PK Assets

Something bad brewing in the corporate bond markets?

Is the glass half full, half empty or empty?

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May you live in interesting times
Ancient Chinese curse

«Stability leads to instability. The more stable things become and the longer things are stable, the more unstable they will be when the crisis hits.»

Hyman Minsky

Are we there again?

We go where it really hurts:

At the crossroads of Investment Grade and Junk, BBB and BB…

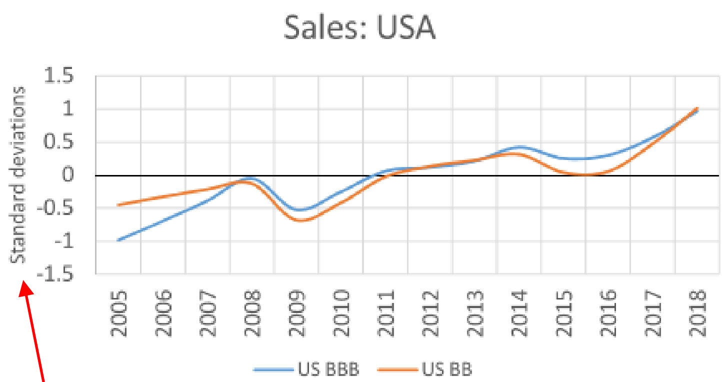
…we analyse **trends in credit quality** of corporate debtors in the USA and Europe

We take 190 BBB and BB rated non-financial debtors (each rated identically by Moody's and S&P's, omitting crossovers) with complete financial figures back to 2005

At first glance things look promising:

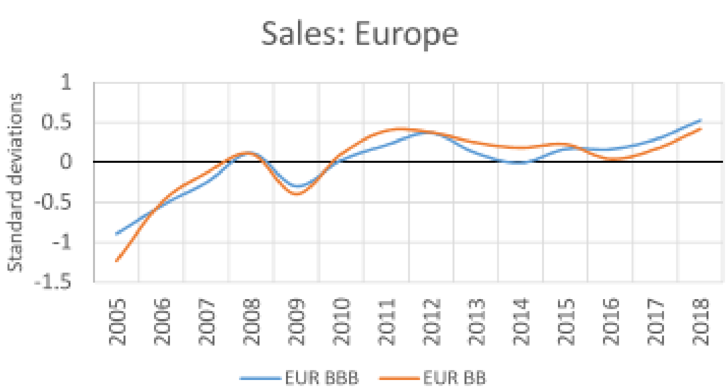
Sales

Companies are growing…



We transform figures into z-scores in order to make companies and samples comparable

Within their brackets, companies are equally weighted



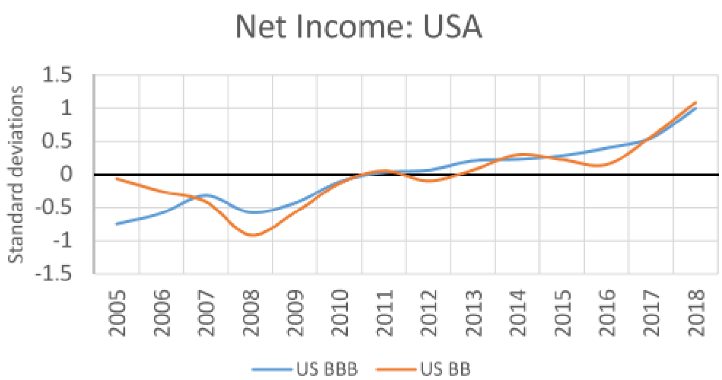
Strong top line growth all over the place be it organically or via M&A

