New Year's Resolution – A Debt Diet

Bullish on Credit for 2019

I think 2019 will be yet another year where simply selling protection on CDX IG will have positive returns (see January 5th's 'IG Beta' T-Report for more detail on that).

There are some powerful forces lined up against this view:

- Leverage ratios have increased;
- Investment Grade Indices are concentrated at the BBB rating level;
- Fear of an economic slowdown;
- Rating agencies, viewed by many as behind the curve, may choose now to wield their might and downgrade the aforementioned leveraged BBB companies;
- Less demand for corporate bonds as foreign investors pull away from U.S. markets;
- The amount of corporate debt outstanding has increased rapidly, though not as swiftly as equity valuations have increased, as we highlighted on January 1st's T-Report titled The Debt Chart You Won't See From 'Debt Gone Wild' Pundits;
- More competition as the U.S. Treasury is forced to issue more and more debt to cover the costs of our seemingly endless deficit spending.

We will tackle many of these arguments, but my bullish outlook revolves around a few key arguments:

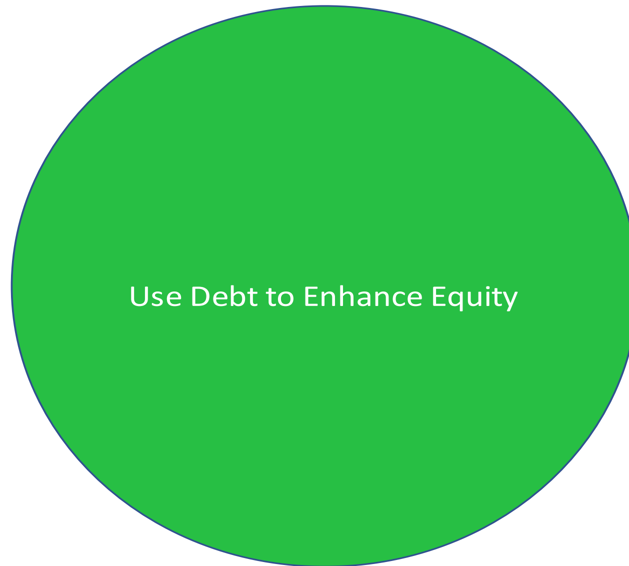
- **Corporate behavior is changing** in response to the increased cost of debt and to the negative impact the perception of being overly leveraged is having on share prices – **the Debt Diet;**
- **Investors are underweight BBB corporate debt**, particularly, at the longer end of the maturity spectrum. This will create demand as investors chase returns if I am correct;
- The economy will not be as bad as expected and companies have a lot more wiggle room with their current cash flows than simple debt to EBITDA ratios capture.

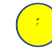
2019 - The Year of the Corporate Debt Diet

Much of my bullish argument surrounding credit comes down to a very simple view **corporate behavior is changing** in response to how markets are pricing debt and how equity markets are treating companies that are perceived to have too much debt. The companies I have the privilege of speaking to are well aware of what they need to do to keep the rating agencies at bay. They are not naively 'Whistling Dixie' and risking their investment grade rating. **The reams and reams of paper that I get, dedicated to the demise of corporate credit, all seem to miss the basic fact** companies are well organized, know what is necessary to remain investment grade, and are committed to remaining investment grade. Most have the resources to do so, even if we experience an economic slowdown.

The Evolution of the Balance Sheet and Equity Enhancement

Q3 2017





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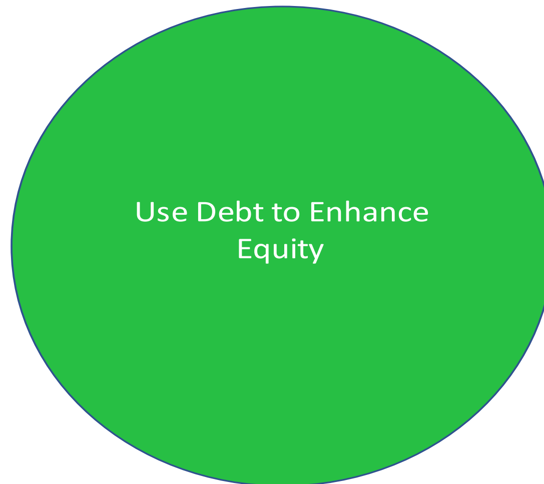

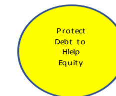

Q3 2019

While the size of the charts are not representative of any actual data, I think there is evidence this trend exists and is accelerating.

