MORNINGSTAR | DBRS

Commentary

High Rates and High Leverage: Negative Credit Rating Actions Will Likely Continue for Weaker Private Credit Borrowers

DBRS Morningstar
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Key Takeaways
Higher interest rates and a weakening ability to pass through price increases are resulting in a ramp-up in negative credit rating actions for weaker private credit borrowers, and we expect this trend to continue.

However, payment defaults within our rated portfolio remain below the broader average for public and private companies in the deep non-investment-grade segment (i.e., B credit rating quality and below), likely due to relatively strong credit profiles and tight, supportive management by private equity sponsors and private lenders.

A significant deterioration in projected liquidity resources and interest-paying ability over the next 12 months would signal that negative credit rating actions may accelerate

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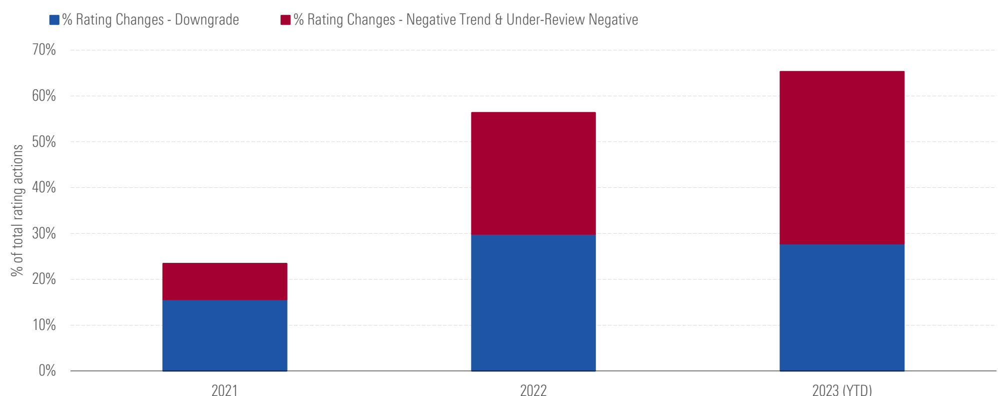
Negative Credit Pressures are Increasing

Our private credit group maintains private credit ratings on a portfolio of approximately 300 higher-leveraged corporate issuers throughout North America and Europe. The group mainly covers private equity-backed companies with operating earnings ranging from approximately USD 10 million to USD 100 million. We have observed the following trends in 2023:

- High interest rates and labour costs driving tighter cash flow;
- Private credit firms struggling to reduce leverage;
- Borrowers focusing on defending margins and slowing acquisitions; and
- Proportion of negative credit rating actions climbing markedly above 50%.

However, our private credit borrowers have so far experienced lower default rates compared with the broader average of public and private companies in the deep non-investment-grade segment (i.e., B credit rating quality and below). We believe this reflects higher covenant restrictions and a close working relationship among management, private equity sponsors, and private lenders for our rated companies. Though we expect to see incremental weakness in financial results going forward, we do not expect a wholesale spike in defaults in our rated portfolio.

Exhibit 1 Negative Credit Rating Changes as a Percentage of Total Credit Rating Actions



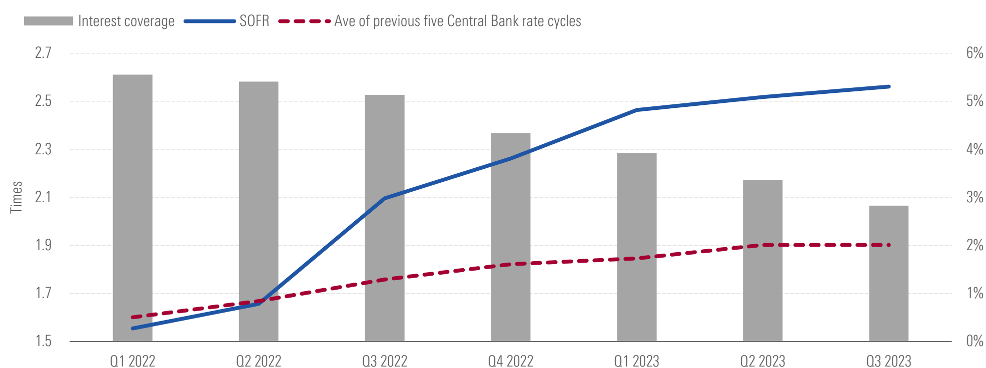
Note: Negative credit rating actions include downgrades, trend changes to Negative, and the placement of ratings Under Review with Negative Implications, shown here as a percentage of all credit rating actions (excluding confirmations, new credit ratings, and withdrawals).
Source: DBRS Morningstar.