- Very strong growth in the U.S. in both the BBB and BB samples

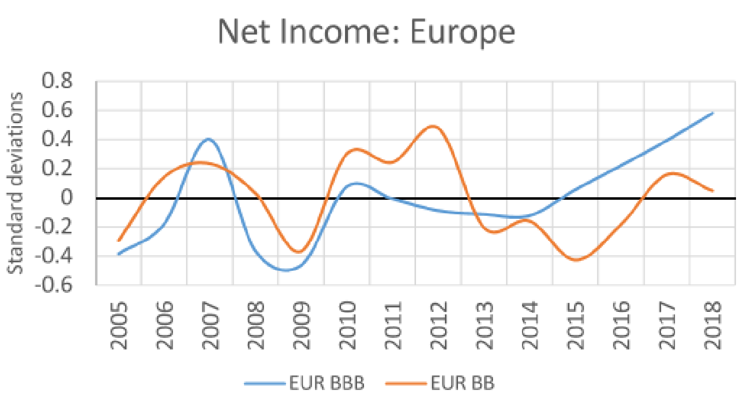
- And Europe too has taken off recently

…earnings soaring…

Strong bottom line growth only few outliers



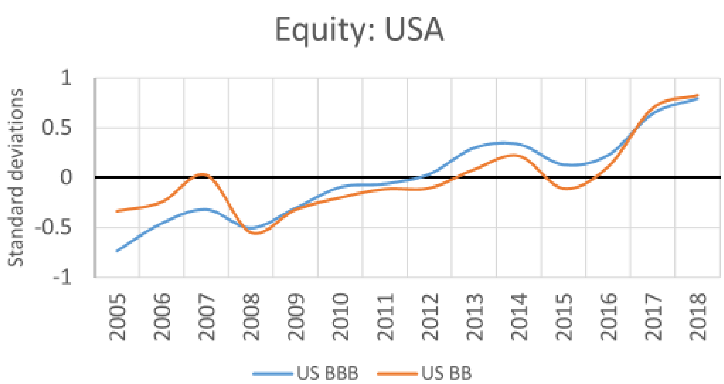
- Net income of U.S. BBB and BB companies at the top of the last 13 years exhibiting a solid upward trend



- Europe looks improved too, with the notable exception of the (small) European BB-sample

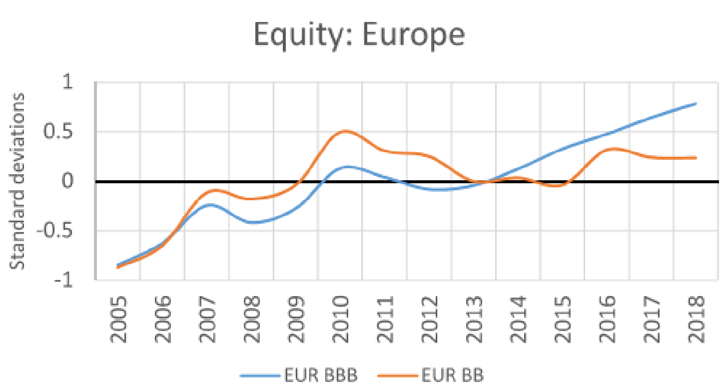
Equity

… improving equity…



Much higher equity acceleration in the U.S.

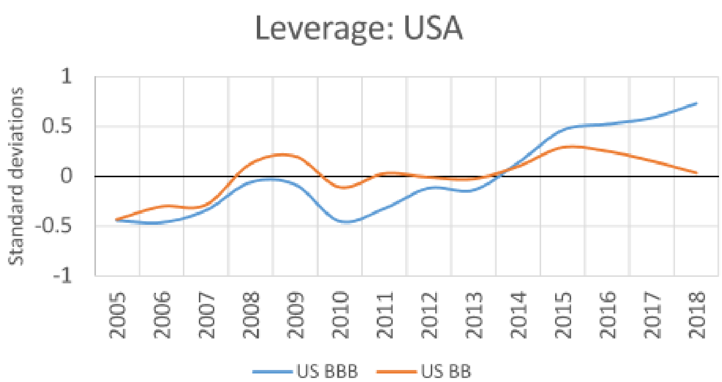
- A lift off during the last two years to a new historical high in the U.S. BBB as well as BB



- In Europe we see a divergence of averages in the BBB and BB-samples, strong growth in BBB, slow improvements in BB

Leverage: «Net Debt / EBITDA»

No leverage stress, with one notable exception

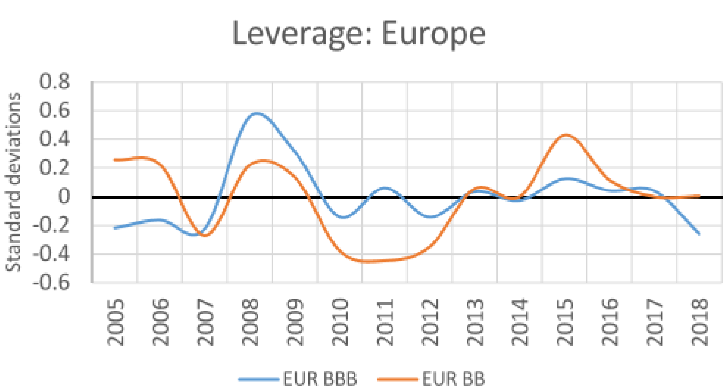


Leverage = Net Debt / EBITDA

BBB looks dismal

the rest of the pack is looking smooth

- The divergence of U.S. BBB and BB is more than obvious



Leverage = Net Debt / EBITDA

- In Europe we see no leverage stress at all, quite to the contrary

- …always using the street's favoured Net Debt/EBITDA metric

Net Debt/EBITDA is the metric of choice of financial analysts, rating agencies and investors. The metric compares Financial Debt (after deduction of liquid assets) with gross profit EBITDA (earnings before interests, taxes, depreciation and amortizations)

