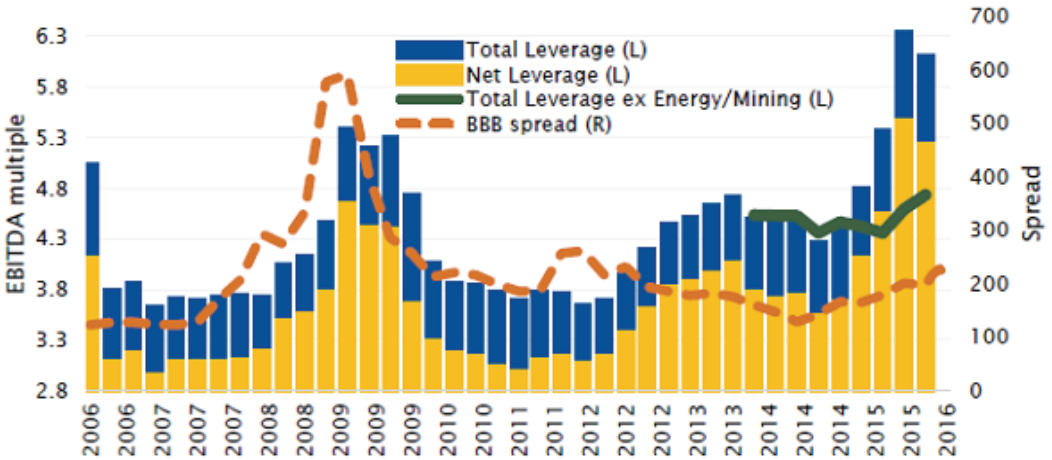
The global corporate debt unwind

Jacob Mitchell | Antipodes Partners | 12 May 2016 |

The extreme thirst for yield has pushed the US high yield (non-investment grade corporate debt) cycle into unchartered territory, with the stock of debt outstanding and the average leverage ratio expanding significantly beyond the previous 2007 profit cycle peak. The cycle is approaching the shakeout phase. The recent widening of spreads, triggered by commodity market dislocation, is unlikely to remain siloed as interlinked funding mechanisms react to accelerating bankruptcies. It's time to sell/short the beneficiaries – the issuers that have applied the funds to fast track corporate ambitions via capital spending, M&A and buybacks and, accordingly, attract a growth premium.

As we entered 2016, high yield leverage ratios already exceeded their 2009 peak, and with the corporate profit cycle likely to have peaked, this set the scene for further deterioration in issuer quality in what are already fragile funding markets. Remarkably, as shown in Figure 1, BBB spreads are still relatively compressed, especially when measured against the peak to trough of the last credit cycle (2007-2009).[1]

Figure 1: High yield issuer fundamentals
(2006 – 2015)



Sources: Bloomberg, Deutsche Bank.

INTRODUCTION

As Reinhart and Rogoff so masterly demonstrated,[2] financial crises almost without exception are preceded by the rapid accumulation of debt, whether it be by sovereigns, corporates or households, posing much greater systemic risks than is imagined during the expansion phase. For recent examples, we need only look back to the sub-prime housing crisis in the US and the sovereign debt crisis in Europe. Perhaps the defining characteristics of the current cycle are the rapid build-up in Chinese corporate and local government affiliate debt, and the explosion of US non-investment grade ("High Yield") debt.

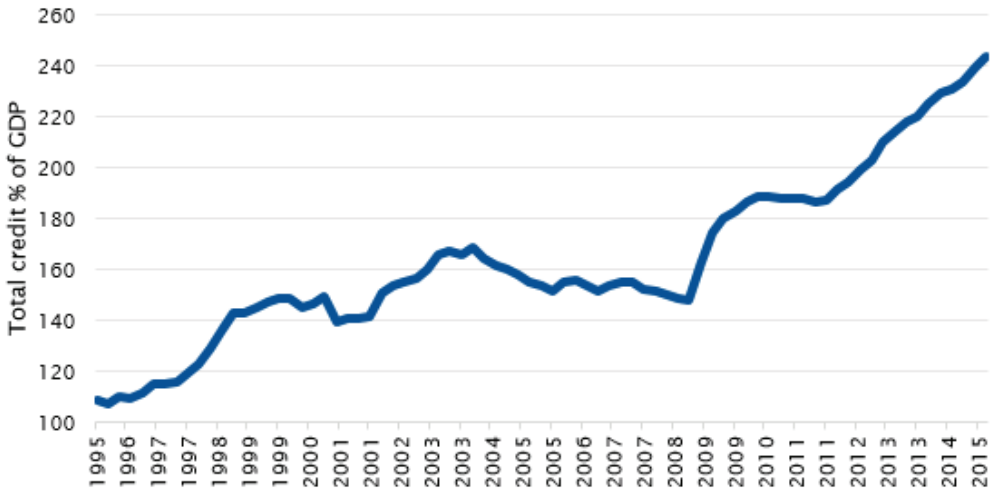
Hence, while this paper focuses on US non-investment grade ("High Yield") debt risks, this requires background understanding of the implications of:

- a Chinese deleveraging cycle on global credit markets; and,
- the US corporate profit cycle in the interpretation of corporate leverage ratios.

CHINA'S CORPORATE DEBT UNWIND

The Chinese policy response to the Global Financial Crisis took the form of a state sponsored fixed asset investment splurge. Accordingly, since 2008, China's aggregate debt level has leapt from 150% to 250% of GDP (Figure 2). Corporates, primarily State Owned Enterprises (SOEs), accounted for the bulk of the increase, particularly the property, infrastructure and industrial sectors even as household and government balance sheets remain relatively healthy.

Figure 2: China total credit to GDP
(1995 – 2015)

