

Assessing corporate leverage trends

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Leverage trends and metrics

p.04

At a glance

- Global leverage has increased substantially since the events of the global financial crisis in 2008-2009. One focal point has been US corporate leverage as the substantial rise in BBB-rated debt leads to concern about the risk of fallen angels.
- Our study shows that leverage, while high, has been decreasing in recent years for listed companies. In addition, alternative leverage and debt servicing (interest coverage) metrics paint a less concerning picture and show leverage levels below long-term averages.
- We argue that the increase in BBB-rated issuers over the past decade is not due to an increase in leverage, but rather from effects set in motion by the 2008 financial crisis. The increase in potential fallen angels from structural changes is indeed a concern for investment grade managers, but for universes with stable rating profiles such as BBB to BB, such concern is diminished.
- Historical fallen angels data is a poor predictor of the future quantity of fallen angels because the broad structure of the universe has changed, and the current issuer mix is far more diverse.
- We argue that ratings drift is a better variable to measure fallen angels supply. Ratings drift is predicted by changes in leverage rather than levels of leverage. Using changes in leverage, we find that predicted downgrade rates are in line with historical averages and significantly below periods of credit market sell-offs.
- Overall, a more optimistic picture of corporate leverage emerges when it is assessed using broader metrics and set against a backdrop of changed debt issuance practices over the past decade.

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Using alternative metrics, we show corporate leverage levels are below long-term averages.

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Introduction

Global leverage has increased substantially since the global financial crisis in 2008-2009.¹ The focus has largely been on government debt burdens in both developed and major emerging market (EM) countries. Leverage has also risen within the corporate sector, although we argue the increase in the US in recent years has been driven by private debt.

Leverage in itself is not a causal element for a shock, but it can indeed exacerbate growth or income shocks. For example, while interest rate rises were the first shock in the financial crisis of 2008, a collapse in US house prices propagated the economic effects. Poor underwriting standards, lax regulations and over-leveraged banks against a backdrop of heavy deregulation added fuel to the fire, culminating in the Lehman Brothers bankruptcy of 2008. Now, with the current cycle stretching over 10 years and higher interest rates in the US, investor focus is on the next area that could potentially generate a systemic risk to the global economy.

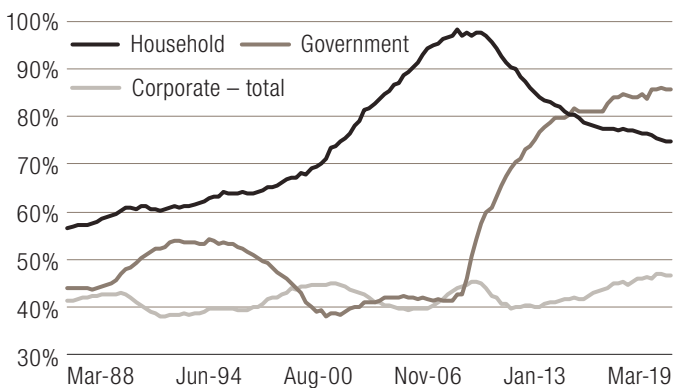
According to our global investment strategy team, the Federal Reserve hiking cycle has ended and the next policy move for the European Central Bank (ECB) is likely to be an easing step rather than tightening. All in all, no major developed market or EM central bank is expected to hike in 2019. This, together with stabilising global growth, should extend the business cycle.²

One focal point has been US corporate leverage, as the substantial increase in BBB-rated debt leads to concern that corporations may have taken undue advantage of low interest rates to leverage up to less sustainable debt levels.

In this paper, we discuss the dynamics of leverage in the US and Eurozone corporate bond markets. We find that corporate leverage has fallen in the US since 2017, albeit from a record level, and has remained unchanged in the Eurozone. We also find that leveraging has been rife in the higher-rated segment of the market with share-buybacks a probable contender for the use of funds. We address investor concerns about the increase in the size of the BBB-rated market and a potential proliferation of issuers downgraded from investment grade (IG) or so-called “fallen angels.” We believe that concerns are allayed when focusing on a more stable rating area of the market, such as the crossover (BBB-BB) segment. We show that change in leverage is a better predictor of rating downgrades than levels of leverage, and that this metric indicates a relatively benign outlook for credit downgrades.

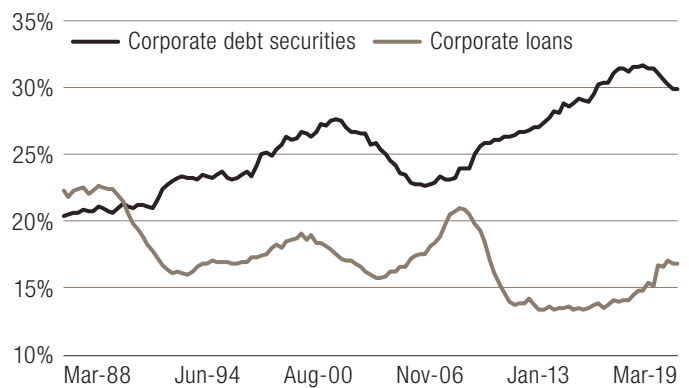
Turning to data trends, by analysing the ratio of Debt-to-GDP in the US split by economic sectors (Figure 1A),³ we find that household debt has reduced substantially since the financial crisis, which was offset by an explosion of government debt. Corporate debt also increased, but at a much lower rate than government debt.

FIG. 1a US DEBT-TO-GDP SPLIT BY SECTORS



Source: Factset, WorldScope, LOIM calculations.

FIG. 1b US CORPORATE DEBT-TO-GDP SPLIT BY COMPONENT



¹ For more on the macroeconomic implications of leverage, please see LOIM paper titled: Leverage matters: shocks, policy and inflation.

² For more on LOIM views, please see paper titled: Global quarterly outlook: low rates, pro-risk.

