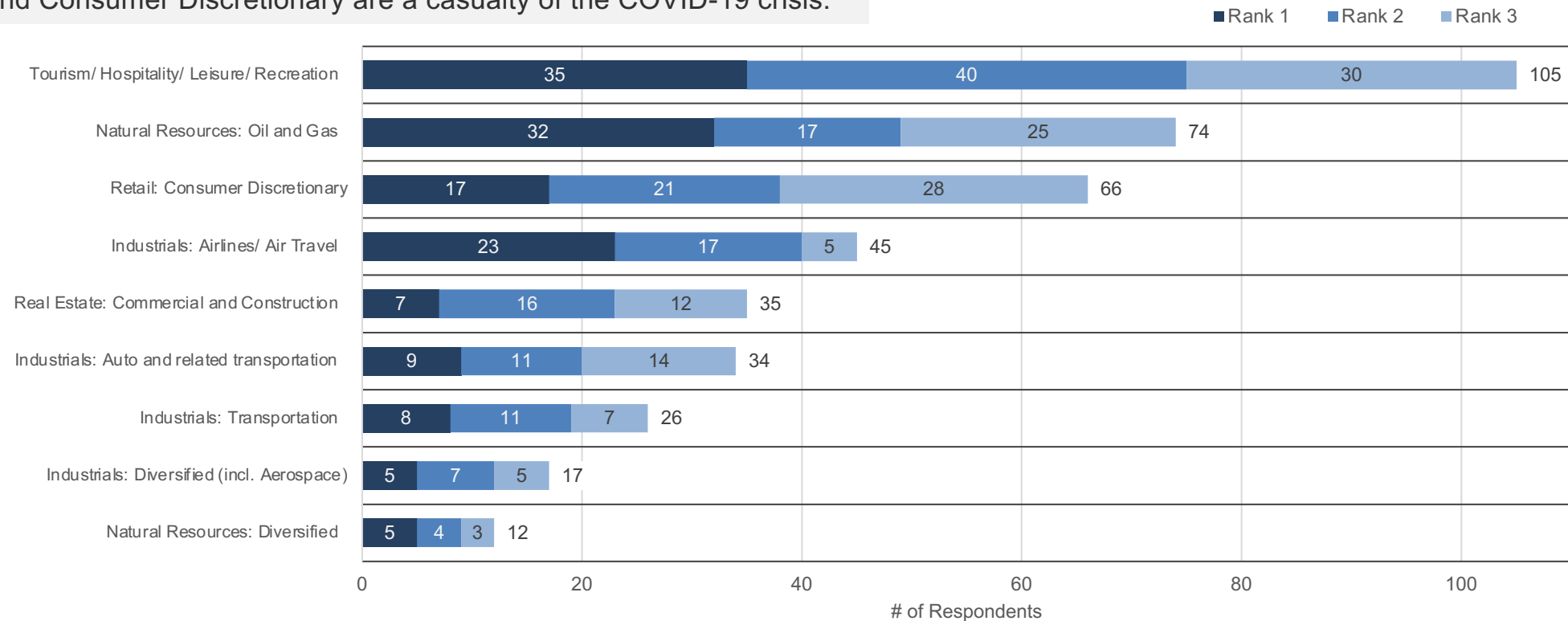
Over the last three months, expectations shifted to a longer and slower recovery.



Source: IACPM CPM Current Issues Survey – Spring 2020

# Financial Institution Survey: Industry Sectors Most At-Risk

Oil and Gas, CRE, and Airlines topped the list already at the end of 1Q.  
Tourism and Consumer Discretionary are a casualty of the COVID-19 crisis.



Source: IACPM CPM Current Issues Survey – Spring 2020



# Capital Markets Adjust: Revisions and Re-Sets

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## Institutional Risk Appetites Revisited and Revised

- Concerns about institutional and client business continuity risks
  - Enhanced emphasis on stress-testing many “at the margin” scenarios
  - Financial institutions generally in good shape financially, so the risk is different from 2008-9
    - If economic impacts continue long enough, there could be fallout for financial institutions
    - Insurance industry concerns
- Regulatory: yet to come, but already concerns about oversight
  - Companies repaying PPP loans and afraid to spend them
  - Annual SNC review is in process: we hear that scrutiny is up
  - Possible revisions in supervision and tighter parameters overall
- Ratings agency implications
- Financial institution risk appetites changing
  - **Intense focus on stress-testing and risk rating updates**



**Risk takes  
center stage amidst  
the pandemic**

# Risk and Resilience: The Markets in 2020

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## Institutional Risk Appetites Revisited and Revised

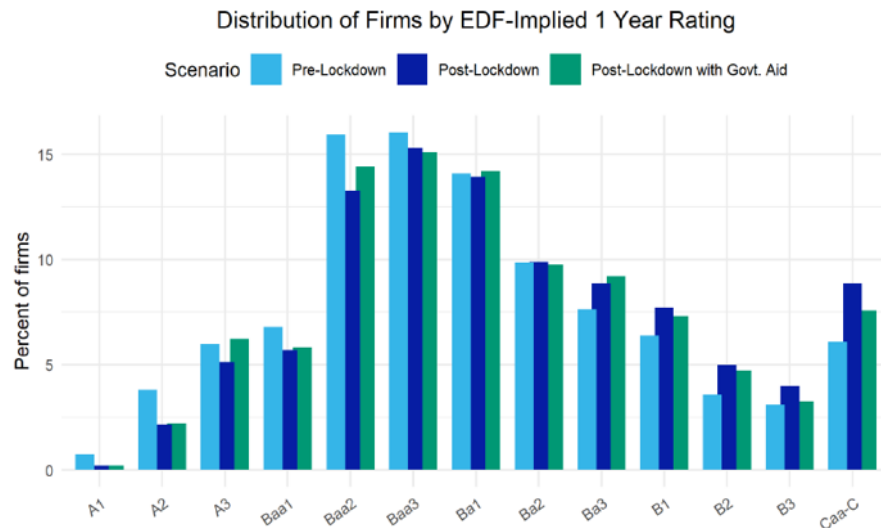
- Financial institution risk appetites
  - Adjusting situationally, but clearly tighter
  - Limits and concentrations emerging
  - Greater focus on risk assessment for the long term, including
    - Risk profiles adjusting to consider global climate risk and transition to low-carbon economy
- Ratings considerations and defaults on the increase
- Bankruptcies, workouts, changing risk profiles create a complex web of interrelated issues for risk managers and corporates alike
- The doors out will be different for every entity. The way through is the great unknown.
- Each story will matter
- Differences by region and Europe versus North America



