Credit Strategy

Leveraging Earnings Stability

Although stable US economic growth has been positive for risk assets, the ensuing decrease in corporate earnings volatility could motivate A-rated companies to run at higher debt loads, potentially resulting in negative ratings momentum. As a result, we continue to favor BBBs over single-A non-financial credits.

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Shobhit Gupta
+1 212 412 2056
shobhit.gupta@barclays.com
BCI, US

Bradford Elliott, CFA
+1 212 526 6704
bradford.elliott@barclays.com
BCI, US

Steve Wang
+1 212 526 4620
steve.wang2@barclays.com
BCI, US

Over the last few years, one key risk that credit investors have been worried about is the potential worsening in BBB fundamentals (and ratings) if the US economy dips into a recession. Somewhat ironically, a continuation of the modest growth environment the US economy has seen over the past decade potentially poses an equally significant and perhaps more proximate risk, in our view. Faced with lower earnings volatility, corporates – especially lowly-leveraged A-rated companies – may voluntarily choose to run at higher debt loads leading to an uptick in leverage, and potentially negative ratings momentum in the A bucket. Indeed, we find that between 2011 and 2019, companies that experienced low earnings volatility increased leverage the most.

The US has enjoyed a period of exceptionally stable growth post the 2008 crisis, with growth volatility declining to all-time lows. As we discuss in *Macroprudential regulation reaping the benefits of a safer banking system*, this has been driven in large part by a safer banking system. US banks are not only better capitalized (TCE ratio is near all-time highs) but have also tightened lending standards resulting in higher asset quality. Both factors have served to dampen the banking system's traditional role as a financial accelerator in the economy, making more extreme growth outcomes (both on the positive and negative front) less likely. This has also lowered contagion risk in the economy which has been evident in declining correlations in sector output growth. With bank regulations unlikely to ease meaningfully in the near future, we expect this trend to continue resulting in longer recovery cycles, shallower recessions and, more generally, lower growth volatility.

The decrease in growth volatility should be a boost for risk asset valuations, driving risk premia lower and credit spreads tighter. Most investment grade companies only need stable EBITDA to maintain steady fundamentals, which should be eminently achievable in periods of low but positive growth. The lower likelihood of a significant decline in growth should reduce tail risk and be supportive of investment grade valuations, in our view.

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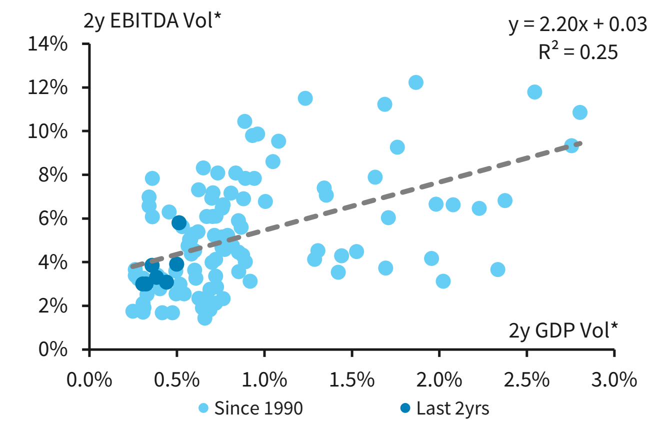
Completed: 12-Feb-20, 22:16 GMT Released: 12-Feb-20, 22:20 GMT Restricted - External

