CFRA
powered by data from S&P Global

Sector Intellect
Trend Analysis – Debt Analysis

January 17, 2019

The Debt Burden Exposed

Lindsey Bell
Investment Strategist
lindsey.bell@cfraresearch.com

Rising Debt Level Goes Hand-in-Hand with Recessions

When credit goes bad, recessions and sharp market downturns typically follow. Debt has a long history of rising ahead of, and sometimes causing, an economic crisis. The increase could come from households or corporations. Ahead of the financial crisis a decade ago, household debt as a percent of gross domestic product (GDP) rose to levels far above the historical trend. When credit dried up, recession set in. Given the track record of credit ahead of crises, we decided to examine the current status of household and corporate debt to determine if there are signals for a potential downturn. Current Federal Reserve Chairman Jerome Powell, former Fed Chair Janet Yellen and former Chairwoman of the FDIC Sheila Bair, have all highlighted a concern for corporate debt levels recently.

At CFRA, we started with a look at the driver of the last downturn, households. The consumer has been vigilant about deleveraging over the past decade. Household debt as a percent of GDP is now well below levels recorded ahead of the Great Recession. Growth in debt at the household level has been in line with income and GDP growth, despite all the headlines about auto loans and student debt loans reaching new highs. The reality is that most borrowing has been done by borrowers with high credit scores. Though student loan and auto loan delinquencies rates in the subprime category are elevated, they are moderating and, while worth monitoring, are not likely to drive the country into a recession.

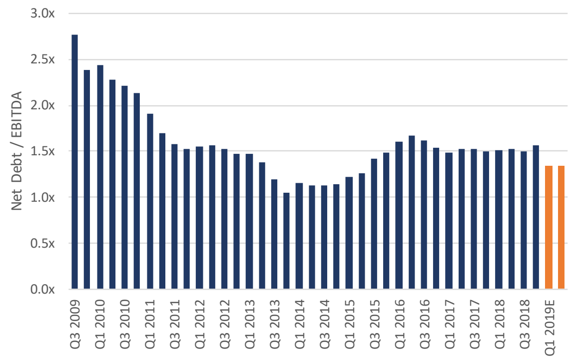
Just like the Fed heads and former FDIC chair warned, we found some red flags with regards to corporate debt levels. However, the concerns aren't as intuitive as you would think. It's been well reported that corporate debt is on the rise. There was $9.6 trillion in outstanding corporate debt at the end of the third quarter of 2018, 75% higher than the $5.5 trillion outstanding ten years ago. Corporate debt as a percent of GDP (a measure we aren't big proponents of, but that is a conversation for another time) is at an all-time high, approaching 46% (the last peak was 45% in Q1 2009). The quality of this debt is of key concern as it is anticipated that the credit ratings system may be deteriorating. Much of the investment-grade debt in the market is rated in the lowest rungs of the investment-grade credit scale. The percentage of BBB (lowest tier of investment grade or one notch above junk) corporate bonds by value now represents well over 40% of all corporate debt, much higher than ever before. Some investors have expressed concern that there might be subtle "grade inflation" by the credit rating agencies and that some of these lowest-tier investment grade bonds actually do not deserve to be investment grade. Indeed, ratings agency Moody's described the amount of investment-grade debt outstanding as "riskier now that it was prior to each recession since 1981 and possibly all downturns through late 1940."

Despite the quality concern, amid rising debt levels, defaults have remained at lows. Improvements in profitability, lower tax rates and a strong economic environment have likely been drivers of this trend. A swift change in that environment could put corporations at the center of a new crisis. That said, not all corporations are the same.

Upon a closer look, we found large-cap companies, classified as members of the S&P 500 index, are best positioned to weather a credit-induced storm. Their ability to pay off the debt on the books is much better than it was heading into the financial crisis. From a leverage perspective, the amount of net debt outstanding versus EBITDA, or earnings before interest, taxes, depreciation and amortization, is 1.6x or almost half the rate it was in 2009.

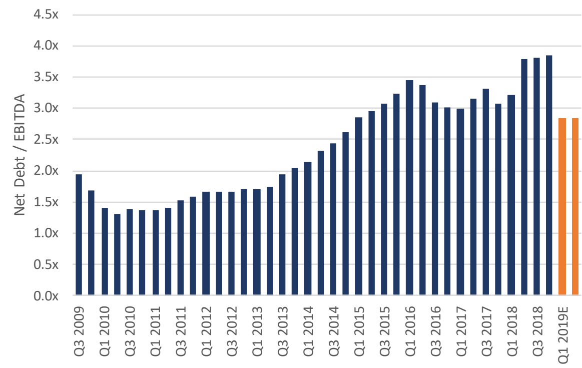
Additionally, due to the tax reform policies of 2018, S&P 500 companies have 63% more cash on hand now than they did at the end of 2016.