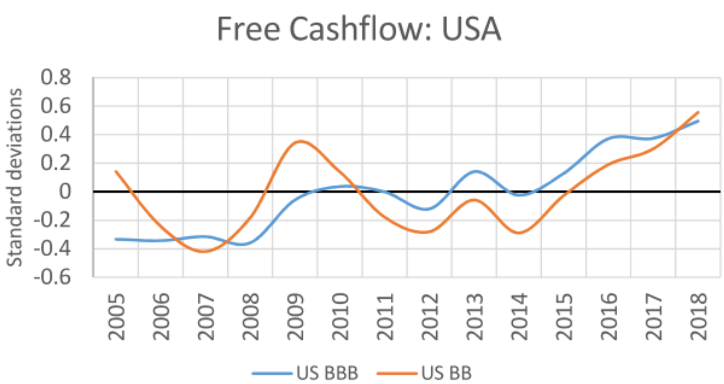
We strongly believe that this metric is rather misleading if not deceptive, since in a recession earnings are breaking away while debt stands tall, creating rating pressure almost immediately and exposing highly levered companies to a financial abyss

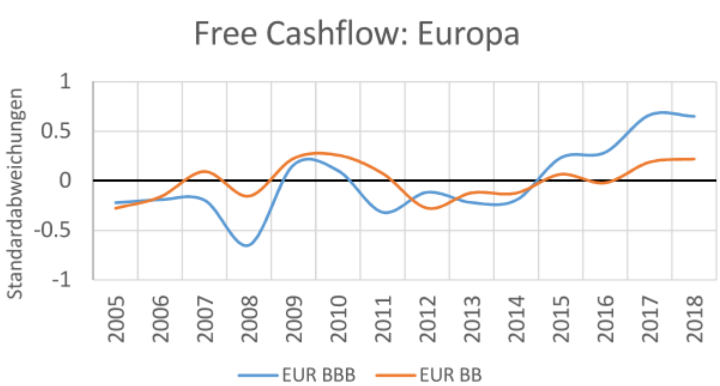
So far so good…

We scratch at the surface:

Free Cash Flow

Is cash coming in?





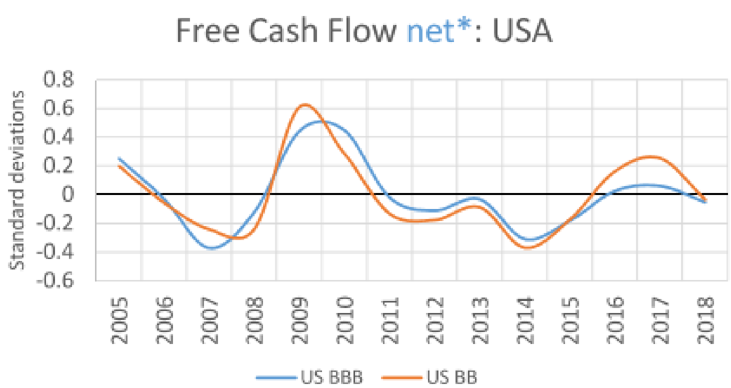
Cash Flow has improved markedly for 3 years USA on a historical peak

- In the wake of the financial crisis FCF trended sideways for a protracted period and then took off in the very recent years
- Growth in the U.S. looks particularly dynamic
- In Europe Investment Grade BBB has done better, High Yield BB is struggling to decisively break out

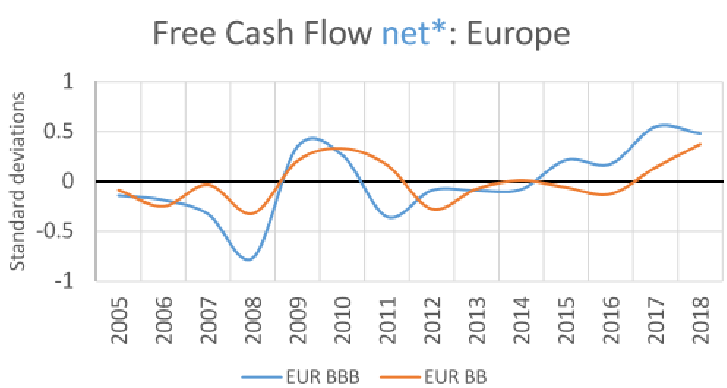
Net Income is a at least partly outcome of accounting, and sustainable only when accompanied by substantial net cash inflows

Free Cash Flow: After dividends and pay backs

What's left for the creditor?



