Crossing Over and Under

Rising Star and Falling Angel Candidates

- With pressure from shareholders, LBO activity, and a still difficult macro-backdrop, some companies are at risk of moving to high yield. Conversely, other credits have traversed the recovery with strong balance sheets and improving earnings. This, coupled with management's commitment to higher ratings, positions them for an upgrade to investment grade.
- We present rising star and falling angel candidates and suggest trading strategies for the names. We note that an upgrade / downgrade doesn't always mean spreads trade tighter / wider, as many credits trade in line with their new rating prior to a change.
- Our falling angel candidates operate in sectors experiencing secular weakness or have struggling business models and include Alcoa, AngloGold, Harsco and Transocean.
- Credits with potential to be upgraded to IG have benefited from low natural gas prices, a housing market recovery, and improving business profiles. These include Ashland, Celanese, Continental Resources, Delphi, DR Horton, Sally Beauty and Toll Brothers.

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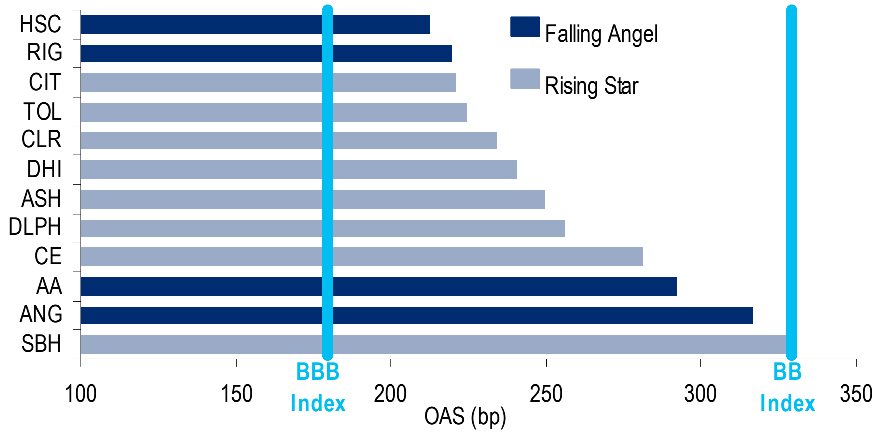
Figure 1. Potential Falling Angels and Rising Stars



Source: Citi Research

Crossing Over and Under

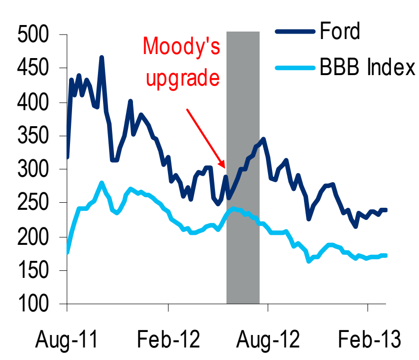
The crossover segment of the credit market has enjoyed a strong run over the last couple of years. Triple-B paper has gained relative to the rest of investment grade because of investor preference for high-beta products, and double-B bonds held their own for much of 2012 as declining Treasury yields supported valuations. Unfortunately, that won't be enough going forward. Spread gaps between rating categories have collapsed and Treasury rates are bouncing off the fall lows. In short, credit selection will become more critical.

Further complicating matters, investors have become better at traversing the technicals resulting from index transition, thereby causing the usual out/underperformance to be less reliable. In this article we detail our expectations for crossovers and recommend certain trades based on fundamental views and potential index transition.

One thing we have noticed is that upgrades to investment grade don't always guarantee an outperforming bond. In May 2012, Moody's raised Ford Motor Company's ratings two notches from Ba2 to Baa3, citing the company's strong market position in North America, good liquidity and its disciplined operating and financial policies as reasons for an upgrade. However, upon news of the upgrade, Ford spreads surprisingly widened. We suspect that many added Ford to their IG books ahead of the upgrade, and once the news was out, the bid for paper waned. Perhaps the credit will get some momentum when it holds an IG rating from all agencies.

