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M&A Deleveraging Stuck in the Slow Lane

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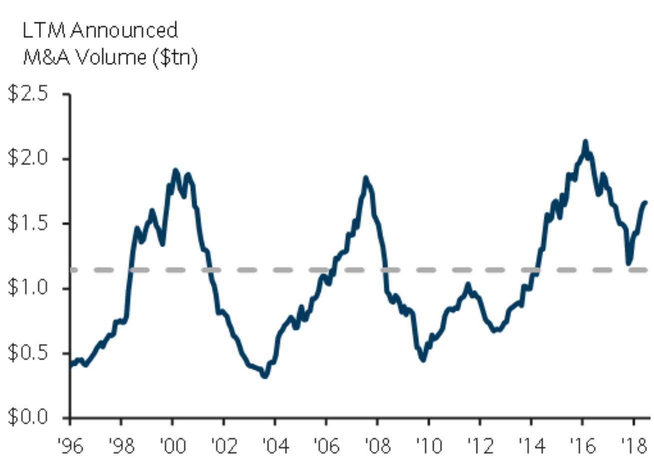
- **Companies that engage in large debt-funded acquisitions generally do not return to pre-acquisition leverage levels within three years of the deal. Single A-rated credits tend to be more comfortable with elevated leverage, while BBB-rated names generally deleverage at a much faster rate, likely because of the greater risk of downgrade.**
- **Leverage increases for deals before and after the financial crisis were broadly the same; however, post-crisis acquirers generally had higher pre-acquisition leverage, as well as maximum leverage after the deal. As a result, spreads for the post-crisis cohort underperformed, while pre-crisis names posted modest outperformance.**
- **Rating agencies have been more lenient on post-crisis transactions, with downgrades less tied to leverage increases for recent deals. That said, companies undertaking these transactions in recent years have been skewed toward lower-beta sectors, implying a more reliable ability to deleverage, especially in times of financial stress.**
- **The historical leverage path post-transaction – with leverage remaining elevated for several quarters (and potentially indefinitely) after a deal – suggests that recent M&A deals could come under pressure should the economic backdrop worsen, although the risk is offset by their generically lower-beta nature. A change in ratings agencies' reaction to large-scale M&A also poses a risk.**

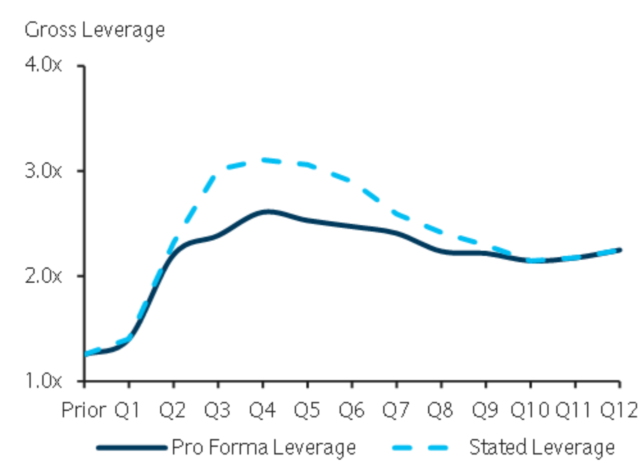
The heightened M&A activity among US companies over the past few years (Figure 1) has been a key source of concern for credit investors. Particularly worrying is the recent trend of debt-funded M&A transactions from larger companies, which has caused the investment grade debt market to balloon over the past five years, particularly at the lower end of the quality spectrum. As we highlighted in *Gauging the Effect of Falling BBBs*, any increase in downgrade rates for these highly leveraged investment grade companies could have dramatic implications for both the investment grade and high yield markets.

FIGURE 1
M&A Volumes Have Been Elevated for Several Years



Note: Dotted line shows the long-term average.
Source: Factset, Bloomberg Barclays Indices, Barclays Research

FIGURE 2
Gross Leverage Following an Acquisition



Source: Factset, Barclays Research

In *Debt-Funded Acquisitions Lose Their Luster*, we found that although debt-funded M&A transactions were accretive for acquirers' equity valuations in 2014 and 2015, these deals were viewed less favorably by the equity markets in 2016 and 2017. This leads us to believe that management teams are likely to favor equity over debt for funding future deals. That said, the companies that have recently undertaken leveraging transactions still pose a risk for the foreseeable future, or at least until they return to their pre-acquisition leverage.