Chart 1: S&P 500 Index Net Debt / EBITDA



Source: CFRA.

Chart 2: S&P 600 Small Cap Index Net Debt / EBITDA

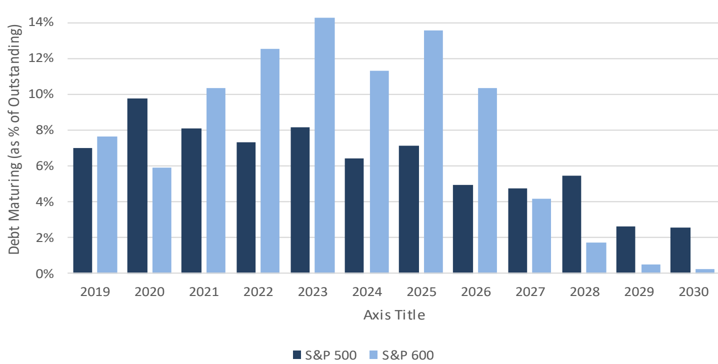


Source: CFRA.

For small-cap companies, those in the S&P 600 Small Cap index, the opposite is true. Because smaller business loaded up on debt in the low interest rate environment of the past decade, their ability to pay down debt quickly has eroded. The net debt to EBITDA ratio has more than doubled since 2009, and while they have about 8% more cash than in 2016, the increase won't be as influential on easing credit concerns for these smaller companies. Net debt / EBITDA at the end of 2018 stood at 3.9x, 1.5x higher than that of the large cap index.

Taking a look at the debt maturity schedule for each index, the S&P 500 has more of its debt expiring in the next two years than the S&P 600, but over the next five years, the small-cap index will see half of its debt expire versus 40% of the debt held by large caps. Given small-cap companies have increased cash balances at a slower rate than large-cap companies over the past two years, they will have few options outside of accessing the debt markets to roll over existing debt when it comes due. If interest rates increase over the next few years, these companies will be rolling over debt at a much higher rate and that will cut into bottom-line profitability.

Chart 3: Debt Maturity Schedule for the S&P 500 and S&P 600 Indices



Source: CFRA.

While investors spent much of 2018 flocking to small, domestically-based companies that were expected to be more immune from trade tensions and other international risks, operating risks have increased for these companies and their stocks. That said, the risk of small-cap debt leading to the next crisis may not be extremely high. The good news is that the total amount of debt held by S&P 600 companies amounts to only 3.5% of that held by the S&P 500, so alone it isn't likely to tip the economy overboard. Regardless, small caps should work on deleveraging while the economy is still strong, because there is one reality about history, it repeats itself. We will keep an eye on the debt situation as an indicator of good or bad things to come.

Disclosures

S&P GLOBAL™ is used under license. The owner of this trademark is S&P Global Inc. or its affiliate, which are not affiliated with CFRA Research or the author of this content.

Stocks are ranked in accordance with the following ranking methodologies:

STARS Stock Reports

Qualitative STARS recommendations are determined and assigned by equity analysts. For reports containing STARS recommendations refer to the Glossary section of the report for detailed methodology and the definition of STARS rankings.

Quantitative Stock Reports

Quantitative recommendations are determined by ranking a universe of common stocks based on 5 measures or model categories: Valuation, Quality, Growth, Street Sentiment, and Price Momentum. In the U.S., a sixth sub-category for Financial Health will also be displayed. Percentile scores are used to compare each company to all other companies in the same universe for each model category. The five (six) model category scores are then weighted and rolled up into a single percentile ranking for that company. For reports containing quantitative recommendations refer to the Glossary section of the report for detailed methodology and the definition of Quantitative rankings.

STARS Stock Reports and Quantitative Stock Reports

The methodologies used in STARS Stock Reports and Quantitative Stock Reports (collectively, the "Research Reports") reflect different criteria, assumptions and analytical methods and may have differing recommendations. The methodologies and data used to generate the different types of Research Reports are believed by the author and distributor reasonable and appropriate. Generally, CFRA does not generate reports with different ranking methodologies for the same issuer. However, in the event that different methodologies or data are used on the analysis of an issuer, the methodologies may lead to different views or recommendations on the issuer, which may at times result in contradicting assessments of an issuer. CFRA reserves the right to alter, replace or vary models, methodologies or assumptions from time to time and without notice to clients.

