Corporate Bonds

Focusing on fundamentals

After years of strong returns from corporate bonds, corporate balance sheets hold the key to investors' valuation dilemma.

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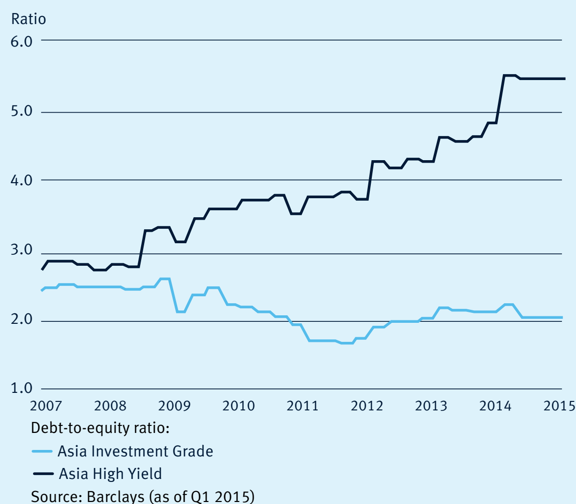
Chart 1
Gross leverage across Asian credit



Source: Barclays (as of Q1 2015)

Choosing between the US and Europe

As corporate bonds have produced strong returns for the last six years, it is increasingly important to focus on the underlying fundamentals of corporate balance sheets and ask if current profitability and creditworthiness warrant present valuations. Investors will want to assess whether the market is nearing a change in the corporate balance sheet cycle that will eventually be detrimental to bondholders.

Our analysis begins by considering the difference in profitability and leverage trends between investment grade (IG) S&P 500 companies and their European counterparts. Using a broad-based IG bond index as a sample source, leverage in US corporates has been relatively flat over the last two years. While recognising that sector composition has shifted, for example there are more cash rich, lowly levered technology companies, using a bond-based benchmark does support the view that a material increase in leverage has not yet occurred. While gross debt has increased, it has not surged and shareholder returns have not generally been enhanced to the detriment of maintaining solid credit profiles.

In Europe, IG balance sheets generally exhibit strong fundamentals. With many European economies showing some signs of a recovery, profits (e.g. EBITDA) growth has supported an improvement in leverage metrics, although margins are still historically low. Given that the economic recovery is still in its early stages, management teams remain prudent. This is evidenced in a number of ways, including a lower rate of M&A transactions relative to the US. Another trend is the increased use of corporate hybrid instruments, the majority of which are accounted for as 100% equity in financial statements.

So, should credit investors favour European or US companies? We think the answer is that both are worthy of consideration. While there are multiple variables in making this decision, in the context of corporate balance sheets the answer is to focus on stock selection. While some sectors are further along the business cycle, especially in the US, broader fundamentals suggest we are not as far down the path of debt-fuelled M&A activity and shareholder returns as many think. However, markets can change rapidly and we believe the best way to position for this is to look at how individual companies and sectors adjust their strategies, structures and balance sheets as the economic climate evolves. A key trigger to examine will be share buybacks, whether they turn back up again and whether they are financed by corporate debt, in turn causing balance sheet stress.

Challenging consensus

European high yield (HY) markets display far greater differentiation, despite much talk of improving credit metrics. Indeed, a 'cosy consensus' has now formed around the subject of balance sheet repair. However, we think the significant change in the composition of the market in recent years warrants caution. There are now many more BB rated credits and, unsurprisingly, higher-rated companies have had a better time of it of late. Lower-rated companies, on the other hand, have actually seen leverage and interest cover deteriorate. This suggests that the overall improvement in credit quality has been driven by the appearance of more BB rated companies rather than a recovery in riskier parts of the market.

While funding costs have been driven down by investor demand for yield, current funding levels do not reflect what has been happening in the companies themselves. If we examine free cash flow (FCF) data we can see that, as a percentage of debt, FCF has decreased among B and CCC rated borrowers. Such a trend raises concerns over this part of the market's vulnerability to rising interest rates, when a reduced appetite for HY and increased funding costs could stretch their liquidity. This caution leads us to believe investors may be best served by running a highly active or focused portfolio, where companies with weak cashflow can be avoided completely.

Emerging market corporate debt is another area where there is far greater differentiation than one might initially expect. For many years, Asian corporate balance sheets grew faster than Asian GDP. However, the recently slower economic environment has led to a marked difference between those IG companies that are using their strong business profile and cashflow generation to reduce leverage, and Asian HY issuers that are struggling to reduce debt given profit pressures (see Chart 1). This could prompt a rise in defaults, emphasising, as in other credit markets, the importance of diligent security selection.

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