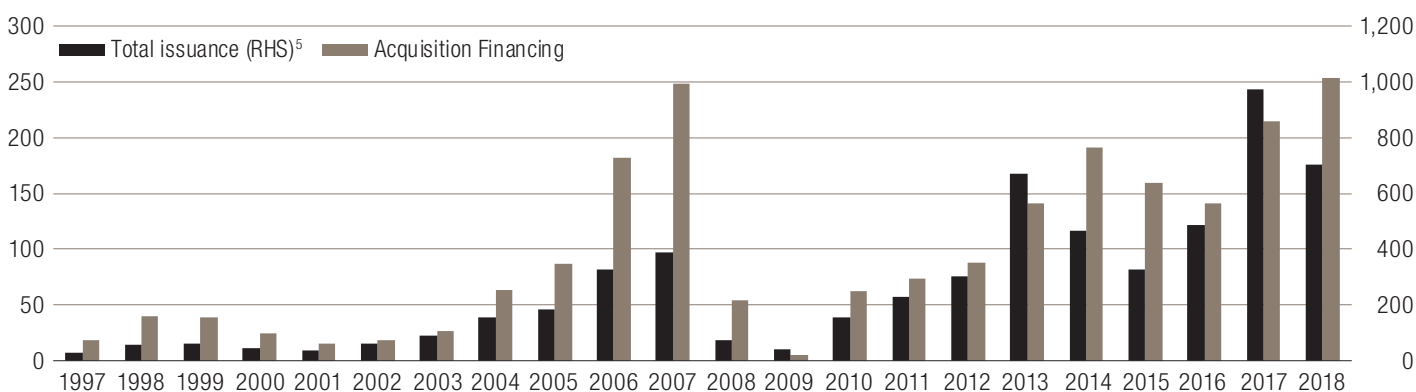
³ All figures in this paper are for illustrative purposes only.

Since we are considering trends and not absolute levels, corporate debt to GDP can be used as a proxy for leverage.⁴ Corporate debt is further split into two main components – debt securities (bonds, money-market etc) and loans, as shown in Figure 1B. An interesting pattern is that the relative size of the loan market has steadily declined in the US since 1990, when it was almost equal in size to the bond market. The first drop in the size of the loan market followed the savings and loans crisis of the early 1990s and the second large drop came after the financial crisis. Both were periods of disintermediation of the banking sector that led to reduced lending to the non-financial sector. The bond market picked up the slack, now accounting for nearly two-thirds of US corporate debt.

Another interesting pattern is in the relative growth of the loan market in 2004-2006 and, more recently, since 2016. This growth in the loan market also coincided with rate hikes of 2004-2006 and 2016-2018. The floating rate nature of loans and a generally benign credit environment in those periods resulted in a preference for loans over fixed-rate bonds.

Increasing leverage via loans or bonds should make corporations equally vulnerable to a shock, however, the broad picture also hides a few crucial points. Later in this paper, we show that corporations have not increased leverage, especially relative to their earnings. Increases in loans have come from both re-financing operations and, more significantly, from leveraged buyouts (LBOs) and acquisition financing. In fact, acquisition financing and LBOs reached record levels in 2017 and 2018 as seen in Figure 2. Acquisition financing and LBOs are not reflected in the aggregation of large, listed companies. Later in this paper, we also show that large listed companies, such as those issuing corporate bonds rated from AAA to BB, have generally deleveraged over the last couple of years.

FIG. 2 US INSTITUTIONAL LOAN ISSUANCE – TOTAL ISSUANCE AND ACQUISITION FINANCING (INCLUDING LEVERAGED BUYOUT)



Source: JPMorgan Research.

⁵ Total issuance is measured by the axis on the right hand side (RHS), while acquisition financing refers to the left hand side. Both series are in USD billions.

⁴ Corporate debt to GDP is not perfect as a debt serviceability metric, as GDP, amongst other things, also includes government expenditure. In addition, below-the-line items, such as labour income are also included within GDP.

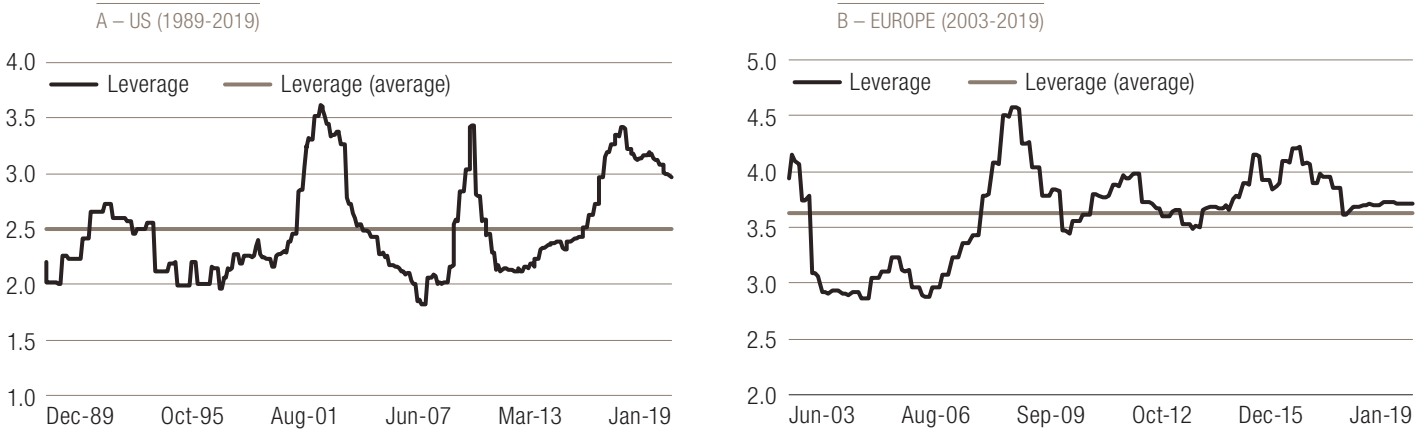
Leverage trends and metrics

In the subsequent section we focus on the debt of listed corporations both in the US and Eurozone.

