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BBBs Have Only a Few Bad Apples

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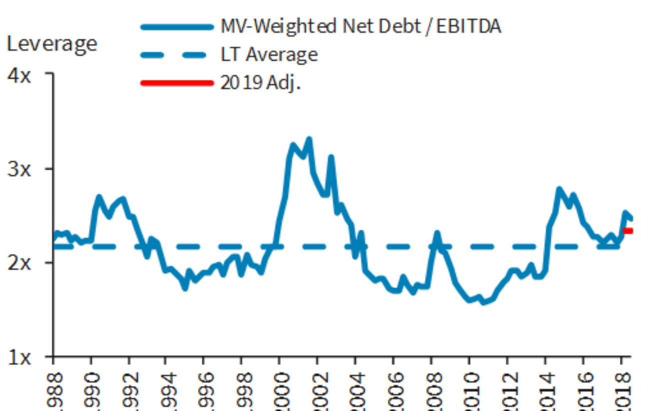
Macro headlines and monetary policy captured investor attention for much of 2019, but with recent US economic data showing signs of weakness, concerns about company balance sheets have increased. Indeed, we recently noted that some companies are likely facing margin compression through year-end (see *Some Weakness at the Margins*), and coming into the year there had already been a lot of ink spilled about the elevated leverage of large investment grade corporates (see *The Lowdown on the Lowest Rated BBBs*).

On the surface, stated net leverage for investment grade non-financials has increased materially, from 2.3x in 4Q18 to 2.5x in 2Q19. However, this increase is artificially inflated because of a 2019 GAAP accounting change that requires operating leases to be accounted for as liabilities. Many analysts were already adjusting for this manually, and while companies are now required to count operating lease obligations toward total debt from a GAAP standpoint, there obviously has not been any incremental risk added in the companies' ability to pay future liabilities. In fact, after we exclude operating leases from our 2019 debt numbers to construct an apples-to-apples comparison with historical data, leverage has actually declined through the first half of 2019, to 2.2x, which is in line with the long-term average (Figure 1). Furthermore, we find that the largest downward revision from this adjustment comes from BBBs, which at face value appeared to see net leverage rise from 2.7x to 3.0x in 2Q19, whereas, in fact, their net leverage was reduced to 2.5x (Figure 2).

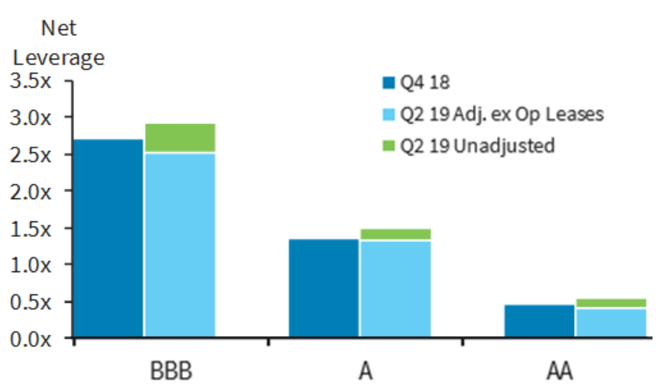
Overall leverage numbers appear to be in line with historical levels even for BBBs. However, likely more troubling to investors is the "tail risk" in the cohort of lower-quality issuers with the highest leverage. Companies that engaged in large-scale debt-funded acquisitions in recent years have received increased scrutiny from ratings agencies and equity investors (see *M&A Names on Notice*), and with weaker economic data this year providing further evidence that we may be in the later stages of the economic cycle (see *Labor Market Momentum Shows Signs of Stalling*), concerns about the ability of these companies to reduce leverage organically appear warranted.

FIGURE 1
2019 Net Leverage Increase Was Due to the GAAP Change in Accounting for Operating Leases as Debt



Source: Compustat, Bloomberg, Barclays Research

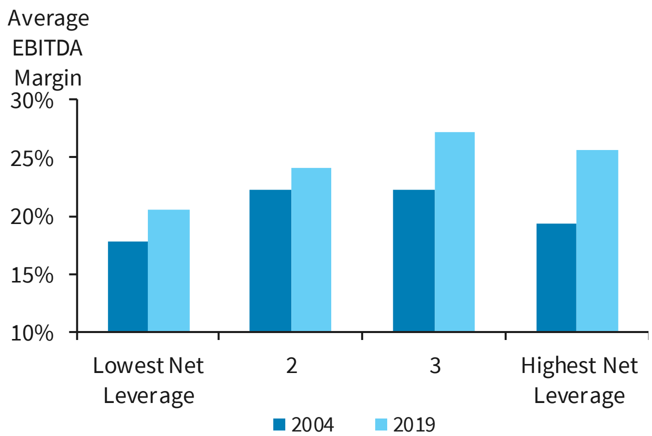
FIGURE 2
BBB Leverage Has Actually Declined after Adjusting for the GAAP Accounting Change



