Less and Less Covered

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After falling from 2009 to 2011, the leverage of U.S. investment grade corporate issuers reversed and has started to rise over the past year. Despite the increase in leverage, we have been relatively unconcerned about aggregate fundamentals because interest coverage has remained robust. Over the next year, however, we expect less supportive conditions for coverage ratios, putting pressure on aggregate fundamentals.

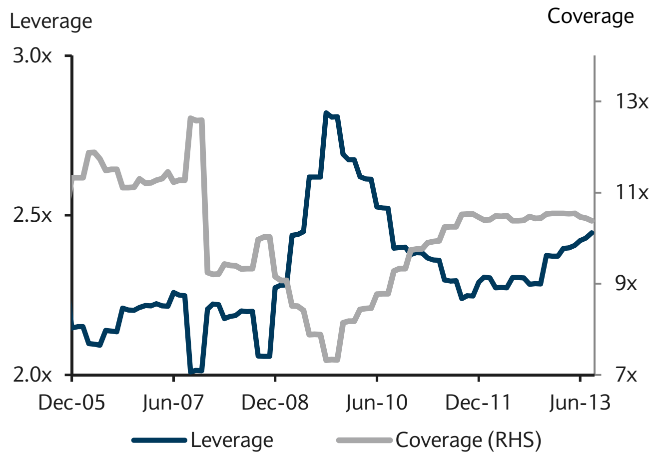
To get a clearer view of this issue (without the complications of index entries and exits), we isolate a group of about 200 non-financial corporate issuers that have been consistent members of the U.S. Credit Index since 2005. For these companies, leverage spiked during the 2008/09 recession, then improved sharply through the end of 2011 before drifting wider over the past year (Figure 1). Coverage correspondingly fell during the recession before bouncing back. Unlike leverage, however, coverage has remained steady over the past year.

The seeming disconnect between leverage and coverage has been, in part, a function of low all-in yields on new debt. Even as companies added new debt, they have seen savings on their interest payments from refinancing maturing high-coupon debt with new low-coupon debt. Since mid-2009, the coupons of new issues have been more than 150bp lower than the coupons of maturing bonds (Figure 2). This effect has been robust – new coupons were low enough to let companies in the group issue about 2x the amount of maturing debt while maintaining a constant coverage (which is essentially what occurred over the past year). Looking at it from another angle, they would have been able to absorb EBITDA declines of more than 10% without a drop in coverage (assuming that debt remained stable).

In our view, however, this beneficial refinancing cycle will draw to a close in 2014. The average coupon of maturing debt is poised to decline over the next 12 months (Figure 2). Even with steady interest rates and spreads, old debt coupons will near convergence with new issue coupons around 12 months from now. If interest rates increase, that convergence will be accelerated.

FIGURE 1

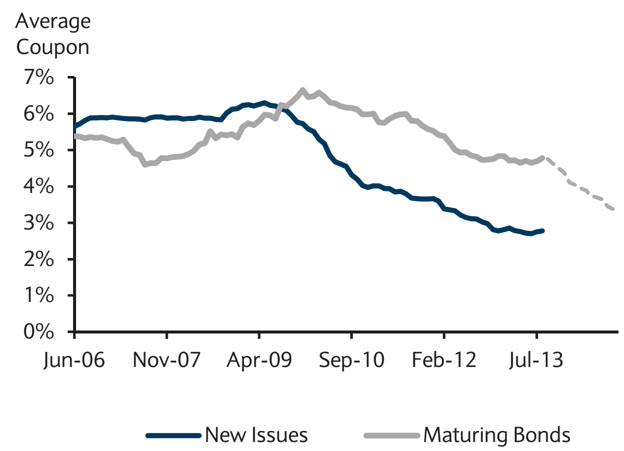
Index Leverage Has Increased, but Coverage Ratios Have Been Stable, Supporting Debt Loads



Source: Barclays Research

FIGURE 2

The Leverage/Coverage Divergence Has Been Supported by Lower Rates on New Issues than Maturing Debt