An often-tracked measure of corporate leverage is the ratio of (gross) Debt-to-EBITDA. In Figure 3, we consider the historical trend of this metric for the investment grade (IG) universe in both the US (over the past 30 years) and Europe (over the past 15 years). Indeed, the US level is high by historical standards, but has trended downwards over the last two years following a peak in Q4 2016. Europe, on the other hand, is at a higher absolute level than the US, but is actually fairly close to its period median (albeit over a shorter analysis period), and has also decreased from a cyclical peak in 2016.

We analyse how leverage trends vary in different segments of the IG universe.⁶ Within the IG universe, we argue that higher-rated firms have leveraged most, whereas lower-rated firms have not leveraged as much. In Figure 4, we create high debt and low debt buckets by splitting the US universe of top 500 companies by market-capitalization at the median quantity of debt.⁷ We find that through the recent leveraging cycle, low debt firms (or those more aligned with higher ratings) leveraged most in relative terms, with leverage ratios almost double where they were following the financial crisis. Although levels have increased, higher debt firms (or those more aligned with lower ratings), have not leveraged as much over the same period. This would suggest vulnerability to downgrades is more prominent in higher rated companies, rather than in BBBs.

FIG. 3 LEVERAGE OF NON-FINANCIAL CORPORATES (GROSS DEBT/EBITDA)

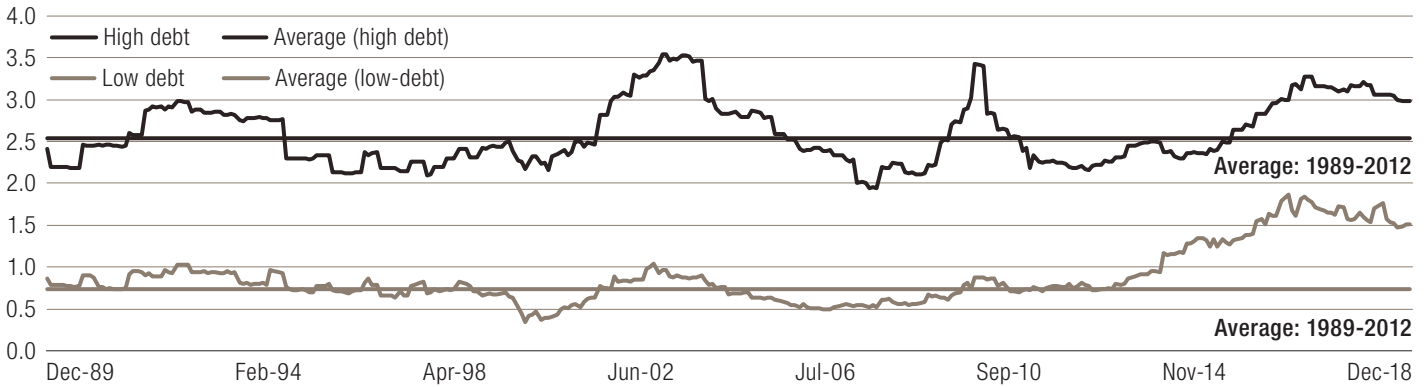


Source: Factset, WorldScope, LOIM calculations.

⁶ We address the BBB/fallen angel debate on page 7.

⁷ We use quantity of debt as a sorting variable to be consistent with debt market-cap weights, however similar conclusions persist if we use debt ratios as a sorting variable.

FIG. 4 LEVERAGE (GROSS DEBT/EBITDA, US ONLY)



Source: Factset, WorldScope, LOIM calculations.

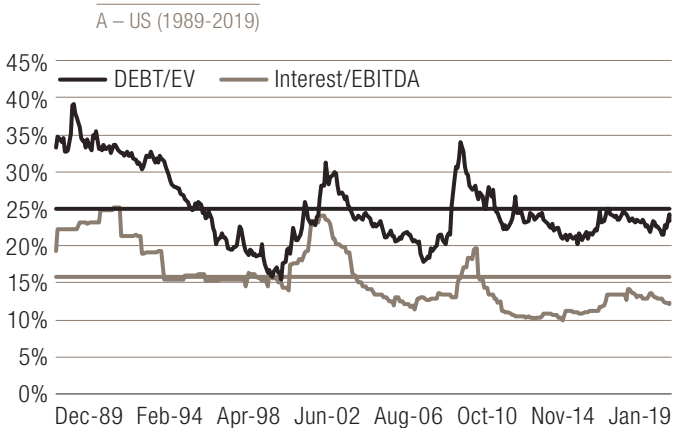
Debt/EBITDA is, however, an incomplete measure that may not show the whole picture. An alternate leverage metric is the ratio of Interest-to-EBITDA (Interest/EBITDA or interest coverage) Figure 5⁸ shows that interest coverage is below long term averages in both regions. Moreover, it could be argued that this is actually a more important metric in terms of short-term debt serviceability, as it is more focused on near term payments and the company’s ability to service its debt with its earnings.

Debt/EBITDA is a backward looking ratio, and depends on the reporting period. While this metric provides value in cross-sectional comparisons, structural shifts, such as systemically low interest rates, make comparisons through time difficult. In Figure 3 we incorporate another metric, which addresses key topics of debate

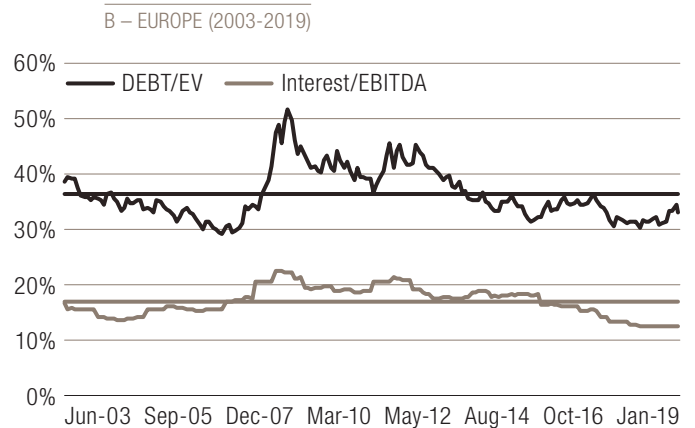
about leverage. By looking at Debt-to-Enterprise-Value (Debt/EV), we pick up a dynamic property introduced by the company’s equity value. The use of equity momentum in credit markets is a research area of its own,⁹ however, the academic grounding of such a relationship can be drawn from the Merton model of corporate debt. Essentially, a company with a greater equity cushion has a larger “distance to default,” as equity value has to be lost before the debt becomes distressed. Like interest coverage, Debt/EV is below historic averages in both regions.