Source: Compustat, Bloomberg, Barclays Research

FIGURE 3

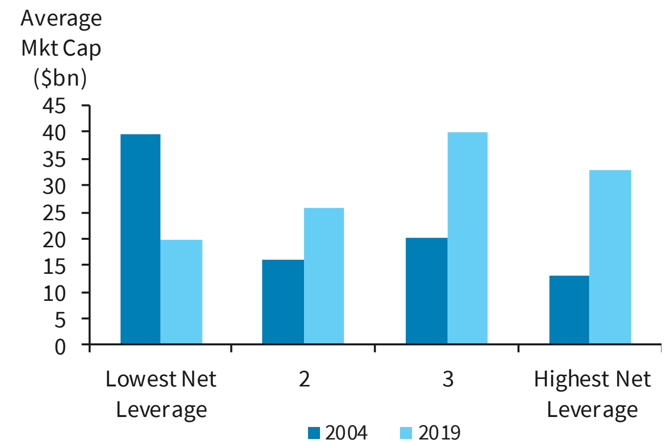
Margins Have Improved for the Most Highly Leveraged BBBs



Note: Industrials only. Source: Compustat, Bloomberg, Barclays Research

FIGURE 4

The Highest Leveraged BBBs Have Larger Market Caps

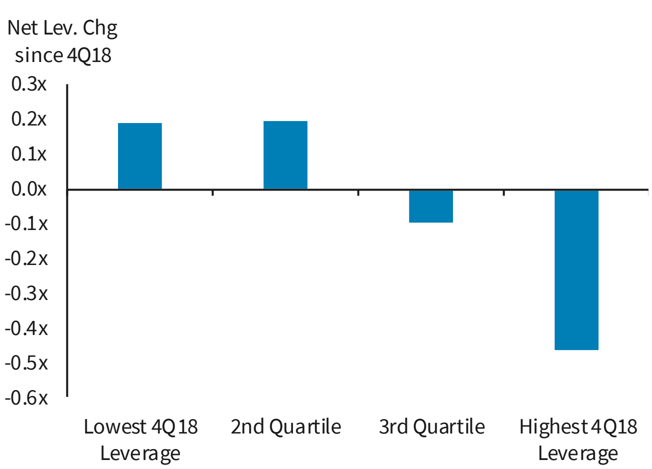


Note: Industrials only. Source: Compustat, Bloomberg, Barclays Research

For the highest leverage BBBs, spot leverage does appear elevated relative to pre-crisis levels, but there are offsetting positive factors. When we group BBB industrial tickers into quartiles by net leverage, the average leverage of the names in the highest quartile is 4.4x as of 2Q19, compared with 3.6x in 2004. However, these companies have seen other fundamental factors improve. Figure 3 compares the average EBITDA margin by leverage quartile in 2004 with 2Q19. Each cohort aside from the lowest quartile posted an improvement in margins, but companies in the highest quartile have seen the greatest increase – from 19% in 2004 to 26% currently. This is important, as EBITDA margins are a better predictor of spread performance than starting leverage in a significant sell-off (see *Beyond Leverage: Fundamental Factors that Matter*). In addition, we find that the most highly leveraged companies have much larger market capitalizations than in 2004, on average (Figure 4). Because of their increased size and diversification, these companies have multiple levers to pull if the current economic slowdown accelerates, reducing the risk that they pose to investors (see *Big BBBs Won't Break Bad*).

FIGURE 5

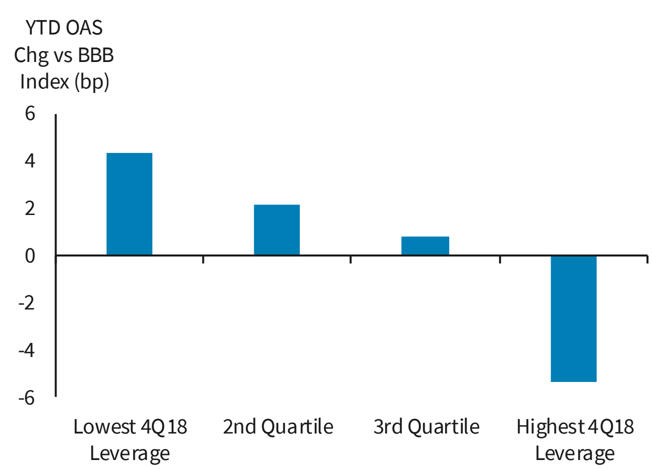
BBB Industrials with the Highest 4Q18 Leverage Have Brought Leverage Down the Most….



