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Goodwill Hurting

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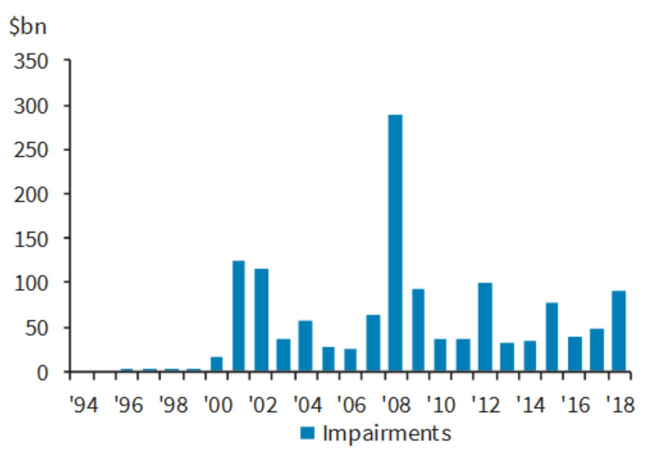
As companies reported annual results at the beginning of 2019, several large US corporations that pursued leveraged M&A transactions in recent years took goodwill impairment charges. GE, CVS, and Kraft Heinz alone took impairments totaling $35bn, contributing to a 2018 goodwill impairment total of $82bn for US non-financials (Figure 1). Total goodwill for these companies also happens to be at an all-time high both in absolute terms (at nearly $3.5trn) and relative to the amount of total assets (Figure 2).

Goodwill and goodwill impairments are usually not cause for concern for credit investors, perhaps outside of cases where impairments can negatively affect financial tests such as debt to total capital ratio requirements used for revolvers. However, we find that goodwill impairments can permanently re-price issuer spreads meaningfully wider and that companies that take impairments see reduced earnings growth in subsequent years, on average. Identifying potential impairment candidates ahead of time is key to avoiding this spread underperformance, and we find that two to three years after M&A is when large impairments typically occur. With 2016 having been a record M&A year, this should increase the focus on impairments today. Certain sectors, such as healthcare, technology, and manufacturers, have seen goodwill increase more than others, and if these sectors come under pressure, from either unexpected margin compression or a broader economic downturn, the large amount of goodwill for certain issuers could be a signal of future underperformance.

What Is Goodwill?

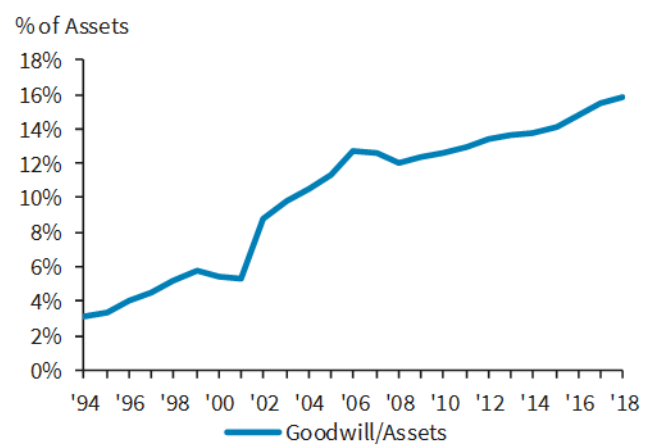
Goodwill is an intangible asset created as a result of an acquisition, defined as the difference between the purchase consideration and the fair values of all the tangible and intangible assets and liabilities when one company acquires another. In other words, it is an accounting plug on the asset side of the ledger for the amount paid for a business above and beyond what the business is worth on paper. Typically, the reason to pay a price above the book value of assets is related to the company's proprietary operations, brands, trademarks, licenses, and/or strong relationships with its customers. While extremely important to the success of the business, these are typically hard to quantify and, unlike other intangible assets, have indefinite useful lives. Goodwill is typically a positive value except in rare distressed instances where the acquisition price that is paid is less than the fair value of the assets of the purchased entity.

FIGURE 1
Goodwill Impairments for US Non-Financials



Source: Compustat, Barclays Research

FIGURE 2
Goodwill as a Percent of Assets for US Non-Financials



Source: Compustat, Barclays Research

What Is an Impairment?

Just like any other asset, goodwill can incur an impairment if its fair value falls below its carrying value (the amount paid for the acquired asset less the net book value of that asset).