In the following analysis, we focus solely on the US universe, due to its increased time-series data availability and quality. Additionally, Eurozone data is affected by sovereign specific effects which we prefer to exclude from the analysis.

FIG. 5 ALTERNATE LEVERAGE RATIOS



Source: Factset, WorldScope, LOIM calculations.



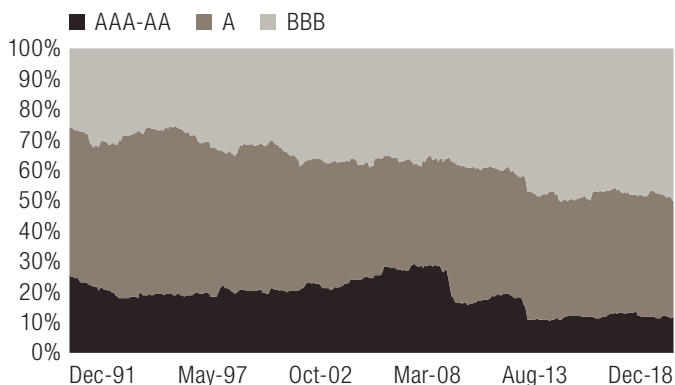
⁸ Metrics have been inverted appropriately to ensure that the increasing value of the metric ties in to less creditworthiness.

⁹ Please see LOIM paper entitled: Equity momentum in corporate bonds.

Taking stock of credit conditions

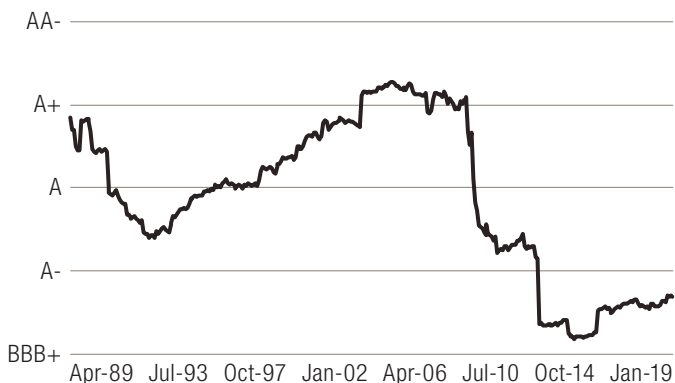
The perceived rise in leverage has coincided with a rise in the representation of BBB bonds within the IG universe (Figure 6). While this may be interpreted by some as a sign of deteriorating credit conditions with IG credit markets, the results in the previous section would suggest that this is not the case. Instead, taking into account corporates' ability to repay debt (Interest/EBITDA) and trends set by equity momentum (Debt/EV) suggest more resilient credit conditions.

FIG. 6 MOODY'S RATING MIX IN US IG UNIVERSE



Source: Bloomberg Barclays Indices.

FIG. 7A AVERAGE RATING¹² OF US FINANCIALS SECTOR



Source: LOIM calculations, Bloomberg Barclays indices, Factset, Worldscope.

We argue that market developments driven by the financial crisis fuelled a structural shift that led to the increased representation of BBB bonds within the IG universe. Ratings agencies reacted to criticism following the financial crisis by becoming potentially more conservative, leading to ratings pressure, especially at the highest end of the rating spectrum (AAA-AA). Downgrades of financials, such as those impacted by the financial crisis and the Eurozone crisis, further exacerbated this effect, with average ratings of financials dropping by nearly 2 notches (from A+ to A-) since 2007, as shown in Figure 7A. Within financials, regulations have prompted this rating decline, as banks have issued significantly more bailable and subordinated debt that are consequently lower rated.¹⁰ While this trend has made the overall financial system more stable, it also led to a general deterioration in ratings.¹¹

The financial crisis and subsequent regulation of the banking sector also made banks less able or willing to issue bank loans, therefore driving small- and medium-sized enterprises towards using public markets for financing. Figure 7B shows that the average size of companies issuing bonds has declined substantially in relative terms since the financial crisis, in a trend that is linked to the increasing disintermediation of banks.

FIG. 7B SIZE RATIO (BY EQUITY MARKET-CAP) OF COMPANIES WITHIN THE BOND VERSUS EQUITY UNIVERSE¹³



¹⁰ Currently, nearly all of a bank's capital structure is bailable allowing the continued survival of the bank in distress periods or an orderly resolution in case of a failure. AT1, LT2 and Senior non-preferred debt are categories of debt that can be bailed-in in the event of distress.

¹¹ Duffie (2018) asserts that for mitigating systematic failure, creditors would need to believe that they would experience a significant loss at solvency. This effect has manifested itself in lower ratings and higher spreads for banks despite a stronger balance sheet via the issuance of bailable debt.

¹² Dor, A., & Xu, Z. (2011). Fallen Angels: Characteristics, Performance, and Implications for Investors. *The Journal of Fixed Income*, 20(4), 33-58,4.