Analyst Certification

STARS Stock Reports are prepared by the equity research analysts of CFRA and its affiliates and subsidiaries. All of the views expressed in STARS Stock Reports accurately reflect the research analyst's personal views regarding any and all of the subject securities or issuers. Analysts generally update stock reports at least four times each year. No part of analyst, CFRA, or its affiliates or subsidiaries compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in a STARS Stock Report.

About CFRA Equity Research's Distributors

This Research Report is published and originally distributed by Accounting Research & Analytics, LLC d/b/a CFRA ("CFRA US"), with the following exceptions: In the UK/EU/EEA, it is published and originally distributed by CFRA UK Limited ("CFRA UK"), which is regulated by the Financial Conduct Authority (No. 775151), and in Malaysia by CFRA MY Sdn Bhd (formerly known as Standard & Poor's Malaysia Sdn Bhd) Company No. 683377-A and regulated by Securities Commission Malaysia, No. CMSL/A0181/2007 ("CFRA Malaysia"). CFRA Malaysia is a wholly-owned subsidiary of CFRA US. These parties and their subsidiaries maintain no responsibility for reports redistributed by third parties such as brokers or financial advisors.

General Disclosure

Notice to all jurisdictions:

Where Research Reports are made available in a language other than English and in the case of inconsistencies between the English and translated versions of a Research Report, **the English version will control and supersede any ambiguities associated with any part or section of a Research Report that has been issued in a foreign language.** Neither CFRA nor its affiliates guarantee the accuracy of the translation. The content of this report and the opinions expressed herein are those of CFRA based upon publicly-available information that CFRA believes to be reliable and the opinions are subject to change without notice. This analysis has not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body. While CFRA exercised due care in compiling this analysis, CFRA AND ALL RELATED ENTITIES SPECIFICALLY DISCLAIM ALL WARRANTIES, EXPRESS OR IMPLIED, to the full extent permitted by law, regarding the accuracy, completeness, or usefulness of this information and assumes no liability with respect to the consequences of relying on this information for investment or other purposes. No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of CFRA. The Content shall not be used for any unlawful or unauthorized purposes. CFRA and any third-party providers, as well as their directors, officers, shareholders, employees or agents do not guarantee the accuracy, completeness, timeliness or availability of the Content.

Past performance is not necessarily indicative of future results.

This document may contain forward-looking statements or forecasts; such forecasts are not a reliable indicator of future performance.

This report is not intended to, and does not, constitute an offer or solicitation to buy and sell securities or engage in any investment activity. This report is for informational purposes only. Recommendations in this report are not made with respect to any particular investor or type of investor. Securities, financial instruments or strategies mentioned herein may not be suitable for all investors and this material is not intended for any specific investor and does not take into account an investor's particular investment objectives, financial situations or needs. Before acting on any recommendation in this material, you should consider whether it is suitable for your particular circumstances and, if necessary, seek professional advice.

CFRA may license certain intellectual property or provide services to, or otherwise have a business relationship with, certain issuers of securities that are the subject of CFRA research reports, including exchange-traded investments whose investment objective is to substantially replicate the returns of a proprietary index of CFRA. In cases where CFRA is paid fees that are tied to the amount of assets invested in a fund or the volume of trading activity in a fund, investment in the fund may result in CFRA receiving compensation in addition to the subscription fees or other compensation for services rendered by CFRA, however, no part of CFRA's compensation for services is tied to any recommendation or rating. Additional information on a subject company may be available upon request.

CFRA's financial data provider is S&P Global Market Intelligence. THIS DOCUMENT CONTAINS COPYRIGHTED AND TRADE SECRET MATERIAL DISTRIBUTED UNDER LICENSE FROM S&P GLOBAL MARKET INTELLIGENCE. FOR RECIPIENT'S INTERNAL USE ONLY.

The Global Industry Classification Standard (GICS®) was developed by and/or is the exclusive property of MSCI, Inc. and S&P Global Market Intelligence. GICS is a service mark of MSCI and S&P Global Market Intelligence and has been licensed for use by CFRA.

