



# S&P Global Fallen Angels: Fallen and Can't Get Up?

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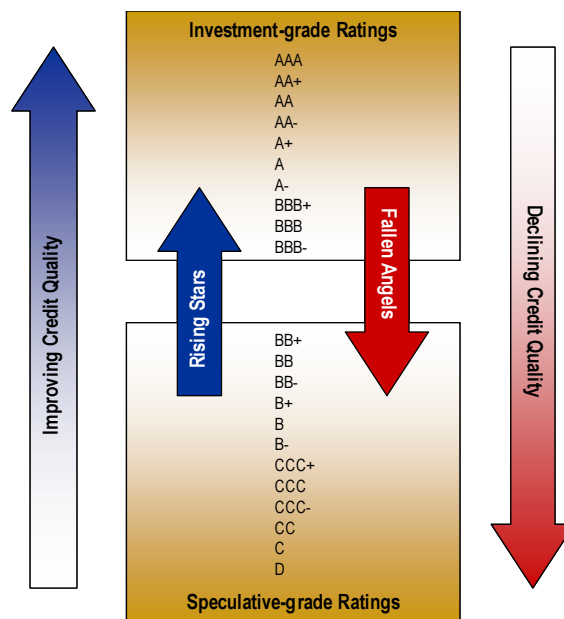
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## ***S&P Global Fallen Angels: Fallen and Can't Get Up?*** ***A 16-Year Study***

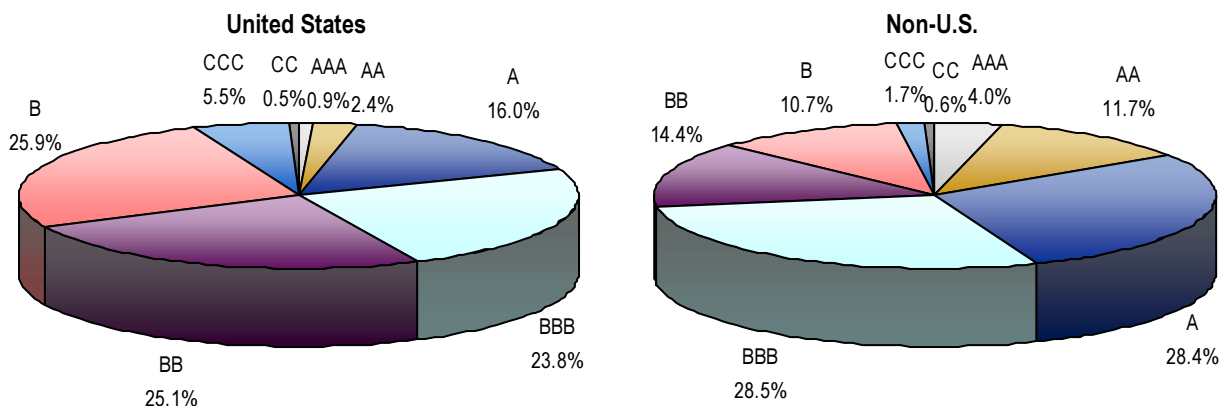
NEW YORK (Standard & Poor's) February 27, 2003—Only one quarter of global fallen angels—investment grade issuers ('BBB-' and above) that have been downgraded to speculative grade ('BB+' and below) in the past 16 years—returned to investment grade status, three quarters did not. Over the past three years, only one of 161 issuers that fell to speculative-grade returned to investment-grade for credit-related reasons. Globally, the largest number of first-time fallen angels came from the financial, consumer products, and utility (mainly power) sectors. By count, the return to investment-grade over the same period was led by financial (mainly banks), consumer products, and forest products & building materials issuers. Going forward, concentrations of issuers returning to investment-grade are most likely to come from the financial, consumer products, high technology, and retail/restaurants sectors based on the number of issuers with a 'BB' rating and with either a positive or stable Outlook or a CreditWatch with a positive implication. This analysis was based on a study of 383 first time fallen angel issuer from 1987 through 2002 and is the first in a series on fallen angels.



