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Alarm over corporate debt and stalled earnings

Cheap borrowing has funded dividends, stock buybacks, and M&A

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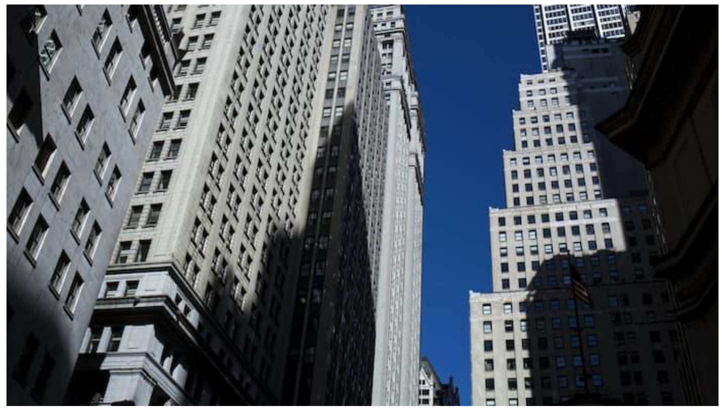
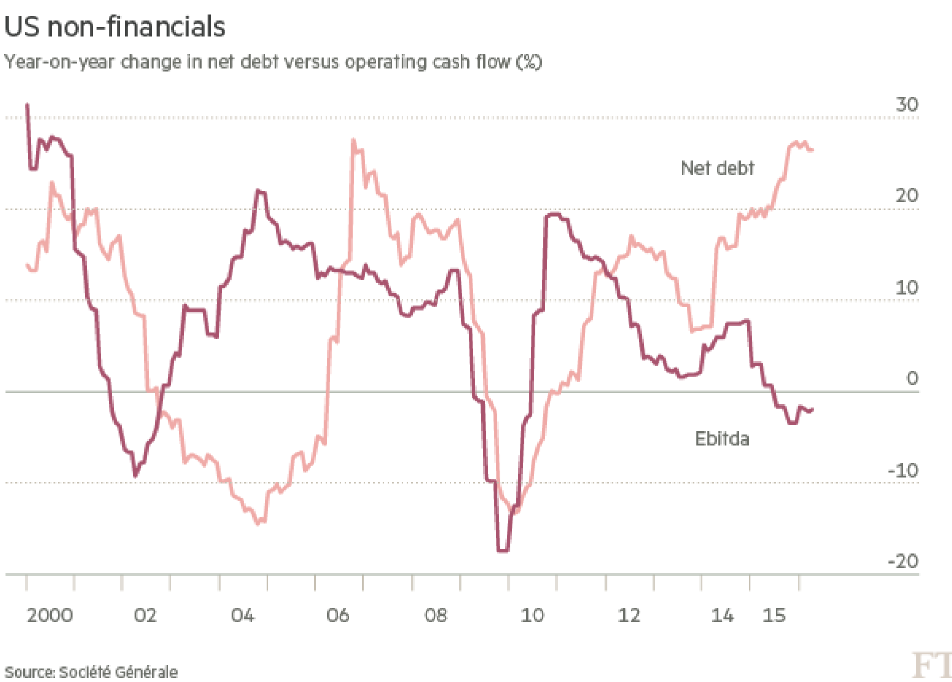


Corporate America is swimming in cash. There is no great news about this, and no great mystery about where it came from. Seven years of historically low interest rateswill prompt companies to borrow.

A new development, however, is that investors are starting to ask in more detail what companies are doing with their cash. And they are starting to revolt against signs of over-leverage.

That over-leverage has grown most blatant in the last year, as earnings growth has petered out and, in many cases, turned negative. This has made the sharp increases in corporate debt in the post-crisis era look far harder to sustain. Perhaps the most alarming illustration of the problem compares annual changes in net debt with the annual change in earnings before interest, tax, depreciation and amortisation, which is a decent approximation for the operating cash flow from which they can expect to repay that debt. As the chart shows, debt has grown at almost 30 per cent over the past year; the cash flow to pay it has fallen slightly.



According to Andrew Lapthorne of Société Générale, the reality is that "US corporates appear to be spending way too much (over 35 per cent more than their gross operating cash flow, the biggest deficit in over 20 years of data) and are using debt issuance to make up the difference". The decline in earnings and cash flows in the past year has accentuated the problem, and brought it to the top of investors' consciousness.

A further issue is the uses to which the debt has been put. As pointed out many times in the post-crisis years, it has generally not gone into capital expenditures, which might arguably be expected to boost the economy. It has instead been deployed to pay dividends, or to buy back stock — or to buy other companies. Shifts in these uses of cash are now affecting markets.

Cash-funded mergers and acquisitions are at a record. In the four quarters to the end of last September, according to Ned Davis Research, S&P 500 companies spent $376bn on acquisitions, 43 per cent above the prior high in 2007, ahead of the credit crisis.

Buyback activity remains intense. According to S&P Dow Jones, for each of the seven quarters up to the third quarter of last year, between 20 and 23 per cent of S&P 500 companies bought back enough shares to reduce their total shares outstanding at a rate of 4 per cent per year. In the last quarter of 2015, 25.8 per cent of companies did so.

However, this year, repurchases have fallen sharply. According to David Santschi of TrimTabs, which tracks uses of corporate cash, US companies have bought back $182bn of their own stock so far this year, barely half the $354bn they bought in the same period last year. He ascribed this to caution about the economy — companies tend to cut down on buybacks and instead conserve cash when they are worried about growth.

Meanwhile, dividend growth has continued, with an increase of 4.6 per cent in the first quarter of this year compared with the first quarter of last year across all US stocks, according to S&P Dow Jones. However, this also showed some caution, as total dividend payments failed to set a new record, while the rate of increase has reduced.

How is the use of cash affecting markets? The clearest symptom that leverage is now a source of concern comes from the market's attitude to share buybacks. It is not just that companies are buying back less of their own stock. It is also that investors are far less enthused to buy the companies that do so.

Over the past year, the PowerShares Buyback Achievers exchange-traded fund, one of the most popular to follow the strategy, has fallen 7.5 per cent, while the S&P 500 has dropped only 1 per cent. The experience of other strategies emphasising buyback stocks has been similar. This follows years of outperformance.

Meanwhile the ProShares S&P 500 Dividend Aristocrats ETF, which tracks companies that pay a high dividend yield, has gained 4.9 per cent.

Such popularity for companies that pay out dividends is generally sign of bearishness and lack of trust. If investors want to be shown the money in this way, it suggests very low confidence in companies' ability to use the cash wisely. At this point, according to Mr Santschi, investors are eschewing buyback stocks because they fear that the buybacks will only be funded with further debt.

Companies can of course afford to stay highly levered without too much difficulty, while they enjoy fixed low rates. The problem, and the reason that investors have now started to focus on the problem, is producing the earnings and cash flows needed to pay their debt. That is why earnings are being watched with such anxiety.

If companies demonstrate that they can generate the earnings needed to deal with their leverage, there should be a rebound for the market, and a period of underperformance for dividend-yielding stocks. Until that happens, the anxiety will continue.

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