GREENLEAF TRUST
Perspectives
MAY 2019
VOLUME 28, ISSUE 5

Corporate Debt, a Rising Concern?

Seth E. Kritzman, CFA®
Fixed Income Analyst

Historically high corporate debt levels are making headlines and garnering increased attention from investors and policymakers. Fed Chair Jerome Powell recently called out corporate debt as a risk and IMF Director Tobias Adrian voiced concerns around rising debt levels and deteriorating underwriting standards in pockets of the corporate sector. Let's explore corporate debt levels, and how our in-house research team is responding to the current environment.

Corporate debt is at an all-time high; but how did it get there? What drove the increase in borrowing? The short answer: low interest rates. Following the global financial crisis of 2008, central banks, including the Federal Reserve, slashed interest rates to 0% (or lower) to encourage borrowing and stimulate growth – and it worked! US corporate debt as a percentage of GDP has increased every year since 2011. Corporations have used these borrowed funds for Mergers & Acquisitions, share repurchases, and growth investments in the form of capital projects and Research & Development.

Figure 1

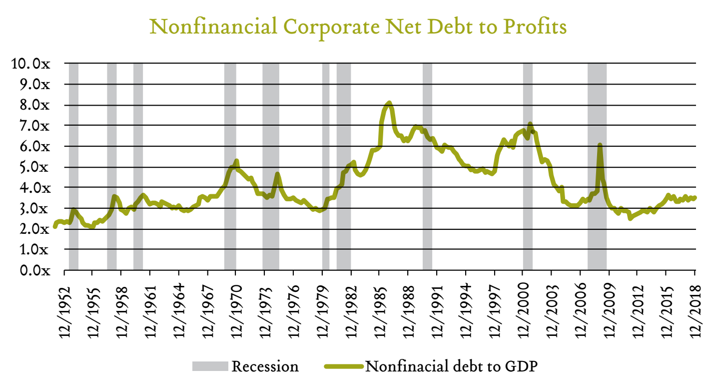
Figure 1 illustrates US corporate debt as a percentage of GDP over time. Viewed this way, it is easy to understand the growing concern among observers. While comparing to GDP is a conventional way to measure debt levels, the approach has some limitations as it relates to evaluating corporate creditworthiness or risk. Specifically, debt-to-GDP ignores:

1. Cash balances — companies are also carrying record levels of offsetting cash on balance sheets, so netting out cash is helpful.
2. Corporate profitability — companies do not service debt with GDP, they do so with profit, so comparing debt to a measure of profitability is more relevant.

> "... corporate debt is at an all-time high; but how did it get there? What drove the increase in borrowing?"

Figure 2 adjusts for these limitations by comparing net debt to profits instead of total debt to GDP. Suddenly the outlook is not quite as stark. Debt is up, but offsetting cash balances and profitability are high, mitigating a portion of the risk associated with increased borrowing.

Figure 2



While net debt to profit levels may be reasonable for the market as a whole, is there a more granular understanding we can develop? Profits are an easy way to view the macro level, but earnings before interest, taxes, depreciation and amortization

(EBITDA) is a better measure of companies' cash flow. With this view, let us consider debt levels by sector and cap size.

Figure 3 highlights current net debt to EBITDA for each sector of the S&P 500. Real estate and utilities are the obvious standouts, with more than twice the debt levels of other sectors. The concern would be that companies in these industries are at greater risk of defaulting on debt in the event of a recession. Fortunately, higher debt levels in real estate and utilities sectors actually reflect stable cash flows and a greater ability to service debt.