Since 2001, GAAP requires goodwill to be tested for impairment at least annually, or if certain events trigger an impairment test (see appendix for more detail). Because goodwill is not considered an identifiable intangible asset, there is some vagueness to measuring its fair value, which is based on assumptions of the value that market participants would give the asset or business unit. Typically, valuation models are used that account for future cash flows or apply similar asset multiples observed in the market, but there is a lack of conformity in methods. The subjectivity embedded in the fair value calculation creates layers of ambiguity, hindering investors' ability to forecast the amount or timing of goodwill impairments and, in turn, sometimes leading to multi-billion dollar surprises.

Goodwill Has Increased since 2000; Why?

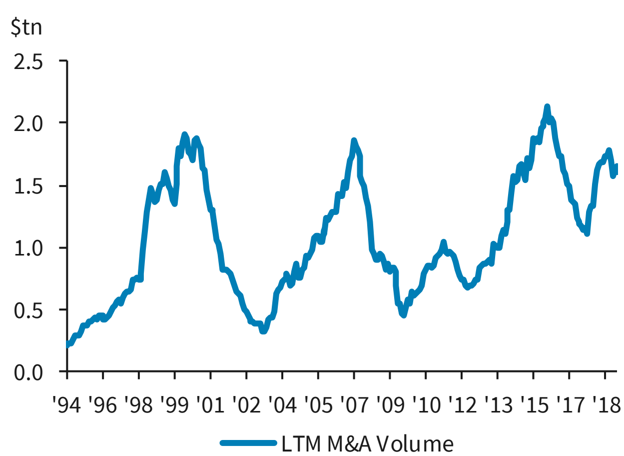
Goodwill has also gone up as a percent of assets since the late 1990s, in part because of a continuing shift to a services-focused economy that relies more on intangible assets. Separately, the post-2000 era has been characterized by an uptick in M&A activity, which is necessary for goodwill to increase given the mechanics of how the asset is created (Figure 3). If more of the total value of what an acquirer is purchasing is intellectual property, proprietary technology, and customer data, the goodwill portion of an acquisition is more likely to be high relative to the total assets being acquired.

Moreover, because of US GAAP reporting requirements, intangible investments such as IP are for the most part not capitalized and therefore not recognized as assets on the balance sheet prior to acquisition; they are expensed on the income statement. Therefore, it is difficult to capture exactly how much companies are investing in these intangibles until said company is acquired. Since the value of the intangible investments are considered when assessing the firm's value, when the company is acquired, all previous intangible investments are "captured" subjectively in the recognition of goodwill. Because the shift toward a more service-focused economy is a natural progression for the developed world, the rise is goodwill is not inherently a cause for concern, in our view.

Figure 4 shows net income as a percent of property, plant, and equipment (PP&E), illustrating the amount of profits companies have derived from physical assets over the past few decades. Indeed, US companies have become more productive in relation to physical assets,

FIGURE 3

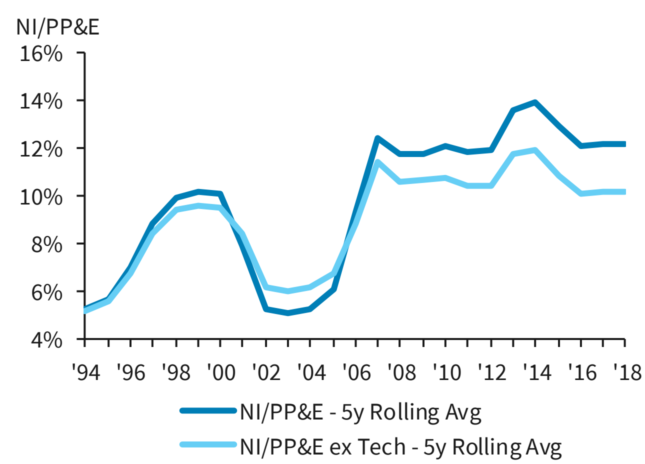
M&A Volume – Rolling LTM



Source: Factset, Barclays Research

FIGURE 4

US Non-Financials Are Generating More Net Income Relative to PP&E



Source: Compustat, Barclays Research

highlighting the shift to a service-based economy. While it can be argued that technology firms have driven the increase in income relative to PP&E, we see a similar trend even after excluding the tech sector. However, as companies rely less on physical assets to run their businesses, this could lead to less downside protection for credit investors. Companies' licenses, brands, trademarks, etc. are inherently illiquid, and the value of these assets could deteriorate at a much faster pace in a downside scenario compared with physical assets. While the liquidation value of a company's assets is less of a concern for investment grade issuers, the subjectivity of valuation for these intangible investments almost certainly increases the volatility of their fair value. In the event of a downturn, this could increase the likelihood of an impairment charge.