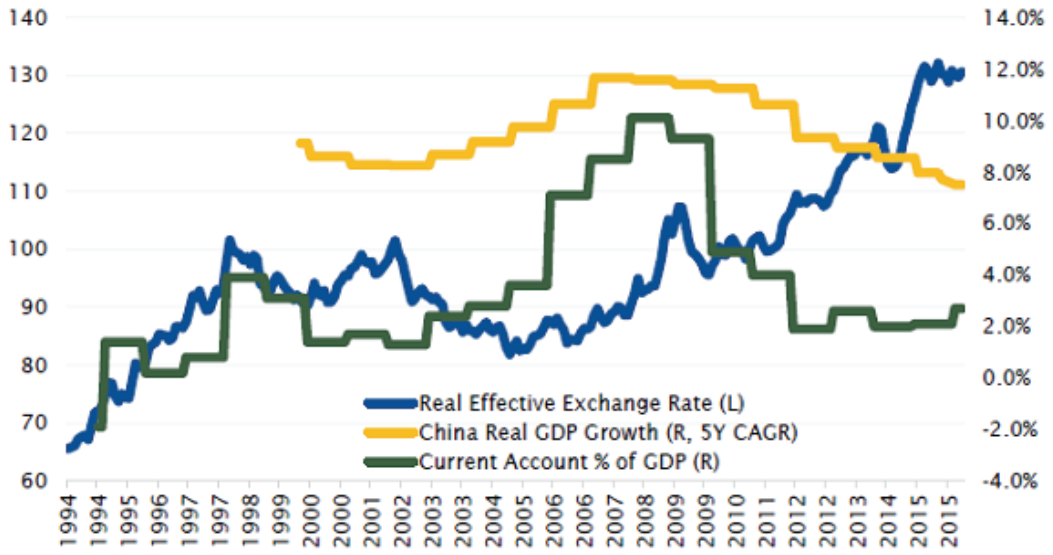


Source: BIS

Much of that additional leverage was underwritten by thinly capitalised, smaller banks (shareholding, city & rural) that managed to grow their share of lending from 30% to 45% of China's banking system assets. Further, President Xi Jinping's overt use of anti-corruption campaigns to sideline rivals and consolidate power is undermining overall confidence in the system. As authorities deal with the looming end to the credit cycle, investors should expect larger banks and other well capitalised SOEs to perform a degree of "national service" by participating in bail-outs of these weaker institutions.[3]

Real interest rates in China though remain high with PPI and CPI inflation running at -5.0% and +1.3%, respectively, versus a policy rate of 4.4%. The Renminbi's competitive position has declined some 50% against its trading partners over the past 10 years as the current account surplus has shrunk from 12% to 4% of GDP (Figure 3). As China's credit-led fixed asset investment boom nears its limits the People's Bank of China (PBOC) is likely to maintain loose monetary policy (policy rates, reserve requirements and currency) in combination with fiscal stimulus in order to ward of the potential for deflation.

Figure 3: The Renminbi is potentially the Chinese release valve (1994 -2016)



Sources: Federal Reserve, BIS.

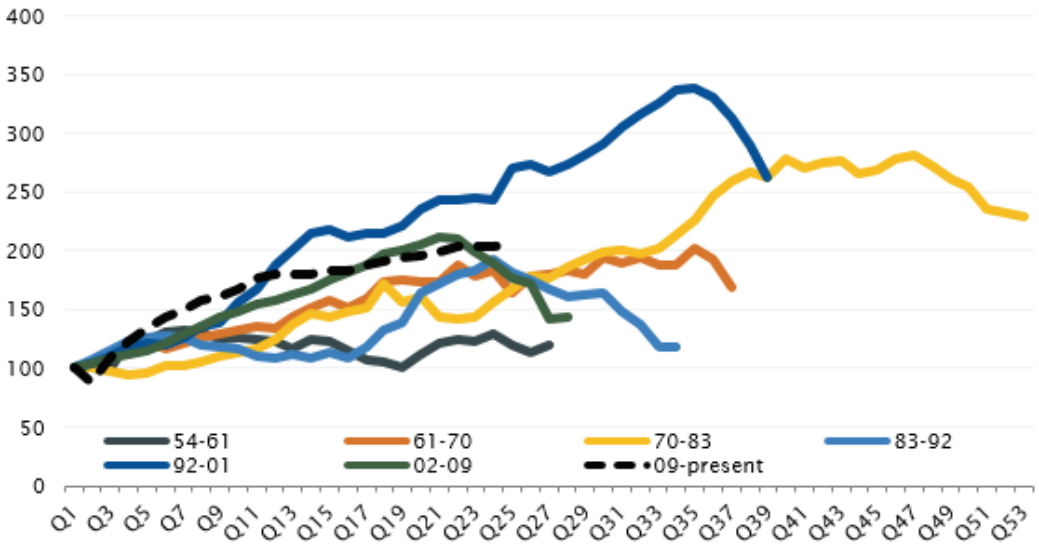
Set against this is the Central Government's determination to maintain financial stability and in particular stem accelerating capital outflows from the country,[4] flows that had underpinned foreign exchange reserve growth as the current account surplus waned. Diverging policy settings between the US and China, with the Federal Reserve now tightening, only exacerbate this pressure and raise the spectre of an uncontrolled devaluation of the Renminbi under the weight of any policy misstep – the ultimate cost being

a depletion of China's holdings of US treasuries, placing upward pressure on the cost of money globally. The un-wind of China's corporate debt bubble has implications beyond China as the related capital flow reversals and exported deflation impute a significant tightening to the rest of the world.

THE AGING US PROFIT CYCLE

Entering year eight of the current equity market cycle, investors should take stock of the corporate profit cycle and consider rising risks as the world emerges from a period of super stimulus. Figure 4 highlights that in the United States the current cycle is now well into middle-age and, outside of the 1992 cycle which was similarly pre-dated by a banking crisis, has been one of the strongest on record.

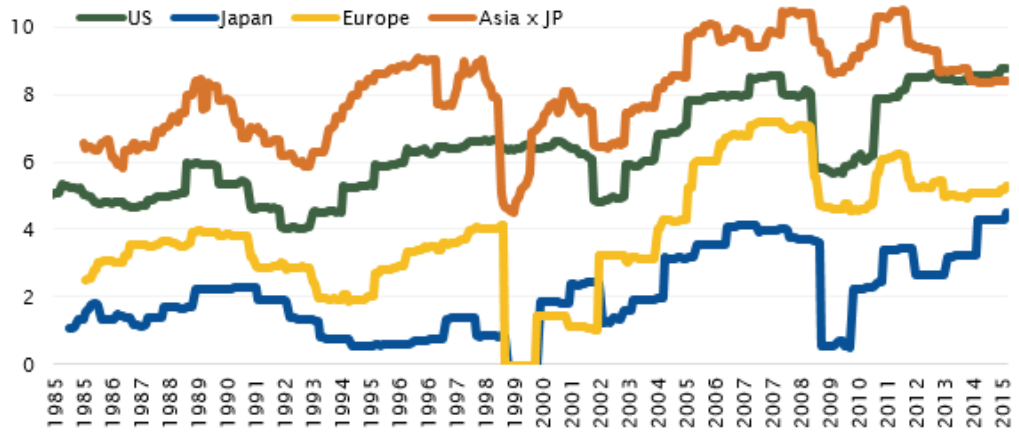
Figure 4: S&P 500 profit cycles
(1950 – present, each cycle rebased to 100)



Sources: Bloomberg, Antipodes Partners.

Extending the analysis across the globe in Figure 5 (overpage), net profit margins in both the United States and Japan have reached new era highs, while those in Europe and Asia ex. Japan have lagged. In the case of Japan, the 2010-12 super strong Yen and Fukushima crises forced a re-think of the "fortress-Japan" mentality. That helped trigger healthy corporate reforms including business portfolio rationalisation and greater profit focus, led by companies such as Mitsubishi Heavy Industries, Hitachi and Panasonic. Poor demographics have paradoxically assisted this process as surplus high-cost fulltime employees retire at an increasingly rapid pace. In the case of Europe, corporate reform is now gathering pace following a profit recovery delayed by the "Euro crisis".

