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Interest rate rise: turning point looms for US debt binge

Eric Platt in New York

With a $4tn mountain of debt maturing over the next five years, corporate America's reliance on cheap cash is about to get tested.

With the prospect of steadily higher interest rates in the coming years as the Federal Reserve gradually tightens policy, US companies that tapped global markets for inexpensive finance over the past four years will soon face a different environment.

US corporate treasurers have rushed to lock in cheap borrowing costs in advance of the expected rate rise, refinancing more than $1tn each year between 2012 and 2014, according to Standard & Poor's.

Tighter borrowing conditions will mark a turning point in the recent debt binge. Companies have had easy access to cash to write cheques for multibillion-dollar takeovers, to fund buybacks and dividend strategies — all welcomed by investors as share prices rallied off 2009 lows.

But as rates turn higher, investors may see the flip side of cheap financing. Analysts warn companies will begin defaulting in greater numbers, particularly in the energy sector, which has found itself in the line of fire as commodity prices languish.

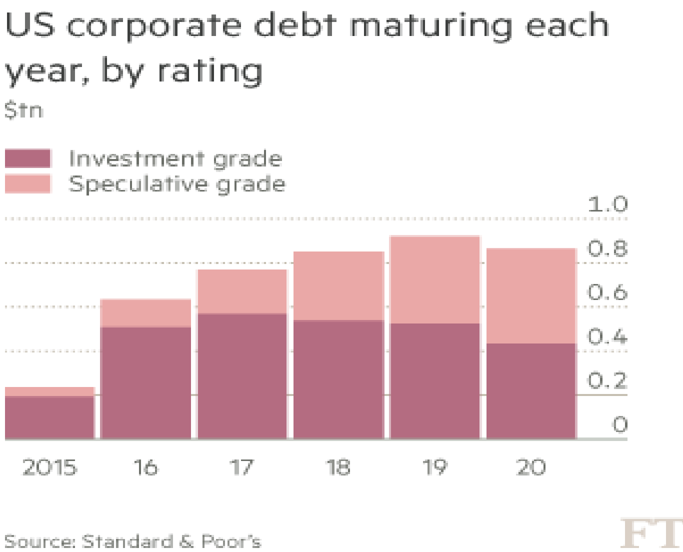
In the first half of 2015, the pace of capital raisings accelerated, with bond issuance from blue-chip companies — those rated "investment grade" by one of the leading credit agencies, such as Apple, Comcast, Exxon and Boeing — jumping nearly 50 per cent from a year earlier. Bond issuance by non-investment grade companies, often called "junk", is up 21 per cent in the first six months of the year from the same point in 2014.

But this hearty bond borrowing binge could be challenged this year. Traders are betting that the Fed will lift interest rates in December, while many economists and analysts are leaning towards a hike as early as this month. "It has become clear we are close to the point when the Fed starts to raise rates," says Hans Mikkelsen, a strategist with Bank of America Merrill Lynch.

That prospect worries some analysts. The increase in corporate debt — often spurred by cheap financing to fund acquisitions or shareholder-friendly measures such as stock buybacks and dividend increases — has led to a deterioration in the health of US companies. The debt burden of US high grade companies has now climbed to 2.62 times trailing 12 month earnings — the highest level since 2002, according to BofA.

Even when excluding sectors rattled by the fall in commodity prices, and adjusting for climbing cash levels, leverage has touched the highest point since 2008 when the financial crisis roiled markets.

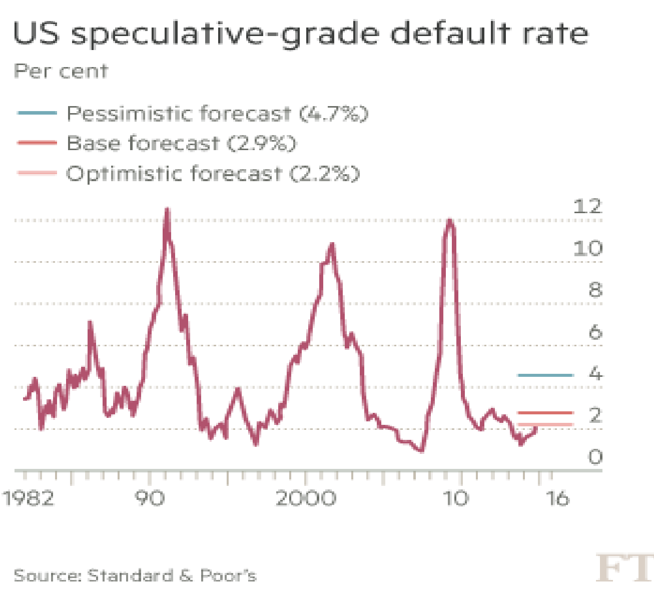
Moody's and S&P warn that defaults are likely to increase in the coming years as interest rates rise, a concern echoed by bond funds such as Pimco. Analysts with S&P expect defaults among junk-rated US companies to hit 2.9 per cent by June 2016, nearly twice the rate in 2013. Moody's list of companies rated B3 with a negative outlook or lower — its lowest rating rungs in the "speculative" space — eclipsed 200 for the first time since 2010 in July . "Credit quality has been deteriorating by and large over the last three years," says Bill Wolfe, an analyst at Moody's. "Speculative grade companies, they've taken advantage of very buoyant market conditions over the last few years. The number of weakly rated companies we rate is much greater than it used to be."



Given the oil price crash the list is naturally dominated by the energy companies — including Goodrich Petroleum, Midstates Petroleum Company, and SandRidge Energy. But they are joined by well-known US companies such as Weight Watchers, Toys R Us, Sears, and Advanced Micro Devices, a chipmaker.