Facts that Support this View:

- BUD and GE are two companies that cut their dividends (and stock buybacks) partly in response to balance sheet concerns;
- Newell Rubbermaid is continuing with stock buybacks but also undertook a debt tender offer to reduce debt;
- Comcast filed an 8-K at the time of their recent bond deal stating that they would suspend stock buybacks to reduce leverage;
- IBM, at the time they announced the Red Hat acquisition, indicated that if the deal was successful, they would forego stock buybacks to reduce the debt they would need to incur because of the deal;
- AT&T stated on an investor call that reducing leverage would benefit shareholders (and I agree).

I am sure I have missed a lot of examples of this occurring, but I suspect this trend will gain momentum as more companies identify that supporting creditors will benefit equity holders (A rated companies have been exempted from this, but that is a story within a story).

Companies with higher credit risk have underperformed lower credit risk companies

This chart proves that markets are differentiating between higher credit risk and lower credit risk companies - something that every CEO and CFO are both conscious of and are likely to take steps to offset. These charts take equities based on their ranking according to a modified Merton Model that uses the HOLT framework to estimate a firm's default probability as a function of leverage and volatility. That is a lot of words and I don't have the components, but other studies

that I have seen point to the same thing – **that the perception of higher credit risk is impacting shareholders negatively**. If you go back in time, these indices really started to diverge in the summer of 2017 and that divergence has been accelerating.

Before moving on, I want to re-iterate two points:

1. There are real world examples demonstrating that this shift in behavior is changing.
2. There seems to be a link between equity returns and level of credit risk – and once higher credit is viewed as a drag on shareholders, it changes the equation for companies.

Higher Debt Costs Will Affect Issuance

In November 2017, **BNP** issued bonds maturing in 2027 at 3.5% at a spread of T + 125. This past week, they issued bonds maturing in 2025 (so almost 2 years shorter) with a coupon of 4.705% that came at a spread of T+235. The bonds are a bit more complex than that, but the comparison still illustrates the point that the cost of debt has risen meaningfully.

Another example from last week, is John Deere Capital. **DE** issued a 5-year bond on January 3rd, 2018 – it had a coupon of 2.7% and came at T+47. This past week, they issued a new 5-year bond, with a coupon of 3.45% that was T+97. That is an extra 0.75% per annum on the coupon.

The cost of debt has risen and that is a factor companies will take into account as they manage their balance sheets.

Tax Reform Reduced the Need to Issue

The big impact from tax reform that dramatically shifted the landscape of debt issuance last year was repatriation. There was very little (if any) issuance from companies in 2018 that were large beneficiaries of the change in tax law making it favorable to return cash onshore.

Apple is a prime example of this. They went from doing their first bond deal in 2013 to becoming a large issuer, with over $100 billion of debt outstanding. But their last issue was in 2017. They did not issue bonds in 2018. They have stated in their 10-Q that they have a goal of having cash on hand equal to their debt outstanding. Something that can be managed much easier as a result of the repatriation changes, which should have an ongoing benefit for companies that continue to generate free cash flow overseas. Apple has $2.5 billion of debt maturing in February. Will they issue debt to repurchase that? Will they issue some debt to tinker with their maturity schedule? They had $6 billion mature in May 2018 and didn't issue debt. How companies like AAPL and CSCO behave this year could have an outsized impact on the bond market. CSCO repaid 2018 debt without issuing bonds. They have over $5 billion coming due between Feb. 15th and March 1st so whether they issue bonds could impact total supply estimates dramatically.

If the repatriation companies don't come to market in a material way, then supply could be constrained.

Free Cash Flow increased for most companies as a result of the corporate tax cuts.

While not as 'sexy' as discussing repatriation, companies benefited from tax cuts and most saw increased earnings and cash flow (Q2 2018, I think, was one of the biggest earnings beats in the

past decade). The ability to service debt, and even repay debt out of free cash flow is higher than it has been. Yes, this would be affected by an economic downturn, but I don't think this ability is being priced in. **The markets are not giving companies enough credit for their ability to reduce debt or issue less debt as a result of the improved cash flow aided by the tax cuts.**

The rush to fund pension plans has ended. Companies could contribute money to their pension plans up until September 2018 and take the deduction as of 2017 – when most companies paid a much higher domestic tax rate. There were bond deals that were done where use of proceeds mentioned these flows. We don't know how much free cash flow that could have gone to debt reduction went to fund pension plans in the first 8 months of 2018, but I suspect we will find that amount was material.