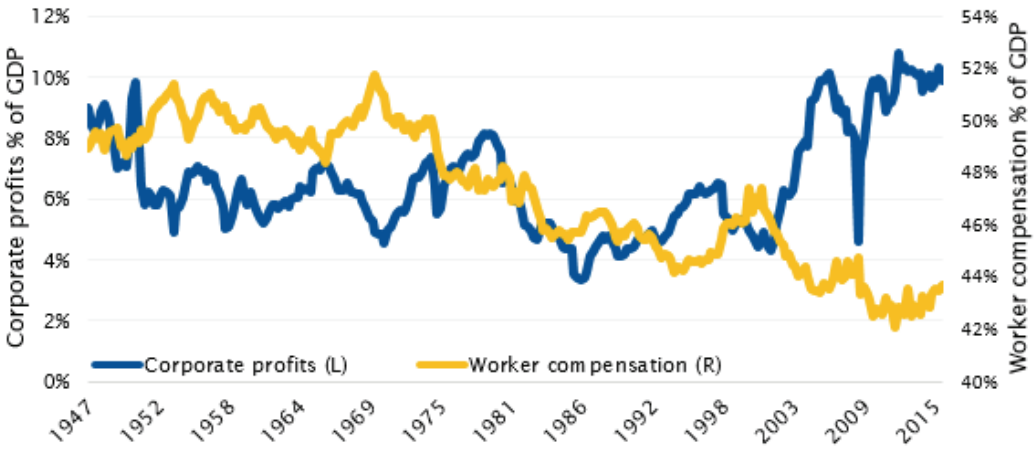
Figure 5: Net profit margins (%)
(1985 – 2015)



Source: Credit Suisse HOLT.

US corporate profit share today reflects a combination of cyclical plus one-time structural factors. Globalisation and offshoring, the break-down of traditional union structures and the more recent phenomena of central bank sponsored reduction in debt funding costs and sophisticated tax minimisation programs have all aligned over the past decade to the benefit of US corporates. It's notable that as corporate profits have soared, wages as a share of GDP have declined from 51% in 1970 to just over 42% today (Figure 6).

Figure 6: Worker compensation and corporate profits as a share of US GDP
(1947 – 2015)



Source: Federal Reserve Economic Data.

A normalisation of central bank policy settings and a more co-ordinated approach to tax capture could see some of these benefits eroded over the years ahead. Further, the rise of far left candidates in Britain and the US are signs that "labour" may yet mount a comeback to reclaim its lost share of earnings.

A perspective on equity valuation is also useful. Given timing differences in earnings cycles across regions, the use of cyclically-adjusted measures of earnings (CAPE)[5] helps to set broader expectations for future equity market returns. Measured as such, the US market today is 15% to 20% above its long-term median level and more than two times trough levels of cyclically-adjusted earnings. Only history will tell if this is a peak, but outside of the great technology bubble of the late 1990s, cyclically-adjusted PEs have generally been capped at recent levels.

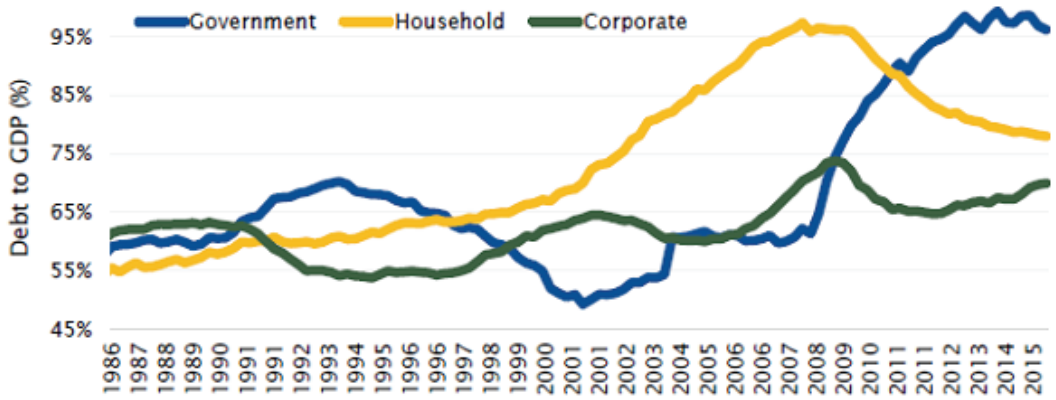
In short, the road ahead for US corporates is unlikely to be as smooth as the one most recently travelled, a position not generally held as the consensus. Importantly, US corporate leverage and debt service ratios should be considered in the context of current potential peak profits versus cyclically adjusted profits.

UNINTENDED CONSEQUENCES - THE HIGH YIELD DEBT CYCLE

In the aftermath of the Global Financial Crisis while the world basked in a period of super stimulus, US corporates quietly re-levered.

Total 2015 US corporate debt outstanding as a proportion of GDP has risen from 64% to 70% while average interest costs have come down by around 200bps to 4% (Figure 7).

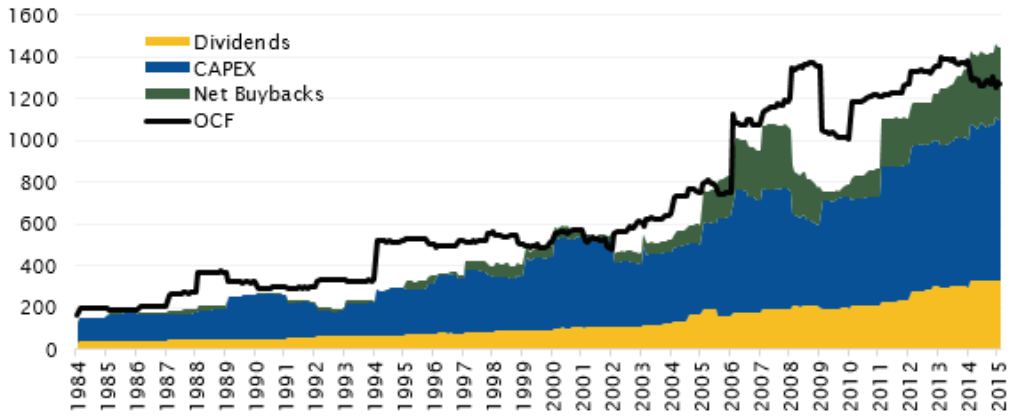
Figure 7: US corporate debt outstanding (1986 -2015)



Source: Goldman Sachs Global Investment Research.

Even with this reduction in funding costs, total operating cash flow[6] is now completely consumed by capex, dividends and buybacks (Figure 8).

