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In focus

The converging worlds and diverging interests of equity and bond investors

January 2020

Investors are used to thinking of equities and corporate bonds separately. However, in reality, they are two sides of the same coin and actions which favour one can have implications for the other. This is important as decisions taken by companies in the past decade have caused these two worlds to converge. As the cycle matures, companies are going to be forced to choose which to favour. The outcome of these deliberations will have a major impact on investors in both markets.

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The conflicting preferences of equity and bond investors are easy to see. For example, debt holders may feel more secure if a company was to keep ample spare cash on its balance sheet to cover debt repayments comfortably, rather than reinvesting or paying it out to shareholders. However, for equity holders, this would be an inefficient use of cash, reducing potential returns. By contrast, paying out too much to shareholders could put debt holders at risk. Two important trends over the past decade highlight the importance of this interaction:

1. The significant accumulation of debt in the corporate sector has been most prominent in sectors that equity and debt holders are used to thinking of as safe.
2. US equity investors have benefited from an unprecedented amount of share buybacks, many of which have been debt financed. An increase in debt holder-friendly actions to protect credit ratings would reduce this leg of support for equities going forward.

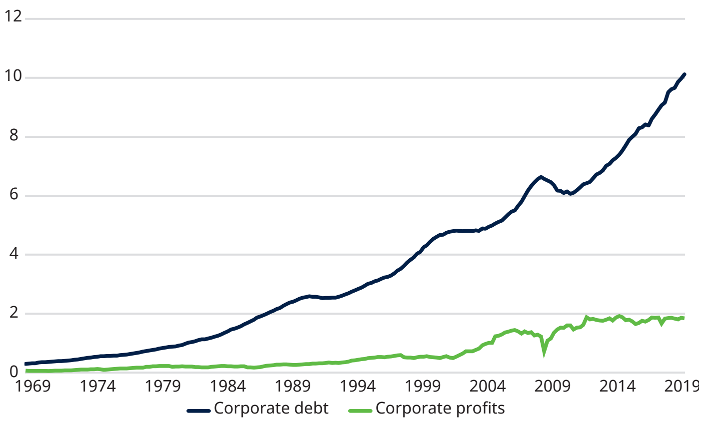
Debt vulnerability is emerging in surprising places

Across developed markets, companies have capitalised on the decline in interest rates since the global financial crisis to increase their debt loads substantially. In the US, this has led to corporate debt increasing by $4 trillion since 2011, reaching a record level of 46% of GDP, against a backdrop stagnant profit growth (Figure 1).

As a consequence, non-financial companies within the US corporate bond market are more highly debt-financed today (in terms of debt-to-equity ratio) than they were during the financial crisis and dotcom crash. High levels of cash on balance sheets offset this slightly but even gearing net of cash is close to record levels (Figure 2).

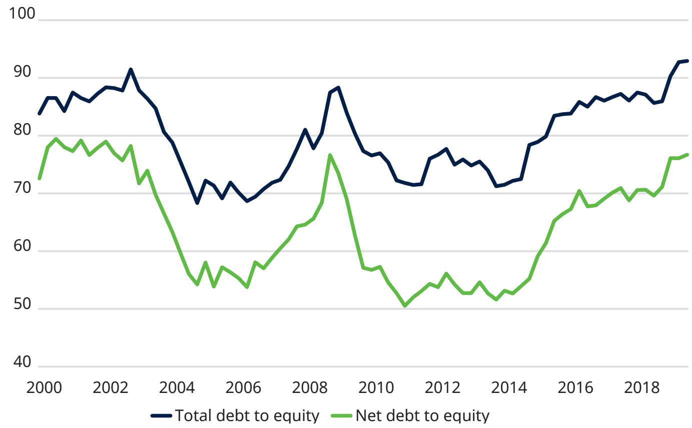
Figure 1: Fast growth in US corporate debt while corporate profits have flat lined

Trillions USD



Source: Schroders, Refinitiv Datastream. Data as at Q3 2019.

