Weaker Fundamentals, Same Price

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While we expect consensus-like growth in EBITDA for non-financial investment grade issuers in 2014, we also expect debt to increase, total and net leverage to rise, and coverage to decline. Outside of a macro downside event, we do not see worsening fundamentals causing absolute spread widening. However, balance sheet deterioration will likely be a headwind to further tightening and, in particular, could lead to underperformance versus financials, where regulatory pressure should continue to promote balance sheet improvements.

Non-financials' Aggregate Fundamentals are Deteriorating

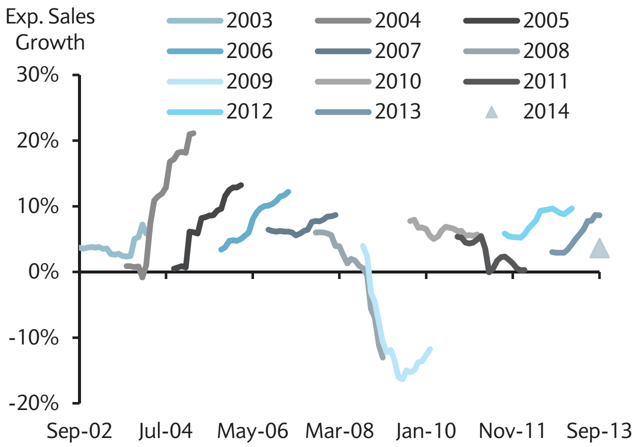
As 2013 nears its end, we have begun to see clear signs of deterioration in the fundamentals of non-financial investment-grade issuers. While deleveraging ended for these firms some time ago, we have more recently noted that coverage ratios are likely to also end their improving trend. In 2014, it appears that both metrics are likely to deteriorate further.

2014 Operating Results Are Likely to Be Similar to 2013's

To develop our outlook for fundamentals, we first look at the underlying operating expectations for non-financial corporate issuers. Starting with the issuers in the US Credit Corporate ex Financials index, we focus on the subset that has been in the index for the past decade (to make comparisons across time more consistent).

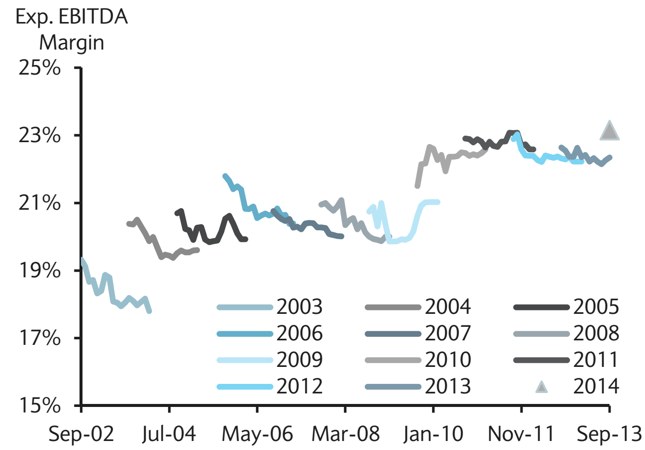
For index issuers, the consensus expected 2014 sales growth is about 3.5%. If that growth rate is realized, 2014 would be below the ~5% average of the past decade, and a significant drop-off from 2013 (which is trending towards growth over 8% for our set of companies). We do see room, however, for growth to outperform. In seven of the last 11 years, realized growth beat expectations from this period in the prior year, rising an average of 8pp as results were realized (Figure 1); the four years in which sales dropped from early expectations had significant macroeconomic downdrafts from financial crises and recessions in the US and Europe. For example, as of September 2012, the consensus saw 2013 sales growing only 3%, but the actual pace of sales has outperformed that by more than 5pp. Barring a significant

FIGURE 1
Sales Growth Expectations Are Returning to the Pre-crisis Pattern of Rising During the Year



Source: Factset, Barclays Research

FIGURE 2
EBITDA Margins Have Risen, but Expectations Still Tend to Start Too Optimistically and Decline



Source: Factset, Barclays Research

economic shock, we believe the growth outlook will rise over the next twelve months and sales growth of index issuers to end the year well above the current estimate.

In contrast to the modest sales growth forecast, the consensus is for EBITDA margins to rise about 1pp next year, which would bring them to the highest level of at least the last decade. In our view, however, they are likely to fall short of this improvement. First, this would require a further increase to margins that are high, but already off their 2011 peak. Second, in eight of the last 11 years, realized margins have ended up below starting consensus expectations, missing by an average of 80bp.

On balance, sales are likely to beat current expectations, but margins will probably miss, with the moves roughly offsetting each other. We see the most probable net result as resulting in underlying EBITDA growth approximately in line with current consensus expectations, which is what we will use in forecasting aggregate changes in credit metrics.