Figure 8: US cash flow allocation ($bn)
(1984 – 2015)

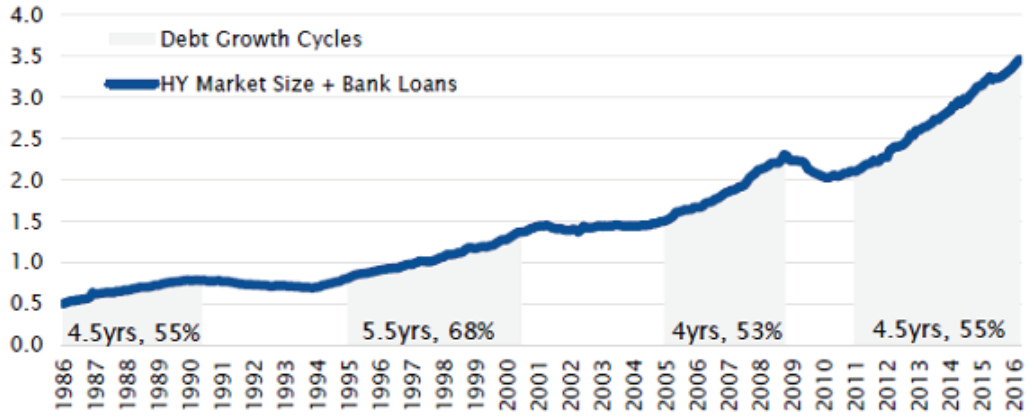


Sources: Factset, Antipodes Partners.

A series of circumstances, starting with the policy response to the 2008 Global Financial Crisis, changed investor and corporate behaviour in ways that were perhaps never intended. As central banks around the world cut policy rates to the lowest level in generations, investors were forced out along the risk curve in order to maintain income levels enjoyed prior to the era of super-low rates. We see direct evidence of this with the share of corporate bonds held by retail funding vehicles (mutual funds, ETF and closed end funds) having more than doubled to around 25% since 2010.

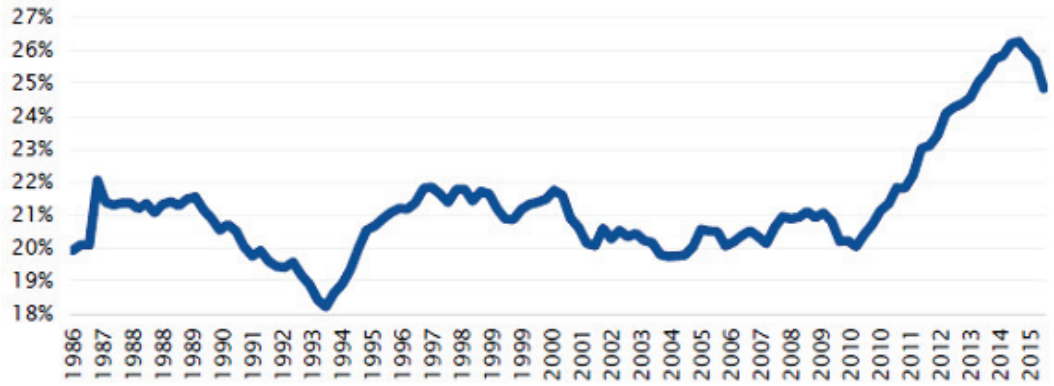
Ready to meet this demand were a long list of issuers eager to tap investors for fresh capital at interest rates not previously available to them. High yield issuance expanded to over $3 trillion, or an unprecedented 26% of total corporate debt issued, vastly surpassing the peak of the systemically dangerous sub-prime mortgage market of approximately $1.3 trillion (Figures 9 and 10 overpage).

Figure 9: Size of the US high yield market ($trn)
(1986 – 2015)



Source: Deutsche Bank.

Figure 10: High yield issuance as a share of total corporate debt
(1986 – 2015)



Sources: US Federal Reserve, Deutsche Bank.

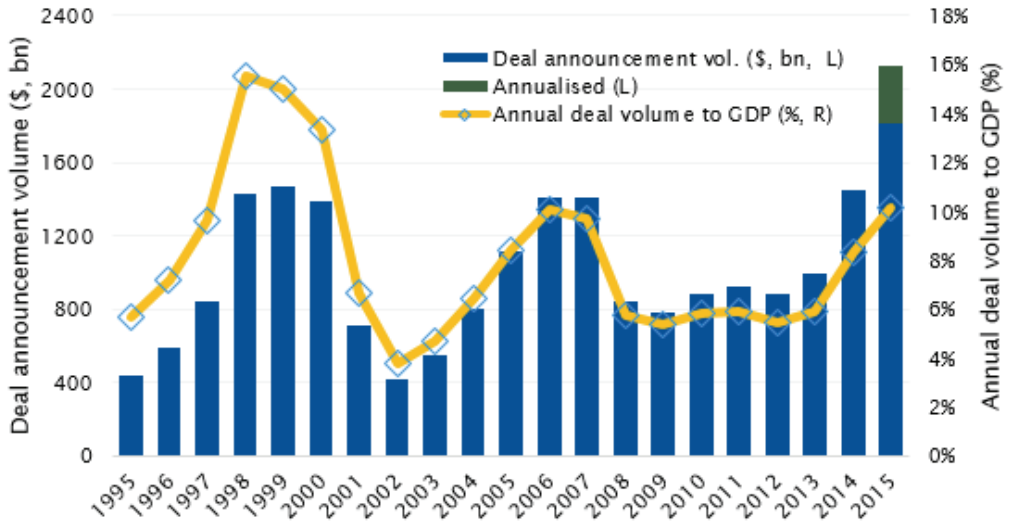
THE BENEFICIARIES OF THE HIGH YIELD DEBT CYCLE

It's time to turn attention to the beneficiaries of the current high yield debt cycle – the issuers who, urged on by a chorus of investors (activists, newly formed ETFs, etc.), have applied the funds to fast track corporate ambitions via M&A, buybacks and capital spending, and, accordingly, attract a growth premium.

Beneficiary 1: The M&A super-cycle

M&A transaction volumes have surpassed the great bull markets of 2007 and the late 1990s underpinned today, as they were then, by easy credit (Figure 11).

Figure 11: US M&A activity
(1995 – 2015)



Sources: Goldman Sachs Global Investment Research, Antipodes Partners

By 2012, the fashion in earnest had become to swap expensive equity for cheap debt funding in all manner of "shareholder friendly" programs. The optics of layering on freshly acquired earnings, funded through inexpensive debt, meant that in the context of a forgiving market, the "numbers" automatically went up, resulting in an equity valuation re-rating. Arbitrageurs stopped worrying about who was going to be bought, knowing they could make as much money simply by knowing who was doing the buying – a peculiar market circumstance indeed. In the process, US corporates have added almost $1 trillion of goodwill to their balance sheets since 2009, highlighting the extent to which acquisitions have occurred at premiums to net asset values in recent years.

