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DROWNING IN DEBT

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Corporate debt is at record levels, fuelled by years of low borrowing costs and liquid markets. But there are fears that the market may be heading for a fall. Brian Caplen, editor of The Banker, considers the outlook for companies and investors.

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Brian Caplen has been editor of *The Banker* since 2003. He frequently chairs discussions on financial topics as well as commenting on banking topics for the BBC and CNN.

When the Global Financial Crisis erupted in 2008, the blame was squarely laid on debt. People had been lured into the sub-prime mortgage sector, bankers had created increasingly exotic products to camouflage the size and nature of the market, and eventually the elaborate edifice of debt collapsed beneath its own weight.

Since that time, the nature of global borrowing has changed but debt levels have soared. According to the Institute of International Finance, global debt now stands at more than $260 trillion, a 50% increase since Lehman Brothers collapsed. Non-financial companies in particular have been on a borrowing spree, more than doubling their debts to around $75 trillion over the past 11 years.

Buoyed by ultra-low interest rates and receptive investors, these firms have come back to the market again and again, prompting widespread concern among industry pundits, particularly against a backdrop of continued geopolitical uncertainty, US-China trade tensions and slow economic growth.

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For the moment, the sector appears to be coping. Debt volumes are high but repayments seem affordable, largely because interest rates are still at rock-bottom. Looking ahead, however, problems are almost certain to arise. Some firms may find that they have borrowed too much to finance equity buybacks. Some may pursue unsuitable acquisitions and some may suffer from disruptive forces that hit their growth and profitability.

High-profile cases, such as the collapses of Thomas Cook in the UK and Deluxe Entertainment in the US, illustrate the burden that debt can impose on companies. Both were heavily indebted and creditors were hit hard. Over the coming months, smaller companies issuing low-grade debt or 'junk' bonds are likely to be especially vulnerable, and there are already reports of investors pulling back from the riskier parts of the US corporate bond market.

This underlines the greed-fear conundrum faced by investors worldwide. The junk bond market is attractive precisely because it offers returns in a moribund low interest rate environment but there are risks attached – and these risks are not always appreciated. According to US-based ICE Data Services, for example, many firms suffered from falling prices last year, hit by individual circumstances and a growing tendency among investors to desert these businesses at the first hint of trouble.

Analytics provider Dealogic echoes this trend. The consultancy explains that issuance remains strong but companies are having to pay up to pique investor interest. Last September, for instance, $304 billion worth of corporate bonds were issued globally, the second highest monthly value in the past five years. But borrowing rates are increasing, with firms having to pay significantly more than they did in the more benign days of 2018.

The BBB rated sector – the lowest investment grade rating in the bond market – has been under particular pressure. This is worrying, as it represents more than 50% by volume of all investment-grade corporate bonds in the US, up from one-third 10 years ago. In Europe, the figure has gone from 50% to 70% over the same period measured by number of issuers. Ratings agency Fitch estimates that between $105 billion and $215 billion of US and European BBB corporate bonds could migrate to BB, and therefore become high-yield securities, in a downturn. Even though this is only a small percentage of the market – worth more than $3 trillion in total – it could still cause unease. When BBB bonds are downgraded, they slip into junk territory where they are viewed as 'fallen angels'. At that point, many institutions can no longer invest in them, often triggering a wave of selling.

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Some sovereigns, sectors and companies are more resilient than others. At the country level, research by Citi shows that despite the increases in corporate debt volumes, the debt service ratio is at a 20-year average for Australia, Belgium, Finland, Germany, the Netherlands, Norway, Sweden and the US. In Denmark, Italy, Japan, South Korea and the UK, however, the figure is below the 20-year average. Corporate deleveraging in Spain and Portugal has brought their ratios to the lowest in two decades while, at the opposite end of the spectrum, Canada and France are at peak levels of

indebtedness. Tracking similar ratios in emerging markets shows China and Turkey to be above average but other countries – including Brazil, the Czech Republic, India, Indonesia, Malaysia, Mexico, Poland, Russia and South Africa – are sitting close to average.

Among US junk bonds, most of the worries used to be around energy companies; now concerns are broader, covering the retail and telecoms sectors too. In US investment grade, concern centres on the healthcare and industrial sectors.

As for sectors, certain areas are under particular scrutiny. In US investment grade, numerous healthcare and industrial bonds have been put on negative watch, suggesting they are vulnerable to downgrades. In an environment of trade disruption, debt-laden exporters are being carefully watched too, not least the auto sector, where many manufacturers have experienced falling sales and profits.

Among US junk bonds, meanwhile, most of the worries used to be around energy companies struggling with falling crude prices; now rating agencies' concerns are broader, covering the retail and telecoms sectors too.

Looking ahead, deleveraging is likely to be a big theme in the market, that is, which companies are best able to reduce debt levels over the coming months. Some may try to raise revenues while keeping debt levels constant. Some may choose to sell off assets or reduce dividends to pay down debt. Some may try to increase their credit ratings to cut borrowing costs and some may look to broaden their investment base and move into other types of security. Of course, many individual corporate bonds will flourish in 2020. But there will be accidents. Some companies are groaning under the weight of debt used to make acquisitions and are dependent on the rewards coming through to pay it back. Such transactions can be fraught with difficulty and calculations often prove overly optimistic. Across the market, researchers also suggest that borrowing costs will rise and volatility will increase. It is a long time since the market looked this vulnerable.

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STOCK EXAMPLES

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