Stable Earnings Bring Higher Leverage

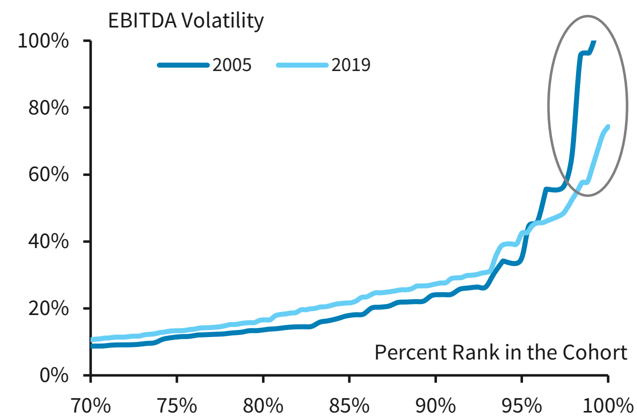
One potential negative outcome of more stable growth is that it could incentivize companies to lever up as management teams feel increasingly comfortable that the tail risk outcomes of meaningful EBITDA declines are less likely. Indeed, corporates' EBITDA volatility has decreased as economic growth has become more stable (Figure 1).

FIGURE 1. **US IG Corporate Earnings Volatility has Declined with US GDP Volatility**



Note: Here and in the rest of the report EBITDA vol is calculated as year-over-year change in LTM EBITDA *Calculated over last 8 quarters
Source: FactSet, CompuStat, Bloomberg, Barclays Research

FIGURE 2. **Distribution of EBITDA Volatility by Ticker in the US Corporate Index**



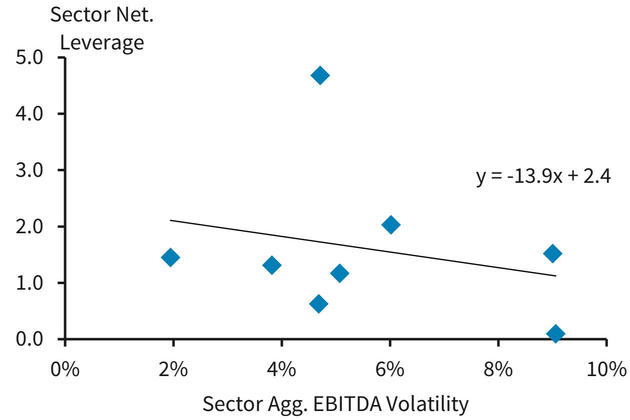
Note: We selected 2005 as an reference when GDP and EBITDA volatility were high.

Source: FactSet, CompuStat, Bloomberg, Barclays Research

Faced with a more stable revenue and earnings profile, companies may choose to increase leverage. Effectively for any corporation, the "optimal leverage" – the leverage level at which the potential cost of financial distress is balanced by the upside of a higher ROE – should increase in the current stable macro environment. This is driven by a reduction in the cost of financial distress which stems from two factors. Not only is the likelihood of meaningful revenue/earnings declines lower when the economy is growing at a modest but positive pace, but the severity of any such decline should also be more moderate (Figure 2). Said another way, a stable growth environment improves a company's worst-case leverage profile (and decreases the likelihood of getting to it), increasing the debt load it can sustain.

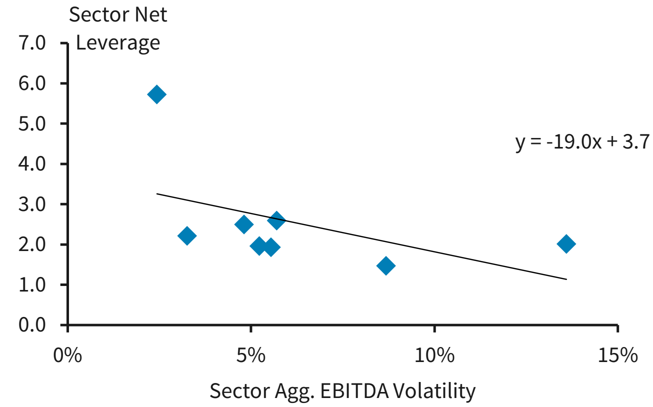
Empirically there is evidence that EBITDA volatility influences corporates' leverage decisions. Sectors with more stable EBITDA profiles tend to run at higher net leverage than those with a more volatile earnings backdrop. Figures 3 and 4 show the relationship between sector leverage and past 2y EBITDA volatility across single-A and BBB credits, respectively. We exclude Energy from these charts as it is an outlier due to the significantly higher earnings volatility experienced by the sector as oil prices have moved around. That said, it is indeed a great example of this point: driven in part by recent heightened earnings volatility, energy companies have been substantially reducing leverage.