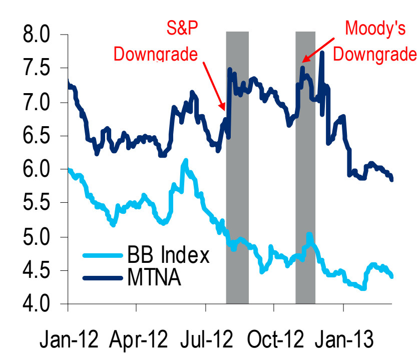
On the flip side, ArcelorMittal performed better after being downgraded. When S&P first took the company's ratings down to BB+ in August 2012, the market was taken by surprise and spreads widened. When Moody's followed with a downgrade to Ba1 in November, bonds rallied. We think that high yield investors were happy to have a new name to trade, and given its importance in the index, there was a strong bid from index-benchmarked investors (e.g. ETFs). Further, compared to other steel sector options in HY, Mittal spreads look attractive given its market leader position and manageable leverage.

Figure 2. Ford sold-off when upgraded
OAS (bp)



Source: Citi Research, Bloomberg

Figure 3. MTNA rallied on second downgrade
YTW (%)



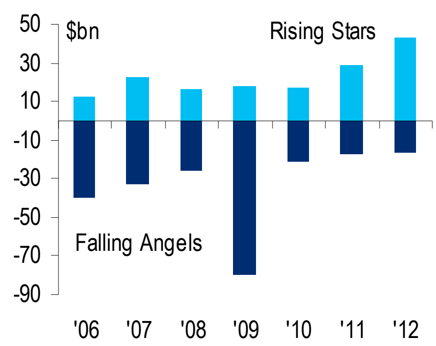
Source: Citi Research, Bloomberg

Finding the candidates

After the turmoil in ratings in 2008/09, we've seen ratings hold fairly steady over the past few years, and the set of credits poised to change ratings classes is limited. Historically, the balance between IG and HY moves has been skewed towards falling angels, which accounted for 70% of ratings shifts from 2006-2010. This

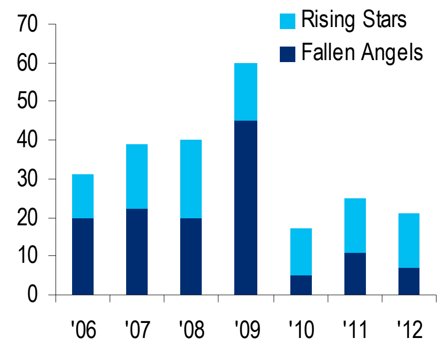
balance reversed in 2011-2012 with rising stars accounting for almost 70% of crossover paper. We expect this relationship to revert back to predominantly fallen angels, and our list of crossover candidates has relatively few rising star names, and only one candidate with greater than $3bn par outstanding. We define falling angels and rising stars using the Citi Indices, which are based on S&P and Moody's ratings. Credits with five-B ratings are included in Citi's Investment Grade Index.

Figure 4. Citi Index Migration (total par amt)



Source: Citi Research

Figure 5. Number of Crossover Issuers



Source: Citi Research

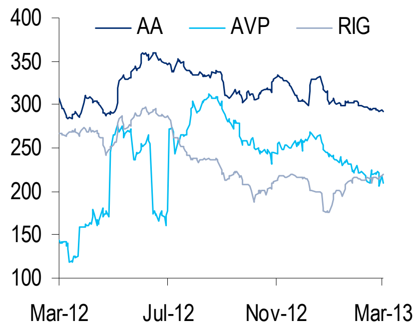
While fallen angels are a small portion of the IG market (S&P states that, on average, they account for only 1.98% of the total rated IG universe), the move from investment grade to high yield can have a meaningful impact on the overall market, depending on the amount of bonds outstanding. And while the move out of IG may not dent the high grade market, it could represent meaningful new net supply for high yield.