**Uncertainty takes  
center stage amidst  
the pandemic**

# Risk and Resilience: The Markets in 2020

## Moody's Analytics Predicts Downgrades



Median EDF-implied rating worsens from Baa3 to Ba1

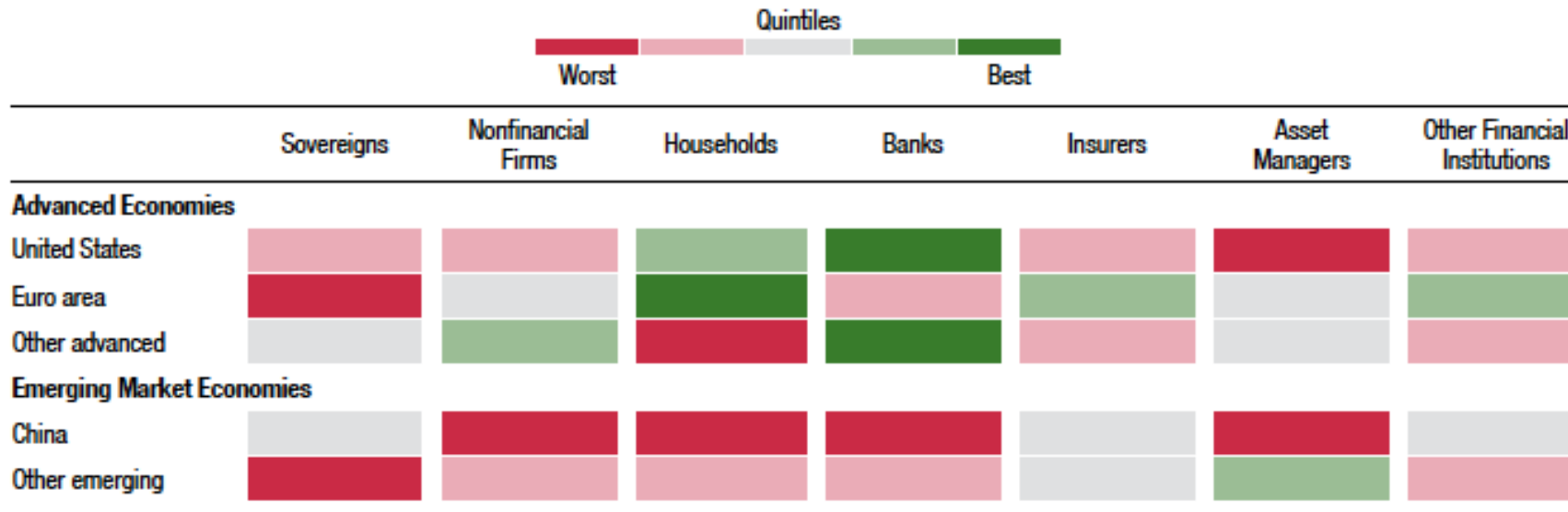
Share of firms rated Caa or lower increases from 6.2% to 8.9% (or 7.6% with government aid)



**Uncertainty takes center stage amidst the pandemic**



# Financial Vulnerabilities by Sector and Region



Source: IMF Global Financial Stability Report April 2020

# First and Second Quarter Results Indicate Playbook for Corporates

## Their own version of the 2008-9-10 playbook unleashed in Q1 and early Q2

- **Marshal liquidity**, suspend buybacks, furlough employees while still operating, access capital, defer cash payments, seek amendments or prepare for them
- Broad agreement that Q2 will have been the worst for many US and US-based multi-nationals
  - Some segments off by 50%
  - International re-openings may counter-balance US closings to a moderate extent
  - Risk of rolling shutdowns by region dampens outlooks globally



# Market Activity Off the Charts through August

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Since the start of April LCD has captured nearly **240 transactions** in which U.S. loan issuers have relieved financial covenants under their credit facilities amid the coronavirus pandemic, which has upended the asset class and economies worldwide.

Many of these activities have included suspending and/or waiving financial maintenance covenant tests for at least a year, readjusting financial maintenance covenants after that covenant holiday, and adding other covenants, such as minimum liquidity requirements. LCD will periodically update this tracker as warranted by the market.



To put that number in perspective, there were **117 covenant-relief transactions** in all of 2017, 2018 and 2019 combined.



# COVID Carve-Out “how-to”

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1

## **EBITDA definitions**

Add-backs for one-time and other expenses

2

## **Covenant Holidays**

Leverage and Coverage covenants suspended for up to a year, which we have not seen since 2009-10. In many cases, replacing with minimum liquidity

3

## **Concerns over Q1-2 21, then trailing 12 will fall “off the cliff”**

Consider build up of EBTDA using proxies

4

## **Substitution of covenants**

5

## **More gating requirements at certain leverage levels**



# What's To Come?

- Defaults?
- Bankruptcies
  - 2020 is on track to have the highest number of retail bankruptcies in a decade, according to S&P Global Market Intelligence.
- Workouts
- Impacts

# Transformation and the Markets

- When and how bad is the next wave? Tied to further recovery
  - Clients are modeling a rolling business reduction to account for second surge
- The stock market is not the economy
- What are the key drivers going forward?