Source: Bloomberg, Compustat, Barclays Research

FIGURE 6

…And Have Also Been the Best Performers



Source: Bloomberg, Compustat, Barclays Research

Highly leveraged companies have also taken steps toward improving fundamentals this year. Figure 5 shows the 4Q18 to 2Q19 change in leverage for companies broken out by 4Q18 leverage quartiles. Companies in the highest quartile at the start of the year have reduced it by roughly 0.5x on average. They have also been the best performers this year – their spreads have tightened 6bp more than BBB industrials (Figure 6). Within this group, the best performing companies have, for the most part, been those that have either made reducing leverage a focus (General Electric, AT&T, Campbell, AB InBev), or that had an inorganic shift in their fundamental profiles, such as Mylan.

Although the cohort has outperformed as a whole, several names have lagged. Figure 7 lists highly leveraged companies that have underperformed BBBs the most (our analysts also provide leverage figures for 4Q18 and 2Q19, as well as estimates for YE2019 and 2020 where possible). At current levels, we believe the risk/reward appears more balanced, with leverage of most of these credits trending lower or remaining stable. Three exceptions are ONEOK, Plains All American, and Molson Coors, which we are Underweight. Below, we provide detailed analyst commentary on the leverage paths of these credits.

FIGURE 7

Highly Leveraged BBBs That Have Underperformed the Most Year-to-Date

				Net Leverage				
Ticker	Market Value ($bn)	Current OAS (bp)	YTD OAS Move (bp)	4Q18	2Q19	4Q19 Est	2020 Est	Analyst Rating
KHC	$21.9	226	+15	4.3x	4.7x			
NWL[1]	$4.7	203	-8	3.7x	4.2x			Overweight
AGN	$13.9	143	-13	2.8x	2.7x			Market Weight
CI	$28.6	137	-16	3.4x	3.1x			Market Weight
OKE	$12.4	200	-22	3.8x	4.2x	4.5x	4.3x	Underweight
CVS	$60.3	148	-24	4.4x	4.2x			
KMI	$29.1	196	-26	4.4x	4.6x	4.5x	4.2x	Market Weight
TRPCN	$15.9	175	-27	5.5x	5.1x	4.7x	4.7x	Market Weight
PAA	$9.0	207	-29	3.8x	3.2x	3.6x	4.1x	Underweight
SHW	$7.6	126	-31	3.2x	3.4x	2.8x	2.5x	Market Weight
WRK	$6.8	144	-34	3.1x	3.1x	3.0x	2.8x	Overweight
TAP	$6.6	159	-35	3.8x	3.9x			Underweight

Note: Includes only $5bn+ capital structures. [1] NWL net leverage excludes operating leases. Source: Bloomberg, Compustat, Barclays Research

Analyst Commentary

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Plains All American Pipeline (PAA)

After largely reaching its deleveraging goal earlier in 2019, we estimate that the combination of weaker Supply & Logistics (S&L) segment EBITDA and capex required for new projects will cause total leverage to increase slightly through 2020, which contrasts with the deleveraging that we estimate for the overall midstream sector. We also think that PAA's $1bn bond deal in September created a more challenging technical, and there are some fundamental concerns associated with potentially slowing production growth in the Permian at the same time that new pipeline capacity has come online.

ONEOK Inc. (OKE)

OKE outspent cash flow on its organic project backlog, which increased its near-term leverage profile. We expect EBITDA growth in 2020-21 to pull OKE's leverage back down next year, although low natural gas and NGL prices may add some uncertainty about its future volume growth. We expect that OKE will potentially trade slightly wide of the sector in the next few quarters as leverage continues to rise.

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WestRock Company (WRK)

Leverage remains elevated following the acquisition of Kapstone in 1Q19, in addition to earnings pressure from declining margins in containerboard and pulp. Containerboard fundamentals are expected to weaken through 2019 and into 2020 (although WRK is less exposed to margin pressure than peers given an advantaged cost position), but we think the company has capacity to repay debt in 2H19 and could accelerate paydown in 2020 as cash flow improves.