Why Have Impairments Happened?

Because impairments to goodwill are based on the expected future cash flow generation of a business unit, brand, trademark, etc., an impairment is taken when expected cash flows have decreased materially. Broadly speaking, significant reversals of earnings expectations happen concurrently with economic downturns, so it is no surprise that the years with the most impairments occur in times of economic stress (Figure 5). In our analysis of the top 15 impairment charges of the past 20 years, common reasons for taking write-downs include significant changes in the sales forecast for a particular product or service. Impairments do not anticipate broader economic downturns, but instead are part of the reaction to a weakening outlook for the sector or business area of the acquired asset.

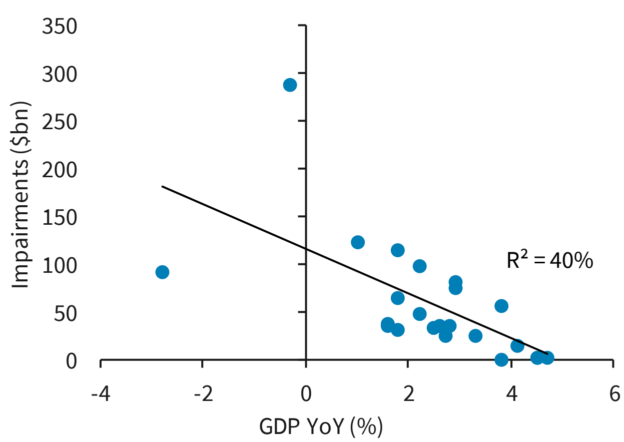
Because companies have been required to test for goodwill impairments at least annually since 2001, most firms test for impairment as a part of their annual reporting requirements. Indeed, we find that more than half of all impairment charges are taken in 4Q, with only one-quarter of impairments occurring in 1Q and 2Q (Figure 6).

Looking Back on Impairments Past

While it is clear that goodwill impairments happen during times of economic stress, companies also take charges outside of recession periods. For instance, in 2018, companies took $82bn of impairments (Figure 7 shows the top 10 impairment charges in 2018). While specifics vary among this cohort, in general, the companies are characterized by either low margins or high fixed costs and, in turn, have the potential to realize sudden decreases in profitability. The two companies that took the largest impairments, General Electric and

FIGURE 5

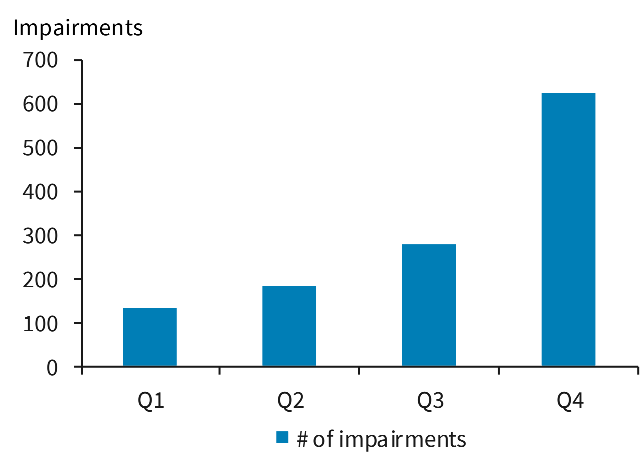
Goodwill Impairments Are Concurrent with Economic Downturns, Lower Growth



