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Love Me Tender

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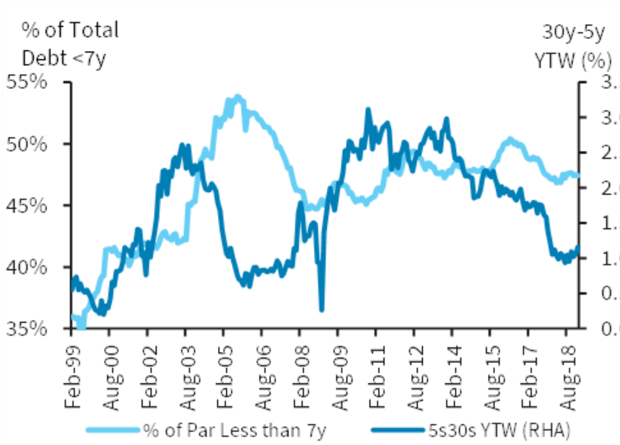
Last week, AT&T launched a liability management exercise to redeem $4bn of front-end debt and replace it with longer-dated paper, effectively terming out debt (see *Front-End Debt Reduction Takes Advantage of Lower Yields*). In a similar move, AB InBev issued $15bn of longer-dated debt during the second week of January, taking out approximately $13bn of front-end paper. The objectives of the two issuers were by no means identical; AT&T's transaction was motivated by reducing interest cost, while ABIBB's was more strategic – reducing refinancing needs in coming years at a relatively low cost.

While the driver in each case was different, we believe the conditions are in place for more duration extension trades to occur. Specifically, yield curves remain flat (the yield differential between 30y and 5y corporate bonds the lowest since before the financial crisis) meaning that terming out debt is not as expensive from the issuer's standpoint. Furthermore, issuers that are concerned that the end of the economic cycle is approaching may find it beneficial to term out short-dated debt while funding conditions are still benign.

Indeed, the last time the corporate yield curve was as flat as it is now, issuers broadly extended duration. Figure 1 illustrates that with a relatively low cost of extension between 2005 and 2007, non-financial corporates reduced the portion of their debt maturing in less than seven years. There was a slight lag between the yield curve's flattening and issuers' extending duration, likely because it took time to adjust issuance plans to reflect the new yield environment. This suggests that while there has not yet been a significant reduction of short-term debt, this may be the beginning of a broader trend (Verizon also recently engaged in a tender offer for some short-dated debt).

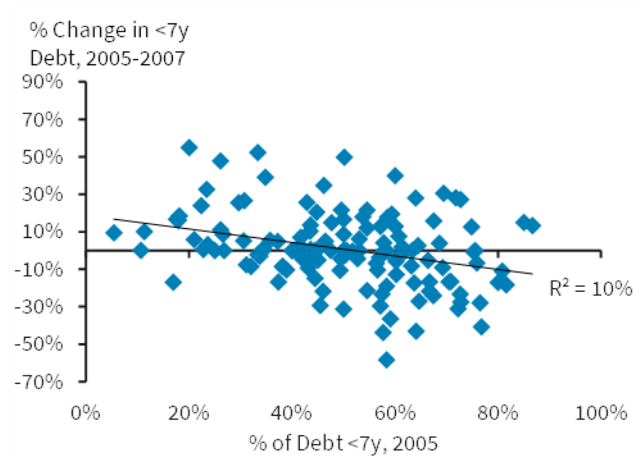
In the pre-crisis period, companies with a greater portion of their debt in the front end tended to reduce their short-term debt the most (Figure 2). Consequently, to identify issuers that are more likely to pursue similar transactions, we screen for companies that have a large amount of short-dated debt, either in absolute terms or as a percentage of their total debt outstanding. This provides an initial screen to identify companies that are more likely to take out their short-term debt (and potentially refinance with longer-dated paper). If tendered, the bonds could have potential upside. For instance, ABIBB bonds rallied 25bp

FIGURE 1
In 2005-07, the Percent of Debt with Less Than Seven Years to Maturity Declined after Yield Curves Flattened…



Note: Graph is industrials only.
Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 2
…And Companies with a Higher Percentage of Short-Term Debt in 2005 Reduced Front-End Debt the Most by 2007



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Source: Bloomberg Barclays Indices, Barclays Research

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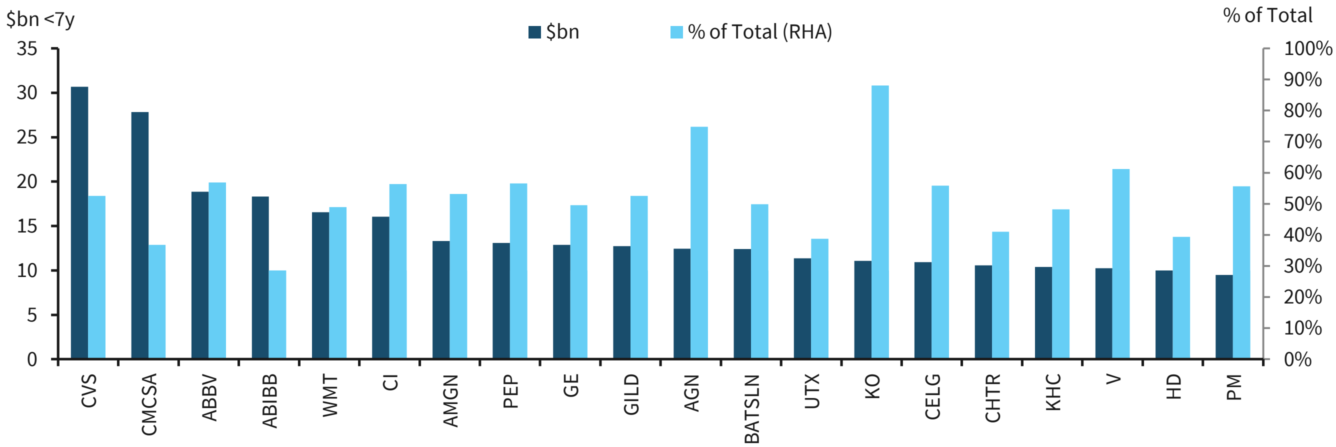
FIGURE 3