In the section below we discuss the most relevant candidates, and our trade recommendations. In the following tables we present the ratings and outlooks for the potential "Falling Angels" or "Rising Stars". Key themes driving the crossover migration include European concerns, shareholder pressure, and low borrowing costs enabling companies to lever up. Fallen angel candidates are mainly from sectors experiencing secular weakness (metals) or companies with struggling businesses. Although the spread differential between BBB and BB-rated companies has narrowed significantly, it seems that most companies are averse to high yield ratings and want to maintain their investment grade ratings.

In high yield, low natural gas prices have helped chemical companies while housing and autos have benefited from a cyclical turn and industry restructuring. A key factor determining whether high yield companies migrate to investment grade is management's long-term commitment to the ratings. While many high yield companies may have investment grade credit metrics, financial policies (i.e., shareholder friendly activities), leverage targets, and overall cash usage often influence rating agency decisions.

Falling Angel Candidates

Figure 6. Falling Angel Spreads (OAS bp)



Source: Citi Research

<u>Alcoa (Baa3, Under review for downgrade / BBB-, Stable)</u>: On the back of weak Q3 2012 earnings due to continued pressure in the global aluminum market, Moody's placed Alcoa's Baa3 rating on review for downgrade in mid-December. The agency cited the weak results that have hampered credit metrics, including leverage that increased to about 6.0x. However, we expected a downgrade to HY post Q4 earnings that were okay, but metrics remained challenged and more in line with a HY credit profile.

We expect the credit to be downgraded if end markets continue to be weak, and if Aloca is unable to improve its cost profile and leverage. However, we do not rule out the prospect of the agencies giving AA more time to reduce debt, allowing this American bellwether to remain investment grade.

Trading strategy: If the company were to be downgraded, we'd expect spreads to widen from here to levels in line with MTNA, which would call for about 50bp of backup. We suggest lightening up on paper as we believe a downgrade is likely, and for fundamental reasons as the end market outlook hasn't yet turned the corner.

<u>Avon Products (Baa2, Stable / BBB-, Negative)</u>: Avon, the direct cosmetic seller, is a well recognized brand with strong global market share. However, as of late the company has had difficulty maintaining operating performance, and as a result, profitability has slipped and leverage has increased beyond a level typically tolerated for its current rating. S&P is expecting the company to use its adequate liquidity to reduce debt in 2013, allowing for a reduction in leverage. The company's issuance earlier this month and cash on hand will be used to repay debt, reducing leverage to around 3.0x, well within S&P's threshold for remaining IG. As such, we think Moody's and S&P will continue to assign investment grade ratings to Avon. However, we believe continued earnings pressure may eventually weigh on credit metrics and ratings, but the company now has a significant amount of leeway to improve its operations.

Trading strategy: AVP bonds are likely at fair value given its current earnings profile. We do not expect significant improvement to earnings, but with management demonstrating a commitment to debt reduction, we'd expect spreads to slowly drift tighter.

<u>Transocean (Baa3, Negative / BBB-, Negative)</u>: Despite best efforts from Transocean's management team to reduce debt to a level more appropriate for an IG rating, pushes from shareholders to return capital may derail those best intentions. While the company's outlook is still dependent on lingering Macondo-related litigation, and higher than its peer group's leverage, any shareholder friendly activity beyond the company's current proposal would be viewed as credit negative.

The fate of RIG's rating is really in the hands of shareholders, and if they force either a dividend payment in excess of the proposed $800mm, or that plans to reduce debt are put on hold, we believe a downgrade would occur. However, under current plans that call for a $2.24 / share dividend and debt repayment, IG ratings would likely remain.

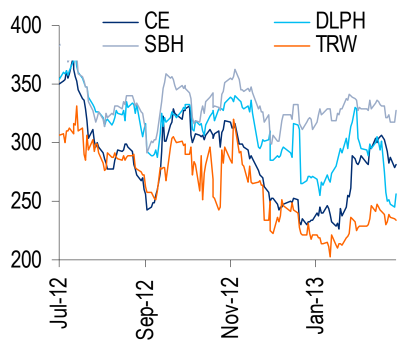
Trading strategy: It is becoming increasingly clear to us that shareholders wield increasing power, and given the already strained credit metrics, we are inclined to think spreads look a bit tight at current levels. If shareholders pass a higher dividend, we believe spreads would widen substantially.

