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SA credit markets – plenty of risks but a wealth of opportunities if managed appropriately

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The fast view

- The deteriorating economic backdrop has negatively impacted companies' ability to repay debt.
- Official credit ratings can be misleading.
- A disciplined approach to portfolio construction is required given the dangers of chasing yield.
- Liquidity can be a challenge, but patient investors should be rewarded with attractive risk-adjusted returns.

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African Bank was the first major corporate bond default in South Africa. It could not survive in an environment where consumers were becoming increasingly indebted against a weakening economic backdrop. Since then, South Africa's macros have deteriorated further and corporate fundamentals have followed suit. The change was incremental, but the compounded impact of this multi-year slowdown is startling.

South Africa's "blue-chips" have all but disappeared, their balance sheets weakened by ever increasing debt and cost pressure. A raft of companies are struggling to survive. PPC, Tongaat and Sasol are shadows of their former selves. Steinhoff is on life support and Edcon's life support has been turned off. Many other businesses are struggling for survival, negotiating with lenders for further reprieve and support, with little prospect of any meaningful value for shareholders. Eskom and Land Bank are reminders that state-owned enterprises have also not been immune. This fragile situation will only get worse as the impact of the COVID-19 pandemic takes hold.

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Against this backdrop, some might expect widespread rating downgrades and a hollowing out of the investment grade universe in South Africa. But the opposite has happened. Ratings have trended up.

Banks and insurance companies are now strong AAs, sometimes touching AAA, only medium-size corporates are below AA and unsecured bonds issued by property companies typically range from single A to AAA, despite ranking behind secured debt. Local ratings are clearly detached from fundamental credit risk and a poor predictor of default. What's going on?

The answer lies in the nature of local ratings. Local or "National Scale" ratings are simply a measure of risk relative to the strongest rating in the country – typically the government. It is important to understand the distinction between these ratings, which are designed to compare entities within a particular country, and global scale ratings, which allow for comparison across countries. As South Africa's sovereign rating deteriorated, the relative rankings within the country converged and none of them are investment grade. Only global scale ratings give a true indication of default probability; and with South Africa now firmly in sub-investment grade territory, local ratings are bunching together, offering very little insight into actual risk.

South Africa's local ratings of AAA to BBB therefore make more sense when translated into their BB to B global rating equivalents. Moody's historic default data (Moody's Annual Default and Recovery Rates 1920-2017, 26 February 2018) suggest only 0.06% of single A credits default per year. This increases to 0.8% for BB and 3.4% for B-rated credit. Over a 3-year period the data suggests one in eight single B credits and 1 in 20 BB credits will default. In short, regular defaults are to be expected in an environment where the universe is sub-investment grade.

So, does this mean local credit should be avoided? The relative strength of South Africa's banking sector suggests that South African credit, if managed correctly, provides ample returns to offset losses. Many institutional track records suggest the same. And in an environment of increasing volatility in equities, currencies and bonds, the risk profile of credit should be more than offset by the compounding cash returns.

However, it is not a free lunch. Ratings are a poor indicator of risk, and in national scale form, offer no guidance to expected loss. Ratings are also by design a very poor warning sign, typically waiting for real evidence before reacting. Active management is required in selecting and monitoring credit. Selection is the best defence and deteriorating credit must be sold quickly, before the market is aware. Credit liquidity has improved markedly, but that is only for strong credit - there is no market for distressed credit.

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And importantly, none of the improved liquidity will offset poor portfolio construction. Local ratings suggest the relative difference between credits is far smaller than in reality, which could make it far too tempting to include some of the riskier credits in standard money market, income and bond funds. In many cases these funds are not constructed with sufficient additional yield to absorb the inevitable defaults that are part and parcel of higher risk credit. A far more discerning approach that avoids the temptation of "chasing yield" is required.

Higher risk credit requires a different approach. The portfolio construction requires diversification and high running yields to absorb defaults. Patience is required; higher risk credit is typically illiquid and prone to become more illiquid with any downturn. Combining patient capital with careful portfolio construction can reward investors handsomely.

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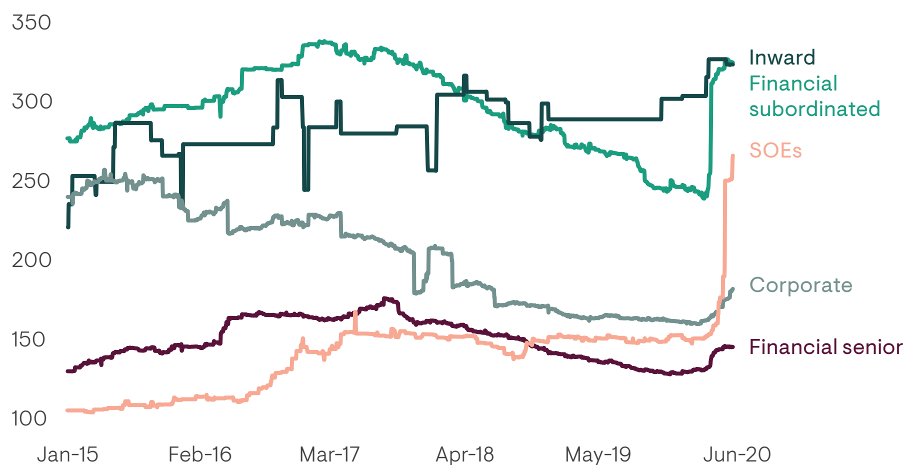
Credit offers an opportunity for investors to diversify their portfolios and earn an attractive yield, but risk management is key to minimising potential downside. This is particularly true in the current environment, where credit spreads have increased, offering higher returns versus cash (see Figure 1). Downside risk can be managed through diversification and favouring the stronger credits such as banks and insurance companies in more liquid portfolios, while secured loans can be considered for the patient capital long-term portfolios.

Figure 1: SA listed credit spreads



Source: RMB and Bloomberg, June 2020.

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