Figure 2: The share of debt in corporate balance sheets has increased substantially



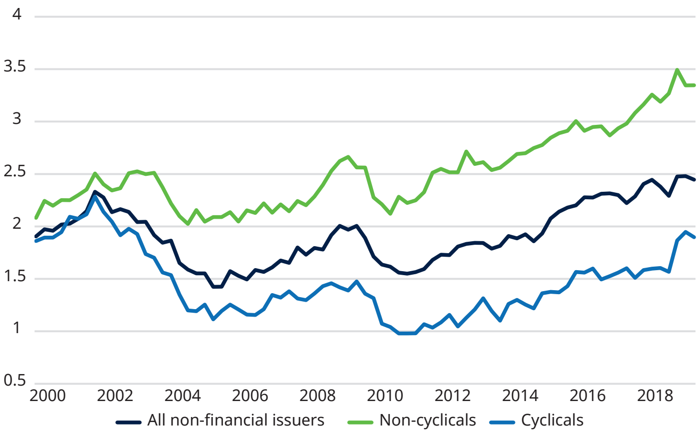
Source: Schroders, Bloomberg. ICE BofAML US Corporate Index median issuer ex-Financials. Data as at Q3 2019.

Schroders

Clearly, from the perspective of a credit investor, this is a worrying trend. However, it also increases risk for equity investors, as high levels of debt increase the risk of financial distress. Importantly for both equity and corporate bond investors, this accumulation of debt has been most prominent in sectors that investors are used to thinking of as relatively safe. Debt as a multiple of EBITDA – earnings before interest, tax, depreciation, and amortisation – among non-cyclical companies, has soared past previous highs (Figure 3). These include companies in the consumer staples, communications, utilities and healthcare sectors[1]. By contrast, borrowers in more cyclical sectors have been relatively restrained. Although their net debt-EBITDA multiples have also been rising, they are not as stretched.

Figure 3: US Investment Grade leverage at record high level with non-cyclical sectors the worst offenders

Net debt to EBITDA



Source: Schroders, Bloomberg. ICE BofAML US Corporate Index median issuer ex-Financials. Data as at Q3 2019. Cyclical sectors: Basic Materials, Consumer Discretionary, Industrials, Technology. Non-cyclical sectors: Communications, Consumer Staples, Utility, Health Care.

In large part this is down to non-cyclical companies engaging in debt-financed mergers and acquisitions (M&A). For example, between 2013 and 2017, approximately 60% of M&A related investment grade corporate bond issuance came from four non-cyclical sectors mentioned above, even though these sectors make up only one-third of the US investment grade market[2].

Debt-financed M&A can be healthy, with leverage expected to fall as cost-savings and other benefits of deals come through. But if acquirers overestimate synergies and the ability to cut debt, expected gains can turn into losses, leaving companies with dangerously high leverage. Worryingly, in both the public and private markets, generous allowances for synergies and cost savings are increasingly underpinning credit ratings.

So far companies' plans to deleverage have remained generally elusive. Out of the 48 largest non-financial BBB companies, only one-third have been able to cut leverage since year-end 2017[3]. This perhaps should not come as a surprise. In the past, leverage has peaked only in downturns when falling earnings force companies to take drastic measures to cut debt.

1 Some of the non-cyclical companies also suffer from low margins. For example, the average net profit margin in the consumer staples and health care sectors are around 7%, notably lower than the average overall market net profit margin of 10%. Source: Schroders, Bloomberg. Data as at Q3 2019.

