Bloomberg

Corporate America's Epic Debt Binge Leaves $119 Billion Hangover

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October 14, 2015 — 8:45 PM EDT
Updated on October 15, 2015 — 6:23 AM EDT


The Financial District in New York City.

Photographer: Andrew Harrer/Bloomberg

The Federal Reserve's historically low borrowing rate isn't benefiting corporate America like it used to.

It's more expensive for even the most creditworthy companies to borrow or refinance even as the Fed has kept its benchmark at near-zero the last seven years. Companies have loaded up on debt. They owe more in interest than they ever have, while their ability to service what they owe, a metric called interest coverage, is at its lowest since 2009, according to data compiled by Bloomberg.

The deterioration of balance-sheet health is "increasingly alarming" and will only worsen if earnings growth continues to stall amid a global economic slowdown, according to Goldman Sachs Group Inc. credit strategists led by Lotfi Karoui. Since corporate credit contraction can lead to recession, high debt loads will be a drag on the economy if investors rein in lending, said Deutsche Bank AG analysts led by Oleg Melentyev, the bank's U.S. credit strategy chief.

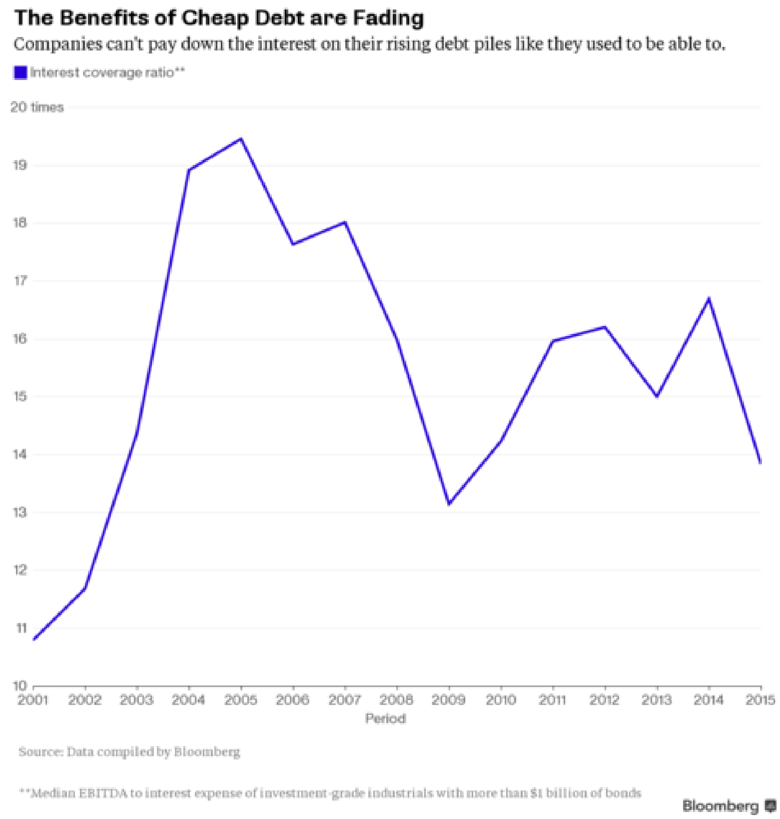
"The benefit of lower yields for corporate issuers is fading," said Eric Beinstein, JPMorgan Chase & Co.'s head of U.S. high-grade strategy.

As of the second quarter, high-grade companies tracked by JPMorgan incurred $119 billion in interest expenses over the last year, the most for data going back to 2000, according to the bank's analysts. The amount the companies owed rose 4 percent in the second quarter, the analysts said.

The risk of default is negligible for companies with good credit. Even so, their health isn't likely to improve when the Fed finally raises the lending rate, and it could worsen even without a hike, said Ashish Shah, the global head of credit strategies at AllianceBernstein Holding. A souring economy or a shocking event such as a prominent terrorist attack could also cause borrowing costs to spike, he said.

Paying Out

The fallout of more borrowing coupled with lower earnings has raised concern among the analysts who track the debt and the money managers who buy it. Yet it seems the companies themselves are acting as if it's not happening. They're still paying out record amounts in buybacks and dividends.



In the second quarter, the most creditworthy companies posted declining earnings before interest, taxes, depreciation and amortization. Yet they returned 35 percent of those earnings to shareholders, according to JPMorgan.

That's kept their cash-payout ratio -- how much money they give to shareholders relative to Ebitda -- steady at a 15-year high.

The borrowing has gotten so aggressive that for the first time in about five years, equity fund managers who said they'd prefer companies use cash flow to improve their balance sheets outnumbered those who said they'd rather have it returned to shareholders, according to a survey by Bank of America Merrill Lynch.

Since May, stocks of companies that have spent the most buying back their shares have performed even worse than the S&P 500 index. That comes after buyback stocksoutperformed the S&P 500 each year since 2007, according to data compiled by Bloomberg.

Companies have been using low interest rates to refinance more expensive debt, but the new debt isn't saving them as much as it used to. As recently as 2012, companies were refinancing at interest rates that were 0.83 percentage point cheaper than the rates on the debt they were replacing, JPMorgan analysts said. That gap narrowed to 0.26 percentage point last year, even without a rise in interest rates, because the average coupon on newly issued debt increased.

Lower Yields

Companies saved a mere 0.21 percentage point in the second quarter on refinancings as investors demanded average yields of 3.12 percent to own high-grade corporate debt -- about half a percentage point more than the post-crisis low in May 2013.

Servicing the debt got tougher for companies in the second quarter, too, at least on paper. Interest coverage, an estimate of how many times a company could pay off its interest using its Ebitda, fell in the last year to a median 13.8 times from 16.7 times for companies with top credit ratings, excluding financial firms, who've issued debt, according to data compiled by Bloomberg.

The weakening has been widespread. If they had to, nearly half of companies could only cover their interest expenses between zero and 10 times with the Ebitda they generate. That compares with the 38 percent of companies that had interest coverage ratios between 0 and 10 times in 2006, according to JPMorgan.

“It does make some of these companies more vulnerable to a growth slowdown or any type of shock,” said Jeff Cucunato, head of U.S. investment-grade credit for BlackRock Inc., the world’s biggest money manager, which said it’s taking a “cautious” approach to high-grade debt. “You’ll continue to see some land mines out there.”

More Vulnerable

Looking into the future, UBS AG’s Matthew Mish sees only tightening lending standards. He warned clients in an Oct. 7 research note that borrowing costs will rise for the most creditworthy borrowers in the first three months of next year.

It would take a meaningful contraction in earnings along with tighter lending to spark a credit crisis, given that interest coverage remains above its historical average, according to Vanguard Group Inc.

“We’re more concerned than we were two years ago,” said Stuart Hosansky, principal in Vanguard’s fixed-income group. “We still view overall corporate credit quality as adequate.” Hosansky said the last time he felt that way was 2006.

Companies are trying to keep the cheap-debt party raging as long as they can. Some investors are joining them for what may turn out to be a nightcap, according to Stephen Antczak, head of U.S. credit strategy at Citigroup Inc.

“There are more people that want to buy into the bullish argument than I would expect,” Antczak said. “Maybe because the buy-the-dips mentality has worked so many times in the past.”