

The new age of credit research

October 2020

We believe our active approach to credit investing allows us to better serve clients, as indiscriminate waves of downgrades following the turbulence that has rattled global financial markets this year presents us with compelling opportunities.

By Holger Mertens, Head Portfolio Manager – Global Credit



We are living in challenging times with COVID-19 impacting our social life as well as the financial world. Our experienced credit research team has now incorporated this new challenge into the analysis of credit quality for our investments during the pandemic. Even for the most experienced teams, this has presented new unknowns that need to be addressed. In the current environment, the credit research community scrutinises two very binary approaches when assessing credit quality. In our view, neither approach, on a standalone basis, fully helps to assess the impact of COVID-19 on the credit quality of companies. On one hand of the discussion, we find companies making use of a newly created term in their earnings reporting, EBITDAC (Earnings Before Interest, Taxes, Depreciation, Amortisation and Coronavirus), to demonstrate their view of what normalised earnings would have been without the virus' impact. On the other hand, rating agencies have been less benign, downgrading companies more aggressively than in any other crisis within the last 15 years. They have reacted to the current crisis by applying mass downgrades across their rating universe.



Source: Shutterstock, Nikko Asset Management

As is often the case in life, we think the truth lies somewhere in the middle. EBITDAC, which most analysts first saw as a slogan on a mug, has some informational value. But what it is missing is the fact that we can't expect all lost earnings to be recovered in the

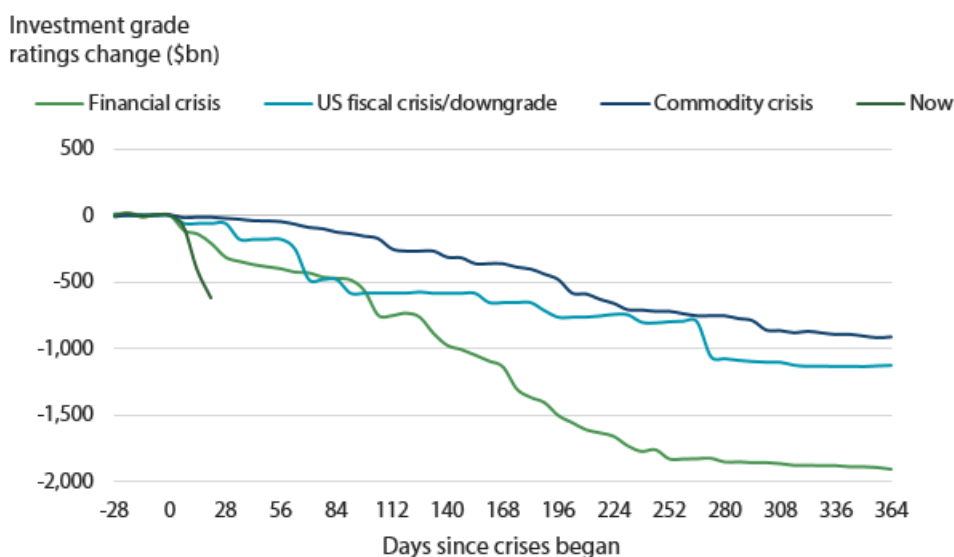


EBITDAC, which most analysts first saw as a slogan on a mug, has some informational value. But what it is missing, is the fact that we can't expect all lost earnings to be recovered in the months to come.

months to come. Some business models, i.e. cruise ship operators, will have to undergo significant changes to survive in the aftermath of COVID-19. We also don't know the duration of the crisis, and if government aid will support liquidity and the solvency of corporates for the full length of the pandemic.

The rating agencies' approach on the other end of the analytical spectrum also has its merits. The agencies were right in pointing out that COVID-19, in combination with the lockdown measures, was impacting most sectors and businesses. But for the market, the negative rating actions often felt too indiscriminate and investors started to draw their own conclusions as a result.

Chart 1: COVID-19 crisis sparks record US company downgrades



Source: BofA Global Research



How will the investment community react to the challenges ahead and which approach is most prudent to follow?