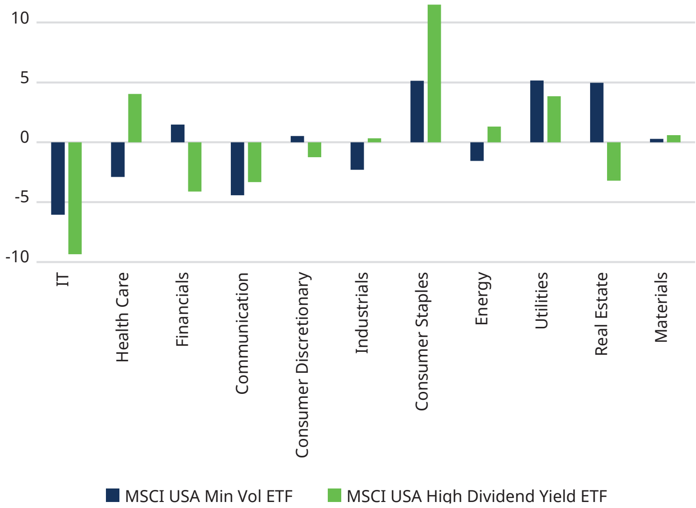
2 Source: Morgan Stanley. Data as at 17 November 2019.

3 Source: Goldman Sachs. Data as at 3 December 2019.

The dangers in low-risk equity strategies

If you are a corporate bond or equity investor, you are used to thinking of these non-cyclical companies as being less sensitive to the economic cycle and, consequently, towards the lower risk end of the spectrum. For example, consumer staples and utilities are popular sectors in low volatility and high dividend equity strategies (Figure 4). However, their borrowing binges mean this can no longer be taken for granted. A simple approach of investing in a basket of non-cyclical companies could expose investors to more risk, not less. Should these companies get in trouble, the performance of strategies which have been aggressively marketed as low risk could suffer. Minimum volatility strategies, for example, could become more volatile than expected and companies with high dividend yields might be forced to cut dividends, resulting in lower income. Credit spreads of defensives could widen more than their supposedly riskier cyclical counterparts. The greater certainty investors are looking for in these strategies could be undermined. Many of these sectors have also been in strong demand due to the relatively weak nature of the economic recovery, and consequently trade at high prices. Not only are they riskier than appreciated, they also offer reduced compensation for that risk.

Figure 4: Popular equity factor strategies are overweight non-cyclical sectors



Source: BlackRock. Data as at 20 November 2019.

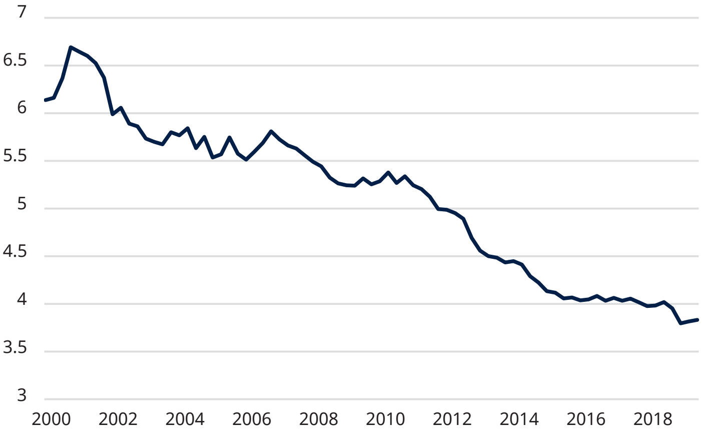
High interest cover should not be taken for granted

One saving grace for investors has been that, even though debt levels have increased substantially, credit risk has remained relatively benign. This has happened as interest rates have collapsed, resulting in interest payments becoming more affordable for borrowers. Compared to the early 2000s, for example, the average company's cost of debt, defined as the annual interest cost as a percentage of debt, has fallen from more than 6% to less than 4% (Figure 5, top chart). As a result, interest cover has been at a very comfortable level (Figure 5, bottom chart) – this has been the main argument used to defend credit markets from criticisms of excess.

