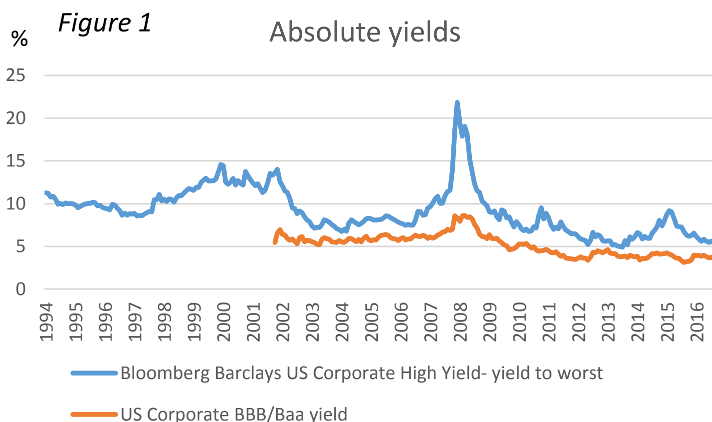
Special paper No.4

Μηδέν ἄγαν – nothing in excess

Ancient inscription on Apollo's temple at Delphi

We are often asked about our propensity to invest in various asset classes, a question which becomes more relevant as higher valuations limit the choices available to investors. Corporate debt is one such mooted alternative to our current combination of equities, cash, index-linked bonds and gold in Troy's multi-asset portfolios. It is an area which warrants consideration, not least for its relevance to our equity exposure but also for its potential to provide diversification and attractive risk-adjusted returns. The Trojan Fund has previously invested in short-dated corporate bonds at attractive yields and held them to maturity. The asset class currently commands our attention for its manifestation of several unusual phenomena.

Figure 1 Absolute yields

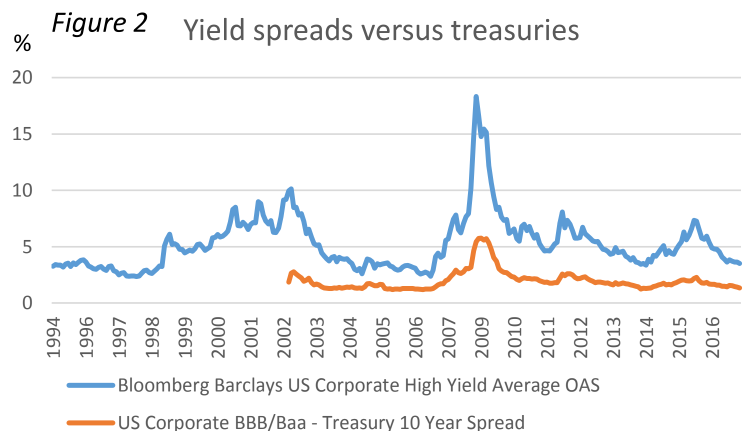


Source: Bloomberg, 31 July 2017

More demand and more supply

Absolute and relative borrowing costs are at or near multi-decade lows for both high-yield and investment-grade corporations. Figures 1 and 2 illustrate the borrowing costs of companies in the US, the largest and most liquid corporate bond market, both on a standalone basis and relative to US Treasuries. The trend is similar in Europe where purchases by the European Central Bank and Bank of England have boosted demand for the asset class. It is remarkable that the option-adjusted spread on the European High Yield Index came within 0.1% of the yield-to-maturity on the US 10-year Treasury at the beginning of August. In the US, the cost of borrowing for sub-investment-grade corporations has actually fallen in spite of higher base rates and an increase in 10-year Treasury yields from 1.4% last July to 2.3% today[1]. Paradoxically, higher rates have led to increased risk-taking when they would ordinarily promote the opposite response.

Figure 2 Yield spreads versus treasuries



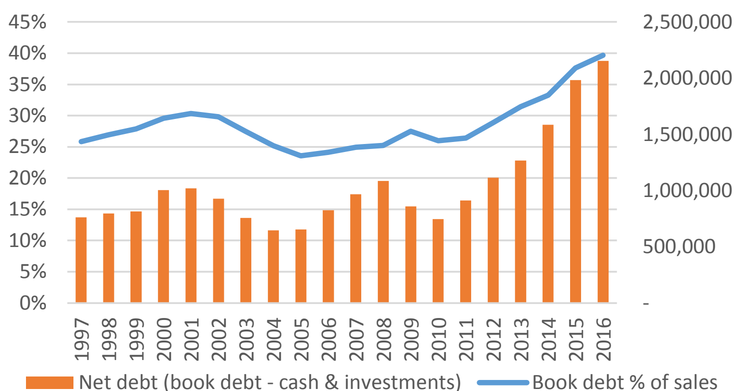
Source: Bloomberg, 31 July 2017

[1] Source Bloomberg, 31 July 2017

Investor demand for corporate credit has been strong. As at the end of July, corporate bond allocations by US fixed-income portfolio managers were at an all-time high of 37%, up from 32% five years ago[2]. Passive inflows have meanwhile flooded corporate bond ETFs. The market capitalisation of the largest investment-grade ETF (iShares iBoxx $ Investment Grade Corporate Bond) has grown 40% to over $38bn so far this year, up from just $3bn in 2008. The ETF's performance year-to-date has been +5%[3]. Supply has responded in kind as businesses have taken this opportunity to increase their leverage. 2017 is on track for another record year in US investment-grade credit issuance following $868bn in the first half. The step-up in borrowing does not correspond with an equivalent increase in corporate growth. Figure 3 illustrates the growth in debt ahead of cash and sales in the US.