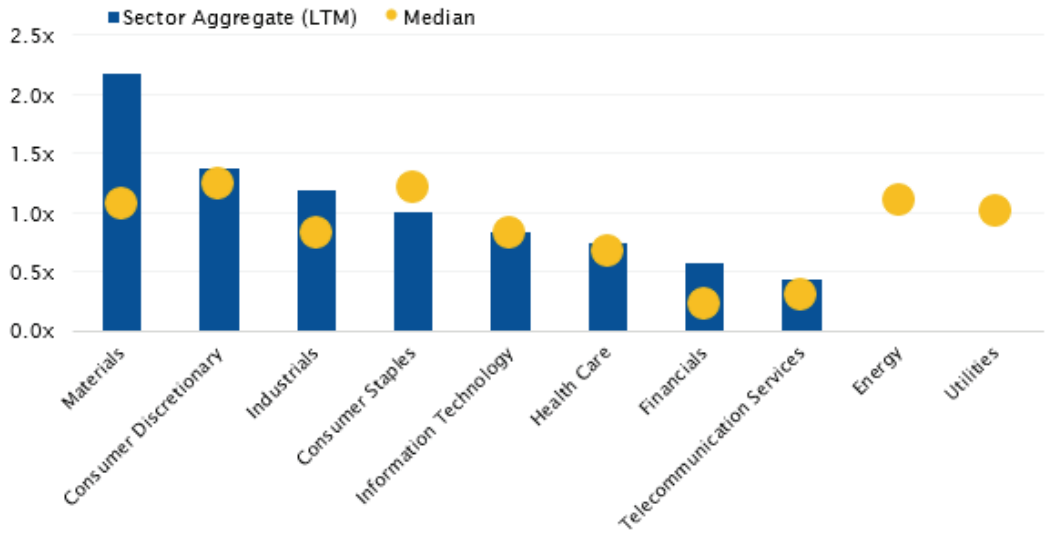
There has been a clear feedback loop from public to private market valuations as evidenced by the recent entry into the investing vernacular of the term "Unicorn".[7] The term has come to represent highly valued, rapidly growing internet start ups, that have attracted private market valuations in excess of $1 billion. The last three years has witnessed an explosion in the number of Unicorns, as excess credit market liquidity spilled over into the venture capital and private equity sectors, creating a virtuous cycle of rising valuations. It is therefore no surprise that in the latter parts of 2015, a number of these valuations have reset to lower levels[8] as investors take stock of the cash burn and competitive landscape faced by start-

ups. History will be the ultimate judge, but many Unicorns may prove to be just as mythical as their literal counterparts as the era of easy credit recedes.

Beneficiary 2: The buyback super-cycle

At the sector level, buybacks appear most extended in the materials, consumer discretionary/staple and industrial sectors, where in each instance buybacks have come to exceed 100% of free cash flows[9] (Figure 12), pushing the overall S&P500 buyback/free cash flow ratio of 1.08 significantly above its long term median level of 0.71.

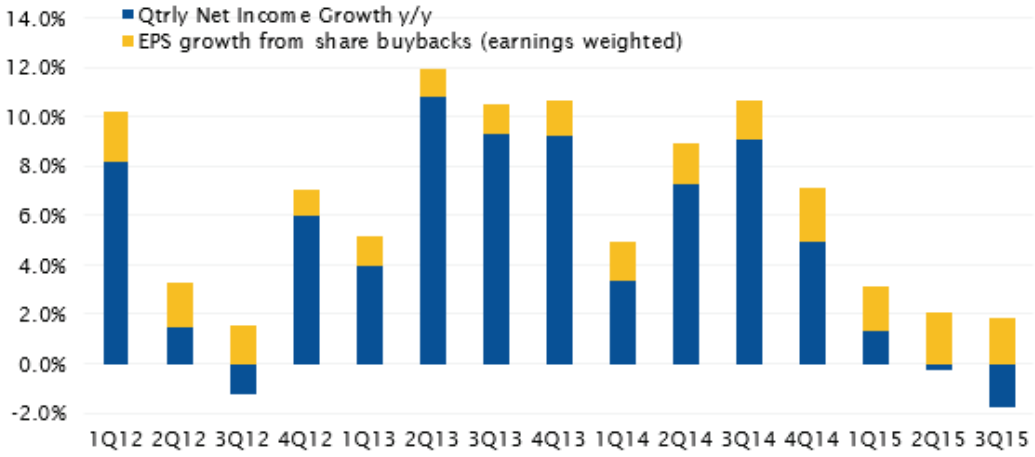
Figure 12: US buybacks to free cash flows by sector (2015)



Source: Factset

According to research from Deutsche Bank, S&P 500 buybacks have contributed a full 25% to EPS growth since the first quarter of 2012, masking sub-par underlying earnings progression in the latter stages of the current corporate profit cycle. Figure 13 (overpage) demonstrates that net income growth has decelerated markedly through the course of 2015, turning negative in the second and third quarters, while earnings per share growth has remained slightly positive held up only by the effects of repurchase activity.

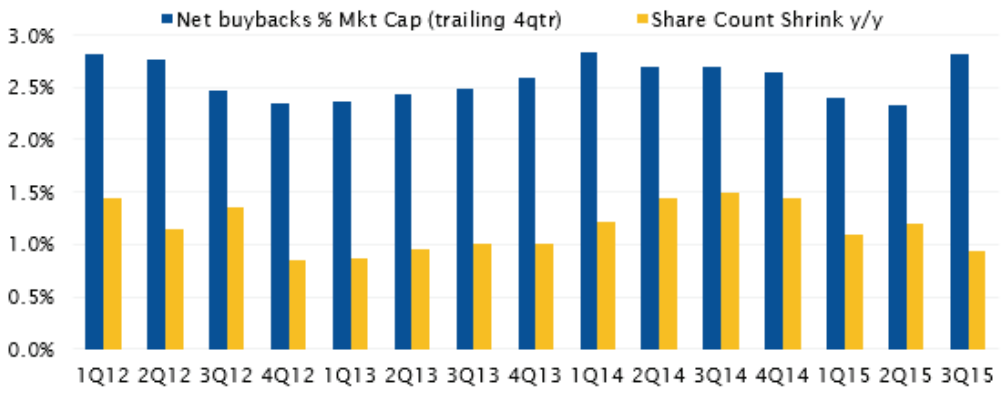
Figure 13: Contributions to S&P EPS growth (2012 – 2015)



Source: Deutsche Bank

While these buybacks sound impressive when announced, the net effect on shares outstanding has been muted due to equity issuance relating to management compensation programs. Since the beginning of 2012, the net reduction in shares outstanding has on average been only 50% of the amount spent on share repurchases (Figure 14). In certain situations, management teams are tapping low cost debt in the bond market to indirectly pay themselves, leaving shareholder balance sheets riskier and themselves wealthier. The potential conflict of interest associated with many buyback decisions deserves similar close attention.

