Introduction

During the glory days of the early 2000s, home prices rose dramatically, allowing millions of homeowners to refinance mortgages and collectively borrow more than US$300 billion based on the inflated market valuation of their properties. Flush with cash, consumers spent freely, bolstering what was already a robust economic growth picture. The party came to an end in 2007 with the global financial crisis, and consumers spent the next decade deleveraging to repair their balance sheets. Ten years later, the scenario appears to be repeating itself. However, this time it’s companies doing the borrowing, not consumers.

Emboldened by low interest rates in the post-crisis years, corporations went on a decade-long credit binge. Today, corporate debt is at record levels. We’ve been here before, but what concerns us this time is that operating margins are at historic highs and may either be in the process of peaking or have already peaked. We could be entering a market environment defined by high corporate debt and falling profit margins against a backdrop characterized by geopolitical and economic uncertainty.

In our view, many companies will struggle to weather an economic downturn if global growth slows. Understanding the financial risks that companies have undertaken in the last decade, and how lower growth and higher interest rates might affect them, is one way for investors to identify which firms may emerge stronger from any slowdown. As asset managers, our task is to highlight potential risks related to corporate debt so investors can navigate the investment landscape through an educated lens.

Paul G. Boyne
Lead Portfolio Manager, Global Equity Team
The buildup of debt and margin

A stagnant economy, muted sales growth, slowing trade, and extraordinarily low interest rates: These factors may have enticed companies into thinking that an easy way to boost earnings per share (EPS) growth was to turn to the debt market to buy out competitors, buy back stock, or increase dividends. These activities typically signal ambition and growth and are generally well received by investors.

For a while, stock buyback programs and generous dividend payouts did contribute to driving EPS and stock prices higher, frequently outpacing growth in top-line revenue and underlying earnings growth. Similarly, investor focus on profit margins as a measure of corporate performance gave companies a reason to work hard toward boosting their margins. Unfortunately, these activities are often undertaken at the expense of investing in the future.

As interest rates have risen from extremely low levels and the U.S. Federal Reserve has continued to reverse a decade of quantitative easing, credit conditions appear to be tightening. In a sense, we’re entering uncharted territory, and given the number of exogenous factors that could undermine global growth, an unwind in a fashion not unlike what we experienced a decade ago is possible.

In our view, highly indebted companies with poor capital allocation skills may have a challenging time meeting their obligations, which could in turn lead to a range of unpleasant outcomes. We believe there’s a chance that we could be at the start of a negative vicious circle, a scenario where company debt is downgraded, leading to higher debt servicing costs and lower profit margins, ultimately leading to dividend cuts, scaled back growth, equity raises, and/or insolvency—all of which are negatives for stock prices. We think this is one of the most concerning risks in the current environment.

The margin mound

Profit margins grow when the positive difference between revenue and expense increases. EBIT (earnings before interest and taxes) margins today are at a 20-year high,¹ the result of a number of drivers, including an 8-year bull market, technological efficiencies, lower manufacturing costs, and globalization. Generally, it becomes more difficult for a company to improve profit margins when they’re already high, especially in an environment with heightened economic, political, and trade concerns. We don’t believe that margins can improve much more, particularly when many companies haven’t made the necessary capital investments to stay competitive.

¹ FactSet, as of December 31, 2018.
The debt mound: charge of the debt brigade

Corporate debt issuance exploded in the last decade. Companies saw the debt market as a cheap way of funding their operations in the aftermath of the global financial crisis. Global nonfinancial corporate debt hit a record high of US$75 trillion in June last year, rising by more than a third from 2008.2

The United States has been leading the charge. Total U.S. corporate bond issuance (financial and nonfinancial firms as well as investment grade and high yield) has exceeded US$1.0 trillion annually since 2009, reaching an all-time high of around US$1.7 trillion in 2017.3

In a troubling development, a significant amount of this corporate issuance is in the bottom investment-grade tier, BBB-rated debt. For context, the amount of BBB-rated debt has increased five-fold since 2007. In the second half of 2018, nearly 60% of all nonfinancial corporate debt (excluding emerging markets) was rated BBB, up from 49% in 2011. While few would claim that an implosion is imminent, a debt-downgrade trend seems to be emerging. As of last October, rating downgrades of high-grade bond debt has exceeded the upgrades by more than 2:1, capping a fourth year in a row of net rating downgrades of high-grade issuers.4 It’s certainly a metric that investors should keep an eye on.

One of the most worrying aspect is that net debt to EBITDA, a measure of a company’s leverage, remains at historically elevated levels. Although the ratio has retreated slightly in recent months, companies’ ability to pay down debt continues to be, in our view, tenuous. We see this as a sign that companies are rushing to right-size their balance sheets before the next slowdown—an exercise that we’ve been encouraging companies to undertake.

And investors, on their part, are beginning to demand action.