FIGURE 3. Net Leverage vs EBITDA Volatility for Single-As: Companies/Sectors with Higher EBITDA Volatility Tend to Operate at Lower Net Leverage



Source: FactSet, CompuStat, Bloomberg, Barclays Research

FIGURE 4. Same Pattern Can Be Observed Among BBB-rated Companies



Source: FactSet, CompuStat, Bloomberg, Barclays Research

We conducted an event-study looking at the 2011-2019 period:

1. We measured EBITDA volatility at a ticker level between 2011-2015 (calculated as the standard deviation of y/y change in LTM EBITDA over this five-year period).
2. For each company, we measured the resulting change in net leverage over the period (calculated as the 2019 leverage versus 2011 levels).

Across nearly 140 non-financial companies (ex energy[1]) the median EBITDA volatility in the 2011-2015 period was 8%. The median company increased net leverage by about 1x, as corporates reversed the deleveraging that had happened in the immediate aftermath of the credit crisis. This change in leverage is consistent with what we have seen across the IG universe: as highlighted in *US Investment Grade Credit Metrics: Q3 19* net leverage for the IG index has gone up from 1.6x to 2.6x during this period.

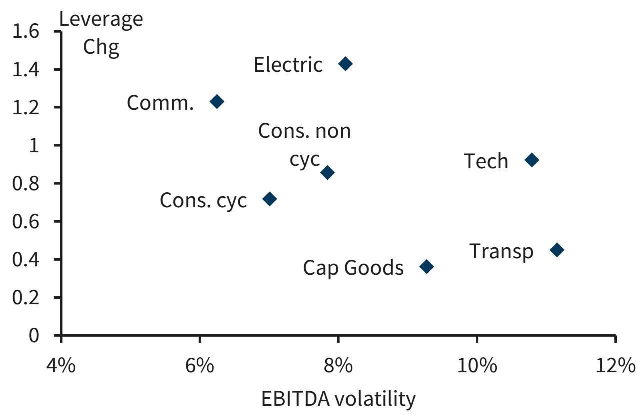
The trends in the relative move in leverage offer valuable insight. Figure 5 plots the median EBITDA vol and leverage change across different sectors. The two appear to be negatively correlated: sectors like communications and utilities had low EBITDA volatility and saw the highest increase in leverage. On the other extreme capital goods and transportation companies leveraged up the least as they faced relatively volatile earnings.

We extended the analysis to a single-name level. Companies are bucketed into quartiles based on EBITDA volatility: the first bucket has companies with the most stable earnings profile while the fourth bucket includes those with the most volatile. Figure 6 shows the average leverage change in each EBITDA volatility quartile. Companies in the first quartile, i.e. those with the lowest EBITDA volatility increased net leverage by the most – nearly 1.3x – in the following four years. This is more than double the change for companies in the fourth quartile, i.e. those that saw higher EBITDA volatility. In at least some of the instances, the move in leverage was involuntary or driven by a more strategic shift by the company. However, the fact that across such a large universe of companies there is a clear negative relation between future leverage and earnings volatility suggests that the latter plays an important role in driving leverage policy.

While we exclude commodity credits from the above analysis given their heightened earnings volatility, we note that these companies have deleveraged significantly post 2015 following the pickup in oil price volatility.

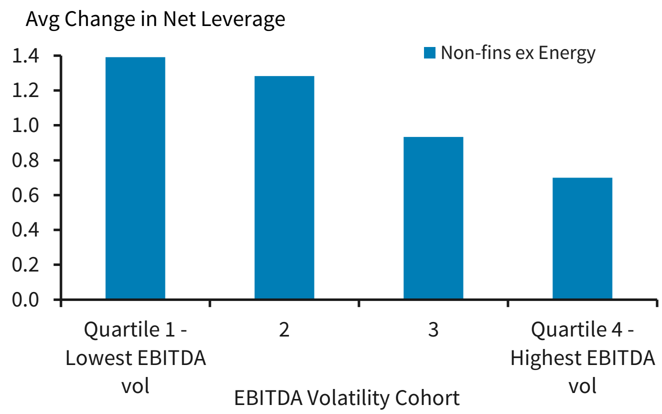
[1] As before, we exclude energy from the analysis given the sector is an outlier in terms of the volatility it suffered during that period.

