

ECB'S EXPANDED QE: GOING INTO OVERDRIVE

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Ratings



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SUMMARY

- The ECB has designed the corporate sector purchase programme (CSPP) to maximize flexibility, limit market disruption, channel support to smaller non-financial companies and, at the margin, promote Capital Market Union.
- With the total stock of eligible non-financial corporate bonds of about €660 billion (50% in the utility, automobile, and telecom sectors) and prospective annual net non-financial corporate issuance of €25 billion-€50 billion, there is ample scope to extend the programme beyond March 2017 (if required) assuming ECB purchases of €5 billion per month from June 2016 until March 2017.
- We expect the CSPP to benefit investment-grade corporate liquidity by encouraging low cost refinancing at ultra-long 10-20 year maturities, although incremental debt funding for capital investment and acquisitions in the region may pick up only moderately.
- Our longer-term credit concerns center on the inducement to debt; the burgeoning costs of servicing defined-benefit pension schemes, and the impairment of market signals due to yield compression and contrived shape of yield curves.

CSPP REINFORCES CORPORATE LIQUIDITY

From a liquidity perspective, we view the ECB's Corporate Sector Purchase Programme (CSPP) as credit positive in so far as it underpins debt service costs at a low level and encourages investment-grade corporates to extend debt maturities further. Moreover, the trickle down impact to the European high-yield market could well prove to be even more beneficial as liquidity returns and yields fall back towards historic lows.

The real questions are to what extent euro area corporates will take advantage of the opportunity of cheaper financing and what the wider, longer-term, credit implications might be.

We see three main drivers behind corporates tapping the bond market:

- **Refinancing:** *Credit neutral/positive.* Refinancing existing debt is at the core of primary bond market activity. One consequence of the CSPP is that companies will be able to extend new debt maturities even beyond 7-10 years as investors grapple with the trade-off between extending duration, moving down the credit curve, or up the rating spectrum to structured credit. We expect investor strategies to encompass all three as they seek incremental yield in a low and negative yield environment. Non-eligible foreign issuers could also take advantage of the opportunity to issue in euros.

Recently, we have started to see some stronger 'A' rated issuers getting good traction for 20-year euro-denominated issues (e.g. Philip Morris, Anheuser-Busch InBev), although investor interest seems more focused on the 10-15-year segment for now (e.g. Coca-Cola European Partners PLC (BBB+/Stable/A-2)).

- **M&A:** *Credit negative/neutral.* We expect to see moderate pick-up in M&A activity through the year as European companies seek to expand externally when they cannot find organic growth opportunities. An increasing proportion is likely to be funded with a higher amount of debt. Depending on current rating headroom, the level of achievable synergies and availability of free cash flow to pay down debt over the rating horizon, this could have negative rating implications. We expect more active sectors to include pharmaceuticals, chemicals, and consumer products¹.
- **Capital Investment:** *Usually credit neutral.* We continue to view investment as primarily demand driven. So, even after such an extended period of lackluster economic recovery in Europe, we are only starting to see capital investment picking up in a few (non-commodity) sectors.

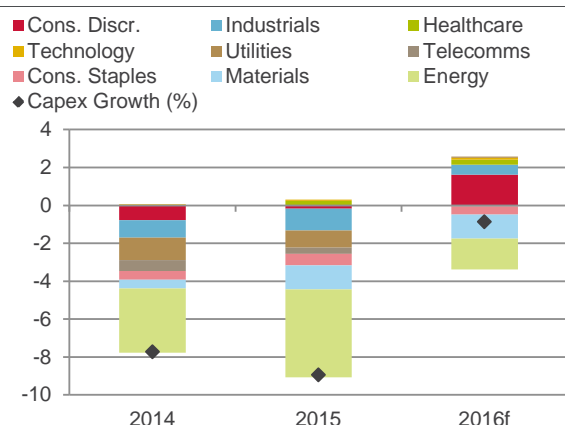
Specifically, we expect modest positive growth in the consumer discretionary, industrials and healthcare sectors in 2016 where, on a combined basis, capex is expected to grow by 7%, equivalent to about €16 billion. The slowdown in the energy and materials sectors continues to outweigh this trend (see chart 1), albeit most of these European borrowers are largely U.S.-dollar funded.