By sector, banks, consumer products, and forest products & building materials showed comparable propensity for recapturing investment-grade status. A number of banks declined to “fallen angel” status during the late 1980s as the U.S. economy went into decline—two-thirds of all fallen angels tracked in this study were U.S. domiciled. These credits were subsequently upgraded following the economic recovery of the mid 1990s. This cycle repeated itself in the late

1990s with another round of banking fallen angels returning to investment-grade in 2000-02, a period in which interest rates were at a 40 year low. Similarly, consumer product companies were among the leading targets of the late 1980s LBO craze, which led to an increased number of fallen angels. By the early 1990s, consumer product companies, with consistent cash flows, were more easily able to repair balance sheets and regain investment-grade status. Forest products and building materials also experienced downward rating pressure in the late 1980s and were also able to establish investment-grade creditworthiness by the mid 1990s.

**Chart 1. Ratings Distribution**



*Includes parent level issuers from the financial, industrial, telecommunications and utility sectors.*

*Data as of Dec. 31, 2002.*

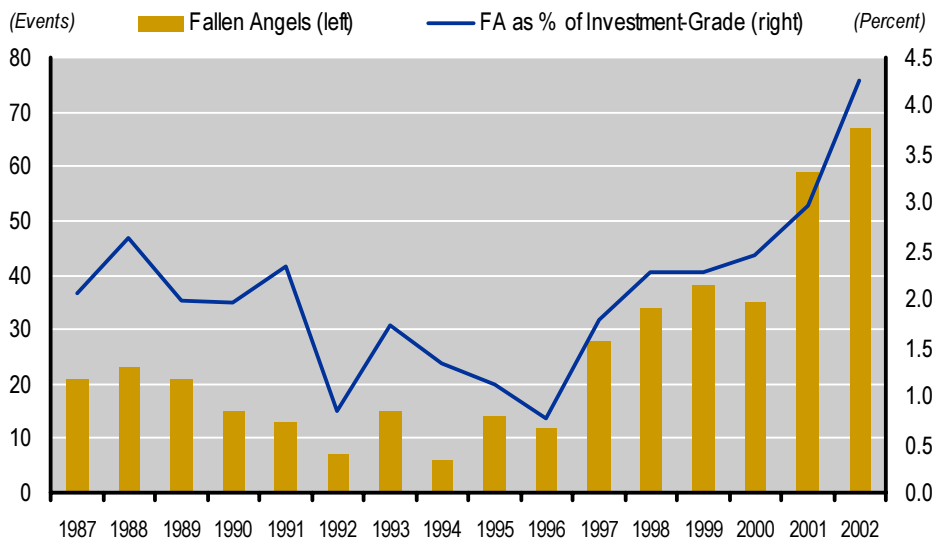
*Source: Standard & Poor's Global Fixed Income Research*

More fallen angels come from the U.S. than abroad due to the difference in regional ratings penetration. The 'BBB' rating category represents 23.8% of rated parent issuers in the U.S. market, versus 28.5% in the non-U.S. market. However, in terms of the count of ratings in each category, there are nearly 60% more 'BBB' rated parent issuers in the U.S. than the rest of the world.

Globally, the record high annual count of 67 fallen angels occurred in 2002, up from a record low of six in 1994. With over 60 issuers currently identified as having the near term potential to become fallen angels (issuers rated 'BBB-' with either a negative outlook or on CreditWatch with negative implications), 2003 is expected to see a high number of fallen angels.

The number of fallen angels each year has followed the global credit market trend. Just as the number of fallen angels rose to a new high in 2002, the investment-grade global credit ratio, issuer rating downgrades to upgrades, rose to a high of 4.37 to 1. This level steadily increased from a low of 0.81 to 1 downgrades to upgrades set in 1996, coinciding with the rise in fallen angels. Similarly, the percent of investment-grade issuers that became fallen angels each year grew to a high of 4.27% in 2002, up from a low of 0.76% in 1996.