Source: Bloomberg, Compustat, Barclays Research

FIGURE 6

Most Goodwill Impairment Charges Are Taken in 4Q

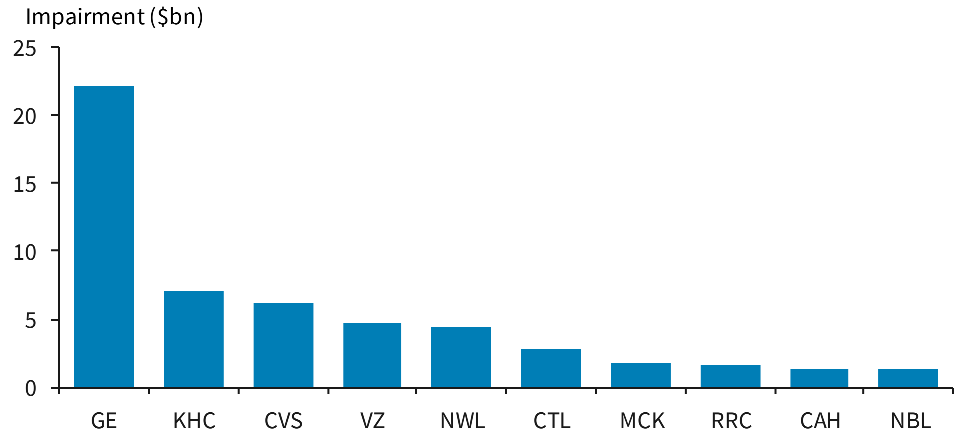


Note: Excludes companies with less than $1bn in assets.
Source: Compustat, Barclays Research

Kraft Heinz, fit this description. GE took an impairment to its capital-intensive power business, writing down almost the entirety of the segment's goodwill, mostly related to the 2015 acquisition of Alstom's thermal and renewable power businesses. Kraft Heinz impaired $15.4bn of intangibles primarily related to lower-margin consumer products, Kraft and Oscar Mayer, of which $7.1bn was goodwill. Interestingly, both impairments were related to blockbuster 2015 combinations as the companies attempted to reignite growth inorganically.

FIGURE 7

2018 Largest Goodwill Impairment Charges



Source: Compustat, Barclays Research

To get a sense of the length of time between acquisition and impairment, we analyzed some the largest impairments over the past two decades. Figure 8 lists the largest impairments tied to specific acquisitions mentioned in company filings, and we find that impairment charges were taken 2-3 years after the transactions, on average. While we recognize that this is a limited sample set, the preponderance of M&A activity in 2015-16 implies that companies that participated in large-scale acquisitions during that period could be susceptible to impairments in the coming years.

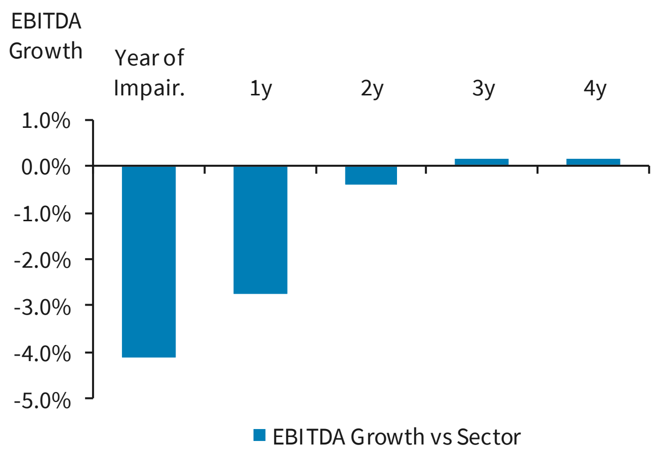
FIGURE 8

Top 15 Goodwill Impairments Associated with Specific Acquisitions

Company	Impairment ($bn)	Acquisition Date	Impairment Date	Years
Viavi Solutions Inc.	50.1	Feb-01	Sep-01	0.6
Time Warner Inc.	44.7	Jan-00	Dec-02	3.0
Sprint Corp	29.7	Aug-05	Dec-07	2.4
ConocoPhillips	25.4	Mar-06	Dec-08	2.8
General Electric Co	22.1	Nov-15	Dec-18	3.2
The Kraft Heinz Co	15.9	Jul-15	Dec-18	3.5
HP Inc.	13.7	Aug-08	Jun-12	3.8
Verisign Inc.	9.9	Jun-00	Jun-01	1.1
Energy Future Holdings	8.9	Oct-07	Dec-08	1.2
Qwest Communications	8.5	Jun-00	Jun-02	2.0
Virgin Media Inc.	8.1	Jan-99	Dec-01	3.0
Symantec Corp	7.4	Sep-05	Dec-09	4.3
Delta Air Lines Inc.	7.3	Jun-07	Mar-08	0.8
Microsoft Corp	6.2	Aug-07	Jun-12	4.9
Freeport-McMoRan Inc.	6.0	Mar-07	Dec-08	1.8
Average				**2.5**