# Transformation and Takeaways

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- 1 By ratings and industry, there are and will be “haves” and “have nots”
- 2 May create opportunities for more M&A even in the mid-market space
- 3 **If recovery takes longer, liquidity may become stretched: Most financial institutions and investors believe recovery not until end of '21-early '22**
- 4 **Internal Risk Evaluation: Companies need to use this time to undertake robust and rigorous business model risk analysis to identify areas of vulnerability (EG supply chain and other)**
- 5 **Know the level and depth of availability in your own capital structure. Identify alternatives or weak links**

# SYCAMORE ASSOCIATES

*We are caught in an inescapable network of  
mutuality, tied in a single garment of destiny.  
Whatever affects one directly, affects all  
indirectly.*

*Dr. Martin Luther King, Jr.*







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# Additional Materials



# How is the Current Corporate Credit Cycle Different from Past Cycles?

## IMF Global View

Sources of Credit: The Investor Base for Corporate Debt	Uses of Credit: Credit Quality of Corporate Debt Issuers
<p><i>Market-based finance</i> has expanded faster than bank lending to the corporate sector which, may imply different market dynamics in periods of stress (Figure 1.8, panel 1):</p> <ul style="list-style-type: none"><li>• The role of <i>investment funds</i>, including exchange-traded funds (ETFs), has increased.<sup>1</sup> Their holdings of corporate bonds in the United States have more than doubled since 2009, reaching about 20 percent in 2018 (Figure 1.8, panel 2). This may imply higher refinancing risks for borrowers.</li><li>• <i>Insurers and pension funds</i> still represent a large share of the investor base in corporate bonds. While these investors are generally viewed as stable, they typically have credit rating restrictions.</li><li>• <i>Foreign investors'</i> share in corporate bond holdings has increased from 25 percent to 30 percent in the United States. These investors may adjust exposures in response to higher foreign exchange hedging costs or to rating downgrades.</li><li>• In the US <i>leveraged loan market</i>, the share of banks declined to only 8 percent, while the share of collateralized loan obligations increased from 47 percent to close to 60 percent.</li></ul>	<p>Corporate bond issuers are now generally <i>more leveraged</i> than before the global financial crisis:</p> <ul style="list-style-type: none"><li>• In the overall credit market, the share of <i>speculative-grade credit</i> (high-yield bonds and leveraged loans) declined from 31 percent in 2007 to 25 percent in 2018.<sup>2</sup></li><li>• In the investment-grade corporate bond market, the outstanding stock of <i>BBB-rated bonds</i> has quadrupled since the global financial crisis, driven by new BBB issuance, rating downgrades, and new entrants (Figure 1.8, panels 3 and 4).<sup>3</sup> Debt-service capacity in the investment-grade market has improved, but leverage has risen (Figure 1.8, panel 5). In the high-yield bond market, the share of <i>CCC-rated bonds</i> has declined from 19 percent in 2007 to 15 percent in 2018.</li><li>• The <i>US leveraged loan market</i> has grown rapidly and approached the size of the high-yield bond market because of new entrants and migration from the high-yield bond market, where investor scrutiny is greater (Figure 1.8, panel 6). The leveraged loan market is now characterized by elevated leverage, limited liquidity, and reduced investor protections.</li></ul>

Source: IMF staff.

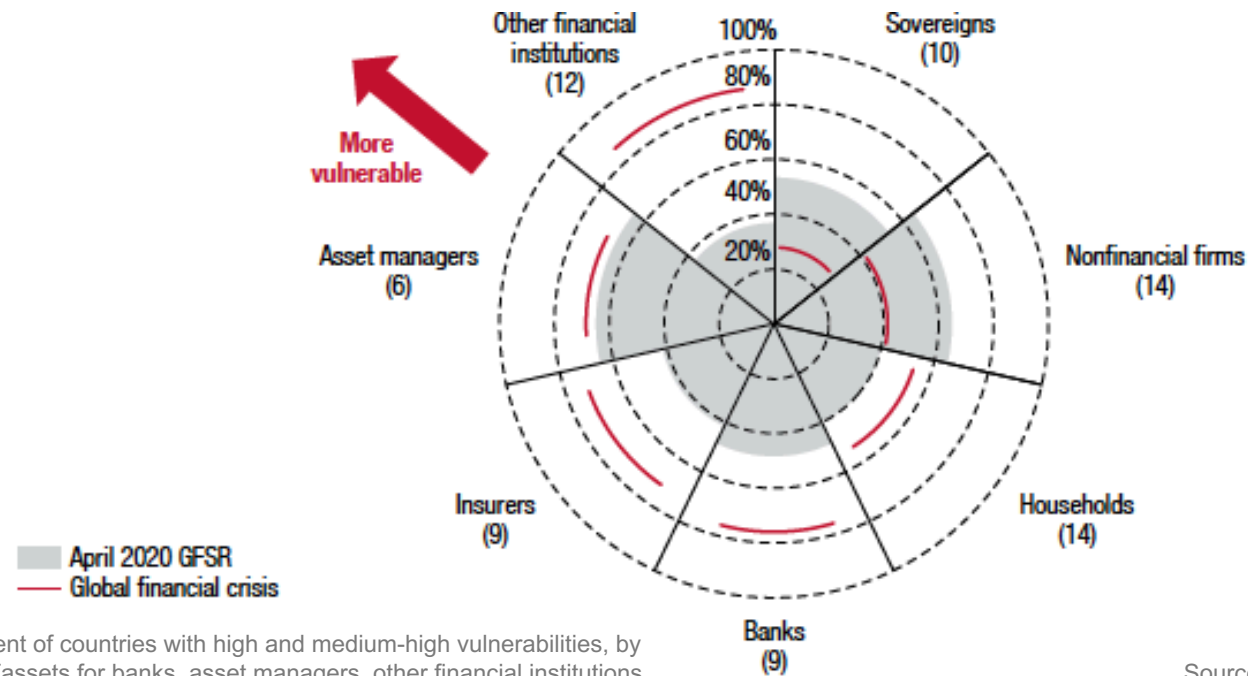
<sup>1</sup> ETFs offer daily liquidity to end-investors but may hold less liquid assets (see the April 2018 *Global Financial Stability Report*).

