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One Potential Winner from Tax Overhaul: Corporate Bonds

Proposed changes to tax code could alter corporate finance, spur bond rally

Apple had $270 billion of cash and marketable securities as of Sept. 30, more than 90% of which was held by foreign subsidiaries. PHOTO:PAUL FAITH/AGENCE FRANCE-PRESSE/GETTY IMAGES

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11 COMMENTS **(worth reading)**

The proposed tax overhaul winding its way through Congress could have significant consequences for the corporate-debt market, changing the way many companies raise capital and boosting the prices of existing bonds.

The Senate bill and the version passed by the House of Representatives in November unlock billions of dollars held overseas for companies such as Apple Inc. and Pfizer Inc., PFE -0.21% allowing them to repatriate future foreign earnings more cheaply. That could reduce their need to borrow.

The proposed tax changes would also make debt more expensive for companies by lowering the corporate tax rate and placing a cap on the corporate interest deduction. Those changes could stress some of the most highly indebted companies, which typically write off interest payments to ease their debt burdens.

The combined effects could ripple through the $7.87 trillion market for nonfinancial corporate bonds, affecting both issuers and investors. One possible fallout, if the supply of new debt diminishes, could be higher prices on existing bonds, which are already in the midst of a rally that has driven yields near historic lows.

A tax overhaul "could have the largest impact on corporate finance in decades," said David Brown, head of global investment-grade credit at investment management firm Neuberger Berman. "It could structurally change the way companies look to finance themselves."

The U.S. corporate bond market is a critical piece of the global financial system. Companies routinely borrow billions in the U.S. for a variety of reasons, including building new factories, financing acquisitions and funding share buybacks. The market is more than triple the size of the euro corporate-debt market, the world's second largest.

Nonfinancial, investment-grade companies in the U.S. have borrowed more than $800 billion this year, already breaking the full-year record set in 2015, according to data provider Dealogic.

Debt is attractive to companies because it is cheaper than selling shares. Its low cost is enhanced by interest deductibility, which began in the early 1900s. Borrowing by investment-grade companies has surged in recent years, largely because of ultralow interest rates and tax incentives. Current law allows U.S. companies to defer paying up to 35% in U.S. taxes on their foreign earnings as long as they keep them in overseas subsidiaries.

That has created an incentive for companies with easy access to the credit markets to leave cash overseas and borrow in the U.S. to fund share buybacks and dividends. Apple, for instance, has issued roughly $90 billion of U.S. dollar bonds since 2013 as part of a $300 billion program to return money to shareholders. The tech giant had about $270 billion of cash and marketable securities as of Sept. 30, more than 90% of which is held by foreign subsidiaries.

Cash held in foreign countries by U.S. nonfinancial corporations is expected to reach $1.4 trillion by the end of this year, according to Moody's Investors Service, more than double the amount at the start of this decade.

Under the competing versions of the legislation that Congress needs to reconcile, multinationals would pay an one-time tax on their accumulated foreign earnings. But there would be no extra tax on transferring that money across borders, giving them an immediate alternative to the bond market the next time they want to invest or buy back shares.

Lower-taxed access to overseas cash could lead to a reduction in investment-grade issuance between roughly $80 billion and $160 billion, one year after the tax law is passed, according to Daniel Sorid, a credit analyst for Citi Research.

Other aspects of the House and Senate tax bills could also crimp borrowing. Both bills in their current form would reduce the corporate tax rate to 20% from 35%, though President Donald Trump has indicated he is open to a 22% rate. That in turn would reduce the value of the corporate interest deduction.

For example, Oracle Corp. sold $10 billion of bonds last month to help fund buybacks, dividends and other investments. The business software maker's offering included $2.75 billion of 10-year bonds that carried a 3.25% interest rate. Under existing tax law, the company could write off the $89.4 million of interest payments from its taxes at a 35% rate, which could result in tax deductions of $31.3 million a year. At a lower 20% tax rate, the savings could drop to $17.9 million.

In addition, both the House and Senate bills would place a cap on the interest deduction. The Senate bill limits interest deductions to 30% of earnings before interest and taxes, a more restrictive definition than the House bill. Both bills use the money to pay for lowering the corporate tax rate.

“All else being equal, if companies were able to deduct all of their interest expenses before and they will be limited in some form, that should make debt a less attractive option to them and they should be less inclined to issue bonds,” said Oleg Melentyev, credit strategist at Bank of America Merrill Lynch.

Even with its tax benefit reduced, issuing debt will still be a cheaper way for companies to raise cash than selling shares because equity investors demand compensation for the greater risk of owning stocks over bonds.

The interest-deduction cap, moreover, would spare all but the most highly leveraged companies in what Dealogic says is the $1.6 trillion market for high yield bonds. Almost 40% of the debt outstanding in the market exceeds the House’s cap, which limits deductions to 30% of earnings before interest, taxes, depreciation, and amortization, according to. Mr. Melentyev.

“It’s a manageable event for the high-yield market,” he said.

Kenneth Harris, a portfolio manager at Denver Investments, said the prospect of a tax overhaul hasn’t changed his recent investment decisions.

While tech companies might issue less debt after an overhaul, they also have investments in corporate bonds that they will likely draw down as they reduce their cash holdings, he said. That could reduce demand for bonds as supply falls, tempering the impact on bond prices.

And once those companies reduce their cash levels far enough, they will “probably start the borrowing machine up again,” Mr. Harris said.

—*Richard Rubin contributed to this article.*

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