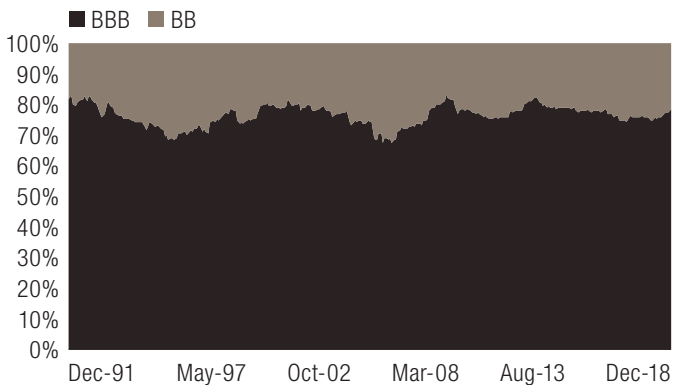
¹³ While bonds can downgrade from A and higher to high yield, this is relatively rare. Over 96% of fallen angels are downgrades from BBB rating and over 93% of fallen angels are downgraded to BB. See Dor, A., & Xu, Z (2011).

Fallen angels: mix and drift

Against this backdrop of an increase in the proportion of BBB's in the IG universe, fears of a spate of so-called "fallen-angels" status has gathered attention. Fallen-angels are bonds that cross the investment-grade/high-yield threshold and show price pressure upon downgrade reflecting a rush of forced-selling from investment-grade managers.¹²

In practice, the quantity of companies that are fallen angels is driven by a combination of the rating mix and the rating drift from BBB to high yield (HY).¹³ The concerns surrounding a greater number of fallen angels stems from an increase in the weight of BBBs within the IG universe. Concerns about increased fallen angels can be addressed at a portfolio level through an average rating approach (where the overall rating of the portfolio is targeted), or by using a fixed ratings mix (where there is a fixed contribution to the portfolio from each rating category). The crossover (BBB-BB) universe is an example of how to address such concerns, as Figure 8 shows that within BBB-BB the proportion of BBB issuers has remained largely constant for

FIG. 8 MOODY'S RATING MIX BBB-BB UNIVERSE



Source: Bloomberg Barclays Indices.

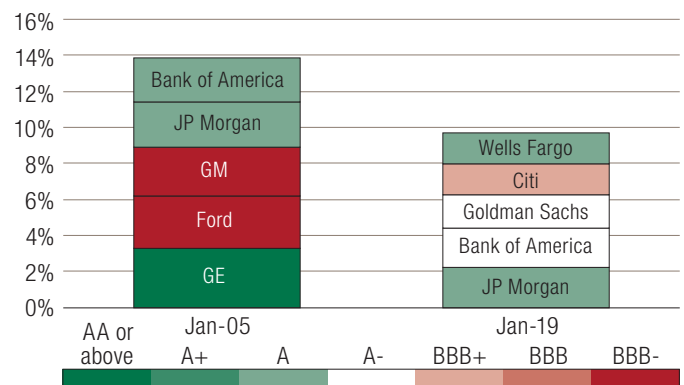
the last 30 years. Market-weighted investment grade portfolios (Figure 6), on the other hand, are more vulnerable than historical standards.

Currently, a more balanced issuer mix of fallen angels complicates comparisons with the past. Historically, idiosyncratic events, such as auto companies downgrades (Ford/GM) in 2005, have driven fallen angels supply. The current issuer mix is more balanced than historically, particularly within the BBB area. Figure 9A shows that the five largest issuers in the US IG universe equate to less than 10% of the total size and reside in the A to BBB+ range. This compares to 2005 where the top five issuers

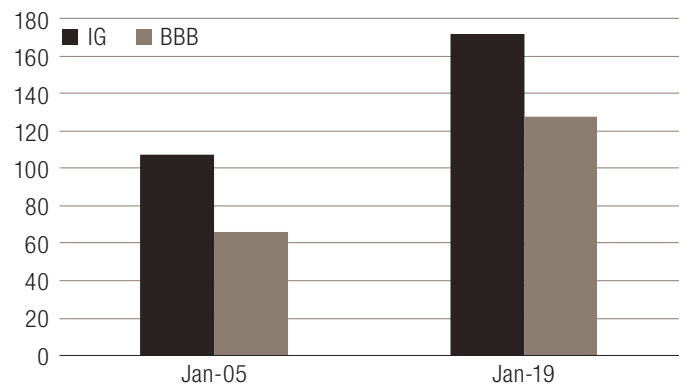
represented 14% of the universe, with almost 6% being in Ford and GM, both at BBB-. That mix clearly posed a large fallen angel risk to the universe at the time. Additionally, Figure 9B shows the increased diversification of the IG universe, particularly in BBB ratings. The effective number of issuers¹⁴ has almost doubled in BBB ratings space. This reduces issuer concentration and attenuates the impact of idiosyncratic drivers relative to those affecting Ford and GM in 2005.

FIG. 9 ISSUER MIX

A – 5 LARGEST ISSUERS – US IG UNIVERSE (MV SHARE)