**Chart 2.** Global Fallen Angels as a Percent of Investment-Grade Universe

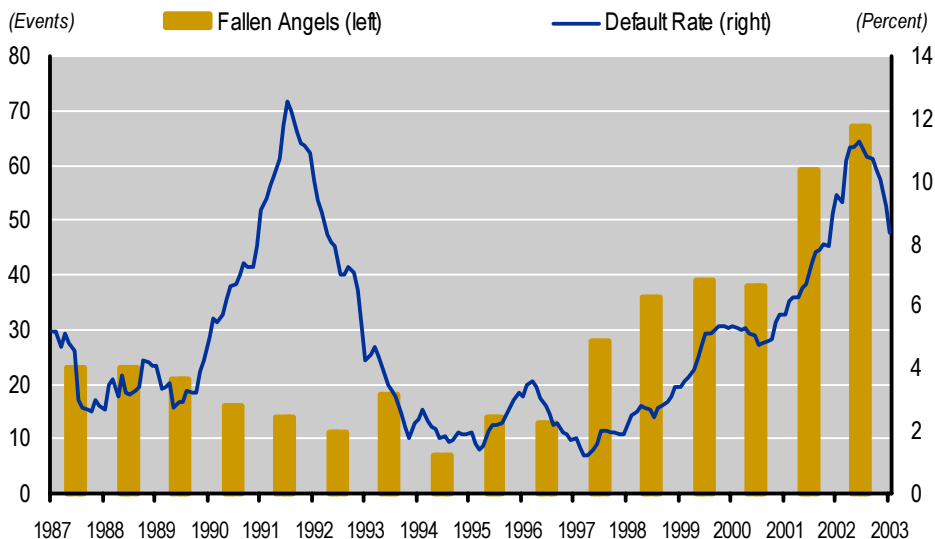


*Includes global financial, industrial, telecommunications and utility sectors. Data as of Dec. 31, 2002.*

*Source: Standard & Poor's Global Fixed Income Research*

Additionally, the global speculative grade default rate (12 month rolling average based on issuer count) has coincided with the fallen angel trend for the past decade. The five and a half year rise in this default rate, currently 8.3%, is up from lows below two percent set in the mid 1990's, but down from its peak in 2001 at 11.08%.

**Chart 3.** Global Fallen Angels vs. Speculative-Grade Default Rate (12 Month Rolling Avg.)



*Includes global financial, industrial, telecommunications and utility sectors. Fallen Angel data as of Dec. 31, 2002. Default data as of Jan. 31, 2003.*

*Source: Standard & Poor's Global Fixed Income Research/Risk Solutions*



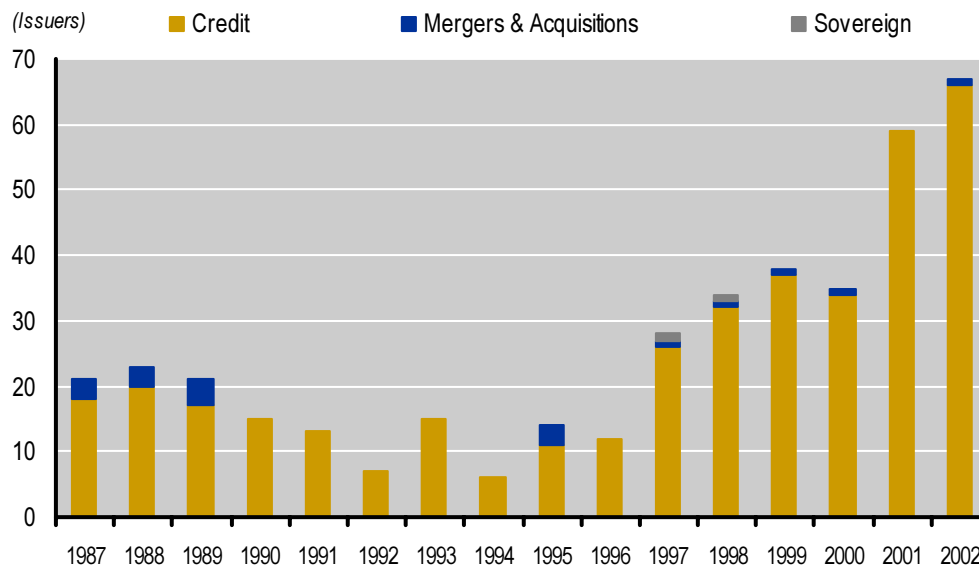
The proportion of speculative grade rated issuers of the total rated entities has grown from 30% in 1994 to 34% in 1997 to currently 42%. Both original high yield issuers and those downgraded issuers initially rated investment-grade have driven this increase.