M&A Effect on Leverage

Leverage added as part of an M&A deal is usually meant to be temporary, with companies promising to deleverage in the years after the transactions, which is a key reason for the benign response from rating agencies and investors to the significant debt added as part of these deals. In order to determine how leverage evolves after M&A deals, we screen for M&A transactions involving non-financial investment grade companies between 2002 and 2016[1] that were at least partly funded by debt (ie, there was debt issued post-acquisition announcement) and resulted in an increase in gross leverage.[2]

Figure 2 shows the median gross leverage from pre-announcement levels across these transactions. The stated leverage in our sample set increased nearly 2.0x, peaking about three quarters post-announcement, which is consistent with our earlier observation that deal-related supply usually comes about 6-9 months after announcement (see our *2018 Investment Grade Issuance Forecast*). The stated leverage levels decline nearly 1x over the next few years, suggesting that companies at least partially fulfil their promise to deleverage.

However, the stated leverage does not accurately reflect the leverage change, in our opinion. It overstates the initial increase, as well as the subsequent decrease, because of timing mismatches between debt funding and EBITDA recognition: EBITDA of the combined entity does not begin to be incorporated in earnings until after the merger completion date is reached, yet companies tend to issue debt prior to the completion of deals. Stated leverage therefore shows an initial spike that corrects over time as new revenue is fully recognized.

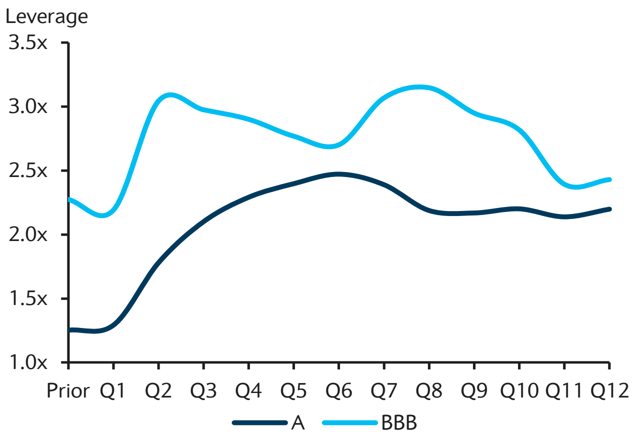
Pro forma leverage, which corrects for this discrepancy by correctly accounting for EBITDA, shows a smoother path, with leverage increasing only 1.4x (compared with nearly 2.0x implied by the stated numbers). It also suggests, however, that the decrease is more limited, with median deleveraging of only about 0.4x in the three years following a deal. In addition, it takes several quarters to occur, which makes sense given that many of the synergies from these deals come with upfront costs and take years to realize fully. Importantly, leverage did not return to pre-acquisition levels even three years after acquisitions were announced. While many companies set out deleveraging paths that are longer than this timeframe, we also believe that many of the names in our study were comfortable with slightly higher leverage – especially given rating agency flexibility on the ratings of issuers with larger scale and combined cash flows.

This is particularly true for corporates with higher pre-announcement ratings. Figure 3 shows that companies that were rated single-A prior to the transactions increased leverage by a larger amount than BBB companies and did not pay down debt as significantly as their lower-rated peers. In fact, the leverage of the two cohorts was only 0.2x different three years after the announced transactions.

[1] In order to filter out smaller deals, we only consider deals greater than $2.5bn in the pre-crisis period (2002-08), while we use a higher $5bn threshold post-crisis (2009-15), reflecting the changing size of the market. We limit our analysis to deals that occurred prior to 2016 in order to capture subsequent deleveraging and spread reaction.
[2] Here and in rest of the report, our preferred measure of leverage is gross leverage. There is often a mismatch between the timing of debt issuance and closing of the transaction (when cash is paid); therefore, net debt may not accurately capture leverage changes.

FIGURE 3

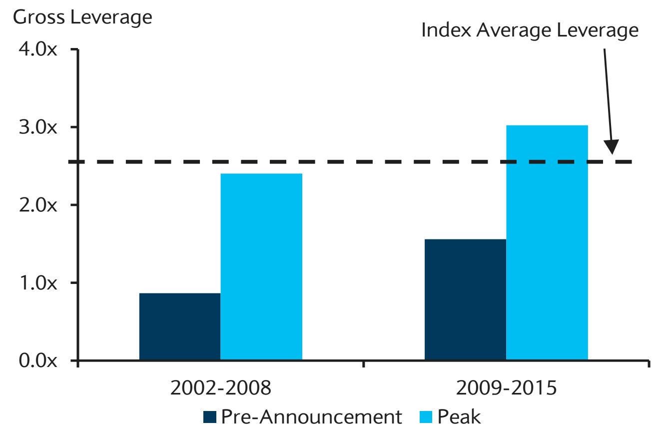
Single-A Names Often Kept Leverage Elevated