Other Disclaimers and Notice

Certain information in this report is provided by S&P Global, Inc. and/or its affiliates and subsidiaries (collectively "S&P Global"). Such information is subject to the following disclaimers and notices: "Copyright © ~~2018~~2019, S&P Global Market Intelligence (and its affiliates as applicable). All rights reserved. Nothing contained herein is investment advice and a reference to a particular investment or security, a credit rating or any observation concerning a security or investment provided by S&P Global is not a recommendation to buy, sell or hold such investment or security or make any other investment decisions. This may contain information obtained from third parties, including ratings from credit ratings agencies. Reproduction and distribution of S&P Global's information and third party content in any form is prohibited except with the prior written permission of S&P Global or the related third party, as applicable. Neither S&P Global nor its third party providers guarantee the accuracy, completeness, timeliness or availability of any information, including ratings, and are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, or for the results obtained from the use of such information or content. S&P GLOBAL AND ITS THIRD PARTY CONTENT PROVIDERS GIVE NO EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE AND ALL S&P INFORMATION IS PROVIDED ON AN AS-IS BASIS. S&P GLOBAL AND ITS THIRD PARTY CONTENT PROVIDERS SHALL NOT BE LIABLE FOR ANY DIRECT, INDIRECT, INCIDENTAL, EXEMPLARY, COMPENSATORY, PUNITIVE, SPECIAL OR CONSEQUENTIAL DAMAGES, COSTS, EXPENSES, LEGAL FEES, OR LOSSES (INCLUDING LOST INCOME OR PROFITS AND OPPORTUNITY COSTS OR LOSSES CAUSED BY NEGLIGENCE) IN CONNECTION WITH ANY USE OF THEIR INFORMATION OR CONTENT, INCLUDING RATINGS. Credit ratings are statements of opinions and are not statements of fact or recommendations to purchase, hold or sell securities. They do not address the suitability of securities or the suitability of securities for investment purposes, and should not be relied on as investment advice."

Certain information in this report may be provided by Securities Evaluations, Inc. ("SE"), a wholly owned subsidiary of Intercontinental Exchange. SE is a registered investment adviser with the United States Securities and Exchange Commission (SEC). SE's advisory services include evaluated pricing and model valuation of fixed income securities, derivative valuations and Odd-Lot Pricing that consists of bid- and ask-side evaluated prices for U.S. Municipal and U.S. Corporate Securities (together called valuation services).

Such information is subject to the following disclaimers and notices: “No content (including credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of SE. The Content shall not be used for any unlawful or unauthorized purposes. SE and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively SE Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. SE Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an “as is” basis. SE PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT’S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall SE Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages. Credit-related and other analyses and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions. SE assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. SE’s opinions and analyses do not address the suitability of any security. SE does not act as a fiduciary or an investment advisor. While SE has obtained information from sources it believes to be reliable, SE does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Valuations services are opinions and not statements of fact or recommendations to purchase, hold or sell any security or instrument, or to make any investment decisions. The information provided as part of valuations services should not be intended as an offer, promotion or solicitation for the purchase or sale of any security or other financial instrument nor should it be considered investment advice. Valuations services do not address the suitability of any security or instrument, and securities, financial instruments or strategies mentioned by SE may not be suitable for all investors. SE does not provide legal, accounting or tax advice, and clients and potential clients of valuation services should consult with an attorney and/or a tax or accounting professional regarding any specific legal, tax or accounting provision(s) applicable to their particular situations and in the countries and jurisdictions where they do business. SE has redistribution relationships that reflect evaluated pricing, derivative valuation and/or equity pricing services of other unaffiliated firms with which SE has contracted to distribute to its client base. Pricing and data provided by these third-party firms are the responsibilities of those firms, and not SE, and are produced under those firms' methodologies, policies and procedures. Valuations services provided by SE and products containing valuations services may not be available in all countries or jurisdictions.

Any portions of the fund information contained in this report supplied by Lipper, A Thomson Reuters Company, are subject to the following: “ Lipper shall not be liable for any errors or delays in the content, or for any actions taken in reliance thereon.”

For residents of the European Union/European Economic Area

Research reports are originally distributed by CFRA UK Limited (company number 08456139 registered in England & Wales with its registered office address at PO Box 698, Titchfield House, 69-85 Tabernacle Street, London, EC2A 4RR, United Kingdom). CFRA UK Limited is regulated by the UK Financial Conduct Authority (No. 775151).

For residents of Malaysia

Research reports are originally produced and distributed by CFRA MY Sdn Bhd (formerly known as Standard & Poor’s Malaysia Sdn Bhd) Company No. 683377-A and regulated by Securities Commission Malaysia, No. CMSL/A0181/2007 (“CFRA Malaysia”). CFRA Malaysia is a wholly-owned subsidiary of CFRA US.

For residents of all other countries

Research reports are originally distributed Accounting Research & Analytics, LLC d/b/a CFRA.