Traditional high yield managers—mutual funds, insurance companies, money managers, and collateralized debt obligations—do not automatically step in as buyers of fallen angels. Covenant protection measures of these formerly investment grade issuers are inferior to the standard covenants of original issuer high yield. Buyers look to those issuers that have limitations on debt incurrence or restricted payments, tests and strong negative pledge clauses, not typically found in investment grade deals. The strong distinction the market makes between investment-grade and speculative-grade ratings is further supported by the dramatic increase in default experience between 'BBB' and 'BB' rated issuers at 3.53% and 14.77%, respectively, for their cumulative annual average default rate over a five-year period.

Most existing holders of these fallen angels are not forced to sell immediately, but in the near term may have to review and adjust holdings accordingly. Many money managers and pension plan investors have leeway to continue to hold downgraded issuers in baskets for lower rated paper, but may not add to existing holdings. Insurance companies may make portfolio adjustments if a downgrade effects reserve requirements. In addition, on an issuer-specific basis, other non-traditional buyers, such as hedge funds, may step in as buyers.

### **Sixteen Years of Fallen Angels**

This study covers a population of 383 parent level issuers across the globe (259 U.S and 124 non-U.S.) that became fallen angels for the first time as indicated by their issuer credit rating or financial strength rating between Jan. 1, 1987 and year-end 2002. U.S. issuers include issuers based in the tax haven of Bermuda. The distribution of these issuers is examined as they experienced downgrades to and upgrades from speculative grade. In some cases, issuers repeated the cycle with additional downgrades and upgrades. During this period, issuers may have experienced rating actions subsequent to becoming a fallen angel and are not necessarily currently rated, rated speculative grade, or exist as an independent company. Fallen angels come from the industrial, financial, sovereign, telecommunications, and utility sectors. The rating changes are the result of credit, merger & acquisition, and sovereign-related issues. For example, Sovereign Bancorp's rating was lowered to 'BB+' from 'BBB-' on November 9, 1999, reflecting Sovereign Bancorp's acquisition of branches from FleetBoston Financial Corp, and, in line with the downgrade of the sovereign rating of the Republic of Slovakia, Standard & Poor's lowered its foreign currency issuer credit rating on Slovenske Elektrarne a.s. to 'BB+' from 'BBB-' on September 17, 1998. In the case of a fallen angel returning to investment grade which subsequently is downgraded again to speculative grade, two fallen angel events would be recorded, but as only one issuer.

**Chart 4.** Fallen Angel Event Count and Reason Distribution

Data through Dec. 31, 2002.

Source: Standard & Poor's Global Fixed Income Research.

#### ***Downgrade to Speculative Grade***

The first downgrade to speculative grade ratings for the 383 investment grade global issuers occurred 95% of the time (363 events) for credit-related reasons, while 5% (18 events) were merger and acquisition-related, and half a percent (two events) were sovereign-related. Representing the largest proportion of fallen angels, the 259 U.S. issuers fell 93% of the time (242 events) for reasons that were credit-related and 7% (17 events) merger. In contrast, nearly all of the 124 non-U.S. issuers fell for credit-related reasons, 98% (121 events), versus only one percent (one event) merger and acquisition-related and two percent (two events) sovereign-related reasons.