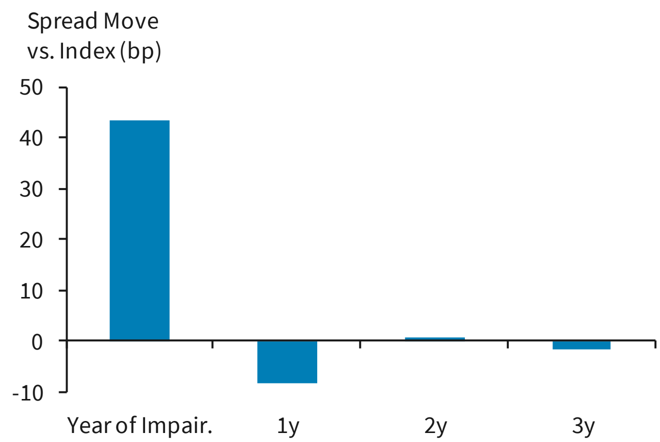
Source: Company filings, Compustat, Barclays Research

FIGURE 9
EBITDA Growth versus Sector after Impairment Charges



Note: Companies with at least $1bn in assets.
Source: Compustat, Barclays Research

FIGURE 10
Spread Performance of Companies with the Largest Impairment Charges



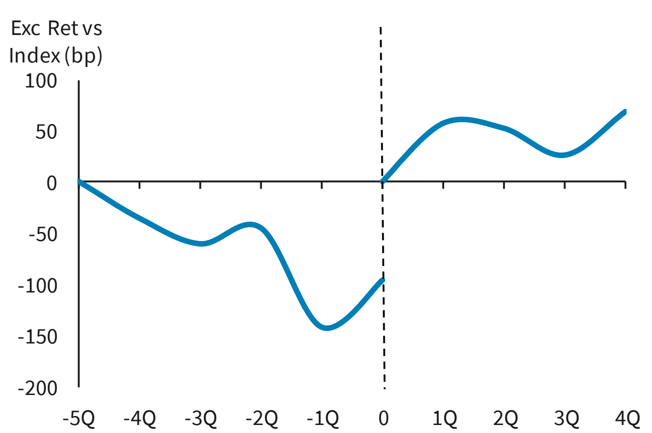
Note: Companies with goodwill impairments of at least $1bn
Source: Compustat, Barclays Research

Credit Market Implications

Since companies that take goodwill impairments tend to be in sectors facing headwinds, it is no surprise that their EBITDA growth lags the rest of the market; however, they also lag their respective sectors. In the year that impairment charges are taken and the subsequent year, these companies tend to underperform their peers, with EBITDA growth significantly behind the sector average (Figure 9). That underperformance tends to wear off in a few years, after which the companies perform in line with the sector. The underperformance is particularly notable given that the economic trends leading to impairment are usually not company specific and tend to affect other companies in the sector as well.

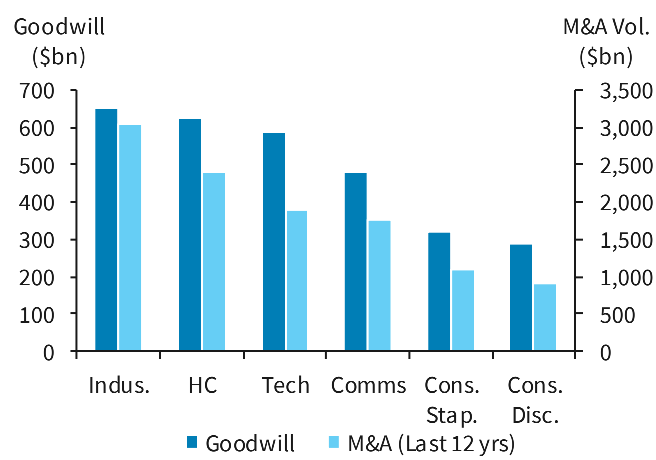
As a consequence of poor operating performance, the spreads of companies with impairment charges of more than $1bn since 1998 have lagged the index. Most of the underperformance occurred in the year of the impairment, and the companies tended to perform in line with the index in subsequent years (Figure 10). This underperformance is expected given that credit investors likely react to an anticipated decline in business

FIGURE 11
Quarterly Excess Returns around Goodwill Impairment Charges



Source: Compustat, Barclays Research

FIGURE 12
Nominal Goodwill by Sector versus M&A Volume



Source: Bloomberg, Compustat, Barclays Research performance even before an impairment charge is taken. Notably, the lack of a rebound in spreads for this cohort in subsequent years suggests that the credits remain off their tights versus the index for the intermediate term.