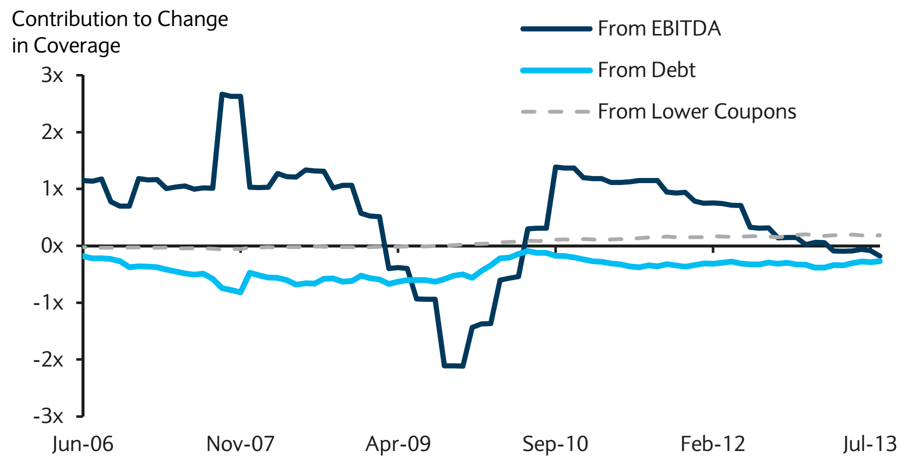


Source: Barclays Research

Finally, we note that for our consistent sample of issuers, EBITDA growth has also slowed. Given the continued growth in leverage, slower-growing EBITDA is not providing the additional support that might offset the switch in coupons (as it would have earlier in the post-2008 recovery cycle). To us, this suggests that aggregate fundamentals are likely to be under pressure on multiple fronts as we move into 2014 (Figure 3).

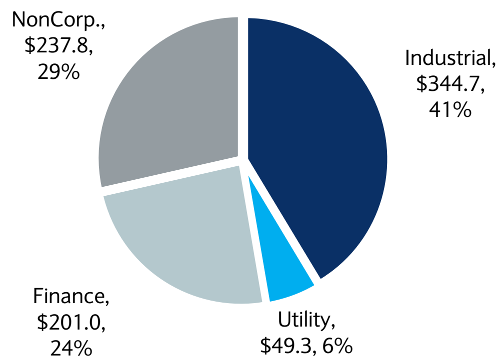
FIGURE 3

EBITDA Growth and Issue Coupons Are Becoming Less Supportive for Coverage Ratios



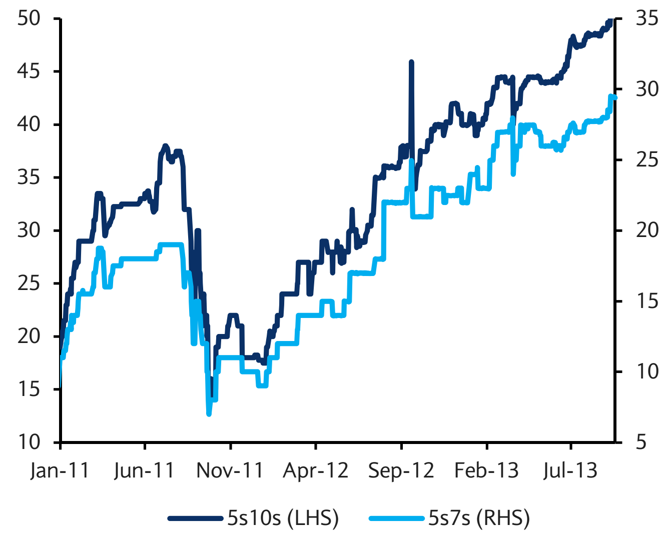
Source: Barclays Research

Year-to-Date 2013 Fixed Investment Grade Supply ($bn)