Figure 14: Annual change in net buybacks and share count progression (2012 – 2015)



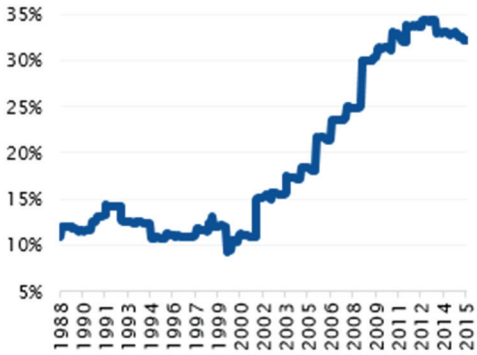
Source: Deutsche Bank

Beneficiary 3: A (distorted) capital spending cycle

One of the goals of central bank policy settings in recent years was to spur corporates on to invest and hire, repairing some of the damage done through the worst of the 2008 crisis. The picture on capital spending amongst US corporates though is somewhat mixed. The oil and gas sector, keyed off the memory of $150 oil prices and break-through fracking technology took up most of the slack, going on a capex binge which was barely interrupted by the 2008 crisis. Energy capex in fact has grown from 20% to 35% of all US capex (Figure 15) over the past 15 years, but now looks set for a sharp reversal under the weight of falling oil prices.

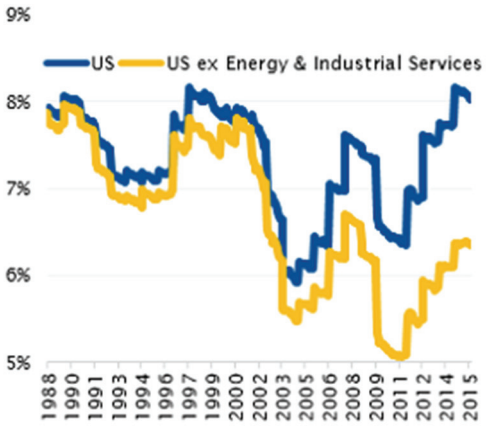
The broader picture of capex excluding energy (Figure 16) demonstrates a relatively muted cycle, and while M&A and buybacks clearly surpassed previous cycle peaks, capex to sales is still well below the level of the 1990s.

Figure 15: Energy capex % of total capex (1988 – 2015)



Sources: Factset, Antipodes Partners.

Figure 16: US capex to sales (1988 – 2015)



Sources: Factset, Antipodes Partners.

TRIGGERS FOR THE HIGH YIELD DEBT UNWIND

As discussed, a further feature of this cycle is the changing nature of bond market liquidity and ownership. Prior to the GFC, investment bank trading desks were so-called suppliers of credit market liquidity, serving the dual purpose of arbitraging market movements for profit and providing much needed supply to bank customers. The changed regulatory regime has significantly diminished the incentive to supply liquidity on this basis and the Volker rule has more or less eliminated bank proprietary trading desks. With corporate debt held by vehicles offering daily liquidity, such as mutual funds and ETFs, having increased so sharply,[10] the potential for a high yield liquidity mismatch thus seems a real possibility, ultimately exacerbating any type of credit market "event" that may arrive. This risk was brought into

focus with the closure and/or liquidation of several high yield credit funds in the latter months of 2015.[11]

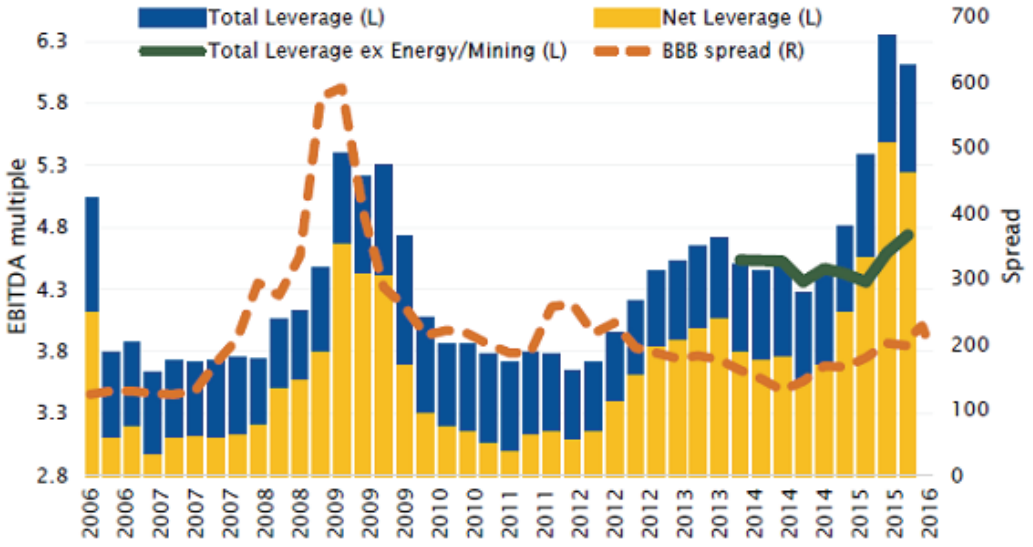
While global equity markets in USD terms ended flat for the March 2016 quarter, albeit punctuated by a sharp first half sell-off and characterised by a spike in cross-asset volatility where the oil price seem to lead almost all other asset classes in a highly correlated manner. The simplistic causality proffered was that a lower oil price creates pressure on emerging market (EM) currencies, greater commodity and EM-related credit stress, rising risk-premia and a consequent negative feedback loop into global equities.

By mid-February, dovish commentary from the US Federal Reserve combined with ongoing improvements in Chinese tier 1 and 2 property markets provided sufficient reason for markets to find an intermediate bottom. This was reinforced by the European Central Bank's announcement of further monetary easing in early March 2016, a combination of more QE and extension of this to include investment grade corporate bonds, various rate cuts (the deposit rate was cut to -0.4%) plus another Targeted Long-Term Refinancing Operation facility (TLTRO) to stimulate bank lending. This somewhat served as a circuit breaker for market concerns regarding high yield debt markets and European bank exposure to the energy sector and, more broadly, capital adequacy.

The subsequent bounce was led by commodities and related emerging markets/currencies (oil +42%, EM ex Asia +37%, Brazilian Real +13% and Russian Rubble +17%) and exhibited similar cross-asset correlation with global equities (+13%) and corporate high yield index (+4%).

Set against this recent bounce in high yield credit, concerns remain regarding the clear deterioration in issuer quality. Figure 17 (overpage) highlights that issuer leverage ratios have risen significantly above levels seen at the peak of the last credit cycle (2007). Though the eye is naturally drawn to peak leverage ratios in 2009, the high yield issuer profit cycle peaked in late 2007, coinciding with a gross debt/EBITDA leverage ratio of 3.8x. The subsequent circa 30% collapse in EBITDA to the early 2009 cycle nadir drove the leverage ratio to its ultimate high of 5.4x.