Higher risk, lower return

Figure 3 USA aggregate: net debt and debt as a % sales



Source: Credit Suisse HOLT, 31 July 2017

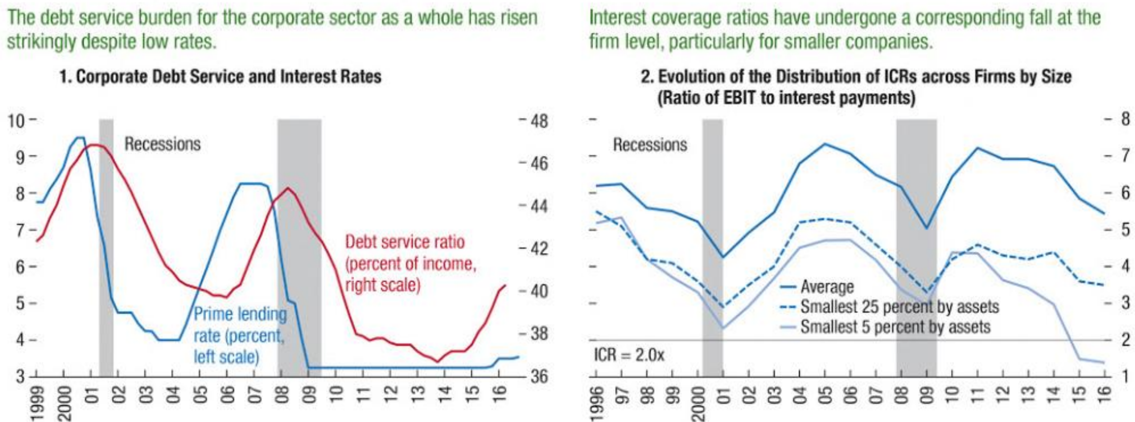
Debt is being issued more cheaply even as corporate balance sheets are weakening. The precariousness of the situation is compounded by the increasingly generous terms on which credit is being offered, fueling appetite for greater leverage across the board. According to S&P Global, covenant-lite[4] loans now account for more than 70% of all US leveraged loans, up from 30% in 2007. Higher levels of debt and looser covenants do not themselves presage imminent collapse. The amount of US sub-prime mortgage debt prior to the financial crisis was not problematic until discounts on adjustable rate mortgages started expiring going into 2006. Today, there is no predetermined expiry date to low corporate borrowing costs. At a sector level, risks to the energy market at the beginning of 2016 have largely dissipated thanks to a higher oil price, and the recent rise in default rates on US retail debt remains confined to the sector, for now.

However, the ability of cash flows to meet interest payments shows a weakening trend. The International Monetary Fund's (IMF) 2017 Global Financial Stability Report alludes to falling interest coverage ratios across US corporates as a potential harbinger of recession (Figure 4, overleaf).

[2] Source: Stone & McCarthy, 1 August 2017
[3] Source: Bloomberg, 31 July 2017

[4] Debt issued with fewer restrictions on collateral, payment terms and level of income

Figure 4



Source: Global Financial Stability Report, April 2017

The debt service ratio of US corporates is approaching pre-crisis highs even though the prime lending rate has more than halved. An increase in the risk premium for corporate debt and/or a deterioration in future corporate profitability could lead to a substantial reduction in current levels of interest coverage.

