A message to our readers

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We're evolving! We have decided to discontinue our Weekly Credit Brief in order to revamp our publications with an aim to offer more comprehensive and insightful analyses. Your perspective is important to us. We encourage you to share any suggestions on how we can better serve your needs.
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The CRI Team

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Weekly Credit Brief **Jan 09 - Jan 15 2024**

The credit outlook of the US healthcare sector deteriorates amidst elevated interest rates and regulatory scrutiny

by Amrita Parab

- **NUS-CRI Forward PD for publicly listed US healthcare companies suggests that reduced access to funding and higher regulatory scrutiny may lead to deterioration in credit health**
- **NUS-CRI Forward PD for the healthcare services sub-industry may experience the highest deterioration in credit outlook**

Despite being a non-cyclical sector resilient to economic downturns, the US healthcare sector has been struggling with challenges such as rising interest costs, inflation, and regulatory changes. These numerous challenges culminated in a record increase in the number of bankruptcies filed by the sector. As a consequence of the numerous headwinds faced, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for publicly listed US healthcare companies climbed to the BB+ upper bound by Q3 2023, when referred to PDiR2.0 bounds[1], as seen in Figure 1a. However, in Q4 2023, the credit profile of US healthcare companies witnessed a significant improvement, possibly due to the simultaneous fall in bond yields as market expectations of an interest rate cut took hold. Looking ahead, however, with the December inflation data showing an uptick, policymakers may not embark on cutting rates in the near term, keeping the rates higher for longer. The elevated interest rates in tandem with intensified regulatory challenges may weigh on the sector's credit health, as indicated by the steep upward trajectory of the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]), crossing the BB+ upper bound over the near term.

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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 18 months, conditional on the firm's survival in the next 6 months

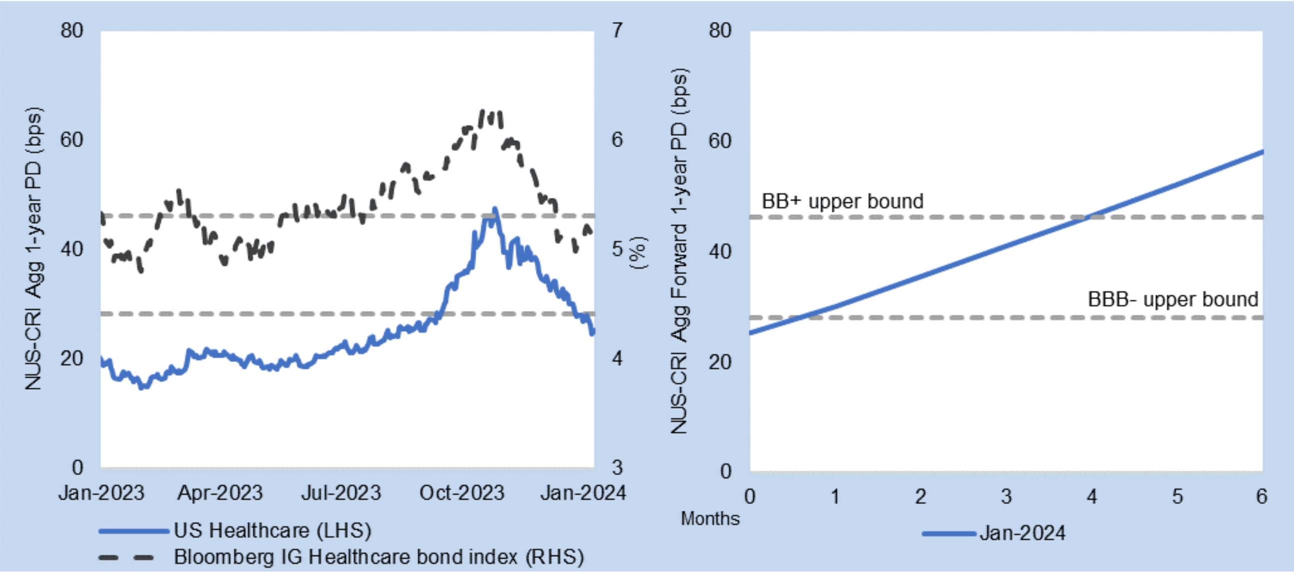

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for publicly listed US healthcare companies, with reference to PDiR2.0 bounds and the index yield to maturity of the Bloomberg investment grade total return bond index. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for publicly listed US healthcare companies as of Jan 2024, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

The US healthcare sector, which expanded significantly by way of numerous mergers and acquisitions in the decade after the global financial crisis, is now facing the consequences brought on by increasing borrowing costs. As of Oct-2023, a record 28 biotech and pharmaceutical firms in the United States declared bankruptcy, based on Securities and Exchange Commission (SEC) filings, reaching the highest level in a decade. The pharmaceutical industry demands significant investment capital to develop products. It is also common to undertake multiple research and development projects in order to increase the likelihood of regulatory approval. Additionally, in the aftermath of the pandemic, a large number of firms required additional capital to restart clinical trials and projects that had to be paused during the pandemic. Resultantly, as higher financing costs caused funding to dry up, companies increasingly faced liquidity issues that adversely impacted their debt serviceability and pushed them closer to bankruptcy.