As a result, we expect corporate demand for new euro-denominated term financing will likely remain quite modest. We think exceptions will include companies involved in the supply chain for infrastructure projects that are quite well advanced as well as real estate operating companies (mostly REITs). For instance, French property REIT Unibail-Rodamco (A/Stable/A-

¹ "Record low cost of capital levels in Europe could boost M&A activity while risks to credit quality are expected to rise", published April 30, 2016

1) recently issued a 6x oversubscribed €500 million 20-year bond as part of a programme to extend their debt maturities.

CHART 1 | CORPORATE CONTRIBUTION TO W. EUROPE CAPEX GROWTH BY SECTOR 2014-2016 (%)



Source: S&P Global Market Intelligence, S&P Global Ratings' calculations, Global Corporate Capex 2000.

DESIGNED TO PROVIDE ECB MAXIMUM FLEXIBILITY

The technical details of the ECB's CSPP programme released on April 21 were a positive surprise. The eligibility criteria have been drafted very broadly to include:

- Euro-denominated issues from euro area-incorporated non-financial subsidiaries of foreign groups, and senior debt issued by insurance companies (excluding those with bank parents).
- A remaining maturity (at purchase) of more than six months but less than 31 years.
- A requirement for only one investment-grade rating for each issue from a registered, or certified, credit rating agency that meets the requirements of the Eurosystem's Credit Assessment Framework (ECAF).

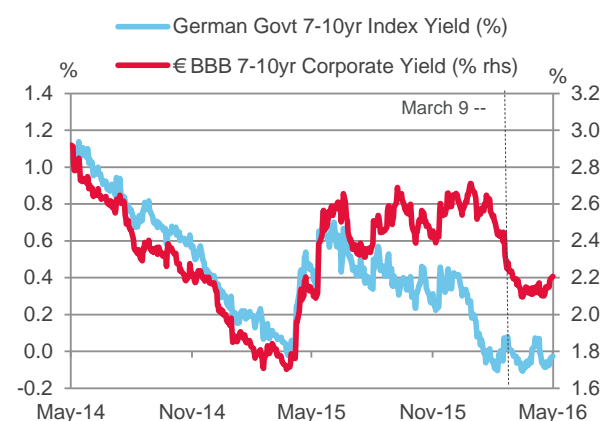
In addition, the ECB will be able to buy up to 70% of eligible issues, either in the primary or secondary market with no lower limit on issue size.

SOME MARKET IMPACT INEVITABLE

The design of the new programme indicates that the ECB is signaling a "light touch" by attempting to prevent excessive market distortions arising in either the primary or secondary markets. However, that is easier said than done. The ECB's March 10 announcement that it would start buying corporate bonds late in the second quarter (expected June 2) has led to a sharp fall in corporate bond yields (see chart 2) and a tightening in corporate spreads. While longer dated German Bund yields have fallen by about 5 basis points (bps), bond yields on 'A' and 'BBB'

rated issues have fallen much further – by 21bps and 24bps respectively (see chart 2 and chart 3).

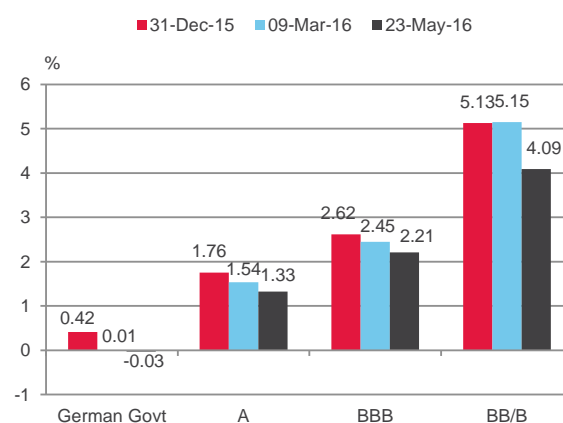
CHART 2 | GERMAN GOVERNMENT AND BBB CORPORATE YIELDS



Source: BoA Merrill Lynch Bond Indices; Thomson Reuters Datastream.

At the same time, the knock-on impact for the high-yield market has been even more significant, also supported by the sharp reversal in commodity prices after their precipitate sell-off in January and February. Spreads on the BoA Merrill Lynch euro corporate 'BB/B' high yield index have tightened 102bps against German government bonds since March 9. Even so, at 4.09%, the yield remains 65bps higher than the 3.44% reached in February 2015 following the ECB's decision to launch its expanded Asset Purchase Programme.

CHART 3 | € INVESTMENT GRADE (7-10 YEAR) AND HIGH YIELD BOND INDEX YIELDS



Source: BoA Merrill Lynch Bond Indices; Thomson Reuters Datastream.