FIGURE 5. **EBITDA Vol in 2011-2015 versus Leverage Change (2019 versus 2011) by Sector**



Source: FactSet, CompuStat, Bloomberg, Barclays Research

FIGURE 6. **Companies with the Lowest EBITDA Volatility during 2011-2015 Increased Net Leverage by the Most**



Source: FactSet, CompuStat, Bloomberg, Barclays Research

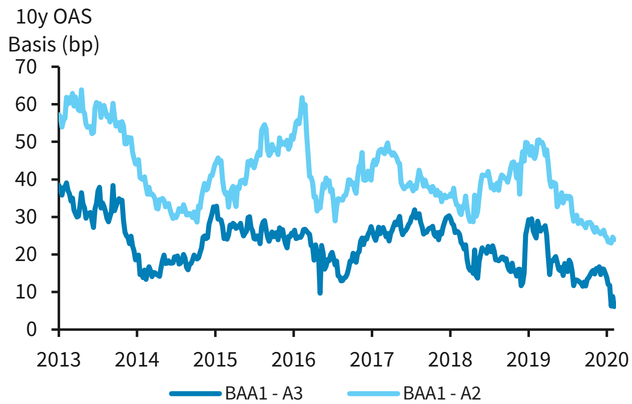
Our house view is that the stable growth environment in the US continues in the medium term: our economists think that the US will continue to grow albeit at a slowing speed, with a forecasted 2% growth in 2020 and 2021. This should keep EBITDA volatility muted, all else equal, which could drive corporate leverage higher.

Leveraging Likely Limited to A-rated Companies

Importantly, we expect any such leverage increase to be confined to the A-rated universe. While downgrades to a high-BBB rating may be palatable for this cohort, most corporates are unlikely to be willing to go down further in the ratings spectrum which should limit the extent of the leverage increase. Specifically, we expect leverage increases to be incremental, perhaps through dividend recap deals, as corporates look to boost ROEs. Equity returns have been fairly elevated during the last few years, but a potential slowdown in the equity rally could also result in shareholder pressure to increase leverage, particularly if yields remain at current levels.

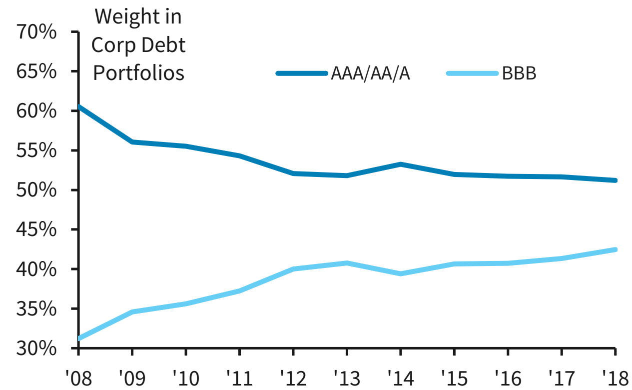
The diminishing advantage of an A-rating, both from a valuation and technical standpoint, would support the decision of A-rated corporates to lever up, even if it comes at the expense of a downgrade. In particular, the difference between A3 and BAA1 spreads have compressed as overall spreads have rallied. Indeed the 10y BAA1 cohort currents trades less than 10bp wide of the 10y A3 debt suggesting that a downgrade to high BBB is not as punitive from a funding standpoint as it was before (Figure 7).