<sup>2</sup> Speculative-grade credit amounted to 3 percent of GDP in the euro area and 12 percent of GDP in the United States in 2018.

<sup>3</sup> BBB-rated bonds are the lowest-rated bonds in the investment-grade category of corporate bonds.

# Capital Markets Adjust: Revisions and Re-Sets

## Proportion of Systemically Important Countries with Elevated Vulnerabilities by Sector



(Percent of countries with high and medium-high vulnerabilities, by GDP [assets for banks, asset managers, other financial institutions, and insurers]; number of vulnerable countries in parentheses)

Source: IMF Global Financial Stability Report April 2020

# Expected Shape of Next Downturn Across Regions

Over the last three months, expectations shifted to a longer and slower recovery.

## Definitions:

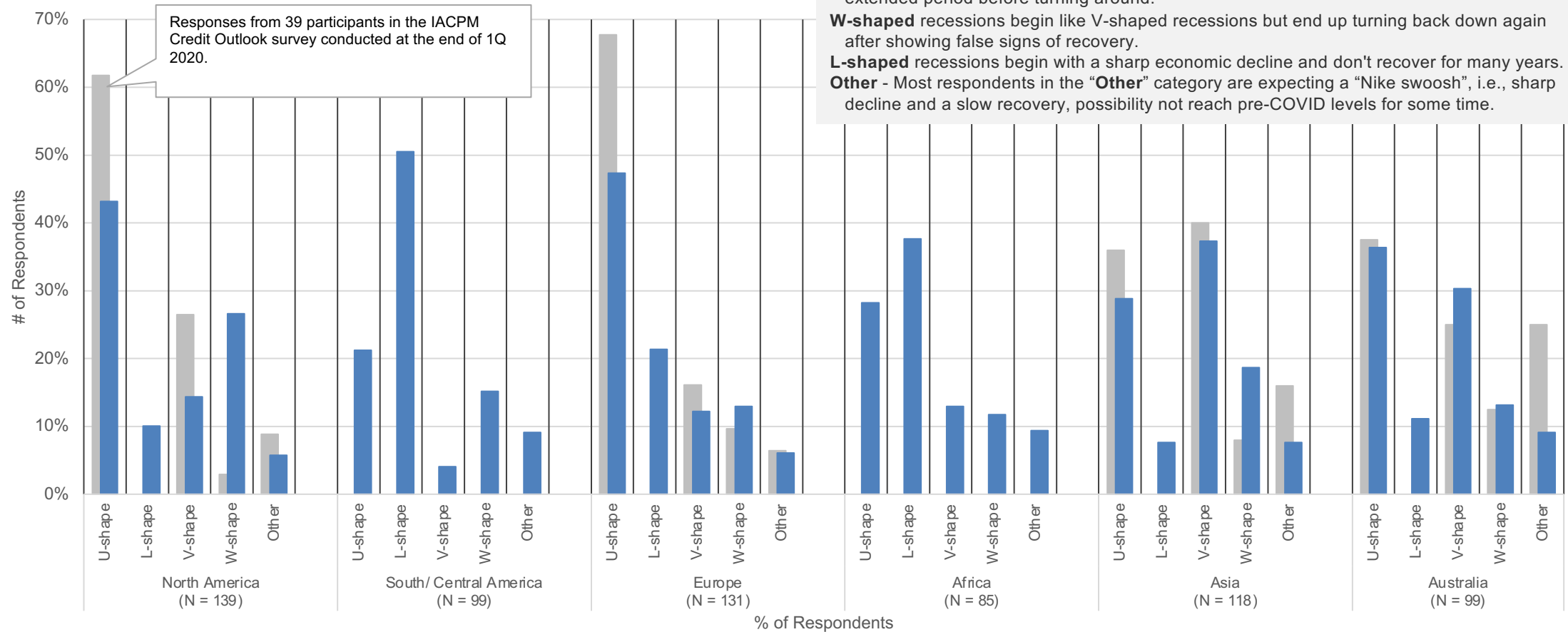
**V-shaped** recessions begin with a sharp but brief period of economic decline, quickly find a bottom, followed by a strong recovery.

**U-shaped** recessions begin with a slow economic decline, remain at the bottom for an extended period before turning around.

**W-shaped** recessions begin like V-shaped recessions but end up turning back down again after showing false signs of recovery.