B – EFFECTIVE NUMBER OF ISSUERS



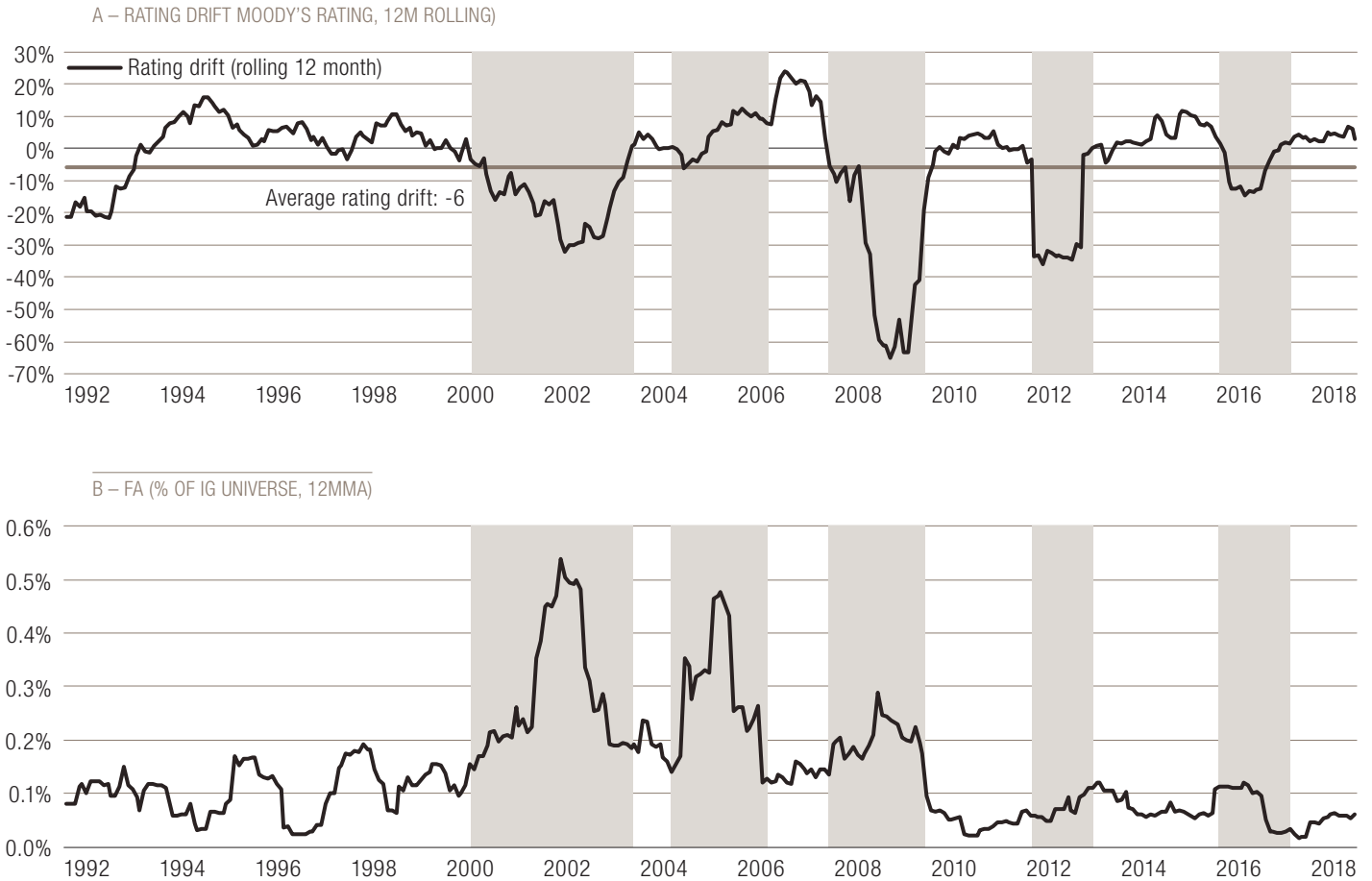
Source: Bloomberg Barclays Indices, LOIM Calculations. Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities.

As such, if the outlook for increasing fallen angels is purely a consequence of structural shifts, as can be seen in the IG universe, historical comparisons of fallen angel levels are less relevant. We prefer to instead use rating drift as our preferred metric to estimate future supply of fallen angels because it is less affected by structural and idiosyncratic shifts in the universe.

¹⁴ Effective number of issuers takes into account weights within a portfolio. This is equivalent to the inverse of the Herfindahl index (sum of square weights). Effective number of issuers takes issuer weights into account and is a better representation of idiosyncratic risk than total number of issuers.

Ratings drift: a relevant variable

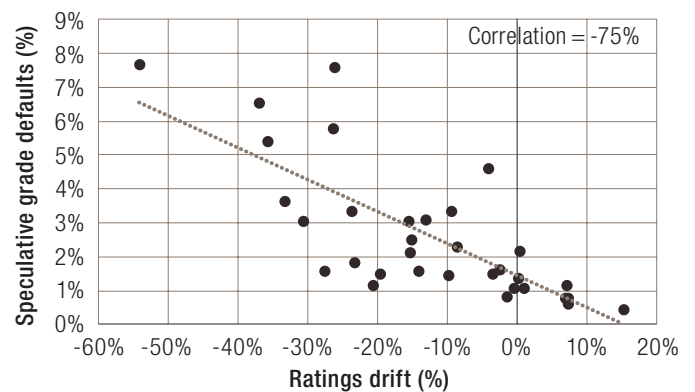
FIG. 10 RATINGS DRIFT AND FALLEN ANGELS THROUGH TIME



Source: Bloomberg Barclays Indices, Moodys, LOIM Calculations.

We calculate ratings drift by comparing the rating of the universe at the end of the month with the universe that was eligible (rated IG) at the start of month. As such, we determine ratings drift as the monthly change in the market value weighted rating (Moody's) of the US IG Index, and then take a 12-month rolling sum to smooth the series. In Figure 10, we compare the behaviour of the metric through time with fallen angels as a percent of the IG universe, focusing particularly on significant periods. Ratings drift dropping below average appears more linked with credit sell-off periods (Figure 10A), and consequently, is highly correlated with speculative grade defaults (Figure 11). Fallen angel percentage is less conclusive, with Ford/GM causing a huge spike in 2005-06 and a relatively muted pickup in the financial crisis and Eurozone crisis.