The US healthcare sector also faces persistent issues arising from regulatory requirements. The implementation of the "No Surprises Act" in early 2022 has posed challenges for US healthcare firms. This legislation, aimed at regulating patient billing and curbing excessive charges, has led to more stringent reimbursement negotiations between medical groups and insurers. Consequently, this has complicated cash flow predictability for many healthcare companies. Some healthcare companies such as Envision Healthcare which filed for bankruptcy have cited the new legislation as one of the main reasons leading to bankruptcy. The healthcare sector, especially drug manufacturers, also faces an additional threat from the Inflation Reduction Act, which intends to introduce price caps on essential drugs, effectively limiting firms' revenue generation.

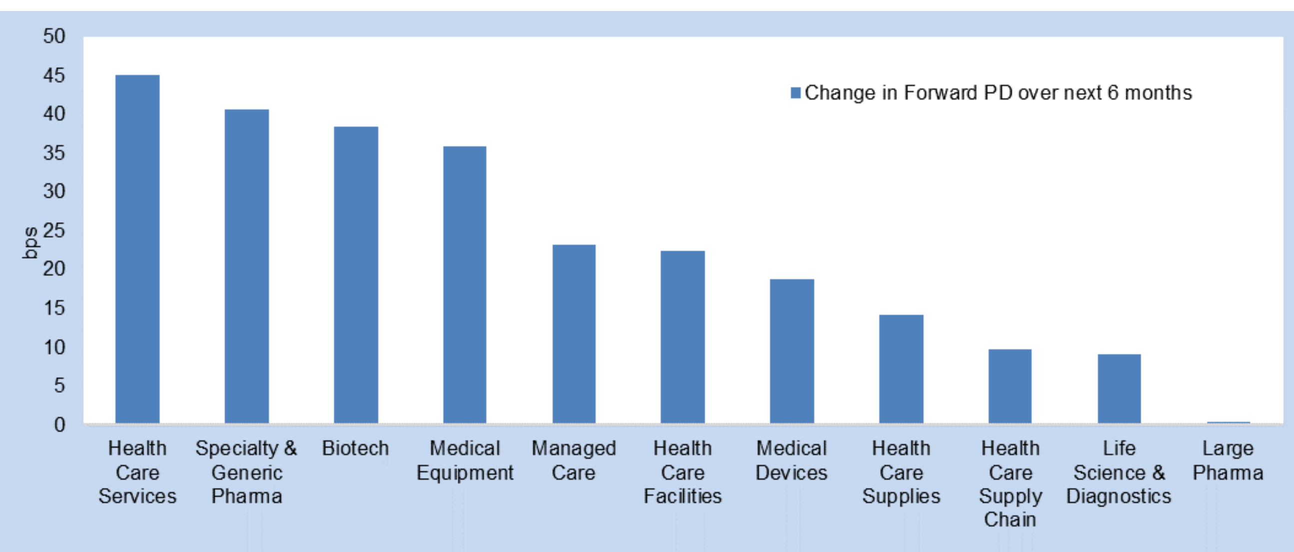

Figure 2: Change in NUS-CRI Agg (median) Forward 1-year PD for the US healthcare sub-industries over the next six months. *Source: NUS-CRI*

Looking at the sub-industry breakdown of the credit outlook, an increase in credit risk may potentially be witnessed across all sub-industries, with healthcare services, specialty & generic pharma, biotech and medical equipment showing the highest increase. Healthcare service providers are the most exposed to the impact of the implementation of the "No Surprises Act". With backlogs of unresolved disputed bills piling up, companies, especially those with upcoming debt maturities, remain vulnerable due to unpredictable cashflows. While reduced access to financing remains a drag on the entire sector, the problem is especially acute for biotech firms as investors move to safer avenues to park capital amidst increased uncertainty. The amount raised by biotech firms via IPOs fell by 90% YoY. At the same time, firms in the biotech and specialty & generic pharma space are expected to face a drag on revenues due to the Inflation Reduction Act.

Going forward, with interest rates staying high, the US pharmaceutical sector may remain restricted in its expansion as investments in research and development slacken. Furthermore, challenges such as narrowing profits, a funding squeeze, and heightened regulatory scrutiny create a complex environment for firms to navigate, increasing credit risk, as seen in Figure 1b.