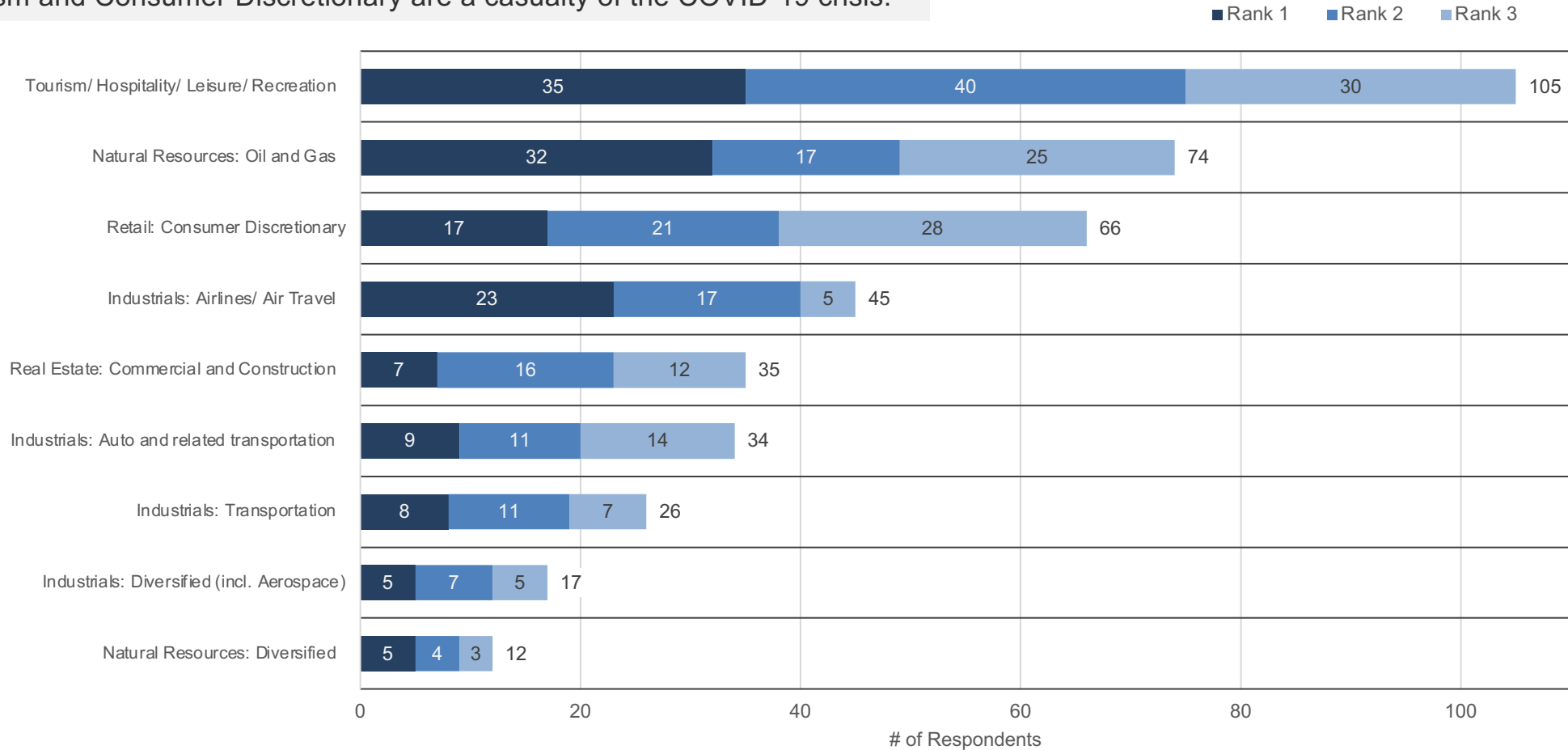
**L-shaped** recessions begin with a sharp economic decline and don't recover for many years.

**Other** - Most respondents in the "Other" category are expecting a "Nike swoosh", i.e., sharp decline and a slow recovery, possibility not reach pre-COVID levels for some time.



# Industry Sector Focus for Risk Mitigation Efforts

Oil and Gas, CRE, and Airlines topped the list already at the end of 1Q.  
Tourism and Consumer Discretionary are a casualty of the COVID-19 crisis.