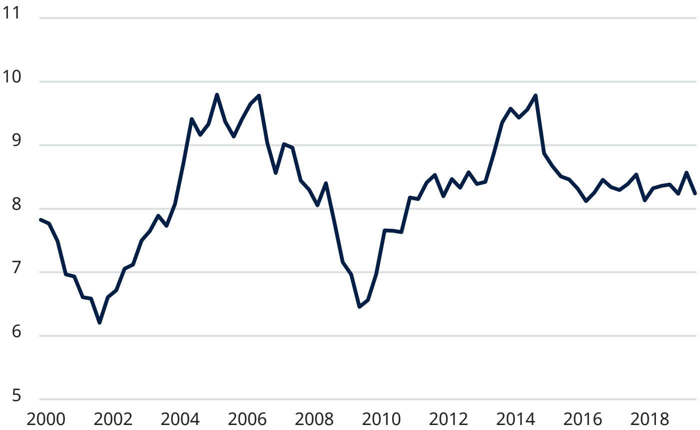
However, this should not be taken for granted. It is worth noting that interest cover was at a similar level on the eve of the financial crisis, but that provided no protection from what was to come. The two risks to interest cover are an increase in interest rates and a decline in earnings. Although neither should be discounted, the latter risk currently appears more pressing. For example, all of the cyclical indicators monitored by Schroders' economics team are signalling that we are at a late stage in the economic cycle. Although a recession is not forecast, profits are projected to decline and downside risks loom large.

Figure 5: Plummeting cost of debt holding up interest coverage ratio

Cost of debt



Interest coverage ratio = EBITDA/interest



Source: Schroders, Bloomberg. ICE BofAML US Corporate Index median issuer ex-Financials. Data as at Q3 2019.

If there is a downturn, the problems stored up by almost a decade of rising debt levels will come sharply into focus. However, even if there is not, it would be naïve of investors to assume that current comfortable levels of interest cover insulate them from credit risk. In addition, markets are likely to start pricing in this risk well in advance of a credit event, such as a default or credit rating downgrade. For example, in late 2018, the credit spreads of some of the most leveraged issuers increased to distressed levels, illustrating that high interest coverage alone was not sufficient to ensure high creditworthiness in the eyes of the market.

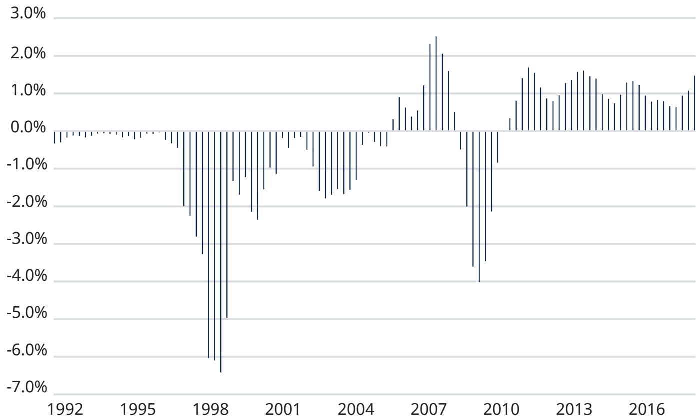
Time for payback for buybacks?

Another important trend over the past decade has been for corporate management teams to increase pay-outs to shareholders through dividends and, notably in the US, share buybacks. This 'bond-mimicking' has been encouraged by shareholders because of a dearth of income opportunities elsewhere.

From the perspective of an equity investor, buybacks have at least two immediate consequences. First, they reduce the number of shares outstanding, which provides a boost to earnings per share. Mathematically, it is easy to see how this occurs – earnings per share is equal to aggregate earnings divided by number of shares, so a reduction in the share count automatically results in an increase to earnings per share. Bank of America calculates that, since 2013, net buybacks have contributed 15% of US stock market earnings growth (Figure 6).

Figure 6: S&P500 net buybacks have supported earnings growth

Buyback impact to annual EPS growth



Source: BofA Merrill Lynch. Data as at Q4 2018.

The second consequence is that buybacks inject an additional source of demand for a company's shares and this higher demand can put upward pressure on share prices. To give an idea of the importance of this source of demand, corporations (via buybacks and M&A) have been the dominant buyer of equities since 2012[4].

As with dividends, investors have come to rely on this income surrogate, with annual projected returns for US equity markets now including buybacks as a matter of course.