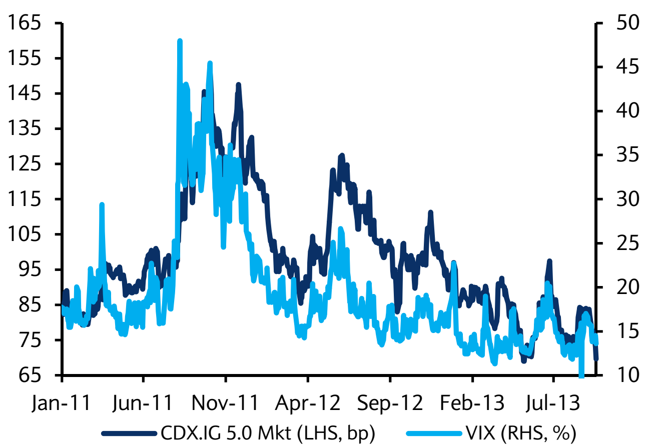
Note: Levels on this page as of Wednesday close. Source: Barclays Research

On-the-Run CDX.IG Curve (bp)



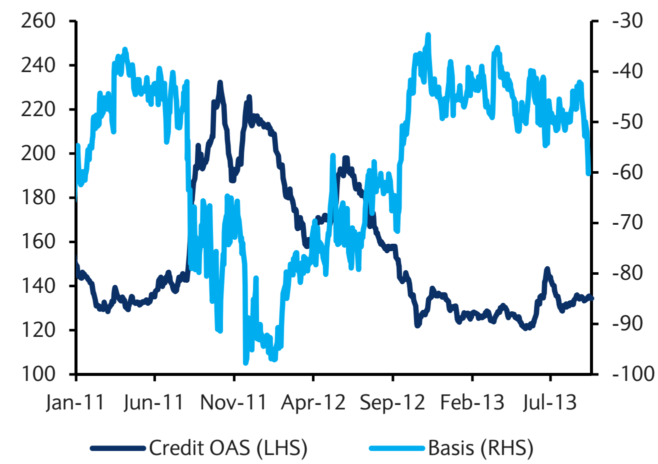
Source: Barclays Research

CDX.IG versus VIX



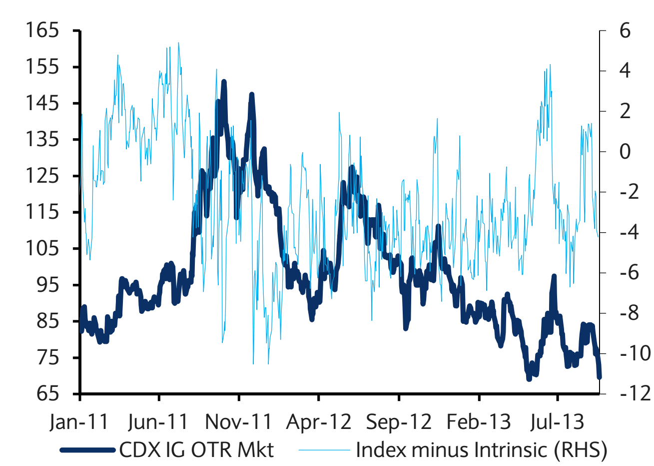
Source: Markit, Barclays Research

CDS-Cash Basis (bp)



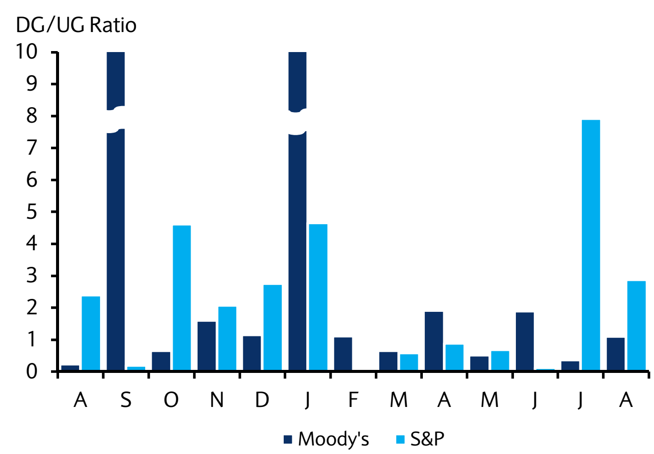
Note: Basis defined as CDX.IG spread – corporate Libor OAS.
Source: Barclays Research

CDX.IG OTR Market versus Intrinsic (bp)



Source: Barclays Research

Par Downgrade/Upgrade Ratio



Note: Broken bars indicate a value of greater than 10x. Source: Barclays Research

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