By sector, the industrial issuers represented the majority of U.S. fallen angels at 73%, followed distantly by financial at 18%. In contrast, non-U.S. issuers were more evenly divided between financial and industrial at 35% and 44%, respectively.

Significant variation exists within the industrial sector of the U.S. and non-U.S. categories. The top three U.S. industrial subsectors, consumer products, high technology, and retail/restaurants, account for 37% of the category (72 events). In contrast, the top three non-U.S. industrial subsectors, metals, mining & steel, transportation, and tied for third, consumer products and media & entertainment, account for 51% of the category (28 events)—40% on 22 events when counting only three of the top industrial sectors.

**Table 1.** Sector & Industrial Subsector Distribution of First Fallen Angel Events and First Return to Investment-Grade Status

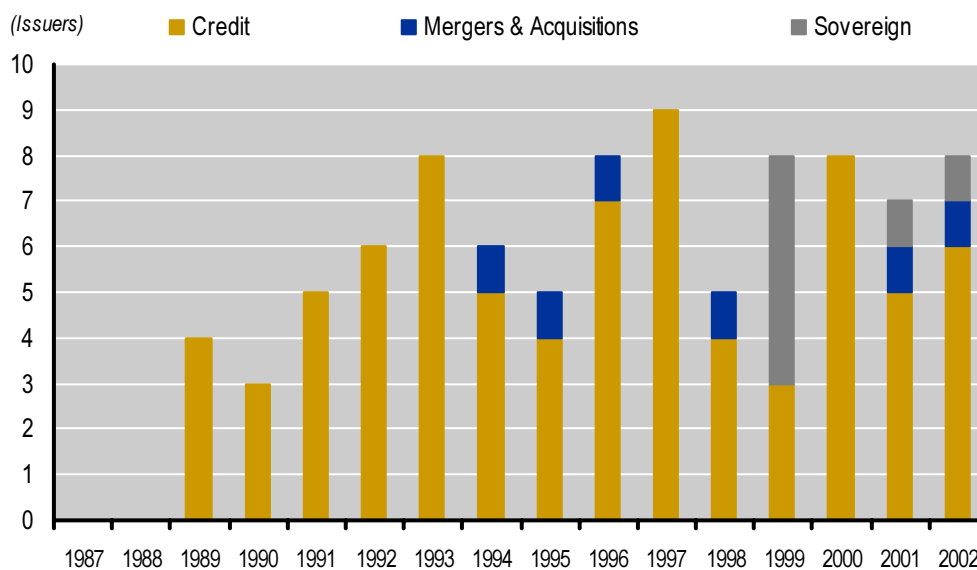
Sector	Fallen Angels		Returns to I.G.		% of Sector Returning to I.G.		
	U.S. Count	Non-U.S. Count	U.S. Count	Non-U.S. Count	U.S.	Non-U.S.	Total
Financial	46	44	14	5	30.4	11.4	21.1
Industrial	188	55	49	9	26.1	16.4	33.8
Aerospace & Defense	3	0	1	0	33.3	0.0	33.3
Automotive	8	1	4	0	50.0	0.0	44.4
Capital Goods	16	2	4	1	25.0	50.0	27.8
Chem, Pack & ES	17	3	2	0	11.8	0.0	10.0
Consumer Products	24	6	6	1	25.0	16.7	23.3
Diversified	0	1	0	0	0.0	0.0	0.0
Forest Products & BM	14	2	6	1	42.9	50.0	43.8
Health Care	13	2	5	0	38.5	0.0	33.3
High Technology	24	5	3	1	12.5	20.0	13.8
Homebuilders/Real Estate	0	5	0	0	0.0	0.0	0.0
Integrated Oil & Gas	0	1	0	0	0.0	0.0	0.0
Media & Entertainment	16	6	3	0	18.8	0.0	13.6
Metals, Mining & Steel	7	9	2	4	28.6	44.4	37.5
Oil & Gas E&P	6	4	2	1	33.3	25.0	30.0
Retail/Restaurants	24	1	5	0	20.8	0.0	20.0
Transportation	16	7	6	0	37.5	0.0	26.1
Sovereign	0	7	0	2	0.0	28.6	28.6
Telecommunications	6	7	1	2	16.7	28.6	23.1
Utility	19	11	4	1	21.1	9.1	16.7
<b>Total</b>	<b>259</b>	<b>124</b>	<b>68</b>	<b>19</b>	<b>26.3%</b>	<b>15.3%</b>	<b>22.7%</b>