FIGURE 7. **Basis between 10y Tenor, BAA1 versus A2 & A3 Is Close to All-time Lows**



Note: Data is for Senior Industrials excluding Energy
Source: Bloomberg, Barclays Research

FIGURE 8. **Insurance Companies Have Increased their Allocations to BBB-debt**



Source: SNL, Barclays Research

Part of the spread compression in the BAA1-A3 basis is due to increasing insurance demand for BBB paper. Life insurance corporate bond portfolios have historically been heavily weighted towards A-rated debt given this rating bucket is more efficient from an NAIC capital charge standpoint. However, as corporate yields have declined, insurance companies have gravitated to BBB debt, increasingly favoring its higher yield over the better risk efficiency of A-rated paper. In fact the weight of BBBs in insurer corporate bond portfolios has increased more than 10pp over the last decade (Figure 8). Although this move is likely driven in part by the increasing weight of BBB debt in the corporate bond universe (BBB weight in the corporate index has increased from 34% in January 2008 to 50% currently), it still points to the increasing willingness of insurance companies to allocate to this rating bucket. This suggests that the demand base is unlikely to differ meaningfully between a single-A and high BBB rating.

Downgrades below the BAA1 rating are more punitive, however, both in terms of diminished insurance demand as well as significantly wider funding spreads. Insurance flows in the lower-rated BBB bucket are lower which could be a constraining factor especially for large capital structures. Further, as we have highlighted before, the BAA2 and BAA3 buckets trade meaningfully wide versus their higher- quality cohorts (see Bring Your BBB Game).

BBB Companies Unlikely to Leverage Up

Although the leveraging argument can be extended to BBB credits, given that the BB-BBB basis is also tight relative to historical levels, we do not expect BBB corporates to lever up voluntarily. Unlike a downgrade from A to BBB, a move from IG to HY is more punitive even if the BB-BBB basis is tight. The loss of a sizable portion of insurance/pension demand could be an insurmountable challenge for large capital structures. More importantly, all-time low yields and flat yield curves have made the long end of the curve especially attractive for issuers. Many IG companies have monetized the cheap financing available in the long end by terming out debt, a trend we expect to continue (*Terming Out is Good for Credit Health*). With 10 years effectively being the longest maturity achievable in the high yield primary market, losing the ability to lock in cheap 20y or 30y funding would be a significant negative for IG issuers if downgraded to HY.

Instead, we expect BBB fundamentals to improve as leverage reduction remains a key focus near-term for debt and equity investors (*Barclays Global Macro Survey: Investors expect more of the same*). Following the increase in BBB leverage, driven in large part by debt-funded M&A, many BBB corporates remain in deleveraging mode. In fact the highest leveraged BBB's – which were at the center of concerns about widespread downgrades in the BBB complex – brought down leverage the most in 2019 as (*BBBs Have Only a few Bad Apples*) these management teams made debt reduction a priority, a trend we expect to continue this year. Debt reduction from BBB companies should also keep overall index leverage relatively range-bound, even as we expect single-A corporates to increase net leverage in the medium-term.

In addition to having stable-to-improving corporate fundamentals, the BAA2/BAA3 cohort also screens cheap and, as a result, we continue to prefer BBBs over A debt within the non-financial universe.

Lower Corporate Tax Rates Has Made Debt Less Attractive

The one counter to the leveraging view is the decrease in the maximum marginal corporate tax rate in 2018 from 35% to 21%. All else equal with lower tax rates, debt appears less attractive than equity on an after-tax basis, meaning the potential benefit of running at a higher leverage has decreased. The argument we make above is that the potential downside of increasing leverage – in terms of downgrades or wider spreads – has also decreased given that earnings volatility is likely to be lower in a more stable economic growth backdrop.

Essentially, corporates now face a new operating environment where both the upside and downside of increasing leverage are lower. We believe that on balance the trade-off favors increasing leverage for A-rated corporates, given that potential negative outcomes in terms of worse-case leverage, valuations and debt buyer base are more benign now. That said, the argument does not extend to lower-rated corporates. In addition to the potential negatives associated with a downgrade to HY – lower demand base, loss of access to long-end issuance – the implementation of interest deductibility caps also increase the downside for high yield companies, and will keep BBB corporates from voluntarily increasing leverage.