Source: Factset, Barclays Research

FIGURE 4

Starting Leverage for Post-Crisis Debt-Funded Acquirers Was Nearly Twice That of Pre-Crisis Debt-Funded Acquirers



Source: Factset, Barclays Research

We believe that the drivers of this difference are two-fold: first, the downside risk of a downgrade is significantly higher for BBB companies, which are likely to face materially higher funding costs, as well as limitations on the availability of debt funding. Second, A-rated companies that participate in sizable M&A are likely to benefit from increased scale and cash flow, leading to more flexibility from the rating agencies if needed. Furthermore, a notch or two downgrade to high to mid-BBB, if fundamentals do come under pressure, is likely not as disruptive to their funding access.

Indeed, two-thirds of the single A-rated companies in our study were downgraded by at least one ratings agency, while just 40% of BBBs were downgraded at least one notch. This supports our generic preference for BBB paper, as the BBB companies in our study were able to limit credit deterioration more effectively than their A-rated counterparts.

The Risk from Debt-Funded M&A Has Increased: Comparing Pre- and Post-Crisis Deals

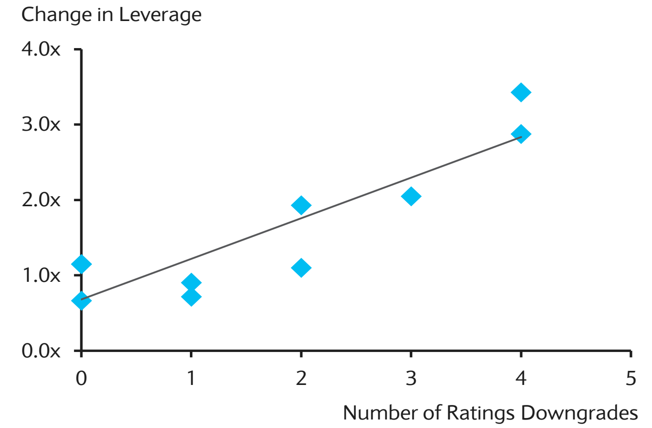
M&A activity was elevated before 2008 as well (Figure 1), and it is instructive to compare deals in the pre-crisis period (2002-08) with similar deals post-crisis (2009-15). Not surprisingly, there have been more debt-funded M&A transactions recently than pre-crisis; our study identified four times as many transactions in the post-crisis period, even though we doubled the minimum deal size requirement (there were 10 pre-crisis transactions and 41 post-crisis transactions in our study). We note that LBOs were more frequent in the years leading up to the crisis, which may explain some of the difference in the amount of companies in our results. In addition, there are several other notable differences.

Starting Leverage of Companies Pursuing M&A Is Higher Now Than Pre-Crisis

Even though they have added roughly the same amount of leverage (1.4x), companies that have increased leverage for M&A during this business cycle are fundamentally weaker than the pre-crisis subset, in terms of pre-announcement leverage, as well as peak leverage post-debt funding. As seen in Figure 4, companies pursuing M&A transactions since 2009 have had pre-transaction leverage 0.7x higher than the companies from 2002-08. The post-crisis subset also increased leverage beyond the average of the investment grade universe, while the pre-crisis companies had below-index average leverage even after funding their acquisitions.

FIGURE 5

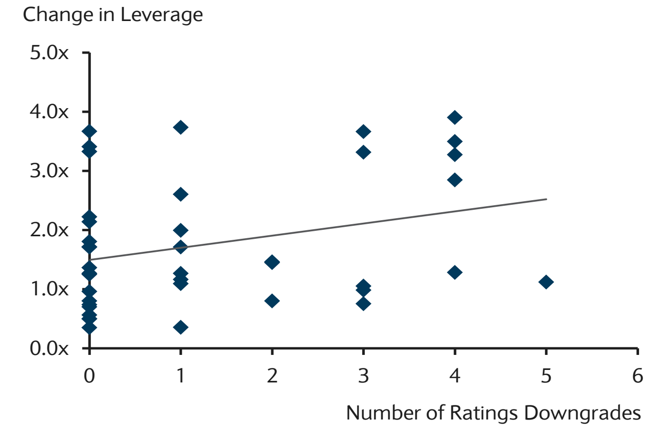
Leverage and Downgrades Had a Stronger Correlation Pre-Crisis…