Figure 7. Potential Falling Angel Candidates

Company	Industry	Moody's	S&P	Amt Out ($mn)	Weighted Avg. OAS	Reasoning	Things to Watch	Ratios for a Downgrade*	Timing for Downgrade
Alcoa (AA)	Metals	Baa3 / UR	BBB- / Stable	6,927	Current: 295 12m range: 288-361	S&P seems to be giving AA a pass for 2013 on its leverage metrics outside the usual bounds, but they expect improvement in 2014.	S&P assumes AA will reduce debt and that aluminum prices will recover to $0.95/lb in 2013 and $1.00/lb in 2014. Look for changes to financial policy.	• Aluminum prices fall below projections • Prolonged debt / EBITDA >4.0x • FFO / total debt needs to improve above 20%	12 months
AngloGold Ashanti (AU)	Metals	Baa2 / Stable	BBB- / Negative	2,750	Current: 328 12m range: 323-406	High unit cash costs and substantial capex program that hamper cash generation ability. Concentrated exposure to South African gold mining.	Gold prices, and the South African government's stance on mining. Cash costs need to come down, but may be pressured by govt actions. Focus on scope of capex plans.	• FFO / debt falls below 30-35%	12 months
Avon Products (AVP)	Consumer	Baa2 / Stable	BBB- / Negative	1,725	Current: 224 12m range: 118-336	Pressure on the business from weakening operating results and increasing leverage. Market share is slipping.	Focus on operating performance, and leverage in particular. S&P is relying on debt reduction via FCF in 2013.	• Sustained adjusted leverage above 3.5x (~3.7x currently)	Remains IG
Cliffs Natural Resources (CLF)	Metals	Baa3 / Stable	BBB- / Stable	2,900	Current: 296 12m range: 238-435	Recent equity raise, dividend cut and planned debt reduction takes near term likelihood of a downgrade off the table.	Management has stated a commitment to IG, but need leverage to improve. Watch for potential shift in shareholder friendly tone.	• Prolonged debt / EBITDA needs to be under 3.5x	Remains IG
Genworth (GNW)	Insurance	Baa3 / Stable	BBB- / Negative	3,600	Current: 255 12m range: 255-591	Rating and outlook reflect low coverage metrics, choppy business performance and the drag from the mortgage insurer business. While prospective strategic actions should improve the company's outlook, lagging businesses remain a drag until the plan is executed.	Look for progress on the strategic plan and for a decrease in operating performance volatility. Financing costs continue to trend higher than peers.	• 3-5x GAAP interest coverage • Hold at least 2x holding company interest expense	Remains IG
Harsco (HSC)	Industrial	Baa3 /UR	BBB / Negative	700	Current: 206 12m range: 108-258	Key markets, including European construction and steel production, remain soft and cash generation is limited. Expectation is for recovery in 2013.	Profitability needs to improve, and cash generation may still be strained given heavy capex spending.	• Downgrade risk if operating margins remain below 7% • Looking for free OCF to exceed $75mm	12 months
Molson Coors Brewing (TAP)	Consumer	Baa2 / Stable	BBB- / Negative	1,900	Current: 124 12m range: 99-219	Concern around the company's aggressive financial policy, which financed a large acquisition with debt.	Management's commitment to credit quality, versus returning funds to shareholders or pursuing further debt-funded acquisitions.	By year end 2013: • Leverage under 4.0x • FFO / total debt ~20% • Need to sustain adequate liquidity	Remains IG
Transocean (RIG)	Energy	Baa3 / Negative	BBB- / Negative	8,900	Current: 232 12m range: 190-317	Recent pushes by shareholders to increase the dividend before delevering is a concern, as are remaining Macondo risks. The debt load is heavy, and capex plans are substantial.	Look for any ruling / charges related to Macondo, and if management caves to shareholder demands at the expense of bondholders.	By year end 2013: • FFO / debt >25% Would likely be the result of revenues below $9.5bn or EBITDA margin less than 39%	6-9 months