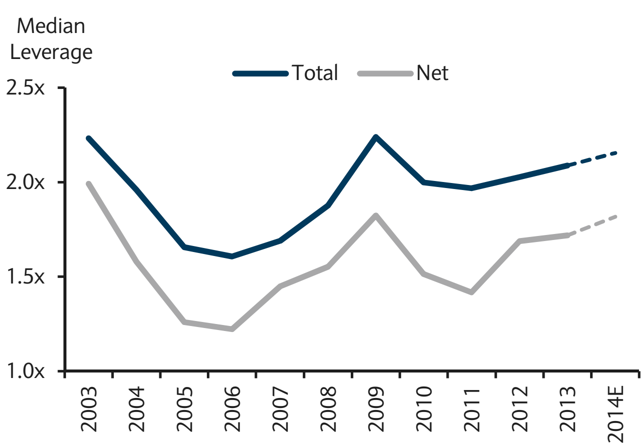
Debt Is Likely to Increase on Continuing EBITDA Growth

The second component of our forecast is fundamental factors more under the control of management policies: how much debt companies are likely to add (or reduce) over the next year and how much cash they are likely to maintain on their balance sheets.

We consider a number of factors that we believe drive the issuance decision for investment grade corporates. Using data from the past decade as the base for a bottom-up estimate, we regress the y/y change in debt for individual issuers on expected EBITDA growth, change in capital spending, and increase in share repurchase authorization. We find a few interesting results:

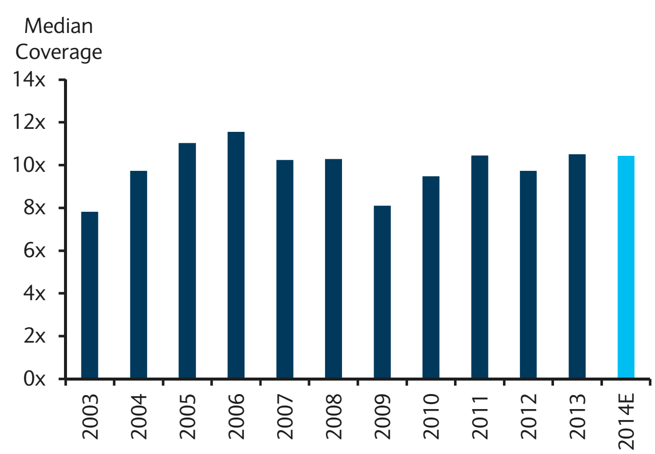
- The most statistically significant driver of rising debt is a consensus forecast of growing EBITDA. This is consistent with the model that IG companies manage to a leverage target and that management will add debt when it foresees improving operations. According to the regression, on average companies add just under $3 of debt over the next year for every $1 of projected EBITDA increase.
- Given that relationship between EBITDA and debt, we believe that in an otherwise improving economy (and absent macro risks that reward debt reduction), US Credit Index issuer leverages trend towards 3x. This is well above the current level of just over 2x.

FIGURE 3
Our Forecast Is for the Total Leverage of Non-financial Corporates to Increase Again in 2014…



Source: Factset, Barclays Research

FIGURE 4
…While Coverage Deteriorates Modestly



Source: Factset, Barclays Research

- Capital spending is also a contributor to an increase in debt, with an additional $0.5 of new debt added for each incremental $1 of capital spending.
- After controlling for EBITDA and capex growth, we see very little relationship between increases in share repurchase authorizations and debt, and to the extent the relationship exists, it appears to be negative. In our view, the relationship between capital returns and leverage is complicated, with increasing returns feeding into debt increases only under a narrow set of conditions (see the August 16, 2013, Credit Alpha: *Pulling the Lever* for details).

Using the model and consensus expectations for EBITDA growth, we forecast total debt issued by index issuers to increase about 11% over the next year. This would be in line with 2013 (the amount outstanding in the US Credit Corporate index debt has grown 10.4% over the past 12 months). This would imply a 7bp increase in total leverage, about the same as last year (Figure 3). Assuming the average coupon of new issues matches the coupon of current debt (as we suggested was likely to be the case in our September 20, 2013, Credit Alpha: *Less and Less Covered*), the median coverage ratio would deteriorate very slightly (Figure 4).

One corporate behavior that has supported fundamentals since 2008 is firms holding increased amounts of cash. Even at a constant total leverage target, this gives companies lower net leverage and more balance sheet flexibility. While the total cash on balance sheets has continued to increase as a natural result of corporate growth, it has been falling as a proportion of total debt after peaking in 2011 (Figure 5). Companies have also become increasingly dependent on short-term financing, with corporate paper balances recently rising above 2008 levels (Figure 6). We forecast this trend to continue, which would return cash (relative to debt) to 2009 levels and increase net leverage 10bp, bringing it to the highest level since 2009.