Source: IACPM CPM Current Issues Survey – Spring 2020

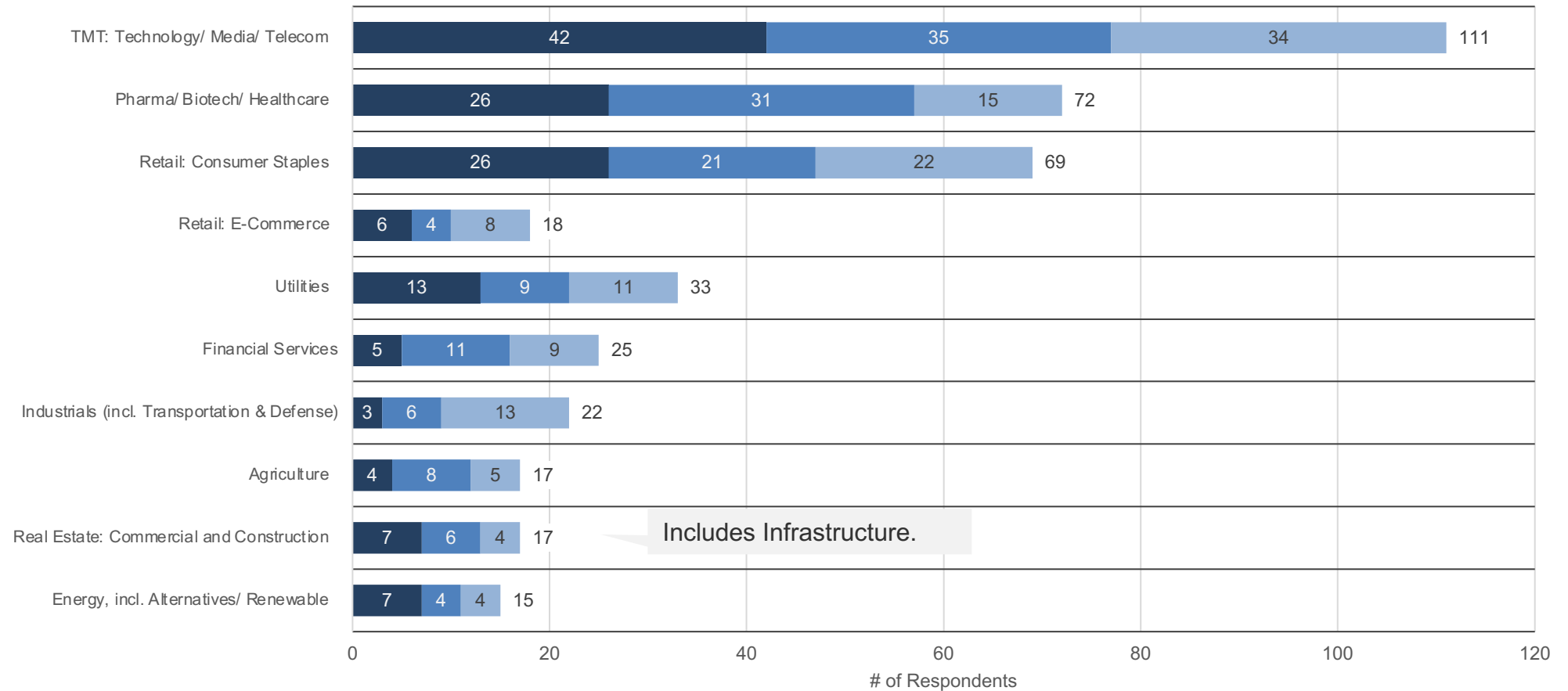
Question: Which three industry sectors are you most focused on for risk mitigation efforts in the next three months? (Q3)



# Most Resilient Industry Sectors

Give the current crisis and the WFH environment, the top sectors should come with no surprise.