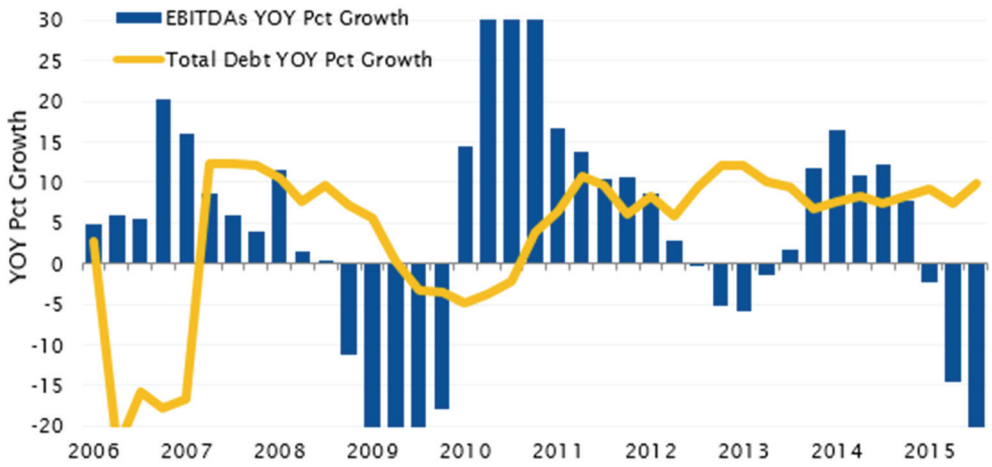
Figure 17: High yield issuer fundamentals
(2006 – 2016)



Sources: Bloomberg, Deutsche Bank

High yield commodity-related EBITDA has already collapsed some 120% from peak driving a sharp deterioration in overall leverage ratios. And although stripping-out the commodity related issuers (roughly 25% of high yield debt outstanding) paints a less distressed picture, there is still cause for concern. The profit cycle of non-commodity related issuers peaked in late 2011, coinciding with a gross debt/EBITDA leverage ratio of 4.0x (higher than corresponding 2007 profit cycle peak level). Since then, non-commodity EBITDA has declined some 20% and EBITDA leverage has expanded to 4.7x (versus 6.1x for the entire group). Consider that the 2009 peak of 5.4x occurred during the depths of the Global Financial Crisis, and it seems there is little margin for error. Interest rates are lower, but the vulnerability of issuers to any small deterioration in the economic environment or risk appetite remains very high.

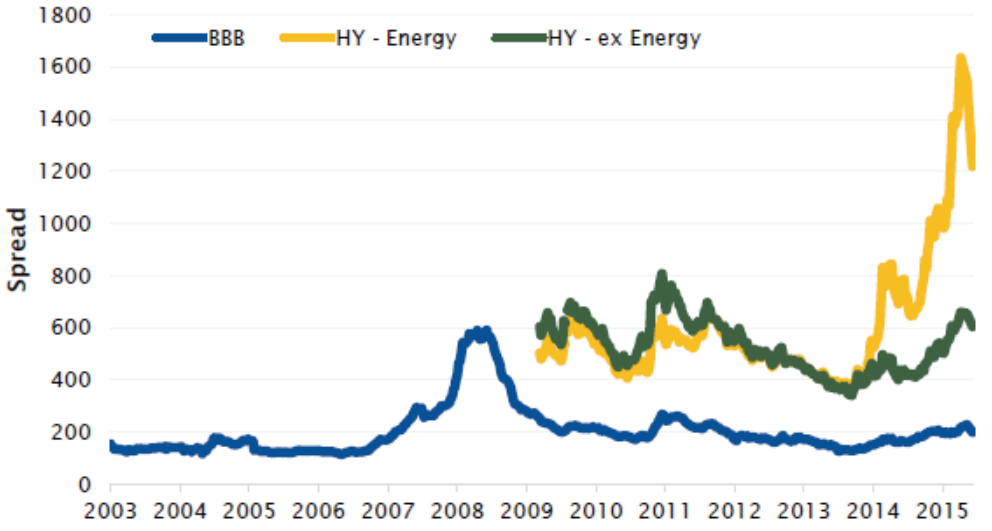
Figure 18: Operating trends in high yield issuers – recession?
(2006 – 2015)



Source: Deutsche Bank

This fragility is evidenced by the recent rise in corporate bond spreads (Figure 19) with the energy and materials sectors taking centre stage. At around 15% of outstanding debt, the energy sector is the single largest issuer of high yield debt, with the proceeds applied to fund growth in US "unconventional oil" and gas production. The collapse in oil prices over the past few years will leave much of this investment impaired and the debt unserviceable. Bankruptcies will inevitably follow, leaving creditors and speculators alike to cast a more discerning eye over other segments of the high yield market.

Figure 19: High yield bond spreads
(2003 – 2015)



Sources: Bloomberg, Deutsche Bank

US HIGH YIELD DEBT SENSITIVE SELLS/SHORTS

Beyond energy, high yield issuance is relatively well spread at the sector level (Figure 20).

Figure 20: US share of high yield issuance, by sector (2015)

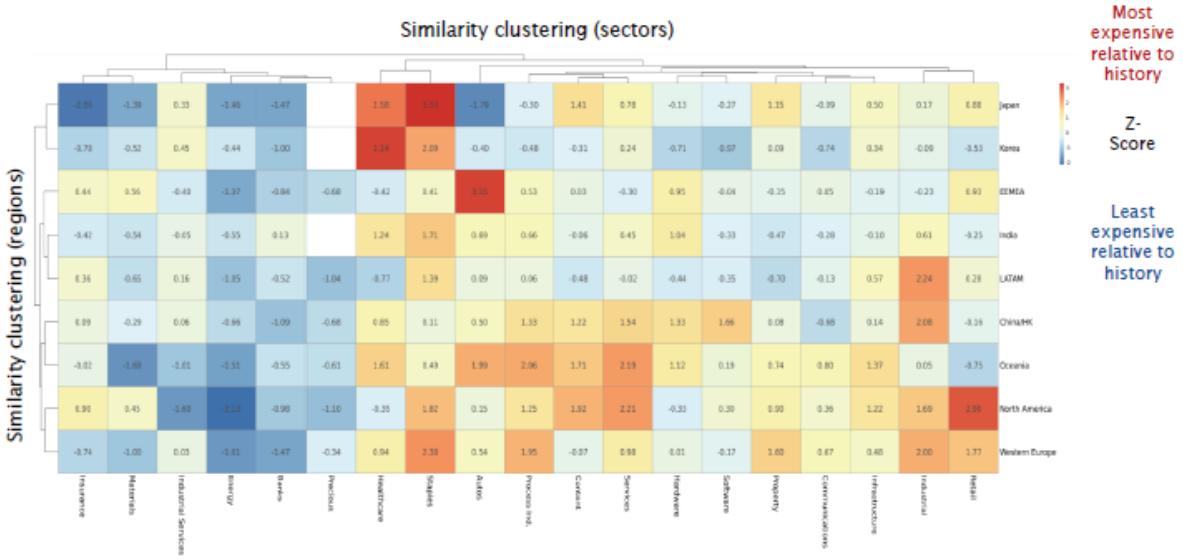
Sector	Face Value $ min's USD	Share of HY Issuance
Energy	216,156	15.4%
Financials	172,168	12.3%
Telecommunications	163,875	11.7%
Materials	121,786	8.7%
Media	111,698	8.0%
Health Care	108,335	7.7%
Technology	65,494	4.7%
Automotive	62,169	4.4%
Commercial Services	61,692	4.4%
Capital Goods	59,110	4.2%
Real Estate	52,090	3.7%
Retail	46,382	3.3%
Gaming, Hotels & Leisure	44,451	3.2%
Utilities	43,347	3.1%
Food	31,157	2.2%
Consumer Products	21,097	1.5%
Transportation	18,781	1.3%

Source: Deutsche Bank, Antipodes Partners.