Aggregate Fundamentals Are Worse, but with Few Immediate Spread Implications

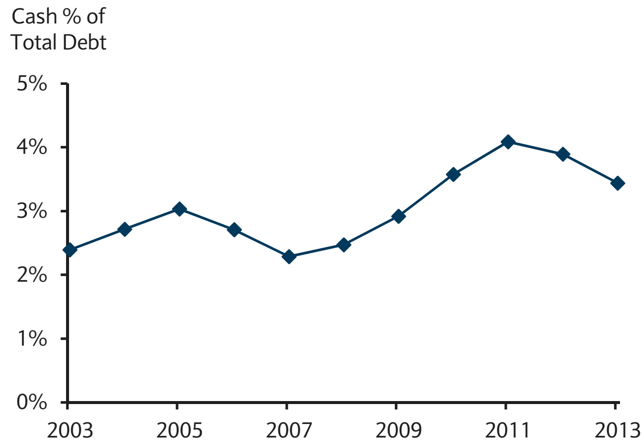
If, as we expect, total and net leverage approach or exceed the 2009 levels, it will be especially notable because the 2009 peak was also function of a recessionary trough EBITDA performance. Put those factors together, and aggregate investment grade fundamentals in 2014 will be worse than they were prior to the 2008 financial crisis, with higher total and net leverage and coverage at a similar or lower level, lower sales growth, and EBITDA margins that have likely peaked.

Despite the downturn in fundamentals, we do not see an immediate consequence for spreads. First, even as fundamentals have taken a turn for the worse, spreads have remained virtually unchanged over the past year. Indeed, they are tighter than they were in 2011, when fundamentals were strongest.

Without a catalyst, the effects of worsening aggregate fundamentals is likely to be muted: industrial index spreads face resistance to further tightening, even if other risk assets rally (which we see causing underperformance versus financial credits, high yield, or other risk asset classes). However, a weaker fundamental backdrop does exacerbate the underperformance of industrials in a macro-driven decline, in our view.

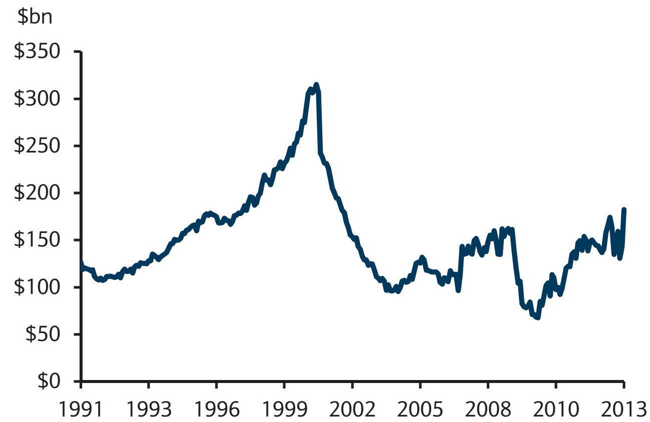
To estimate the potential downside for industrials in case of a negative macro catalyst, we believe it is illustrative to look back to 1998-2003. At that time, the US Credit Industrials traded with an average OAS of 200bp or wider. Fundamentals, however, were worse, with median net leverage well above 2x, and spreads approached those levels only after the start of a recession and strong fall in equity markets. Even after their recent deterioration, aggregate fundamentals are better now than they were heading into 1998, suggesting that

FIGURE 5
Aggregate Cash/Debt Remains High, but Has Been Declining



Source: Factset, Barclays Research

FIGURE 6
Commercial Paper Balances Are at Their Highest Levels since 2001



Source: Bloomberg, Barclays Research

the distribution of possible downside spreads might cluster around the tighter end of that range (perhaps 175-200bp). If fundamentals worsen in 2014 and beyond, however, we would expect the distribution of possible spreads to move towards the wider end of that range (which peaks at 250bp).

Financials' Fundamentals Are Continuing to Improve

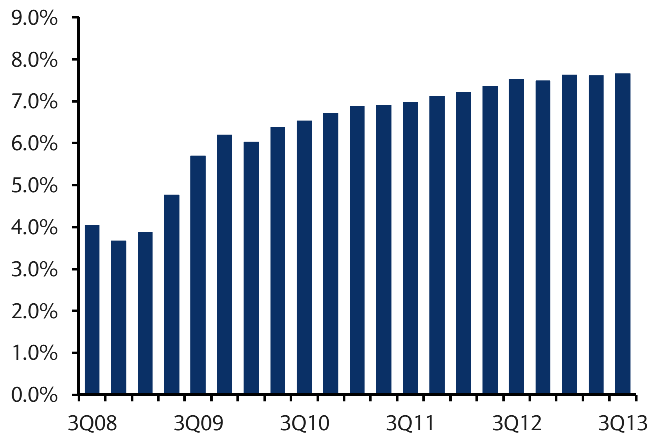
In contrast to industrials, financial credits are continuing to improve their fundamental health. Banks and insurance companies, which make up the vast majority of the financial index, have significantly strengthened their balance sheets after the financial crisis, a trend we expect to continue in 2014.