At one point AA-rated energy companies were trading at the same spread level as BBB-rated technology companies. This left investors wondering if spreads might be a better measure to assess credit quality than ratings. At the end of the day, a spread combines the thinking of the analyst community with regards to the credit quality of a particular issuer. But another fear evolved out of the wave of downgrades by the agencies; investors thought that ratings might have become too generous over the last decade and the agencies were now taking the chance to correct this misalignment. As you may remember, in 2008, the agencies faced criticism for being too benign in their assessments. This time, they might have felt the pressure to act quicker and in a more decisive manner. However, investors are hoping that the agencies are looking through the business cycle in their analysis, rather than reacting only to the currently unfolding crisis.

How will the investment community react to the challenges ahead, and which approach is most prudent to follow? We think it is important to take a look through this crisis and develop a normalised EBITDA as the companies' management teams suggest. However, not every add back that the companies are proposing makes sense and analysts will have to adjust a corporate-calculated EBITDAC to what they think is right. For example, if our analysts see a line of business in a corporation which will be negatively impacted by the current situation on a longer-term basis, it doesn't make sense to add back past revenues and earnings.

On the other hand, we are critical of the indiscriminate manner in which the rating agencies have made their downgrades. Naturally some of the downgrades were well

deserved; for example, the leisure industry will feel the impact of the pandemic for years to come.

However, we think that even in the current environment, some sectors will strive and see potential improvements in their credit quality. Getting the big picture right and identifying attractive sectors and investment themes is one of the key benefits of active portfolio management. For example, in the technology sector we see some companies, such as those in streaming services, gaining from the current situation. The banking sector also might not be hit as hard as some rating actions suggest. The involvement of banks has become a very important part of the central banks' strategy in transmitting liquidity into the private sector. In order to fulfil this role, banks have been supported by easing of regulatory burdens and cheap funding. We believe these measures will benefit the sector's credit quality, although the banks are currently out of favour with the rating agencies.

This is where we believe our active approach to credit investing allows us to better serve clients, as indiscriminate waves of downgrades present us with opportunities. We are uncovering situations in which it makes sense to be a contrarian; this involves prudently investing in downgraded bonds that retain solid fundamentals despite their cheap valuations. We believe that strong investment ideas exist even in difficult times, and Nikko AM's Global Fixed Income team will continue to identify such opportunities for our clients.

Important information: This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute personal investment advice or a personal recommendation and it does not consider in any way the objectives, financial situation or needs of any recipients. All recipients are recommended to consult with their independent tax, financial and legal advisers prior to any investment.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this document will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual securities, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association.

United Kingdom and rest of Europe: This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority (the FCA) (FRN 122084). This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the FCA in the United Kingdom, and is directed at professional clients as defined in the FCA Handbook of Rules and Guidance.

United States: This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information to institutional investors as defined in the Securities and Futures Act (Chapter 289), and intermediaries only. Nikko Asset Management Asia Limited (Co. Reg. No. 198202562H) is regulated by the Monetary Authority of Singapore.

Hong Kong: This document is for information to professional investors as defined in the Securities and Futures Ordinance, and intermediaries only. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: This document is issued in Australia by Nikko AM Limited (ABN 99 003 376 252, AFSL 237563). It is for the use of wholesale clients, researchers, licensed financial advisers and their authorised representatives only.

New Zealand: This document is issued in New Zealand by Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562). It is for the use of wholesale clients, researchers, licensed financial advisers and their authorised representatives only.

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME. This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Holdings group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof). No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.

Republic of Korea: This document is being provided for general information purposes only, and shall not, and under no circumstances is, to be construed as, an offering of financial investment products or services. Nikko AM is not making any representation with respect to the eligibility of any person to acquire any financial investment product or service. The offering and sale of any financial investment product is subject to the applicable regulations of the Republic of Korea. Any interests in a fund or collective investment scheme shall be sold after such fund is registered under the private placement registration regime in accordance with the applicable regulations of the Republic of Korea, and the offering of such registered fund shall be conducted only through a locally licensed distributor.