Figure 3

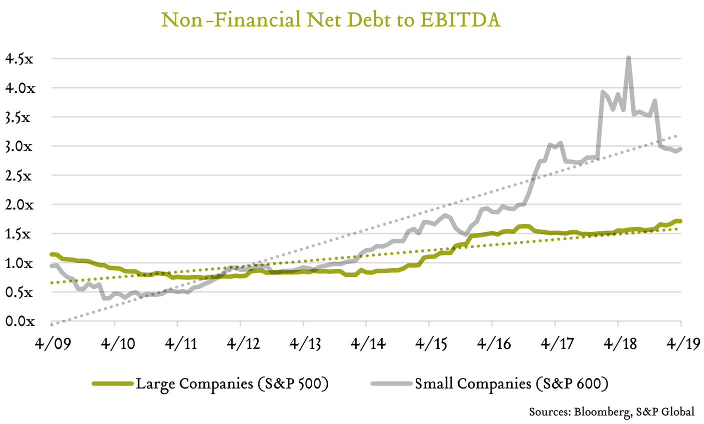
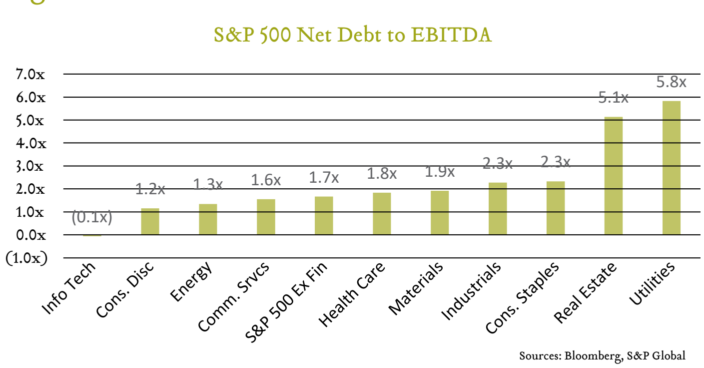


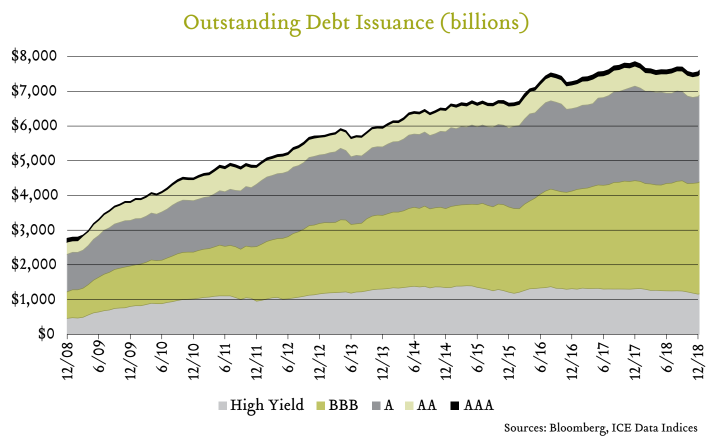
Figure 4 compares net debt to EBITDA trends for small companies and large companies. The trend divergence here is somewhat concerning. Both small and large companies have responded to accommodative policy by borrowing more money. Over the last decade, net debt among small companies has increased at a greater rate than EBITDA, while large companies have increased debt levels more ratably with EBITDA.

Figure 4



It is also important to monitor the overall picture of credit quality as determined by ratings agencies. Figure 5 provides perspective on the changing complexion of credit quality since the crisis. While investment grade issuances have increased significantly, the volume of AAA- and AA-rated debt (highest quality) is virtually unchanged. This means growth has been concentrated in lower-quality A-bonds and BBB-rated bonds. Overall, these dynamics have contributed to a dilution in credit quality.

Figure 5



Our in-house research team has been taking steps to mitigate some of the risks described above in client accounts. We recently recommended redeployment of a portion of corporate debt allocations into treasuries and have been working to upgrade the credit quality of remaining corporate debt allocations. While we are not predicting a meaningful disruption in credit markets, we have been preparing for the potential of greater volatility. We will continue to monitor and respond to market dynamics in our efforts to help you reach your financial goals and objectives.

If you would like to discuss these ideas and their impact on your portfolio further, please contact any member of our team. Thank you for the opportunity to serve on your behalf.

Sources:
Bloomberg
US Federal Reserve,
https://www.federalreserve.gov/apps/fof/FOFTables.aspx
https://www.federalreserve.gov/releases/z1/preview/html/default.htm
Bureau of Economic Analysis
S&P Global
ICE Data Indices