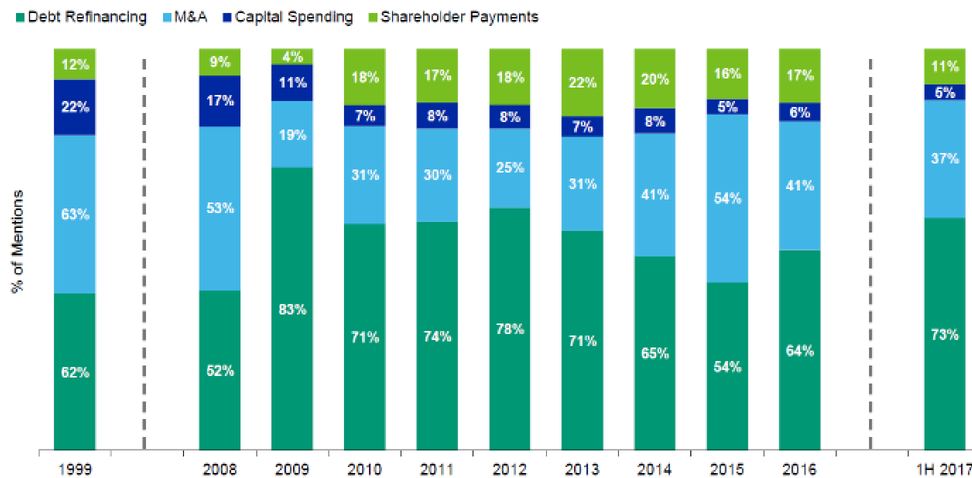
Debt misallocated

And there are good reasons for creditors to demand higher risk premia. A simmering but potentially existential threat to US corporate health lies in the outlook for returns from current uses of capital, namely share buybacks and M&A (Figure 5, overleaf). These expenditures, which have been fundamental to the re-rating of equity markets, are not deducted from income and so have no detrimental impact on the numerator of the aforementioned interest coverage figures. They do however have a significant impact on a company's interest expense and its returns on invested capital. Just as future returns from investing in equities at current valuations can be expected to be low, so should returns from acquisitions and share repurchases made at elevated prices. Valuations of recent acquisitions have been eye-watering and in many instances have significantly increased the balance sheet risk of the acquiring companies. US spice and flavourings manufacturer McCormick recently committed to increasing its leverage from just over 2x to almost 5x net debt to EBITDA in order to fund the $4.2bn purchase of Reckitt Benckiser's Food Division, best known for its French's mustard brand. The deal represents a multiple of over 7x 2016 sales and 20x EBITDA. Assuming the business can generate after-tax margins of

Figure 5

Debt Refinancing and M&A are Most Frequently Stated Uses of Proceeds

Uses of Funds from USD High Yield Bonds and Bank Loans[1]



Source: Moody's Analytics, 31 July 2017

1 % mentions for each respective period in bond issue or bank loan programme tranche documents. Excludes issues of less than $25m and general corporate purposes. An issue can have multiple purposes and, as a result, percentages do not sum

over 30%, in line with McCormick's synergy expectations, and a topline growth rate of 4%, cash payback will take 20 years, before accounting for interest costs.

Whilst we do not believe that McCormick is at risk of imminent default, its balance sheet is weakened and its returns on invested capital reduced. The company's behaviour is reflective of a wider trend that has extended to several other highly profitable franchises. We do not own McCormick in Troy's funds but have reduced shareholdings in British American Tobacco and Becton Dickinson, both of which are significantly increasing leverage to fund acquisitions. The trend has also extended to unprofitable businesses far beyond Troy's investable universe. Electric vehicle manufacturer Tesla is currently burning through cash at a rate of $1bn a quarter. With $4.8bn in net debt at the end of June[5], the business operates like Minsky's Ponzi Financing credit regime, in which a country's cash flows cover neither principal nor interest. Nevertheless, the bond market willingly supplied a further $1.8bn of credit to the loss-making entity in August at a rate of 5.3% for eight years. This is a paltry return for the level of risk assumed. According to the company, this latest addition to the company's debt is intended to 'further strengthen its balance sheet'.

[5] Source Bloomberg, 31 July 2017

A coiled spring

A rise in rates may not immediately threaten the existence of such corporations but it will impact the rate at which debt is refinanced and the cost of capital against which future returns are measured. Moody's notes that investment-grade North American corporates under its coverage have refinancing needs in excess of $800bn over the next four years. With yields near all-time lows, it is likely that these borrowings will be refinanced at higher rates. If the weighted-average cost of debt for the largest 100 companies in the S&P 500 were to return to its 2010 level of 3%, up from 2% currently[6], interest coverage would fall by one third, all else equal.

The compression of corporate bond yields is just one manifestation of investor complacency against a backdrop of abundant liquidity and scarce opportunity. The Federal Reserve has noted the expensiveness of asset prices across the board and indicated a consequent willingness to raise rates in the absence of higher inflation. This move away from so-called data dependency towards a consideration of financial conditions, including credit spreads, could awaken investors to the unsustainability of current yields. The negligible impact of recent rate rises on corporate bond yields serves to further compress the spring for when it eventually uncoils. Given the likely future direction of base rates, and the record-low level of spreads, there would appear to be little scope for upside from developed market corporate bonds.

The same can be said of most asset classes. However, the inherent illiquidity of the corporate debt market will likely magnify its vulnerability in the case of a downturn. Trading is ordinarily fragmented across multiple issues for each borrower. Since the global financial crisis, liquidity has been reduced further by a collapse in primary dealer inventories on account of regulatory capital requirements. Net holdings of corporate debt by primary dealers of the Fed have fallen more than 90% since 2007[7]. Money that has flowed so freely into ETFs may struggle to find the exit with commensurate ease. We expect that this could precipitate a greater crisis than an initial upturn in spreads might suggest. An increase in credit risk premia would likely have a much greater impact on equities, with the most indebted at greatest risk. The ongoing cycle of debt issuance for stock buybacks would be disrupted, removing an essential support behind current equity market levels. For this reason, we remain cautious on both asset classes, willing to consider opportunities as they arise.

Charlotte Yonge
August 2017

[6] Source Bloomberg, 31 July 2017

[7] Source: New York Fed

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