Source: Citi Research, S&P, Moody's
*Based on S&P and Moody's requirements

Figure 8. Rising Star Spreads (OAS bp)



Source: Citi Research

Rising Star Candidates

Celanese Corp (Ba2, Positive / BB, Positive): Celanese is a chemical producer with a diverse product and geographical footprint and leading market technology. The company's new CEO has publicly stated that he wants to attain investment grade ratings and has made progress on this front, reducing secured debt down to 52% from 67% of total debt in the fourth quarter. We think the company will continue to move towards an unsecured capital structure. Citi's HY chemicals analyst, James Finnerty, believes that Celanese is a solid crossover candidate with positive event risk and is Overweight the credit (**Celanese Corp. (CE)**).

Trading strategy: Celanese trades 100bp behind the BBB Index and IG peers, with the CE '22s trading 122bp wide of Dow '22s. We think this relationship should compress as the company continues to move towards its investment grade target.

Delphi Automotive (Ba1, Stable / BB+, Positive): Delphi is positioned to benefit from secular trends in autos focused on fuel economy, safety and electronics. Although ratings agencies have expressed European exposure (45% of sales) as a key uncertainty for the company, Delphi has been able to produce strong results in a difficult macro environment. Despite share buybacks and dividend initiation, Delphi has ample liquidity and has been moving towards an unsecured capital structure. We think Delphi should be able to continue to execute its business strategy and has the potential to get upgraded in the near future. S&P raised its outlook on Delphi to Positive on February 11th, stating "there is a one-third probability that we could raise the ratings in the next year."

Trading strategy: Delphi currently trades 74bp wide of the BBB Index and should continue to tighten as the company delivers results. Delphi already has an investment grade rating at Fitch (BBB-), so an upgrade by one agency will move the company into most IG indices.

Sally Beauty Holdings (Ba3, Positive / BB+, Positive): Sally, the distributor of beauty products, has exhibited strong organic sales growth in a fairly stable, non-cyclical business line. The recent exit by private equity sponsors of their remaining stake is a positive for the credit as ratings agencies previously stated that private equity ownership was an impediment for an upgrade. Sally generates strong free cash flow and we believe any shareholder friendly actions should be funded with internal cash.

Trading strategy: Sally bonds are trading an average of 146bp wide of the BBB index, making it one of the most attractive candidates for spread tightening from a ratings upgrade.

TRW Automotive (Ba2, Stable / BB+, Positive): Although rated BBB- by Fitch, we don't think TRW will completely migrate to investment grade in the near future. The company continues to pursue shareholder friendly activities and announced a new $1bn share repurchase program in 4Q 2012, which may be partially funded by its recently issued 4.5% notes. TRW's high exposure to Europe (43% of sales) will also likely prohibit achieving IG ratings as that market is expected to continue to deteriorate. Cit's HY auto analyst, Manish Somaiya, highlighted the bearish view on the European market in his piece, **European Auto Industry Trends.**

Trading strategy: We would recommend selling TRW given that it already trades like a low BBB credit and we think it is unlikely to migrate to IG. Furthermore, spreads are slightly off their 12 month low and we believe investors are not well compensated for the risk of earnings deteriorating or further debt-funded shareholder friendly activities.