Source: Factset, Moody's, S&P =, Barclays Research

FIGURE 6

…Than They Do Post-Crisis



Source: Factset, Moody's, S&P, Barclays Research

Despite the Higher Starting Leverage of Acquirers, Rating Agencies Have Generally Been More Lenient

We compare the change in leverage for companies in our study with the ratings provided by Moody's and S&P. For 2002-08, there was a strong correlation between increases in leverage and subsequent ratings migrations (Figure 5). However, this relationship deteriorated for post-crisis transactions (Figure 6), illustrating that the ratings agencies have become increasingly comfortable with increased leverage as part of these deals. This is also evident when we narrow the scope to companies in our study that did not receive a ratings downgrade from either of the two agencies. In the post-crisis period, companies that did not experience a ratings change increased leverage by an average of 1.3x, higher than the pre-crisis peer average of 0.9x.

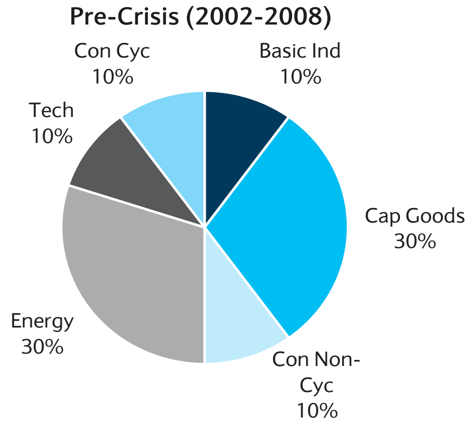
We believe the more benign rating agency reaction is driven by two main factors:

1. Rating agencies likely have more trust in deleveraging plans, especially for companies with track records of deleveraging after acquisitions. Furthermore, it appears that they have increased their focus on other factors (such as cash flow and scale).

2. Perhaps more important, many of the large M&A transactions post-crisis have been in the consumer non-cyclical sector, which generally has more stable cash flows during times of macroeconomic softness. Although pre-crisis transactions in our sample are limited, the increase in consumer non-cyclical deals is significant (Figures 7 and 8). As a result, rating agencies may be somewhat more patient with these companies. For example, Anheuser-Busch (ABIBB) increased gross leverage to over 6.0x from under 3.0x following its acquisition of SABMiller (announced in 2015 and included in our post-crisis cohort). The company was downgraded only one notch by both Moody's and S&P as a result, with its track record on acquisitions, conservative financial policy, scale, and cash flow supporting its single-A rating.

FIGURE 7

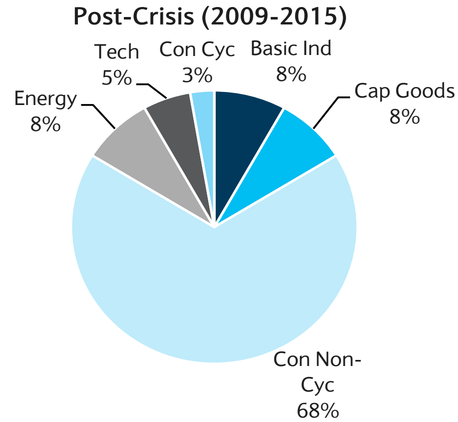
Large Debt-Funded M&A Was Skewed toward Higher-Beta Sectors Pre-Crisis…



Source: Factset, Bloomberg Barclays Live

FIGURE 8

…But Was Dominated by Consumer Non-Cyclical Companies Post-Crisis



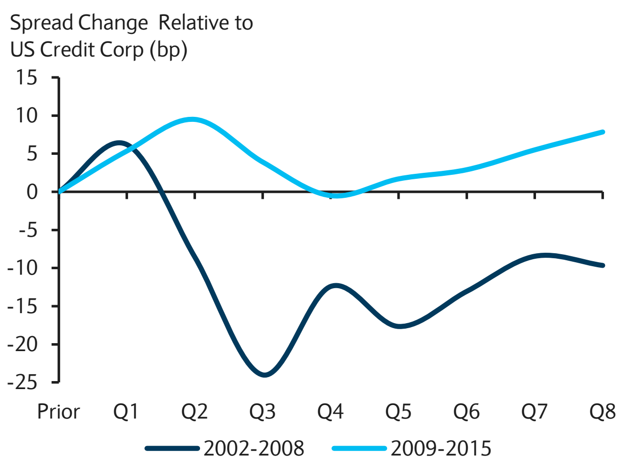
Source: Factset, Bloomberg Barclays Live

Spread Reaction Has Been Similar across the Two Periods

Generally, spreads of the post-crisis companies in our study underperformed the investment grade index slightly in the two years after the announcement of M&A (Figure 9). Conversely, spreads of the pre-crisis cohort outperformed roughly 10bp over the same span. We believe this difference is likely due to the lower pre-acquisition leverage of the pre-crisis companies, as well as maximum leverage that was below the index-wide averages. As a result, investors were more likely to view the transactions positively. The post-crisis credits, on the other hand, increased leverage above the index average, and as a result, investors seemed to be more cautious.