KEY TERMS OF THE CSPP INCLUDE:

- The CSPP will cover all non-bank corporations established in the euro area that issue euro-denominated bonds. This will include companies incorporated in the euro area whose ultimate parent is based abroad subject to meeting all other eligibility requirements.
- The ECB will likely commence the CSPP from June 2 (acting through six nominated National Central Banks (NCBs) and purchases will contribute towards the recently upsized €80 billion (previously €60 billion) monthly target under the Asset Purchase Programme (APP).
- Eligibility under the Eurosystem's collateral framework will be required. Securities issued by credit institutions, and by entities with a parent company which belongs to a banking group, will not be eligible. Automotive captive finance subsidiaries will be eligible. Also, the programme will include insurance companies that are not owned by a bank subject to meeting the other eligibility criteria.
- Eligible credit quality – at a minimum issues will require a Credit Quality Step 3 grade (i.e. a 'BBB-' rating or higher) from at least one recognized External Credit Assessment Institution (ECAI) that meets the requirements of the Eurosystem's Credit Assessment Framework (ECAF).
- Purchases will be conducted in both the primary (excluding Government Related Entities (GRE)) and secondary markets.
- Eligible issues will have residual maturities of between six months and (less than) 31 years.
- The ECB will be able to buy up to 70% of any eligible issue, although more restrictive provisions will be applied to GREs in line with the existing APP. As part of its risk management procedures, the ECB will also set some individual obligor concentration limits so in practice a limit below 70% may apply to the largest issuers.
- There is no minimum issue size so as not to exclude smaller (eligible) companies from participating.

€660 BILLION ELIGIBLE BONDS OUTSTANDING

We estimate that there would be about €660 billion in eligible bonds outstanding, of which about €49 billion comprises insurance company debt. The utility sector is the largest individual sector with as much as €175 billion of eligible bonds outstanding by our estimates. Auto original equipment manufacturers (including suppliers) are the second-largest segment at €87 billion, also taking account of the eligibility of their captive finance businesses. This was explicitly confirmed by the ECB in

their latest technical update² ...“as long as no parent of the issuer of the debt is a bank the issuer will fulfil the non-bank criteria”.

In fact, we estimate that including communications (mainly telecoms) these three sectors on their own would represent almost 50% of all eligible corporate bonds.

TABLE 1 | OUTSTANDING CSPP ELIGIBLE CORPORATE BONDS (Mil. €)

Sector/Industry Group	Eligible Bonds (mil. €)
Utilities	163,200
Consumer Discretionary	108,600
<i>Auto Manufacturers & Suppliers</i>	<i>87,000</i>
Financials	83,000
<i>Insurance</i>	<i>48,800</i>
<i>Real Estate</i>	<i>34,200</i>
Industrials	72,200
Communications	71,650
Energy	48,550
Consumer Staples	48,200
Materials	34,850
Health Care	22,250
Technology	8,050
GRAND TOTAL	660,550

Source: Bloomberg; Dealogic; S&P Global Ratings' calculations.

PRIMARY MARKET HELPS ECB TO BUY BUT DOES LITTLE TO EXPAND THE UNIVERSE

In addition to outstanding volume, primary bond issuance is also in scope for the ECB's CSPP programme. While difficult to be precise, we assume that net new eligible non-financial corporate issuance could amount to between €2.0 billion–€4.0 billion per month on average. For context, €4 billion per month would be in line with the average annual (net) issuance of euro-denominated longer-term debt issued by euro area non-financial corporates seen since 2010.

This could be an underestimate if issuers switch funding from other currencies into euros, such as oil and gas, or technology, companies that are typically U.S. dollar funders (matching their functional currency), or if an ECB-induced shift in relative pricing in the bond market encouraged corporates to refinance bank debt.

While the amount of net issuance is unlikely to expand the eligible universe significantly, the primary market will still play an important role. Specifically, it will be an efficient way for the ECB to purchase bonds in reasonable size, either on an outright basis, or by purchasing outstanding eligible bonds when investors switch into new issues.

CSPP COULD HELP PROMOTE CAPITAL MARKET UNION IN THE MID-MARKET

Less obviously, we think there could be other potential benefits of this programme from the ECB's viewpoint. The

² More details on the Eurosystem's corporate sector purchase programme (CSPP) – Questions and answers. 13th May 2016

first might be tactical. Taking the widespread (and reasonable) presumption that the ECB is only targeting corporate purchases of about €5 billion per month between June 2016 and March 2017, the large volume of eligible paper (€330 billion even with 50% ownership) provides ample scope for the ECB to extend the CSPP programme beyond March 2017 if deemed appropriate.