For some of the largest impairments, we took a more granular look at quarterly excess returns versus the index around the impairment dates. We found that these credits lagged the index by approximately 100bp in the five quarters leading up to impairment (Figure 11). After the impairment charges were taken, excess returns were positive relative to the index. Because spreads for these issuers had re-priced wider, the credits had higher carry post-impairment, so some outperformance in excess return terms is not altogether surprising.

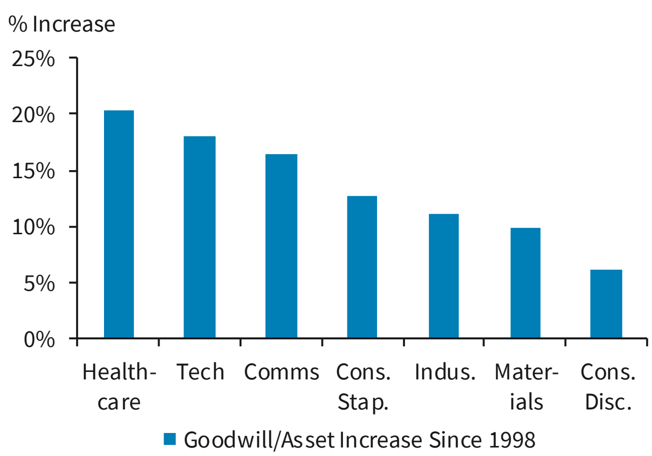
Sector Trends

The industrials sector has the largest nominal amount of goodwill on the balance sheet because of the prevalence of large, acquisitive companies. Not surprisingly, industrial companies have also engaged in the largest amount of M&A transactions over the past 12 years (Figures 12). Companies with the highest goodwill totals in the sector include large conglomerates such as GE; aerospace & defense companies such as United Technologies, Honeywell, and Raytheon; and railroad roll-ups such as Burlington Northern Santa Fe. These companies are in very mature sub-industries that have been characterized by consolidation throughout the past few decades and have therefore engaged in a significant amount of M&A transactions. The aerospace & defense industry, in particular, has seen massive consolidation as companies have looked to streamline supply chains and achieve greater economies of scale, using M&A to accomplish those goals. While industrials have the most amount of goodwill on the balance sheet, they also constitute the largest sector by assets. After taking into consideration the larger asset base for these companies, healthcare and technology have the largest amount of goodwill as determined by percent of assets.

Goodwill as a percent of assets has increased the most in healthcare since 2000, mostly because of the growing reliance on intangible assets, notably patents and proprietary processes, as well as the acquisitive nature of large well-capitalized firms that have grown more reliant on focused innovative start-ups for their drug candidate pipelines. Over the past decade, pharmaceutical companies have increasingly shifted drug development from a mostly in-house operation to an "off-balance-sheet" research and development model. Instead of spending years (often up to a decade) trying to move candidates through various stages in the clinic, at a large opportunity cost for internal resources, they have grown to prefer allowing small biotechs to first identify promising candidates that have shown reasonable success in early phases of trial and then acquiring and incubating them through,

FIGURE 13

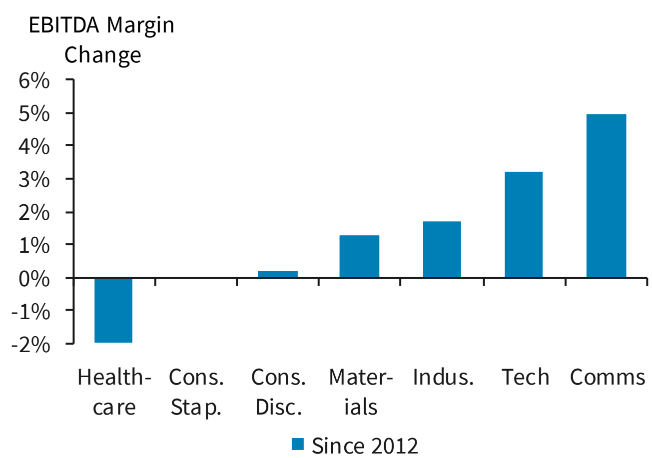
Goodwill as a Percent of Total Assets Increase since 1998



Source: Compustat, Barclays Research

FIGURE 14

EBITDA Margin Change by Sector since 2012



Source: Compustat, Barclays Research

hopefully, commercialization. Since the value of pre-revenue biotech companies is largely based on the expected future value of a portfolio of drugs still in development, acquisitions are often executed at prices significantly above the book value of assets.