There are factors at work that should reduce the amount of debt required by companies.

Stock Buybacks are a 'Luxury' Item for Corporations

Companies will work hard to preserve their dividends. Companies know that investors expect the dividend, maybe even need the dividend for their income. There are so many mutual funds and ETFs that invest in dividend stocks that they want to be included in those strategies – many of which focus on how consistent the dividend history has been. Cutting the dividend is typically a last resort that companies are reluctant to take – though we have already seen a few examples as highlighted earlier.

But stock buybacks are a luxury item. There aren't even many 'buyback' ETFs and some like PKW, have seen their shares outstanding decline by 70% since their peak in 2014. Maybe the fact that the 1-year, 3-year and 5-year performance of PKW is worse than those of SPY have something to do with that.

We at Academy worked with an outside firm to run some analysis on how quickly some of the large IG issuers can reduce their leverage ratio with changes to their buyback policy – the numbers are material.

While I think dividends are treated with the utmost respect by companies, as they should be, I think the willingness and ability to forego stock buybacks is underappreciated. The amount of stock buybacks went from something relatively unusual, to commonplace, to one of the key drivers in the market in a relatively short time frame.

There will always be buybacks – and there should be. Companies that are in position to buyback shares should do so. I'm not opposed to stock buybacks at all. I have always assumed, that the purpose of stock buybacks is to increase share prices. It should be. **But if we have entered a market environment where increased leverage and the perception of credit risk does more damage to a stock than the buyback can do good, it shouldn't be done.**

There is no exact number for that, but as companies watch some stocks get hit by the debt burden they have incurred and see stock pirces decline despite buybacks, they may alter their behavior. If the goal of spending cash is to increase share prices, and spending cash on debt buybacks seems to benefit the stock price more (for some companies), it is only rational that they would do that.

This will not be a 'one size fits all' type of situation but, and I think this is a very important but, it will impact the companies that credit markets are most concerned about, the most. So, you will actually get the desired behavior from the companies you need it from the most. They may also see that it is better to act early as if the situation gets out of control, it can quickly shift to a focus on the dividend which isn't a good outcome.

One thing I've learned in my travels is that companies do pay attention to what percentage of cash flow their peers are using to buy back shares. Like everything else, companies don't want to necessarily be outliers. They are acutely aware of what their peers are doing. So as one company increased it buyback activity, it is logical that its peers did too, so as not to be left behind. Will the same action occur in reverse?

To be clear, I like stock buybacks, I think they are an important part of any CEO's arsenal, I just think that we will find more companies finding that their money might be spent in different ways to enhance shareholder value.

How Big Will the Debt Diet Be?

I expect about $300 billion of net issue with total supply less than $1 trillion.

By my calculations (and I'm sure if I got some things wrong), I get about $690 billion of debt maturing. How much of that will be rolled? AAPL, CSCO and ORCL have relatively large amounts of debt maturing in 2019 ($9 billion, $7.25 billion and $6.5 billion, respectively) who did not issue bonds in 2018. If they issue a lot of debt to fund these maturities, then I will want to revise my estimates on supply, but if they just issue some debt, possibly to optimize their maturity structure, then I would be comfortable with my work.

The last time we were under $1 trillion of IG issuance in the U.S. was in 2011.

We were as high as $1.42 trillion in 2017. That dropped to $1.25 trillion in 2018, a 12.3% drop.

We would need at 20% decline in issuance from 2018 to 2019 for me to be correct.

In the second half of 2018, issuance dropped to $520 billion (just over $1 trillion run rate) and a 20.7% decline from 2017. That weakness was despite September clocking in as the busiest month of the year at $150 billion. If the 2nd half of 2018 is any indication of what is to come, and I think it is, then we are already on a run rate of barely over $1 trillion. That barely beat 2014's second half but was better than 2011's 2nd half (remember, that was the last year we didn't get to $1 trillion).

Can Investment Grade Bonds rally with net supply of $300 billion? Yes, though it will depend on the composition of that supply, but if I am right, we will find that we are currently being overcompensated for long dated IG credit risk, particularly in the BBB sector. We might have to make it through January's robust calendar, but IG credit risk is a risk I like to take.

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