Figure 9. Potential Rising Star Candidates

Company	Industry	Moody's	S&P	Amt Out ($mn)	Average OAS	Reasoning	Things to Watch	Ratios for an Upgrade*	Timing for Upgrade
Ashland (ASH)	Chemicals	Ba1, Stable	BB, Stable	2,450	Current: 249 12m range: 229 – 313	Management is focused on achieving IG ratings. Recent $2.3bn bond issuance and term loan pay down move the company towards unsecured capital structure.	S&P expects ASH's credit profile will continue to improve through earnings growth and debt reduction via FCF. Management has a leverage target of 2.0x	• EBITDA margins >12% • Retained Cash Flow/Debt at least 20% • FCF/Debt at least 10% • FFO to debt 20-25%	12-24 months
Celanese (CE)	Chemicals	Ba2, Positive	BB, Positive	1,500	Current: 281 12m range: 227 - 443	Diverse geographic and product exposure with solid operating performance. Management has stated IG ratings as a goal.	Continue refinancing of secured debt with unsecured. Agencies are looking for specific financial metric guidance from management. Acquisitions with cash that will increase EBITDA and cash flow would be positive for ratings.	• Total Debt/EBITDA below 3.3x • Retained Cash Flow/Debt near 20% • FFO to Debt 25-30%	18 months
CIT Group (CIT)	Financials	Ba3, Stable	BB-, Positive	11,750	Current: 221 12m range: 221 - 474	While a much longer term story, CIT could be upgraded over time. The company has improved earnings, lowered borrowing costs and repaid debt.	CIT needs to demonstrate Q4 results as a run-rate.	• Core pretax ROA for more than 1.25%	24 months
CNH Group (CNH)	Industrials	Ba2, Stable	BB+, Stable	3,002	Current: 281 12m range: 267 - 444	Leader in farm equipment market with improving competitive position and credit metrics.	Further upgrade is dependent on improvement at Fiat Industrial. Closing the $2.3bn liquidity shortfall. Clarity on pro-forma capital structure of the overall company.	• EBIT/Interest 4.0x • Debt/EBITDA < 3.0x	Remains HY
Continental Resources (CLR)	Energy	Ba1, Stable	BB+, Positive	2,900	Current: 234 12m range: 221 - 408	Potential for growth in reserves and production in the attractive Bakken Shale region.	Continued increase in production and reserves with a conservative capital structure. Moody's is looking for production diversification and takeaway infrastructure in the Bakken.	• Maintain leverage of 1.5x	12 months
Delphi (DLPH)	Autos	Ba1, Stable	BB+, Positive	1,800	Current: 256 12m range: 245 - 376	Positioned to benefit from secular trends in autos focused on fuel economy, safety and electronics.	Continued performance amid weak European markets. Ability to generate FCF to sustain shareholder friendly activities. Repayment of secured debt with unsecured debt.	• Adj margins > 13% • FCF range of 10-25% throughout a cycle • Debt/total capital < 45% • Leverage 2.0x or less	12 months
DR Horton (DHI)	Homebuilder	Ba2, Positive	BB-, Positive	2,239	Current: 241 12m range: 214 - 373	Leading cash flow generation and low leverage in the industry.	Net income growth as market recovers. Maintenance of liquidity position amid land spend.	• Maintaining debt leverage close to 40% • Mid-teen sales growth • EBITDA margins in the low 9% area	24 months
Sally Beauty (SBH)	Consumer	Ba3, Positive	BB+, Positive	1,600	Current: 328 12m range: 291 - 423	Strong organic sales growth in a fairly stable, non-cyclical business line, private equity ownership exit	Continued improvement in operating and credit metrics Balance of debt reduction and shareholder friendly activities.	• Debt/EBITDA below 4.0x (lease-adjusted basis) • EBITDA/interest >3.25x	12 months
Toll Brothers (TOL)	Homebuilder	Ba1, Stable	BB+, Stable	1,638	Current: 225 12m range: 210 - 352	Improving operating metrics, conservative capital structure, and growing tower and luxury businesses.	Overall housing market recovery. Negative cash flow for land investments. Continued earnings improvement.	• Debt/EBITDA 2.0x-3.0x • Interest coverage in the mid single-digits • Gross margins >23%	18 months
TRW Automotive (TRW)	Autos	Ba2, Stable	BB+, Positive	970	Current: 234 12m range: 203-363	Currently meets credit metrics for upgrade, but exposure to European markets, uncertainty around the anti-trust investigation, and the company's $1bn share buyback program may impair liquidity.	Continued earnings performance despite weak European auto market European anti-trust investigation settlement Impact of shareholder friendly activity on liquidity	• EBITDA margins of 10-11% • FFO/Debt of 40% or better • Debt/Capital < 45%	Remains HY

Source: Citi Research, S&P, Moody's

*Based on S&P and Moody's Requirements

Appendix A-1

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