Companies with the Most Index-Eligible Debt Maturing in Less Than Seven Years



Source: Bloomberg Barclays Indices, Barclays Research

following the tender, while AT&T made whole its front-end debt 20-40bp tighter than pre-announcement trading levels. Figure 3 shows non-financial companies with the most index-eligible debt maturing inside seven years. The screen excludes issuers that, in our view, are unlikely to engage in extension trades because of the nature of their business or their stated leverage targets,[1] as well as those that have recently executed such trades. Consumer non-cyclicals (pharmaceticals, healthcare, tobacco, and food & beverage) and consumer cyclicals (such as retailers) are the sectors that populate most of this screen. Broadly speaking, these sectors also include most of the names we examined in *M&A Names on Notice*, which have engaged in M&A transactions in recent years and are tracking behind their target leverage. Companies with above-trend leverage that are concerned about growth prospects may seek to manage their refinancing needs before a potential cycle turn. Barclays' fundamental analysts provide commentary on the other sectors that are heavily represented below. Separately, we recently discussed GE's prospects for tendering its front-end debt in *4Q18: Top Priorities Aligned with Bondholder Interests*.

Below, our analysts provide commentary on the sectors with names that might execute these transactions:

Food & Beverage/Retailers/Tobacco

Priya Ohri-Gupta

In our view, LME extension trades can help manage concerns about the ability of a credit to balance refinancing risk and bring its maturities more in line with cash flow needs. We think this can be a factor for companies that have larger debt loads where deleveraging activity and/or cash flow has been pressured. While we do not see this as a broad need across the sector, there is potential for Walmart and Philip Morris to look at possible LME extension trades given the amount of short-dated maturities in their debt stack. We do not think this would completely diminish the potential for PM still to pay down a portion of its current maturities given its cash balance and cash generation capabilities. In our view, Pepsi and Home Depot are less likely to engage in such actions even though one-third or more of their maturities are coming due through 2025. Coca-Cola has historically not issued dollar bonds

[1] Technology companies will allow most of their short-term debt to roll off given their substantial cash position and dearth of issuance since the passing of the Tax Cuts and Jobs Act. Auto manufacturers and Construction Machinery companies need to keep a large amount of front-end debt in order to match the duration of customer leases. Energy companies are mostly in the deleveraging stage of their balance sheet cycles therefore a maturity extension might send a negative signal to investors. The Utility sector continues to be net issuers due to elevated organic capex and dividend growth matching rate base growth. Strong regulatory mechanisms mean quick recovery of investment, keeping leverage in check. For the sector, LME as likely to be mainly opportunistic.

further out the curve than ten years, so while we would classify most of its debt as front end, we do not expect the company to begin extending its maturity wall further. For Kraft Heinz, while the absolute value of its front end debt is high, the maturities appear fairly well spread out; roughly 20% of its debt matures in the next four years. The company also expects to improve its pace of deleveraging through cash that has been freed up through its dividend reduction and using asset sale proceeds as it further adjusts its portfolio.

Pharmaceuticals/Healthcare

Brittany Chen

In our view, many healthcare issuers for which LME extensions might otherwise make sense are still idly sitting on large, sub-optimally utilized cash balances. Even after returning a growing amount of capital to shareholders through buybacks and/or dividends, the cash flow generative profiles of these companies leave them with excess liquidity, previously inaccessible before tax reform, that has been earmarked for yet-to-be-found M&A opportunities. This makes LME activity likely for short-dated debt, even though companies may choose to take them out with cash rather than refinance it. This is particularly true if the interest expense saved would be more accretive than interest income earned on cash equivalents and other short-term investments. Separately, healthcare companies, most of which operate globally and are expanding their presences overseas, may look to refinance shorter-dated bonds with non-dollar-denominated notes, which would simultaneously help better align their foreign earnings with their corporate liabilities.

Specifically, Amgen and Gilead each had approximately $30bn of cash on hand at year-end, while Allergan needs to repay (rather than simply refinance) upcoming maturities in order to achieve its leverage target amid an eroding earnings base. In Celgene's case, assuming that its pending acquisition by Bristol-Myers proceeds as planned, we suspect that existing CELG bonds may be opportunistically refinanced with new BMY debt, depending on the price at which BMY could issue bonds in excess of what is needed to consummate the deal relative to CELG's current coupons; however, this could get complicated if the deal is prefunded with special mandatory redemption language, as the timing of any CELG debt take-out could be contingent upon shareholder approval (mid-April vote).

Finally, among our covered credits, we believe that an LME extension could make the most sense for AbbVie. ABBV's cash on hand fell significantly in 2Q18 as much of the unlocked offshore cash was redeployed. We think the company will likely operate with lower balances than it has historically, making its front-end debt a more plausible contender for this type of refinancing transaction. AbbVie, unlike AMGN and GILD, is not sitting on as much idle cash relative to its short-term debt stack and, thus, could capitalize on the flat yield curve and clear the runway to focus on diversifying the business away from Humira through a combination of near-term pipeline launches and tuck-in M&A.

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