Debt-financed mergers—When synergies don’t materialize as expected

CASE STUDY: Anheuser-Busch InBev NV

The world’s largest brewer, Anheuser-Busch InBev NV, announced that it will cut dividends by half in October 2018—a decision likely prompted at least in part by its hefty debt load: Net debt was six times relative to EBITDA as of June 30, 2018—twice the level at which investors typically get a little nervous. While the firm could comfortably fund its dividend payout with earnings, it wasn’t able to make much progress on the debt front, much of which stemmed from its purchase of SABMiller in 2016. With net operating cash flow of only US$6.4 billion against capital expenditures of US$4.4 billion and dividends of US$2.7 billion, there probably wasn’t much cash left to pay down debt. Credit rating agency Moody’s came to the same conclusion and downgraded the firm’s rating in December, prompting concerns that others may do the same. The downgrade is seen as the motivating force behind the firm’s decision to embark on a rebalancing program, enabling it to pay off debts that are due over the next seven years with a credit facility that matures at a much later date.

CASE STUDY: Newell Brands

Consumer products giant Newell Rubbermaid cemented its reputation as a serial acquirer when it signed a multi-billion-dollar deal to buy Jarden Corporation in 2015, a significant portion of which was financed by debt. Investors didn’t take well to the news, sending the company’s share prices down by nearly a fifth when it resumed trading as Newell Brands. It’s fair to say that expected synergies have yet to materialize three years after the deal, as the operating margin at the firm has fallen significantly in the last two years. Once again, investors took note, and the company’s share price fell by nearly two-thirds between mid-2017 and the end of last year. With net debt of around US$8 billion, the company’s net debt/EBITDA ratio remains at an elevated level, at just under six times. The company announced a massive restructuring plan in January last year, with the goal of offloading noncore businesses—no doubt with an eye on managing its debt load. The company’s ability to hang on to (or improve) its current BBB rating, which is just a notch above junk, will to a large extent depend on how well it executes its restructuring plan.

5 The citation of specific securities is for illustrative purposes only. This material does not constitute an offer or an invitation by or on behalf of Manulife Asset Management (US) to any person to buy or sell any security. This material should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any investment products or to adopt any investment strategy. Past performance does not guarantee future results. 6 “Anheuser-Busch cuts dividend in half, shares crater to 6-year low,” CNBC, October 25, 2018. 7 FactSet, September 30, 2018. 8 “Moody’s Downgrades Anheuser-Busch InBev to Baa1: affirms Prime-2; Outlook stable,” Moody’s, December 10, 2018. 9 “Investors support AB InBev’s debt rebalancing,” Financial Times, January 27, 2019. 10 Bloomberg, January 31, 2019. 11 FactSet, as of September 30, 2018. 12 “Newell Rubbermaid, Jarden to Merge in $17B Deal,” The Street, December 14, 2015.
Market implications

The decade-long corporate debt binge was always going to come with a sting in the tail: Trillions of dollars in debt will come due in the next few years, and as rates rise, so will interest expense costs. This is significant, because if we assume that companies will choose to roll over their debt at higher yields, it would mean diverting cash away from more productive investments, ultimately hurting growth and squeezing margins, which is likely to have a negative impact on share prices.

The growth of BBB-rated debt, particularly in the United States, means that the asset class accounts for more than half of the U.S. investment-grade index. This brings about a different set of risks—it isn’t uncommon for BBB-rated borrowers to be downgraded to junk status as their finances deteriorate due to weakening economic conditions. At a company level, a rating downgrade would mean higher borrowing costs, making already difficult conditions even more challenging. It could also trigger forced selling in strategies that aren’t permitted to invest in this market segment. But a more serious problem could be on the horizon: If a significant number of downgrades were to occur, it could overwhelm the high-yield market, resulting in market disruptions, with the weakest borrowers potentially losing access to capital. The impact will also likely be felt in the equity markets, where risk will once again be repriced.


Conclusion

Not all companies use debt in a way that destroys capital, but it’s an issue that warrants close monitoring—particularly in view of the current levels of corporate debt and the likelihood that profit margins have already peaked. As margins begin to trend down, it will ultimately have a negative impact on stock prices.

From a valuation perspective, global equities might seem reasonable at this juncture, given that the price-to-earnings ratio of the MSCI World Index is currently trading near long-term averages; however, things look decidedly different when measured using the debt-adjusted metric EV/EBITDA.

Given where we are in the business cycle, we as investors are wary of highly indebted companies—particularly those whose management has demonstrated poor capital allocation skills. Instead, it makes sense to adopt a defensive approach toward investing, focusing on high-quality, cash generative, and sustainable franchises with manageable debt.

We firmly believe that companies with solid balance sheets will be better able to weather any debt-related market upheaval, particularly in an environment where rates are likely to continue to rise even as margins start to fall.
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Manulife Asset Management

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