- **Banks:** Bank fundamentals have improved dramatically over the past few years, and we expect them to remain strong in the medium term. Over the past five years, bank capital ratios have increased and liquidity and asset quality have improved. In particular, the 25 largest U.S. banks have increased tangible common equity as a percentage of tangible assets to 7.7% from below 4% in late 2008. In regard to asset quality, non-performing assets (NPAs) have fallen 53% from their peak in 2009, and forward-looking indicators suggest continued improvement in the coming quarters. Importantly, unlike industrials, we do not expect the trend of strengthening fundamentals for banks to reverse. Stricter capital and liquidity requirements, many of which are being phased in over the next five years or so, limit their ability to re-leverage meaningfully in the medium term. Additionally, stricter risk-weightings make it more difficult for them to increase holdings of riskier assets without comparable increases in capital.

  While regulatory changes have generally been positive for bank creditors, regulatory and legal issues also pose risks. For example, the potential minimum debt requirement could be negative if it leads to a significant pickup in bank supply. However, we expect the structure of the rule to avoid requiring banks to increase their overall amount of debt outstanding. We do see potential for a minimum debt requirement to cause banks to increase subordinated debt issuance (with a corresponding decrease in senior issuance), which could create a negative technical in subordinated markets. A second headwind has been continued high litigation for the U.S. banks. In recent weeks, the most prominent example of this risk has been JPMorgan's reported $13bn settlement with the U.S. government over RMBS-related issues. While the charges are large – and likely to

FIGURE 7

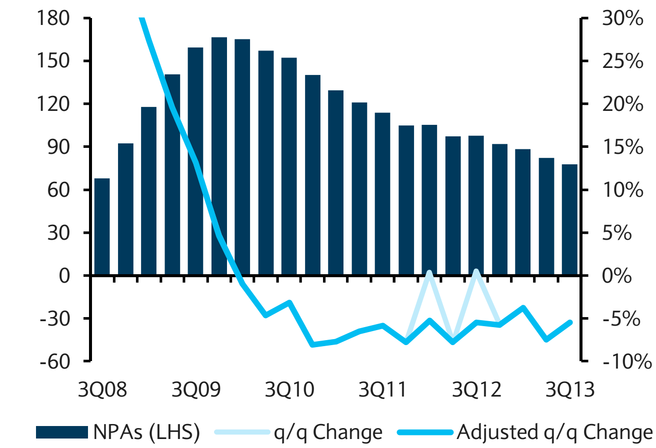
Tangible Common Equity % Tangible Assets, 25 U.S. Bank Aggregate (%)



Source: Company reports, SNL, Barclays Research

FIGURE 8

Non-performing Assets, 25 U.S. Bank Aggregate ($bn)



Source: Company reports, SNL, Barclays Research

continue for some time – we believe they are manageable in the context of existing reserves, current capitalization, and future earnings. Our bank analyst Brian Monteleone does not see litigation risk as derailing the favorable fundamental trends and remains Overweight U.S. banks and finance companies.

- **Insurance:** Insurance fundamentals appear to be on a similar trajectory to banks'. Life insurers are enjoying near record levels of capital and liquidity, and we expect fundamentals to remain strong in the medium term, given increased regulatory/rating agency scrutiny. Following the financial crisis, life insurers emerged with a level of self-discipline that resulted in stronger capital metrics, a better perspective on risk, and a healthy respect for the level of volatility in the capital markets. At the operating level, the industry's risk-based capital (RBC) ratio has been maintained in excess of 400%, a historically elevated level. From a liquidity perspective, the rating agencies have became more conservative and mandated 2x coverage of interest and upcoming debt maturities at the holding company level. In addition, operating trends in the P&C sector remain favorable, characterized by increasing premium rates and continued favorable reserve development. The challenging investing environment has been a blessing in disguise, as low rates have helped force pricing discipline on the sector.

The divergent fundamental trends between financials and industrials have been reflected in the tightening of the financial-industrial basis (Figure 9). After tightening for the past several years, that basis turned negative recently and is now at its most negative level since the financial crisis. Despite already trading inside of industrials, financials have further room to outperform. For context, the average financial-industrial basis from 2000 to mid 2007 was -35bp, which would suggest up to ~25bp of further outperformance.

FIGURE 9

Financials OAS minus Non-financials OAS (bp)

Source: Barclays Research

Analyst Certification

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