Margin Compression Combined with Increased Goodwill

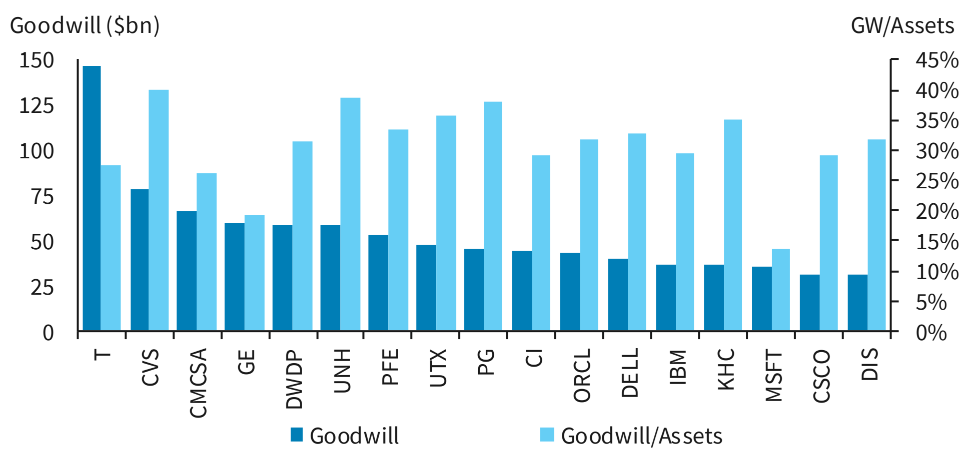
Since impairments occur as a result of material changes in the outlooks for business units or products, we view declining margins as a signal for sectors that are currently experiencing economic stress in one of their business segments. Moreover, we view sectors that have increased goodwill as a percentage of their asset base and have contemporaneously experienced margin compression as having the greatest potential for future impairments. While healthcare, technology, and communications have seen the largest increases in goodwill, technology and communications have expanded their EBITDA margins more than any other sectors (Figures 13 and 14). Conversely, healthcare has seen the largest EBITDA margin decline since 2012. Interestingly, healthcare companies were relatively unscathed in 2008-09, taking only around $12bn of impairments during the crisis (less than 0.6% of total assets), near the lowest among all sectors.

Companies with Elevated Goodwill

Figure 15 lists the investment grade companies with the largest amounts of goodwill on their balance sheets, and we include goodwill as a percent of assets to illustrate its relative magnitude. Although our economic outlook remains generally sanguine and we are not specifically negative on the listed names, these companies could have more downside if they impair a portion of their goodwill. Moreover, we believe it is noteworthy that the three largest impairments in 2018 were taken by companies on the list (GE, Kraft Heinz, and CVS).

FIGURE 15

Companies with the Largest Amount of Goodwill



Source: Compustat, Barclays Research

Appendix

Impairments

GAAP requires goodwill to be tested for impairment at least annually, or if certain events trigger an impairment test. Examples of events that could trigger an impairment test include:

- External sources - Adverse legal actions (ie, lawsuits or changes in regulatory environment), a significant decline in share price, adverse changes in technology, interest rates volatility, and/or net assets higher than market capitalization.

- Internal sources – Asset is idle, physical damage of an asset, worse-than-expected performance, and/or accumulation of costs significantly above expectations.

If it is concluded that an impairment test must be completed, the company begins calculating the fair value of the asset to assess whether it is less than the carrying value. When evaluating whether fair value is less than the carrying amount, the company should assess relevant events such as macroeconomic conditions, limitations on accessing capital, currency fluctuations, financial performance, changes in strategy, or a sustained decrease in share price. After all of these factors are considered and fair value is calculated, if the assessment is lower than the carrying value, a one-time impairment charge is taken to reduce the value of the asset, as well as the income in that reporting period. It is important to note that a subsequent reversal of a previously recognized impairment loss is prohibited once the loss is recognized.

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