FIG. 11 ANNUAL GLOBAL RATING DRIFT VERSUS SPECULATIVE GRADE DEFAULT LOSSES (MOODY'S RATING)

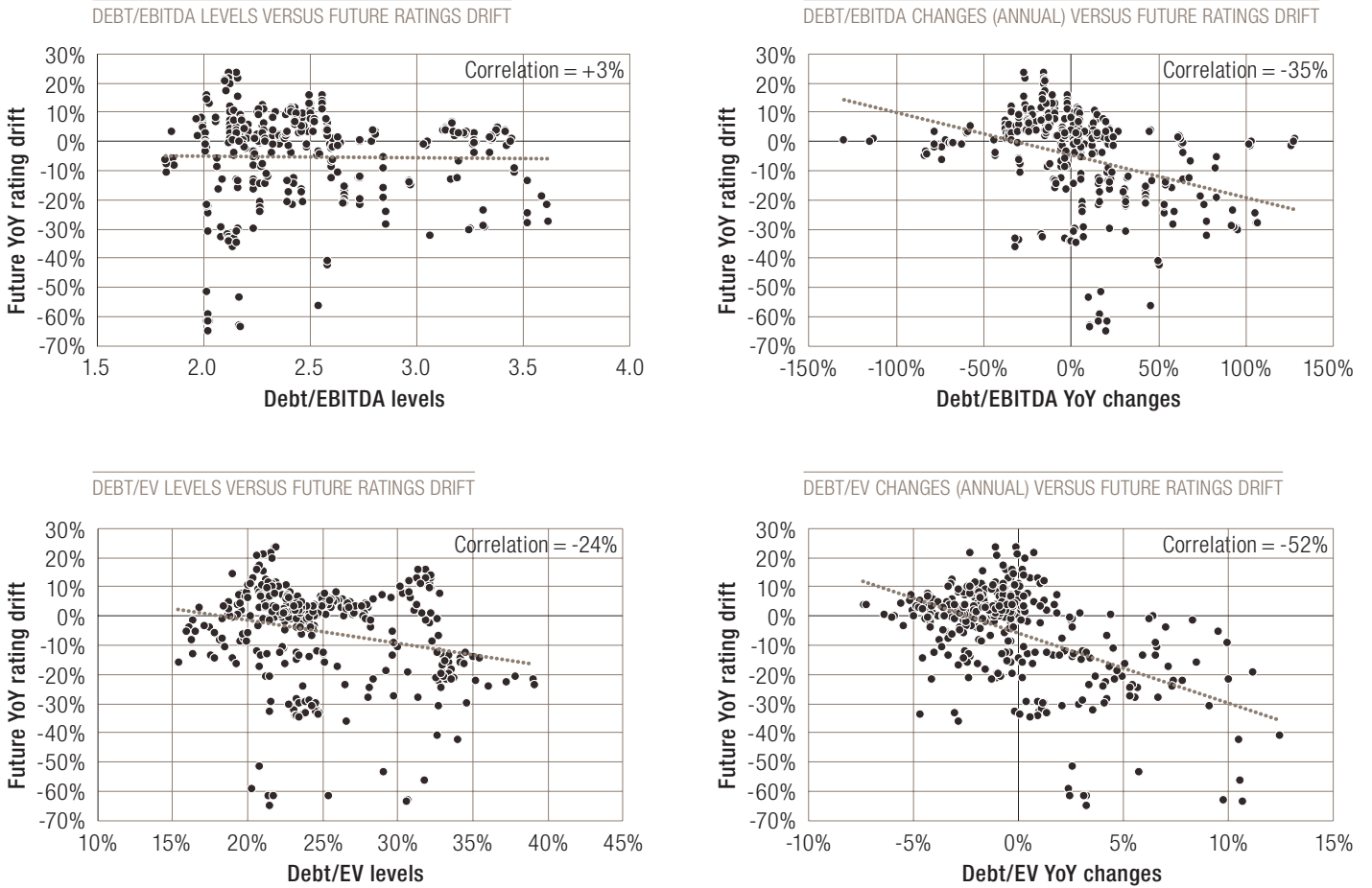


Source: Bloomberg Barclays Indices, Moodys, LOIM Calculations.
Reference period 1985-2017.

If ratings drift is the relevant variable, returning to our original leverage metrics, what is the best predictor? As shown in Figure 12, Debt/EV levels have a much stronger negative correlation with ratings drift over the coming year compared to Debt/EBITDA

levels. However, importantly, an even stronger negative relationship exists between annual changes in the leverage metrics and future ratings drift. This implies that it is not so much the level of the leverage metric that matters, but the trend.

FIG. 12 LEVERAGE METRICS CORRELATION WITH FUTURE RATINGS DRIFT

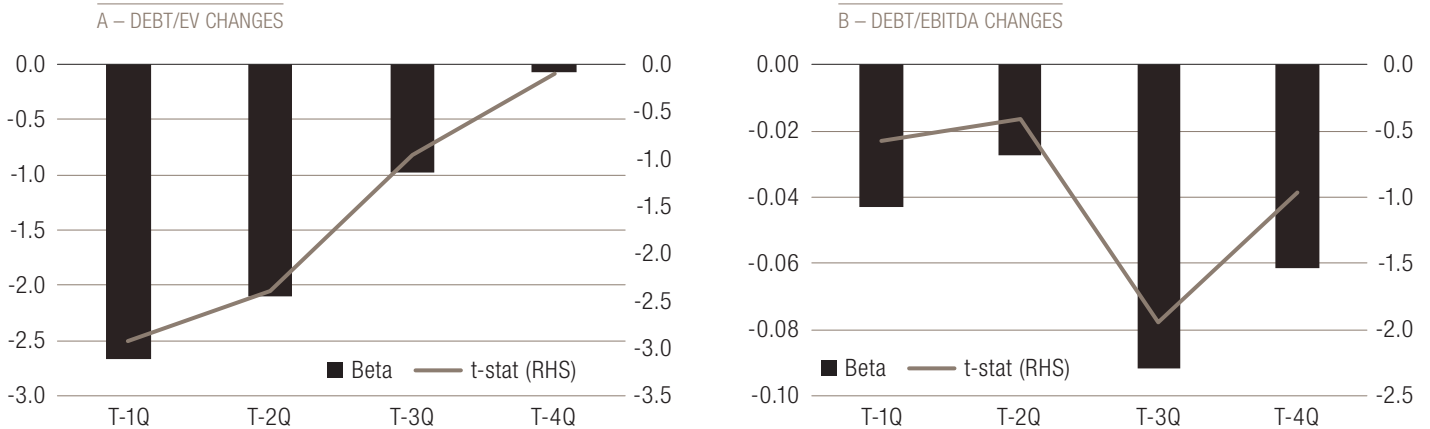


Source: Bloomberg Barclays Indices, Moodys, LOIM Calculations.