Companies in the communications, infrastructure, media and healthcare sectors stand out as known beneficiaries, in many cases using cheap debt to fast track corporate ambitions for growth. Whether it be aggressive share repurchase programs or earnings accretive M&A,[12]

the turn in the credit cycle now underway will undermine these once prominent share price supports. Further, premium equity valuations (Figure 21) which many of these stocks have attracted, may yet turn to discounts as the reality of highly levered balance sheets draws more intense scrutiny in the face of a high yield "bust" and manufactured earnings support erodes.

Figure 21: Valuation heat map



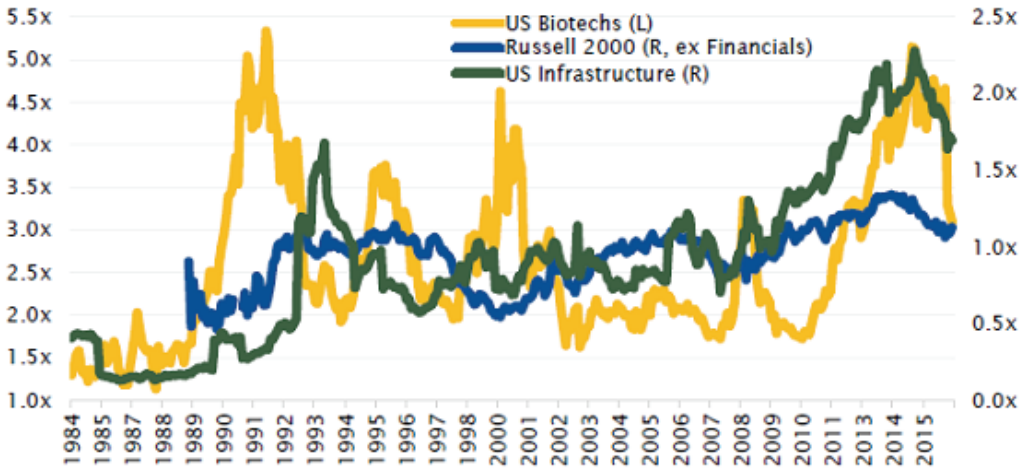
Source: Factset, Antipodes Partners. The Valuation Heat-map provides a more granular illustration of valuation clustering across sectors and regions. Cell colouring indicates the degree to which a sectors' price to book ratio (relative to the world) is above or below its 20-year relative trend. The warmer the colour, the greater the relative price to book valuation versus history; vice versa for the cooler blues, with extremes highlighted by the boldest of colours. Note, the premium paid for most North American sectors in a global context. Note also the global discount that has been applied to the Energy (including Industrial Services), Precious metals, Materials and Financial sectors.

Moving beyond the general, the following are clear red-flags that, all else equal, investors should seek to avoid in their equity stock selection:

- rapid growth in leverage combined with declining long-term marginal return on capital employed, especially where acquired intangibles have become an increasing component of capital employed;
- expensive, lower quality businesses approaching the cyclical shake-out phase;
- over-hyped “disruptors” with deteriorating fundamentals (e.g. Russell 2000 Index constituents ex-Financials (Figure 22)); and

- low volatility, bond proxies favoured by passive strategies that confuse momentum with value and low volatility with quality (e.g., infrastructure assets (Figure 22)) priced for the illusion of duration.

Figure 22: Price to book as a multiple of global price to book (1984 – 2015)



Sources: Factset, Antipodes Partners

CONCLUSION

Taking stock of the evidence, the risk-reward for US high yield debt investors today appears dangerously skewed. The extreme thirst for yield has pushed the high yield cycle into unchartered territory with the stock of debt outstanding and the average leverage ratio expanding significantly beyond the previous 2007 peak. In a clear case of déjà vu (though replace "subprime" with "high yield"), the cycle has reached the shakeout phase.

The long-term widening of spreads, triggered by commodity market dislocation, is unlikely to remain siloed as interlinked funding mechanisms react to accelerating bankruptcies. This has obvious implications for direct investors in high yield debt. However, the spill-over of a high yield bust into a general equity valuations and the real economy could be equally significant. Further, current obvious vulnerabilities are potentially exacerbated by the cresting nature of the corporate profit cycle and the ongoing tightening in monetary conditions imposed by the un-wind of China's corporate debt cycle.

There are short opportunities amongst the beneficiaries of the current high yield debt cycle i.e. the issuers that have applied the funds to fast track corporate ambitions via capital spending, M&A and buybacks and, accordingly, attract a growth premium.

ENDNOTES

1. This paper is prepared for wholesale investors only. The information contained in this article is not intended as a statement of opinion intended to influence a person(s) in making a decision in relation to investment.

2. This Time Is Different: Eight Centuries of Financial Folly", Carmen Reinhart and Kenneth Rogoff, 2009.

3. In December, Chinese insurer PICC announced a $3.9bn acquisition (from Deutsche Bank) of a stake in Huaxi Bank, a second-tier Chinese bank with heavy exposure to the manufacturing, property and construction sectors.

4. Official net capital out-flow for the 6 months to December 2015 was $364bn against ~$3.3tn of reserves, down from peak reserves of $3.9tn.

5. Cyclically-adjusted PE ratio: current price divided by 7 year average EPS in today's dollars. Seven years is used as this best represents the average duration of the corporate profit cycle.

6. Operating cash flow (OCF) refers to cash flows before capital expenditures. Corporates can only fund these commitments by taking on increasing amounts of debt.

7. Tech Crunch

8. New York Times

9. Free cash flow refers to cash flows after capex but before dividends.

10. Retail holdings of corporate bonds have increased from around 10% in 2010 to 25% in 2015, the most dramatic ownership shift in 50 years.

11. In December 2015, Lucidus Capital Partners, Third Avenue Funds and Stone Lion Capital Partners all announced the closure of credit funds citing credit price dislocation.

12. The fashion has become to quote "adjusted EBITDA", as the metric by which to measure the uplift from M&A transactions. EBITDA itself is an adjusted number, meaning investors have been persuaded to adjust the adjustments.

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