FIGURE 9

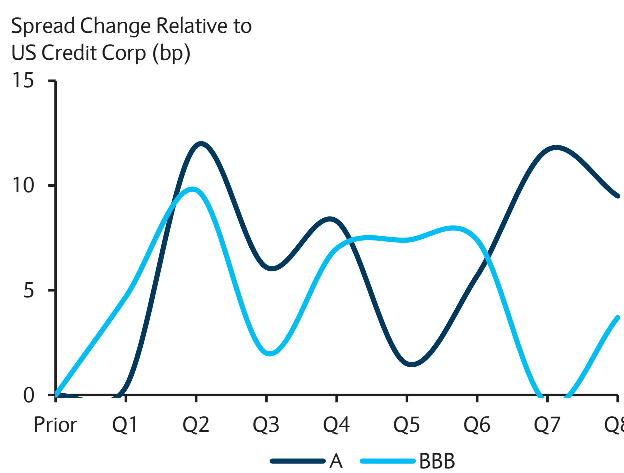
Companies Underperformed the Index by About 20bp in the Three Years Following Deal Announcement



Source: FactSet, Bloomberg Barclays Live

FIGURE 10

Underperformance Was Slightly Worse for A Names Than for BBB Names



Source: FactSet, Bloomberg Barclays Live

Spread moves were broadly in line for companies that were initially rated A and BBB, with both buckets underperforming the index slightly. Spreads between the two ratings cohorts reacted similarly even though single-A names took on more leverage and deleveraged less than their BBB counterparts. This is partly offset by the greater ratings risk for BBB names that could fall to high yield.

Implications for Recent M&A Transactions

These results have some interesting implications for the current crop of leveraging transactions. The companies that announced significant debt-funded M&A in 2016-present had leverage that was broadly in line with the 2009-15 cohort and well above the 2002-08 cohort.

- The sixteen companies in the most recent bucket (2016-present) had median pre-acquisition gross leverage of 1.8x – roughly 0.2x greater than the 2009-15 cohort. That said, index-wide leverage has been elevated since 2015 (current gross leverage 3.1x), implying that the current bucket of leveraging companies is in a better position relative to the index than the 2009-15 bucket.
- In terms of ratings, the companies that undertook significant leveraging transactions from 2016 to the present were 75% BBB rated at the time of the announcement. Our findings show that BBB-rated companies are more likely to return to pre-transaction leverage, while A-rated names are more likely to keep leverage elevated. This implies that the current crop of transactions should be committed to deleveraging.
- In addition, ratings agency leniency continued for the transactions in this sample, likely because of the increased focus on other metrics (cash flows, scale, etc,), as well as the large number of transactions in low-beta sectors. Much like the 2009-15 bucket, consumer non-cyclical companies dominated the 2016-present cohort. This sector weighting supports the idea that these companies are fundamentally more stable than equivalently leveraged companies from higher-beta sectors.

While our base case is that the credit environment will remain sound over the short to medium term, we note that a macroeconomic downturn could be a headwind to deleveraging, ultimately leading to underperformance of higher-leveraged names. For example, the companies in our study that added leverage immediately before the last recession exprienced some spread underperformance relative to the index during the financial crisis. That said, as we discussed in *Deleveraging Post-M&A: Implications in the Case of a Credit Downturn*, the current crop of companies that have increased leverage to fund M&A have the size and cash flow necessary to provide financial flexibility in the case of an economic downturn, especially those in low-beta industries.

In fact, we believe that the greater risk for these companies is more restrictive treatment by the rating agencies. We have begun to see agency commentary shift toward a stricter tone. For example, Moody's recently placed Newell Brands (NWL) and Conagra Foods (CAG) on review for downgrade, citing the potential for elevated leverage following recent M&A transactions. A change in ratings agencies' reaction to large-scale M&A could ultimately lead investors to become more skeptical of these deleveraging stories.

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