Based on this, we construct a model by regressing the ratings drift over the next 12-months on quarterly changes in both Debt/EBITDA and Debt/EV. For each independent variable, we include quarterly changes for the last four, non-overlapping quarters. Figure 13 displays the t-statistics and betas for the various lags of each metric. Clearly, the dominant betas come from more recent changes in Debt/EV, which is to be expected due to the fast moving nature of the equity component within EV.

Based on our regression period of April 1990 to January 2018, current leverage change values forecast a ratings drift of between -3% and -5% over the coming 12-months, as shown in Figure 14. Not only is this well below the numbers seen in various crisis periods over the regression period, it is actually below the long-term average of -6%. If we take the current USD 650 billion market value of BBB- issuers, it would translate to USD 30-50 billion of fallen angels in the coming year.

FIG. 13 LAGGED QOQ LEVERAGE CHANGES ON RATING DRIFT



Source: Factset, WorldScope, Bloomberg Barclays Indices, Moody's, LOIM Calculations.

FIG. 14 RATINGS DRIFT: WHERE ARE WE NOW?

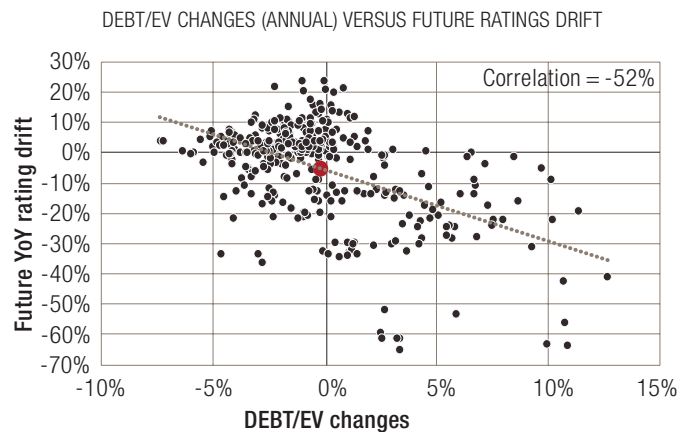
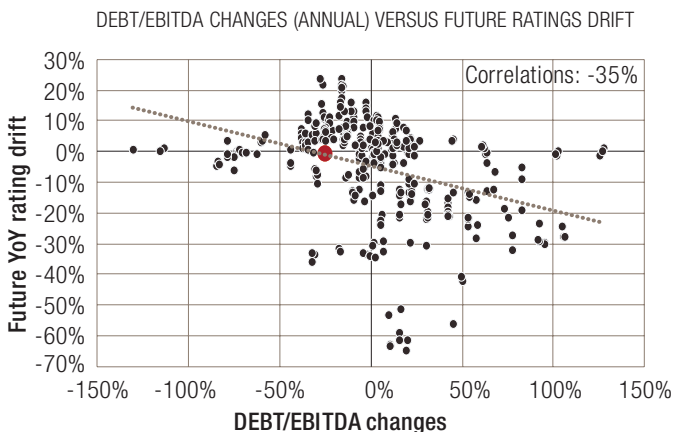
RATINGS DRIFT: MODEL ESTIMATE AND SELL OFFS

PERIOD	YOY RATING DRIFT
Estimate based on current data @ 28 February 2019	-3%
Long term average (1989-2018)	-6%
RATINGS DRIFT INCRISIS PERIODS (%/Y)	
Savings and Loans crisis +oil price shock – 1990-1993	-18%
Telecom crisis (related to dot-com crash) – 2000-2003	-18%
Global financial crisis – 2007-2009	-35%
Eurozone crisis – 2010-2016	-16%
Commodities crisis – 2015-2016	-11%

Past performance is no guarantee of future results.

Source: Factset, WorldScope, Bloomberg Barclays Indices, Moody's, LOIM Calculations.

LEVERAGE METRICS AND RATINGS DRIFT: CURRENT VERSUS HISTORY



Source: Factset, WorldScope, Bloomberg Barclays Indices, Moody's, LOIM Calculations.

Conclusion

Corporate leverage, as measured by metrics such as Debt/EBITDA, has been in greater focus recently. In addition, the rise in quantity of BBBs within the investment grade universe has placed fallen angels risk at the fore of investor concerns. In our study, we show that leverage, while high, has been decreasing in recent years. In addition, alternative leverage and debt servicing (interest coverage) metrics paint a less concerning picture, showing leverage levels below long-term averages.

The structure of the investment-grade universe has changed significantly in the past decade, with a proliferation of BBB issuers. We argue that the increase in BBBs is not due to an increase in leverage, but rather from effects set in motion by the financial crisis, including smaller companies accessing public markets and financials issuing more subordinated debt. The increase in potential fallen angels from structural changes (more BBBs) is indeed a concern for investment grade managers, but for universes with stable rating profiles such as BBB-BB, such concern is diminished.

The second driver of fallen angels supply is the ratings drift of the universe. We show that historical fallen angels data is a poor predictor of the future quantity of fallen angels because the broad structure of the universe has changed (there are more BBBs), and the issuer mix is much more diverse than in the past. Utilizing ratings drift as our preferred metric avoids including the impact of idiosyncratic events, such as Ford/GM downgrades in 2005. We show that ratings drift is predicted by changes in leverage rather than levels of leverage, and, in particular, by changes in Debt-to-Enterprise Value (Debt/EV). Using changes in leverage, we find that predicted downgrade rates are in line with historical averages and significantly below periods of credit market sell-offs.

Overall, a more optimistic picture of corporate leverage emerges when it is assessed using broader metrics and when set against a backdrop of changed debt issuance practices over the past decade.

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Dor, A., & Xu, Z. (2011). Fallen Angels: Characteristics, Performance, and Implications for Investors. *The Journal of Fixed Income*, 20(4), 33-58,4.

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