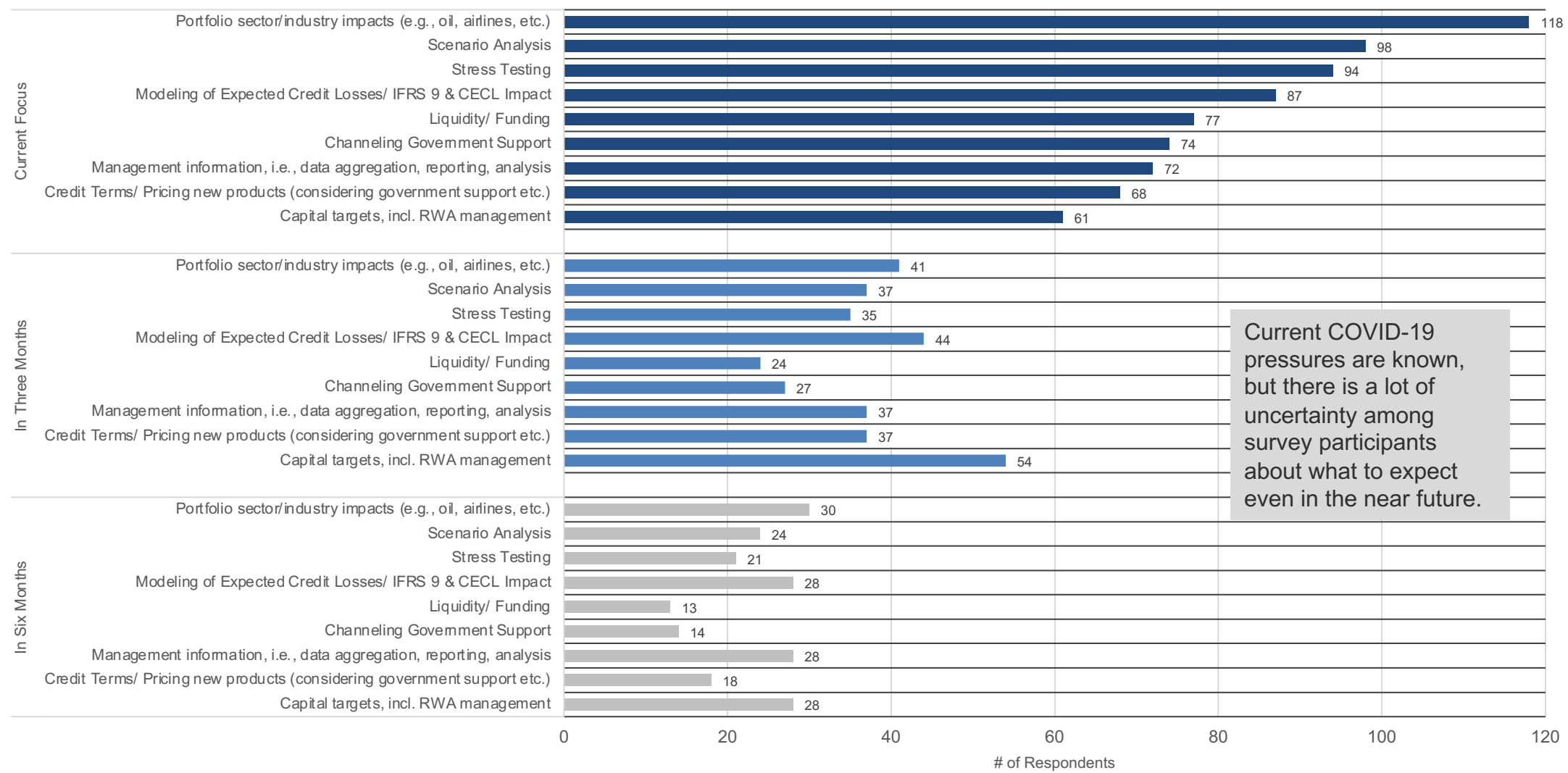
■ Rank 1 ■ Rank 2 ■ Rank 3



Source: IACPM CPM Current Issues Survey – Spring 2020

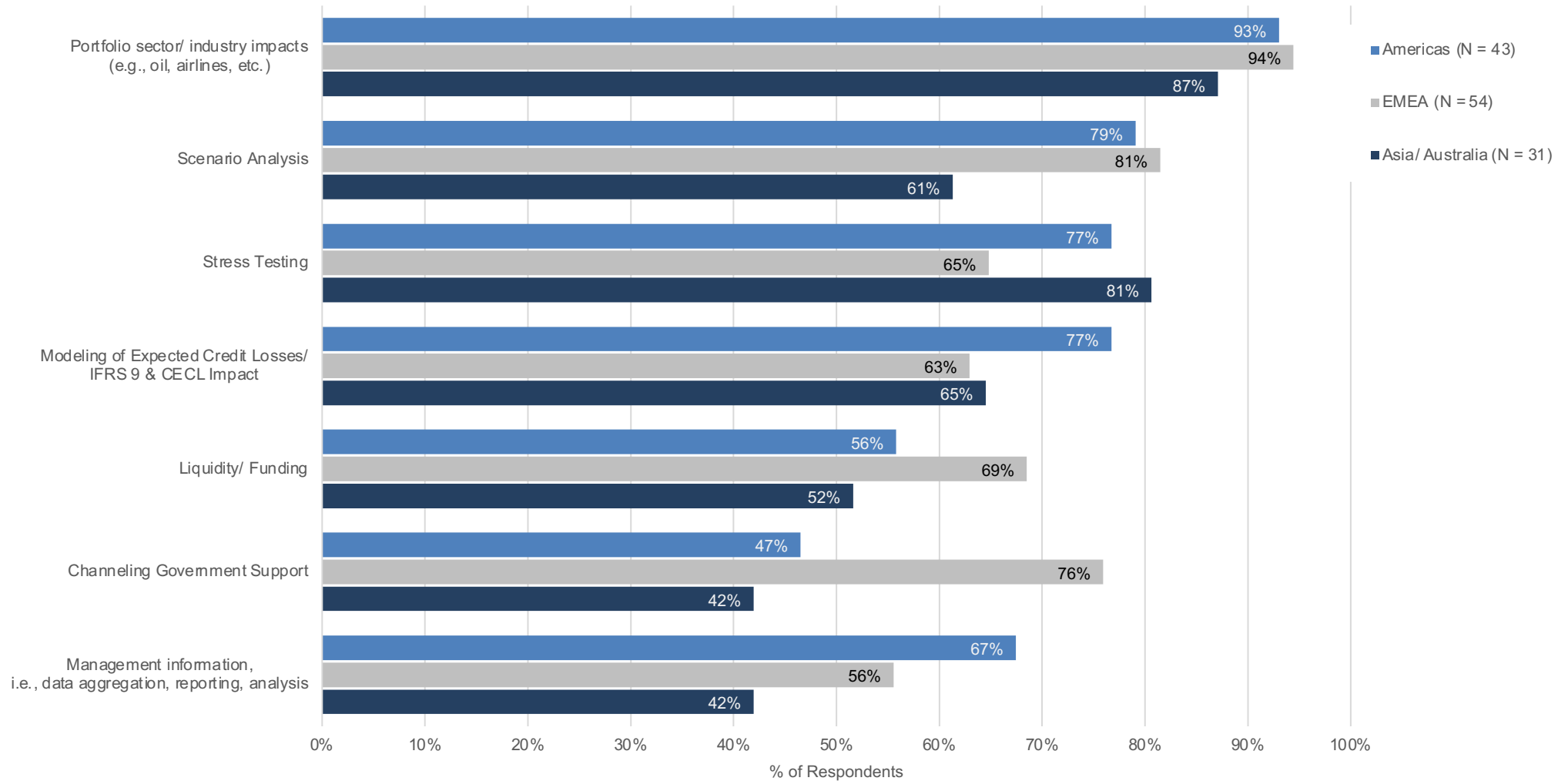
Question: Which three industry sectors do you see as most resilient in the current COVID-19 crisis? (Q4)

# COVID-19 Pressures and Priorities Going Forward



Source: IACPM CPM Current Issues Survey – Spring 2020  
 Question: Which aspects of the COVID-19 pressure is your institution most focused on now and expected to be in the near future? Please select all that apply. (Q5)