Investor focus has centred on energy and materials groups that have struggled with a drop in commodity prices and higher borrowing costs. "Sectors like drillers, metals [and] mining can continue to remain under pressure given weaker growth in emerging markets, particularly China," says Mohit Mittal, a fund manager at Pimco.

While most strategists and investors still take a relatively sanguine view on the overall corporate debt market — expecting the rise in defaults to remain well below the rate seen during the financial crisis — the ability for companies to issue new debt has been flagged as a concern.



"There's reason to believe that primary markets on the debt side become less robust once the Fed starts hiking rates, both in terms of the size of deals that can reasonably be priced in markets and also the kind of interest rates companies will have to pay on that debt," Mr Mikkelsen says.

But not all companies will be affected equally, with indebted energy companies likely to be the biggest victims. Eric Gross, a strategist with Barclays, points out that the concern for lowly rated energy companies is not if they pay 7 per cent or 9 per cent interest rates, but whether "they can get financing at all".

For the vast majority of solid investment grade companies, the ability to tap debt markets as rates rise has not come into question. Investors have instead wondered what the impact will be on buyback and dividend policies, as well as what obstacles mergers and acquisitions activity will face — important bulwarks for frothy US stock market valuations in recent years.

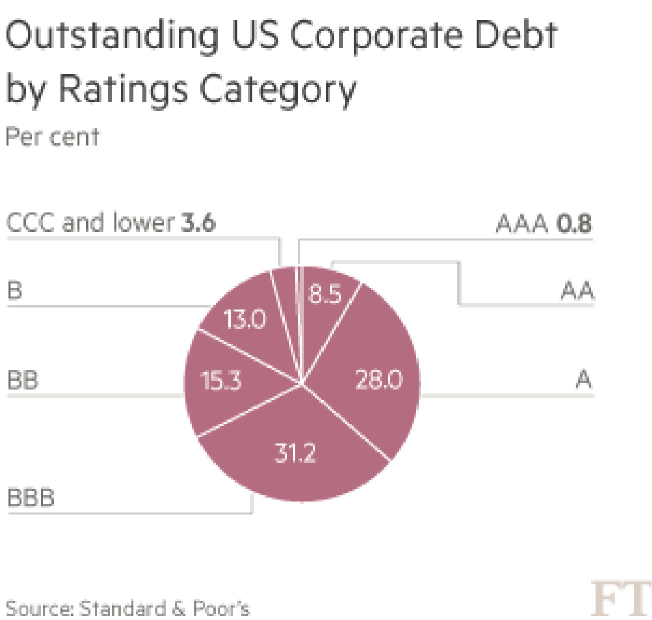
Marc Zenner, a senior JPMorgan banker, says that higher rates should not be an issue for most companies, particularly if the US economy is improving and sales are healthy. "If rates rise because the economy is doing well and firms are bullish, you could see more buybacks because they'll be generating more cash flow," he predicts.

Analysts say the pharmaceuticals and healthcare industry, which has been engaged in a wave of debt-fuelled dealmaking, could be one of the hardest hit sectors when rates rise.

Fitch downgraded its outlook on the sector from stable to negative at the start of the year, though it did little to dampen investor appetite for chunky debt offerings.

In March, Valeant raised $10bn to fund its purchase of Salix in one of the largest junk bond offerings on record, demonstrating significant investor demand.

But Fitch warns that the relative ease with which companies can tap the debt markets has pushed up M&A valuations, and that the sector could be "exposed to rising rates, a more volatile business risk profile and elevated leverage, which could undermine credit quality".



Monica Erickson, a portfolio manager with DoubleLine, a bond fund management group, argues that increasing interest rates could spark more responsible behaviour from corporate treasurers that have grown comfortable with cheap and abundant funding.

"It may be better off if rates are rising and companies behave a little better," Ms Erickson said. "Maybe share buybacks and dividends will decrease, maybe M&A will decrease and perhaps we'll see less debt issuance."

Additional reporting by David Crow.

The way some people see it, higher interest rates will spell doom for the online marketplace lenders. The likes of Lending Club, Prosper and SoFi have grown rapidly in recent years, matching yield-hungry investors with borrowers unable, or unwilling, to obtain funds from traditional sources, writes *Ben McLannahan*.

But once rates start to tick up, the argument goes, the marketplace lenders' advantage will erode. Until now, they've had a clear run: offering net yields in the high single-digits, they've been an obvious choice for investors seeking income. But if rising rates make traditional assets more appealing, then institutional investors will start to shop around — especially if defaults begin to rise on the marketplace lenders' relatively unseasoned portfolios. And if funding dries up, then the business dries up. At Lending Club, for example, 89 per cent of second-quarter income came from fees for originating and selling new loans.

Rubbish, says Renaud Laplanche, chief executive of Lending Club, which owes most of its growth to consumers refinancing variable credit-card debt pegged to banks' prime rates. If that prime rate rises, he says, then Lending Club's rates will rise too. And it is silly to associate rising rates with higher defaults, he says. If anything, delinquencies should drop in a period of economic expansion.

At SoFi, chief executive Mike Cagney accepts that if long-term bond yields rise to about 5 per cent, say, his core product — refinancing government-backed loans at 6 or 7 per cent — could be less appealing to investors. But such rates are a long way off. Until then, he says, there is plenty of scope to push into other products such as mortgages and personal loans. And more opportunities to develop partnerships like the one with Citizens, the Rhode Island-based bank, which has agreed to buy up to $700m of SoFi's student loans.

"They need assets like any other bank does," he says. "They recognise we're originating cheaper and faster than they can do on their own."