Sherman-Williams Co. (SHW)

Following the Valspar acquisition in 2Q17, leverage has been elevated and deleveraging has moved slowly, with additional earnings pressure from raw material inflation in 2018 that flowed through into early 2019. We expect coatings fundamentals to remain strong in 2019 and SHW to reach its target of 3.0x by YE19 by paying down debt; beyond 2019, we expect continued gradual deleveraging from EBITDA growth as the company works toward a 2.0-2.5x long term target

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Cigna Corp (CI)

Despite the diversifying nature of its Express Scripts acquisition, Cigna's consolidated credit profile remains highly correlated to the performance of its legacy health insurance business. With the political narrative heavily centered on the ongoing "Medicare for All" debate and only expected to accelerate over time, investors have opportunistically trimmed their holdings throughout the year to lock in the returns generated since new issue. With the healthcare debate unlikely to subside soon, we do not anticipate a reversal of this weakness over the next few quarters, but also do not foresee another leg wider across the structure so long as management continues to reiterate its near-term deleveraging targets. We maintain a Market Weight rating on CI.

Allergan PLC (AGN)

In response to persistent pressure from equity investors, Allergan appeared increasingly likely to pursue one or more drastic actions to facilitate share price recovery through most of 1H19. Options it might have considered, according to management, included a break-up of the company, which is almost always credit negative for bondholders, who are left with a smaller and less diversified entity. This outlook, coupled with competitive concerns about the in-market portfolio, led the market to consider fallen angel risk. Around midyear, it was announced that Allergan would be sold to AbbVie, a deal that would purportedly eliminate downgrade risk if successfully completed. AGN bonds squeezed tighter briefly, but have since leaked wider given expectations of $30bn in new senior notes pursuant to the financing plan and, to a lesser degree, concerns about a potential deal break-up.

Priya Ohri-Gupta – Food & Beverage/Consumer Products

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BCI, US Molson Coors (TAP)

While TAP made progress toward its leverage target of 3.75x as it paid down $936mn through 1H19 (net leverage at the end of the quarter was 3.9x), the company delayed its deleveraging trajectory, walking back a previously discussed 3.75x net debt/EBITDA objective to an expectation to be "below 4x" by year-end. With CEO Hunter stepping down at the end of September to be replaced by MillerCoors CEO Gavin Hattersley, the company has said that it will look to change through innovation. The name has traded within a 24bp OAS range relative to BBB industrials and currently trades modestly wide of the year-to-date average (60th percentile). While we do not foresee the company having an issue meeting its leverage target by year-end, the lack of innovation, recent volatility related to its joint venture Truss with HEXO (the company recently pulled its guidance and announced that its CFO was stepping down), continued pressure within US beer, and the lack of a near-term catalyst support our Underweight rating.

Newell Brands (NWL)

NWL's year-to-date underperformance has been weighted toward the early part of the year, as the name underperformed BBB industrials by about 84bp through April 29, when the relationship was at the wides. Since then, however, NWL has outperformed BBB industrials by 54bp, as the company delivered solid earnings relative to expectations two quarters in a row, driven by operational momentum and strategic execution including asset sales and a recent tender offering. Moody's moved its outlook on the credit to stable on August 2. We feel comfortable fundamentally with regard to the story given working capital improvement that has led to strengthening free cash flow, as well as sharpened focus on innovation, SKU count, and improved positioning within a dynamic retail landscape.

Analyst Certification

We, Brittany Chen, Bradford Elliott, CFA, Shobhit Gupta, Andrew Keches, CFA, James K Martin, Harry Mateer and Priya Ohri-Gupta, CFA, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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CIGNA CORP, Market Weight, CD/CE/J/K/M/N

CVS HEALTH CORP, Overweight, A/CD/CE/D/E/J/K/L/M

DOW CHEMICAL CO/THE, Market Weight, A/CD/D/J/K/L/M

KINDER MORGAN INC/DE, Market Weight, CD/CE/D/J/K/L/M

KRAFT HEINZ FOODS CO, Market Weight, A/CD/D/J/K/L/M

MOLSON COORS BREWING CO, Underweight, CD/CE/J/K/N

NEWELL BRANDS INC, Overweight, CD/CE/D/J/K/L/M/N

ONEOK INC, Underweight, A/CD/CE/D/J/K/L/M

PLAINS ALL AMERICAN PIPELINE LP / PAA FINANCE CORP, Underweight, A/CD/D/J/K/L/M

SHERWIN-WILLIAMS CO/THE, Market Weight, CD/CE/J

TRANSCANADA PIPELINES LTD, Market Weight, CD/D/J/K/L/M

WRKCO INC, Overweight, CD/J/K/M/N

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The analyst expects the six-month excess return of the country's index eligible bonds to exceed the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
Market Weight (MW):
The analyst expects the six-month excess return of the country's index eligible bonds to be in line with the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
Underweight (UW):
The analyst expects the six-month excess return of the country's index eligible bonds to be less than the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
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