From the perspective of a debt holder, buybacks are unequivocally negative. Firstly, they reduce the amount of equity capital on companies' balance sheets, meaning there is less of a buffer to take a hit before debt holders are exposed to losses. In addition, if they are financed with spare cash, that is cash that could have been used to cover future debt repayments. However, a bigger concern is that large volumes of buybacks have not been financed with idle cash, but with new borrowings. At the cyclical peak to date in 2017, $150 billion or 34% of US buybacks were funded with debt[5]. Although the share of debt-financed buybacks has declined over the last two years, this has been mainly driven by increased use of repatriated overseas cash[6]. While it can be argued that the switch from equity to debt has been a rational choice given low interest rates, this behaviour might have now reached its natural limit, especially for the most vulnerable companies.

4 Six reasons you should care about share buybacks, Schroders, November 2018.

5 Source: J.P. Morgan. Data as at July 2019.

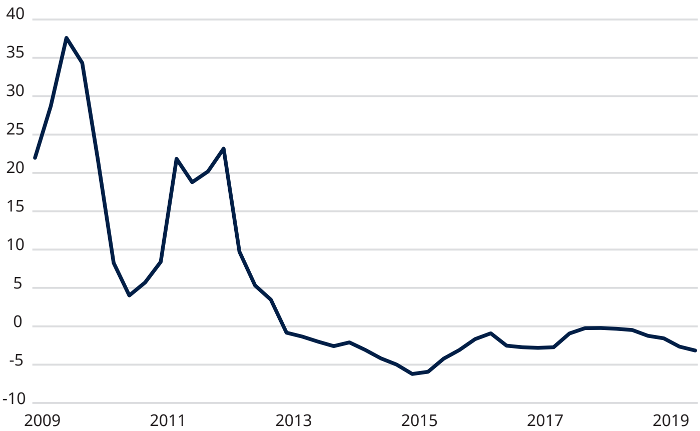
6 The 2017 Tax Cuts and Jobs Act (TCJA) lowered taxes for US corporations and imposed a one-time tax of 15.5% for foreign profits held in cash form, and 8% for profits held in non-cash form, payable over eight years, regardless of whether companies repatriate old overseas earnings. This new law incentivized US corporations to repatriate oversees cash and use some of it for share buybacks.

We therefore have a situation where dividends and buybacks have helped support equity returns, but have been at least partly dependent on new borrowings in order to do so. However, with borrowings already at high levels, this increasingly looks unsustainable. Any move by borrowers to de-risk on the credit side could have negative consequences on the equity side. The alternative of a continuation of debt-fuelled buybacks would clearly increase risk for corporate bond investors.

In addition, replacing equity with debt in the balance sheet reduces the balance sheet's buffer to absorb future losses. The reduction in flexibility can force companies to cut (discretionary) shareholder payments and potentially issue more shares down the line to shore up the gap. It might come as a surprise to some investors that, before 2004, new stock issuance regularly exceeded buybacks. The utilities sector could be a canary in the coal mine in this regard. Since 2013, utility companies have issued more shares then they have bought back, going against the general trend in the market (Figure 7).

Figure 7: Companies in utilities sector have been forced to issue more shares

US Utilities sector buyback to income ratio (%)



Source: Schroders, Bloomberg. Median issuer. Data as at Q3 2019.