High Interest Rates and Labour Costs Drive Tighter Cash Flow

Private credit borrowers began to experience margin pressure in 2022, particularly firms with labour-intensive cost structures. Many firms were able to mitigate this impact by passing through higher costs to customers amid strong demand conditions following the Coronavirus Disease (COVID-19) period. In 2023, however, we have observed ongoing cost inflation and fewer private credit issuers passing on such costs due to waning pricing power, contributing to continued pressure on operating margins.

Current higher interest rates also persist and private credit issuers continue to absorb the impact of this trend because debt in this portfolio is almost entirely composed of variable-rate term loans priced at a benchmark rate (typically the Secured Overnight Funding Rate (SOFR)) plus a spread of approximately 5% to 7%. Central bank rate hikes have driven all-in borrowing costs to a range of 10% to 12% for most of our rated borrowers. Our rated private borrowers have exhibited weaker ability, on average, to cover their interest expenses with operating income since Q1 2022, when aggressive rate increases began to reverse decades of historically low borrowing costs (see Exhibit 2).

Exhibit 2 EBITDA Interest Coverage (Q1 2022 to Q3 2023)



Note: Interest coverage = earnings before interest, taxes, depreciation, and amortization/interest expense.
SOFR = Secured Overnight Funding Rate.
Sources: Bank of Canada, Federal Reserve Bank of New York, Bank for International Settlements, Bundesbank, DBRS Morningstar.

High-Risk Issuers are Particularly Affected

The average EBITDA interest coverage for our rated portfolio declined to closer to 2.0 times (x) in 2023 from over 2.5x in early 2022 (Exhibit 1). However, we note a sharper decline for weaker credits to just above 1.0x in 2023 from over 2.0x. Approximately 10% of the portfolio currently has forecasted EBITDA interest coverage of below 1.3x. These at-risk issuers often share the following characteristics:

- Lower rated within the private credit portfolio;
- Aggressively underwritten with high leverage on the back of optimistic sponsor and lender growth assumptions;
- Weaker liquidity profiles;
- Less control over operating costs (including a high proportion of inflexible labour costs and high fixed-asset costs); and
- For acquisitive borrowers, challenges in executing cost synergies for previous acquisition activity.

Private Credit Firms Struggle to Reduce Leverage

Through weaker operating profit and borrowings against revolving credit facilities to cover for cash flow decline, we have observed leverage climbing instead of falling for more private credit borrowers compared with higher-rated corporate issuers with more reliable internal liquidity sources to manage their capital structures. The persistent high interest rate environment and heavy debt burdens have left some private credit companies with limited or negative free cash flows, restricting their ability to pay down debt.

Borrowers Now Focus on Defending Margins and Slowing Acquisitions

This year, we also noted a general reduction in consolidation transactions (roll-up acquisitions) for borrowers that have historically been highly acquisitive. Instead, these borrowers are shifting toward more aggressive cost-reduction efforts to optimize returns on prior debt-financed acquisitions. That said, we have not yet seen widespread drawing against committed credit facilities as observed at the outset of the coronavirus pandemic in 2020, as these too have floating interest rates.

Proportion of Negative Credit Rating Actions Climbs Markedly Above 50%

Driven by weaking financial risk assessments and liquidity positions, we have observed a marked uptick to 65% in the number of negative rating actions as a proportion of total credit rating changes in 2023 relative to 2022 (see Exhibit 1). In a normal year, this ratio would normally be around or just above 50%. The artificially strong performance in 2021 reflected the massive, but temporary, government stimulus due to the coronavirus pandemic.

Our credit ratings in the private credit portfolio already incorporate some cushion; however, we expect negative credit rating momentum to persist as pressure builds for weaker issuers, resulting in additional movements down the rating scale. Overall, we expect negative credit rating actions to increase in the current environment to the extent that borrowing costs remain near current levels.

Liquidity and Interest Coverage Will be Critical Signposts

Liquidity and interest coverage are critical for lower-rated, highly leveraged borrowers. Over the next 12 months, we will be examining projected liquidity for evidence of firms needing to draw on lines of credit to cover capital needs, which could indicate fundamental deterioration. Material weakness in other key financial metrics, such as operating cash flow as a percentage of debt and free cash generation, may also reveal rising default risk. If EBITDA interest coverage ratios fall below 1.0x, we will likely take negative credit rating actions as this would signal an issuer's inability to fully cover interest charges with its current operating income. We see a small but growing portion of our rated private credit borrowers approaching this threshold, and will continue to monitor the environment going forward.

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