Note: The count of U.S. versus non-U.S. fallen angels should not be interpreted to represent a worse credit environment in the U.S. because U.S. issuers made up a greater proportion of the Standard & Poor's rated universe during the period of this study, particularly during the 1980s.

### Return to Investment Grade

The total population of 383 global fallen angels had 87 issuers regain their investment grade status, returning stars, albeit only temporarily for a few. Rising stars include all returning stars and original high-yield issuers rising to investment-grade for the first time. Of the upgrades to investment-grade, 74 were credit-related, six were merger and acquisition-related, and seven were sovereign-related. The 68 U.S. issuers that regained investment grade status were divided as 62 credit-related and six merger and acquisition-related. Of the remaining 19 non-U.S. issuers, 12 rose entirely for credit-related reasons and seven for a sovereign-related reason.

The sector distribution of the 87 returning stars reflects a similar pattern as in their initial decent. U.S. industrials covered the majority at 72% (49 events) followed by financial at 20% (14 events). The industrials also led the non-U.S. issuers at 47% (eight events) followed closely by financial at 26% (five events).

**Chart 5.** Returning Stars Event Count and Reason Distribution

Returning Stars are those issuers that are Fallen Angels who are subsequently upgraded to investment-grade ('BBB-' or above). The five sovereign-related returning stars in 1999 resulted from the sovereign upgrade of Korea from 'BB+' to 'BBB-' on January 25, 1999. Data through Dec. 31, 2002.

*Source: Standard & Poor's Global Fixed Income Research.*

Consumer products, forest product & building materials, and transportation had the greatest presence within the U.S. industrial upgrades to investment grade for a combined 18 events or 37% of the 49 events. Interestingly, of these sectors only consumer products was within the top three sources for U.S. industrial downgrades to fallen angels. With eight upgrades to investment grade for the sector, the only non-U.S. industrial subsector to significantly return to investment-grade was metals & mining at 44% based on 4 issuers.

#### ***Second Time Around***

Twenty-four of the 87 returning stars that returned to investment grade were downgraded to speculative grade for a second time. All 24 of those issuers were U.S. companies and fell for credit-related reasons. Continuing the sector distribution pattern, 79.2% (19 events) of the downgrades were within the industrial sector with the remainder falling 12.5% (three events) in financial, and 8.3% (two events) in Utility.

**Table 2.** Sector & Industrial Distribution of Second Fallen Angel Event

<i>Sector</i>	<i>U.S.</i>	
	<i>Count</i>	<i>Percent</i>
Financial	3	12.5
Industrial	19	79.2
<i>Automotive</i>	4	16.7
<i>Capital Goods</i>	2	8.3
<i>Chem, Pack &amp; ES</i>	1	4.2
<i>Consumer Products</i>	2	8.3
<i>Forest Products &amp; BM</i>	2	8.3
<i>Health Care</i>	1	4.2
<i>High Technology</i>	1	4.2
<i>Metals, Mining &amp; Steel</i>	1	4.2
<i>Oil &amp; Gas E&amp;P</i>	1	4.2
<i>Retail/Restaurants</i>	1	4.2
<i>Transportation</i>	3	12.5
Utility	2	8.3
<b>Total</b>	<b>24</b>	<b>100</b>

Completing a second cycle, three of the 24 issuers were upgraded to investment grade for a second time—Cummins Inc., Ocean Energy Inc., and USX Corp. All were U.S. industrial companies and upgraded for credit-related reasons. One of the three issuers, Cummins Inc., began a third cycle by falling to speculative grade for credit related reasons.