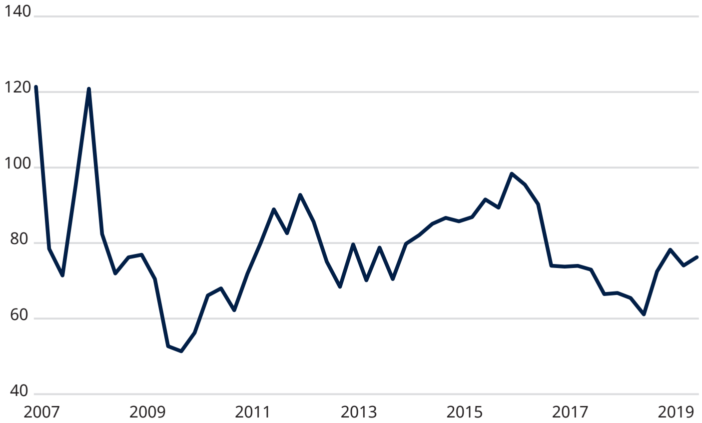
More broadly, there are a number of other signs that the tide could be turning less equity-friendly and more credit-friendly. The median payout ratio[7] of companies in the US dollar corporate bond market has fallen from near 100% to 72% (Figure 8), as some of the most leveraged issuers have been taking steps to cut leverage. In addition, an increasing proportion of M&A deals, by value, have been financed with new equity rather than debt or balance sheet cash – the average equity share of M&A deals has risen from a low of 12% in 2017 to 38%[8]. For credit investors, these moves reduce risk compared with alternatives, but for equity investors, lower pay-outs and greater new equity issuance would remove at least some of the current income support.

7 The payout ratio shows the percentage of annual earnings paid to shareholders in the form of dividends and share buybacks.

8 Source: Goldman Sachs. Data as at June 2019.

Figure 8: US Corporate Index total payout ratio

Percentage of earnings



Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q3 2019.

Watch out for BBBs

Another area of vulnerability for credit and equity markets is the BBB-rated segment of the corporate bond market. These are the most vulnerable investment grade companies, on the cusp of sub-investment grade (high yield) status. This is important as the loss of an investment grade rating is usually associated with a substantial increase in borrowing costs. This occurs in part because many investors are not permitted to hold sub-investment grade bonds, so become forced sellers in the event of a downgrade. This means that companies are highly motivated to avoid being downgraded to high yield.

This issue has grown in importance as the volume of BBB bonds has increased substantially. They now make up more than 50% of the US investment grade corporate bond market. The potential volume of downgrades is significant. This is clearly not the kind of uncertainty that investors expect when buying these bonds for stable income. As we have written previously, navigating the challenging environment requires considerable flexibility. Please see The downgrade risks facing passive investment grade bondholders[9] to read how we believe bond investors should manage this downgrade risk.

This also has major implications for equity investors. To avoid a downgrade, companies often cut dividends and share buybacks, sell assets, issue new equity, or any combination of these. Although such actions would reduce credit risk, they would be bad for equity investors. BBB-rated bonds are not a problem for bond investors alone.

9 Sean Markowicz, "The downgrade risks facing passive investment grade bond holders", Schroders, June 2019.

Conclusion

How to navigate a more challenging environment

Investors in both equities and bonds now face a number of common issues, suggesting that the two worlds are, to some extent converging. To navigate this more challenging environment, we believe that shareholders will need to adopt more of the balance sheet perspective of credit analysts, with perhaps less of a focus on earnings growth. Similarly, bond holders will increasingly need to focus more on the viability of current margins and future earnings, instead of falling back on the fragile crutch of high interest coverage.

Specifically:

1. **Leverage and vulnerability is high in the prime income generating and perceived safe sectors in equities and investment grade fixed income**
2. **Leverage normally peaks only when earnings turn and low margin sectors, such as consumer staples, look especially vulnerable, as any margin erosion will have a larger proportionate effect on earnings**
3. **Debt-financed share buybacks have transformed corporate capital structures and supported equity markets…but are starting to look increasingly stretched**
4. **Increasingly common aggressive assumptions over future cost savings and earnings baked into M&A deals might not be achievable, especially if growth weakens further. Both investment grade and high yield issuers are exposed**

Companies that continue to engage in equity-friendly actions could put bond holders under pressure. Credit spreads could increase as default and downgrade risk rise. In contrast, companies that take actions which prioritise bond holders are likely to be less generous when distributing cash to shareholders. Investors have a tendency to look at equity and credit investments in isolation, separate from one another. However, this is no longer appropriate (if it ever was). As the economic and credit cycles enter their later stages, their worlds are converging but their interests are diverging.

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