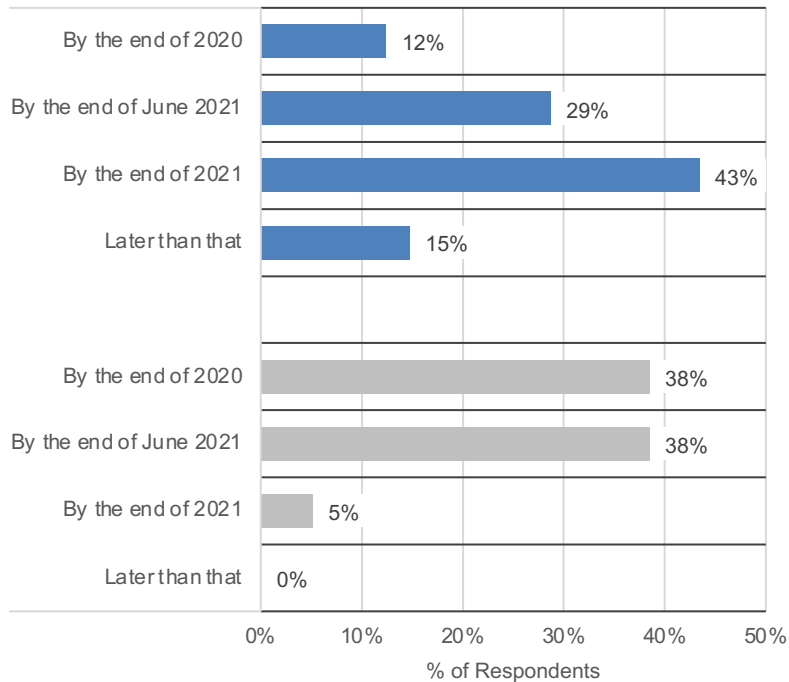
# Current COVID-19 Pressures can Differ by Region



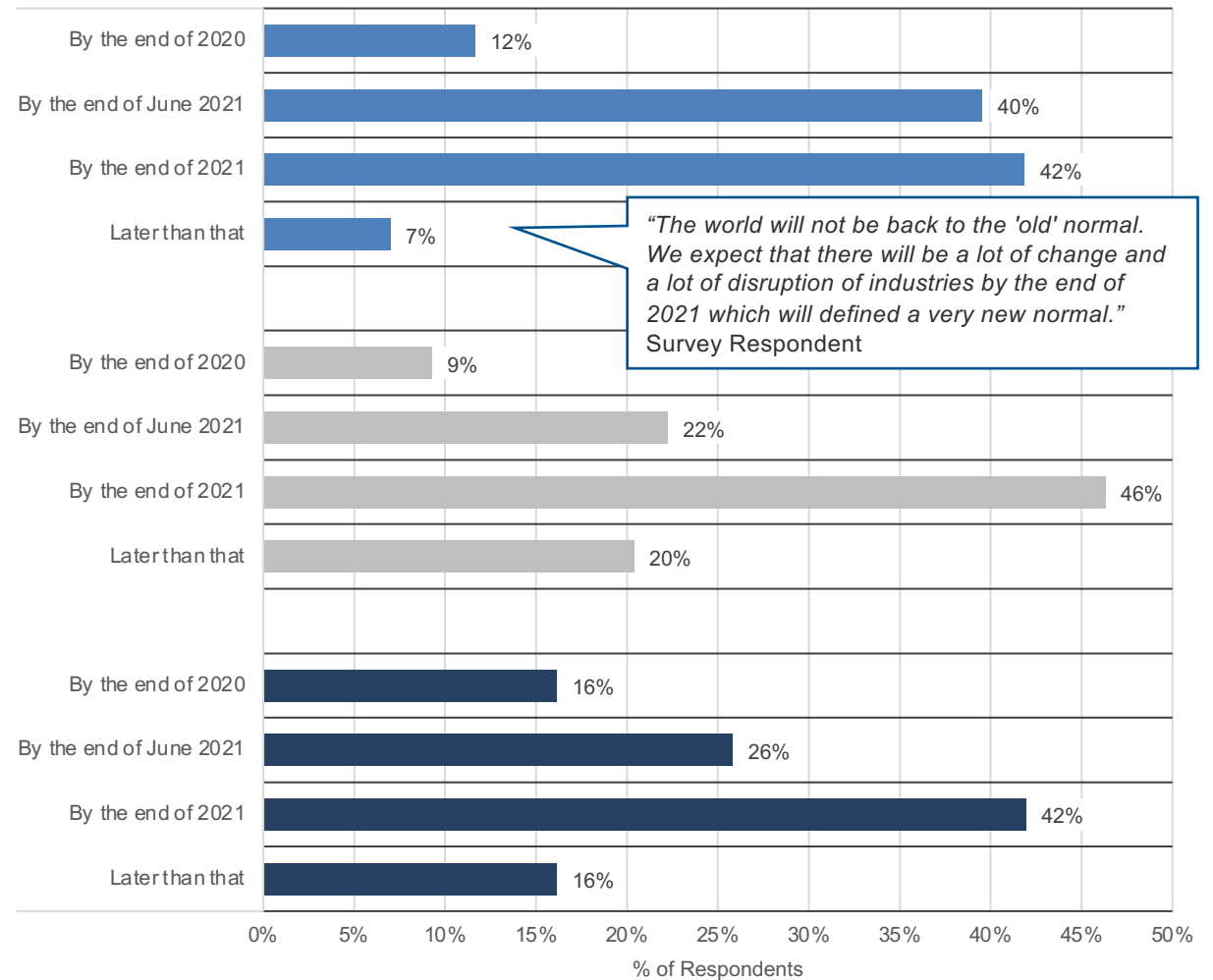
Source: IACPM CPM Current Issues Survey – Spring 2020

Question: Which aspects of the COVID-19 pressure is your institution most focused on now and expected to be in the near future? Please select all that apply. (Q5)

# Estimated Timing for the World to be Mostly Back to “Normal”



Later estimates range between 2022 and 2025. Overall there is the consensus that the new “Normal” will be nothing like before and necessitates the availability of an effective vaccine. Multiple respondents remark that a timeframe *“is barely possible to predict as it depends primarily on some variables that we cannot control now as the availability of a vaccine and the occurrence and hence seriousness of a second wave.”*



Source: IACPM CPM Current Issues Survey – Spring 2020 | Question: Approximately when, do you think, will the world be mostly back to “normal” following the outbreak of COVID-19? Given the current uncertainties, we will rely on your expertise to define your new “normal”. (Q8)



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