Screening for Single-A Corporates Likely to Leverage Up

Given our finding that companies with lower EBITDA volatility tend to increase leverage in the years following the period of low volatility, we screen for single-A corporates that have lower earnings volatility than their peers (sector and rating-matched). We further filter for companies that are currently running below their sector's average net leverage (across all ratings), and may therefore have capacity to add debt, and overlay views from the Barclays fundamental analyst team. In addition, there are a few other companies that do not meet the criteria above but our analysts believe are potential candidates for increasing leverage.

Figure 9 shows the results. In our opinion, these companies are the most likely to increase net leverage in the medium-term. We note that some of the companies highlighted below, in particular retailers, rely on CP funding. While we believe they have room to leverage up, we do not think they will increase debt burden to the point where the A rating is at risk.

FIGURE 9. **Single-A Credits Likely to Increase Net Leverage in the Medium-term**

				EBITDA Vol (last 2 years)			Leverage	
Ticker	MV ($bn)	Net Leverage	Sector	EBITDA Vol	Peers' EBITDA Vol	Vs. Peers	Sector Leverage	Vs. Sector
COST	$4.5	0.0x	Retailers	2.0%	2.8%	-0.8%	3.00	-3.00
ECL	$4.8	2.0x	Chemicals	0.9%	11.1%	-10.2%	2.39	-0.43
GD	$9.0	1.8x	Aerospace/Defense	4.1%	6.9%	-2.8%	2.88	-1.11
ITW	$4.4	1.5x	Diversified Manufacturing	5.1%	6.9%	-1.8%	2.88	-1.35
KMB	$5.9	1.5x	Consumer Products	1.3%	5.8%	-4.4%	3.06	-1.60
LMT	$13.5	1.2x	Aerospace/Defense	2.4%	7.5%	-5.1%	2.88	-1.71
MDT	$12.2	1.4x	Healthcare	1.9%	5.8%	-3.9%	3.06	-1.63
MMM	$14.2	1.2x	Diversified Manufacturing	4.1%	6.9%	-2.8%	2.88	-1.68
NKE	$3.9	0.4x	Retailers	2.6%	2.8%	-0.2%	3.00	-2.56
ORCL	$54.7	1.0x	Technology	3.1%	7.0%	-3.9%	2.44	-1.47
PEP	$26.0	1.9x	Food and Beverage	1.8%	5.8%	-4.0%	3.06	-1.15
PFE	$34.9	1.3x	Pharmaceuticals	1.4%	5.8%	-4.4%	3.06	-1.76
SPGI	$4.1	0.5x	Media Entertainment	3.9%	13.9%	-10.0%	3.15	-2.68
TGT	$11.2	1.8x	Retailers	1.9%	2.8%	-0.9%	3.00	-1.22
UPS	$13.9	1.9x	Transportation Services	9.0%	10.7%	-1.7%	2.49	-0.60
Other Potential Leveraging Credits								
GILD	$25.7	0.5x	Pharmaceuticals	10.9%	5.8%	5.1%	3.06	-2.56
GSK	$18.3	3.3x	Pharmaceuticals	NA	5.8%	NA	3.06	0.24
LLY	$8.7	2.6x	Pharmaceuticals	15.2%	5.8%	9.4%	3.06	-0.46
MRK	$19.4	1.5x	Pharmaceuticals	18.2%	5.8%	12.4%	3.06	-1.56
SANFP	$4.3	2.6x	Pharmaceuticals	NA	5.8%	NA	3.06	-0.46
UNANA	$11.3	1.4x	Consumer Products	NA	5.8%	NA	3.06	-1.66

Note: EBITDA volatility for some of the pharmaceutical companies might be artificially elevated due to M&A activity.
Source: Compustat, Factset, Bloomberg, Barclays Research

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