More strategically, the programme provides the ECB with substantial discretion to target liquidity towards specific countries and smaller/mid-market size companies as and when required, subject to credit eligibility requirements.

A third, and somewhat related, strategic benefit might be that the CSPP helps to nudge the Capital Markets Union project forward (at least within the euro area) by encouraging more debut corporate issuers to approach the bond market. Greater diversification of corporate funding would be credit positive for corporates and help the single market to build greater financial resilience and promote (private sector) risk sharing on a cross border basis - key goals of the European Commission's blueprint for Capital Market Union.

It remains to be seen to what extent the CSPP will benefit midsize and smaller companies and/or countries where the credit transmission channels may not always operate smoothly. Even if it is relatively small, channeling credit directly towards these type of companies (subject to the minimum rating standard) would support the local economies, free up local banks' lending capacity and, importantly, help to solidify bond financing terms and conditions across the euro area.

In this regard, the ECB might benefit from not having to manage its corporate exposure by country of incorporation, or country of risk, according to the its capital key arrangement utilized for the APP. Rather, its stated intention is to manage a diversified portfolio and set group limits by reference to a neutral (but undefined) benchmark.

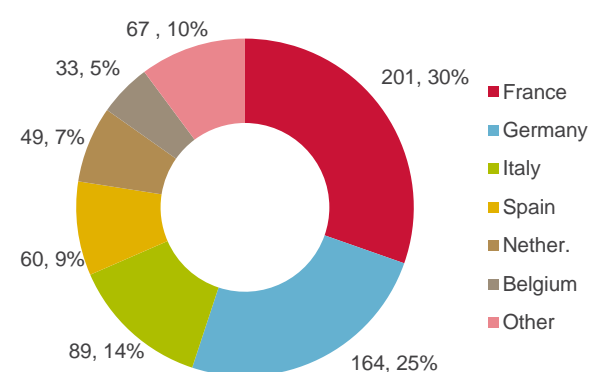
From our perspective, it would be highly unusual for investment-grade rated non-financial corporates to be constrained by either the cost or access to debt financing. Investment-grade corresponds to Credit Quality Step 3 and higher on the supervisory authorities standardized rating scale. This is defined in draft legislation by the European Supervisory Authorities to mean a "rated entity has adequate capacity to meet its financial commitments and is subject to moderate credit risk", equivalent to the 'BBB+' to 'BBB-' long-term rating categories (as well as MMS-2 or higher on S&P Global Ratings' mid-market rating scale). Quantitatively, this translates to an expectation of default no higher than 2.39% over a three-year horizon.

However, as only one investment-grade issue, or issuer rating, is required from one of the four accredited External Credit Assessment Institutions (ECAI) that currently meet the requirements of the Eurosystem's Credit Assessment

Framework (ECAF), it would be reasonable to expect to see some smaller issuers to succeed in making the grade.

In this context it is interesting to note that the Bank of Finland has been tasked with coordinating CSPP purchases for some of the smaller market segments, specifically for Austria, Estonia, Ireland, Latvia, Lithuania, as well as, of course, Finland. From our screen, by country of risk these segments contribute about €23 billion or 3.5% to the total volume of outstanding eligible bonds.

CHART 4 | ELIGIBLE CORPORATE BONDS BY COUNTRY OF RISK (BIL. €, %)



Source: Bloomberg; Dealogic; S&P Global Ratings' calculations.

Cyprus (BB-/Positive/B) and Greece (B-/Stable/B) are exceptions, however. We would expect very few companies to be eligible in these two countries given their low sovereign credit ratings, although there are separate provisions relating to guarantees that may be provided by Member States under financial assistance programmes such as Greece.

LONGER-TERM QUESTIONS REMAIN

At a broader level, the expansion of the ECB's QE programme raises several longer-term concerns, in our view. First, the ECB is explicitly favouring debt over equity, risking capital structures becoming even more debt-heavy than they already are. Second, we remain concerned about the burgeoning cost of partially, or unfunded, defined-benefit pension schemes as long-term corporate bond yields remain low, or fall further. Third, official intervention in the operation of the corporate bond market in the euro area threatens to distort the level and shape of yield curves, raising the prospect of higher volatility in due course. All in all, while the ECB's QE programme is poised to step up another gear, the many longer-term implications still need to be properly assessed.

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