Cummins Inc. is currently rated 'BB+' with a Negative Outlook, USX Corp. is currently rated 'BBB+' with Stable Outlook, and Ocean Energy Inc. is currently rated 'BBB-' with a Positive Outlook.

### **A Look Ahead**

The short-term prospects for the 383 global fallen angels tracked in this study to return to investment-grade ratings remain limited since very few of these issuers currently carry a 'BB' rating with either a positive Outlook or a CreditWatch with a positive implication. Interestingly, of those issuers that are rated 'BB' with a stable Outlook, nearly all U.S. issuers are within the industrial sector whereas the non-U.S. issuers are divided almost equally between industrial and financial issuers. The largest number of U.S. industrial issuers with a stable Outlook are within the high technology and retail/restaurant sectors.

Table 3. Sector &amp; Industrial Distribution of Potential Returning Stars\*

	U.S.		Non-U.S.			Total
	<i>Outlook Stable</i>	<i>Outlook Positive</i>	<i>Outlook Stable</i>	<i>CreditWatch Positive</i>	<i>Outlook Positive</i>	
Financial	-	1	9	-	-	10
Industrial	34	7	10	1	1	53
<i>Automotive</i>	3	1	-	-	-	4
<i>Capital Goods</i>	2	-	1	-	-	3
<i>Chemicals, Packaging &amp; Environmental Services</i>	2	2	1	-	-	5
<i>Consumer Products</i>	4	2	-	-	1	7
<i>Forest Products &amp; Building Materials</i>	4	-	1	-	-	5
<i>Health Care</i>	2	2	-	-	-	4
<i>High Technology</i>	7	-	-	-	-	7
<i>Homebuilders/Real Estate Co.</i>	-	-	2	-	-	2
<i>Media &amp; Entertainment</i>	2	-	2	-	-	4
<i>Metals, Mining &amp; Steel</i>	-	-	2	-	-	2
<i>Oil &amp; Gas Exploration &amp; Production</i>	1	-	-	-	-	1
<i>Retail/Restaurants</i>	5	-	1	-	-	6
<i>Transportation</i>	2	-	-	1	-	3
Sovereign	-	-	1	-	-	1
Telecommunications	-	-	1	-	-	1
Utility	1	-	-	-	-	1
<b>Total</b>	<b>35</b>	<b>8</b>	<b>21</b>	<b>1</b>	<b>1</b>	<b>66</b>

\* Issuers with a 'BB+', 'BB', or 'BB-' rating and CreditWatch positive, Outlook positive, or Outlook stable.



**Table 4. Supplement**

- **Largest Fallen Angels**
  - WorldCom Inc. on 5/10/2002 affecting US\$ 30.0 billion (BBB to BB), currently D.
  - El Paso Corp. on 12/02/2002 affecting US\$20.9 billion (BBB to BB), currently at B+ on Negative Outlook
  
- **Largest Rising Stars from Fallen Angels**
  - HCA Inc. on 02/05/2002 affecting US\$7.8 billion (BB+ to BBB-), currently at BBB- on Stable Outlook
  - USX Corp. second rise on 11/26/1996 affecting US\$7.5 billion (BB+ to BBB-), currently BBB+ on Stable Outlook
  
- Nissan Motor Co. Ltd. is the only issuer that has fallen to speculative-grade (to 'BB+' from 'BBB-' on 2/7/2000) in the past three years and then subsequently returned to investment-grade (to 'BBB-' from 'BB+' on 5/9/2002) for credit-related reasons. Nissan Motor Co. Ltd. is currently rated 'BBB' with a stable Outlook.

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