Credit News

Emerging market debt issuance hits record as borrowing costs fall

Jan 10. In the first days of 2024, emerging markets and companies have sold a record USD 50bn in debt, driven by a recent drop in borrowing costs. Saudi Arabia's USD 12bn issuance this week contributed to the total of USD 51bn, surpassing last year's USD 42bn for the same period. Despite lower yields, Saudi Arabia's sale attracted USD 30bn in demand, reflecting robust investor appetite. The rally in emerging market debt prices at the end of 2023, fueled by expectations of a softer Federal Reserve policy, has led governments to front-load borrowing amid uncertainty about future trends. (FT)

Investors warn of 'complacency' over junk bond risks

Jan 10. The junk bond market is showing signs of complacency regarding the risks confronting corporate America, as investors and economists caution against underestimating the challenges of high interest rates and a potential economic downturn for low-grade, heavily indebted borrowers. Despite a recent drop in debt funding costs driven by hopes of rapid interest rate cuts, the average yield on US junk bonds remains around 8%, down from 9.4% in early November. Some experts argue that the market is overly optimistic, trading as if zero interest rates have returned, while concerns persist about economic uncertainties, increased funding costs, and rising wages for companies. (FT)

Turmoil at South Korean builder revives risk fear after Legoland credit crunch

Jan 12. Creditors of Taeyoung Engineering & Construction, a financially strained South Korean builder, are initiating a restructuring process amidst the country's challenges of high interest rates and a downturn in the property market. Taeyoung, which sought debt restructuring with the Korea Development Bank, faces an April 11 deadline for the proposal. The situation evokes memories of the 2022 liquidity crisis triggered by a Legoland theme park developer's default. While Korean authorities have pledged increased support, analysts caution that Taeyoung's troubles may impact smaller builders and non-bank financial firms exposed to property-related loans amid rising interest rates and a real estate slump. (FT)

Europe's record bond sales draw global buyers hunting yields

Jan 12. Europe saw a surge in government borrowing as global investors sought bonds with solid yields before anticipated interest-rate cuts later in the year. Central banks and funds from Asia and the Middle East eagerly lent to countries like Spain, Italy, and Belgium, resulting in historic order books. This early funding for 2024 budgets is crucial as the European Central Bank shifts from a bond market supporter to a seller. Foreign investors, particularly from Japan and China, are diversifying to Europe, attracted by the prospect of decent returns after years of sub-zero rates. This trend supports a stable euro and could bring significant cash influx. (Bloomberg)

Fall of Chinese shadow bank Zhongzhi highlights uncertainty over economy

Jan 11. Until last summer, the link between China's property slowdown and the shadow banking sector was vague. However, in July, the troubles of long-standing wealth management group Zhongzhi, a major player in China's financial landscape, heightened concerns about a spillover from the real estate cash crunch. Zhongzhi, which swiftly unraveled and declared bankruptcy, indicates government apprehension over the prolonged real estate industry slowdown, adding uncertainty to China's economic and financial path. The bankruptcy highlights risks in the shadow banking sector, particularly in non-bank entities' wealth management products. Zhongzhi's rapid fall underscores broader concerns about China's financial stability amid ongoing property market challenges. (FT)

Gramercy bets on beaten-down Chinese property company bonds (FT)

US consumer borrowing surges on jump in credit card balances (Business Times)

Fed minutes suggest rate hikes are over, but offer no timetable on cuts (WSJ)

Regulatory Updates

Turkey's central bank tells investors tightening cycle is near end

Jan 12. In a New York investor meeting, Turkey's central bank indicated that interest rates are approaching the threshold for disinflation, aiming to conclude the tightening cycle promptly. Governor Hafize Gaye Erkan highlighted improvements in inflation expectations and outlined ongoing policies for price stability. While acknowledging progress, she underscored the persistent commitment until stability is attained. These statements are part of Turkey's efforts to attract investors post-President Erdogan's policy overhaul. Addressing investor concerns, JPMorgan advised waiting for Turkish yields to rise or inflation to decline before considering investments in lira bonds. (Bloomberg)

Bank of Korea hints at pivot towards policy easing after standing pat

Jan 11. South Korea's central bank, the Bank of Korea (BOK), suggested a potential shift towards monetary easing, aligning with global peers. While maintaining its benchmark rate at 3.50% in Seoul, the BOK omitted language indicating the need for further rate hikes, signaling a potential move towards policy easing. The central bank acknowledged the impact on long-term Korean Treasury bond yields due to expectations of a policy pivot. Governor Rhee Chang-yong downplayed expectations of imminent rate cuts, citing concerns about reigniting inflation and property market speculation. Analysts anticipate BOK rate cuts in Q3 2024, influenced by easing U.S. Federal Reserve policies and evolving economic conditions. (Reuters)

Treasury yields turn lower after hawkish Fed official's remarks (FT)

Spain draws record EUR 138bn of orders at bond sale (FT)

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