* After deduction of dividends and share buybacks



* After deduction of dividends and share buybacks

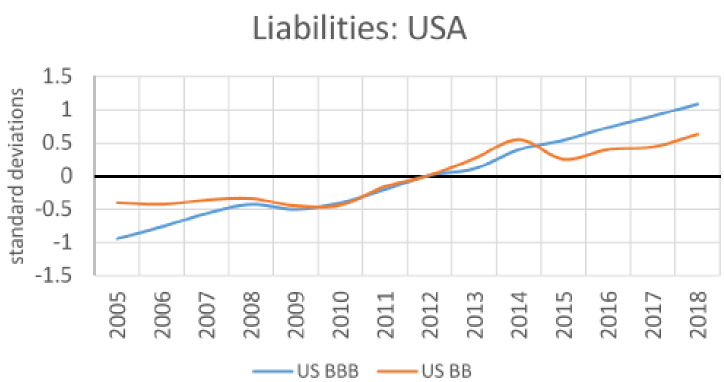
No FCF-growth ex dividends and share buybacks in the U.S.

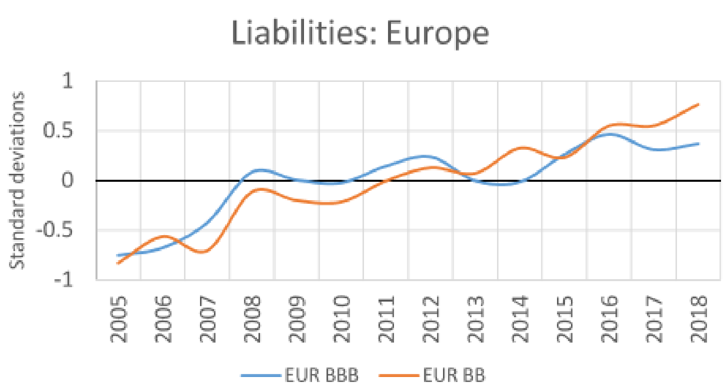
Europe looks comparably better

- Gross FCF is growing strongly, similar to net income
- If you consider cash to shareholders and deduct it from gross FCF, then there is no improvement visible for bond holders
- In Europe the situation is marginally better
- Admittedly, dividends and share buybacks are not mandatory, but equity investors tend to rely on such remunerations and often react drastically when deprived of these goodies
- So at least on aggregates, dividends are much more stable than earnings and free cash flow streams, even when things turn sour

Flipside of growing balance sheets: Much higher liabilities

Debt and liabilities are exploding



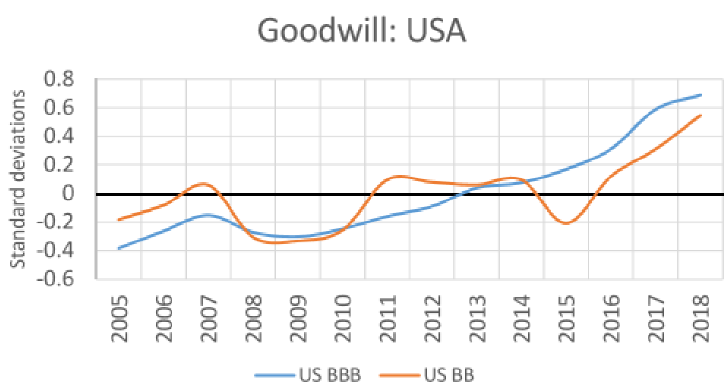


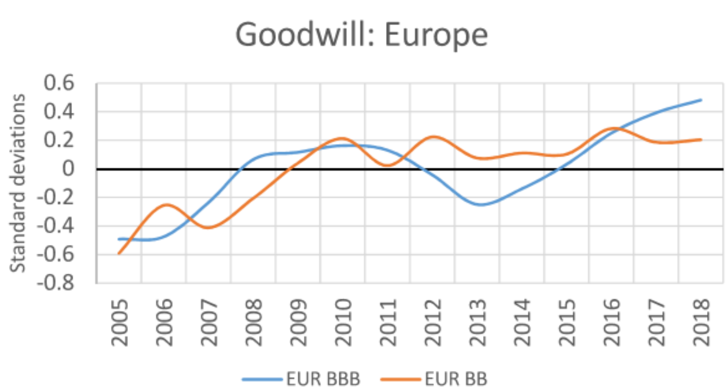
US BBB in the focus, but not exclusively so we prefer «liabilities» rather than «debt» figures

- The eye catcher: U.S. BBB liability explosion …
- … but in the BB sample as well, liabilities are at the peak of the last 13 years history
- And liabilities in the European BB sector is growing dynamically
- While growth in liabilities has somewhat abated in the Europe BBB sample

«Liabilities»: We tend to favor liabilities – including pension deficits, leasing etc- to mere financial debt figures when gauging a company’s leverage.

Mind blowing acquisition goodwill





Overpayments in M&A devastate balance sheets

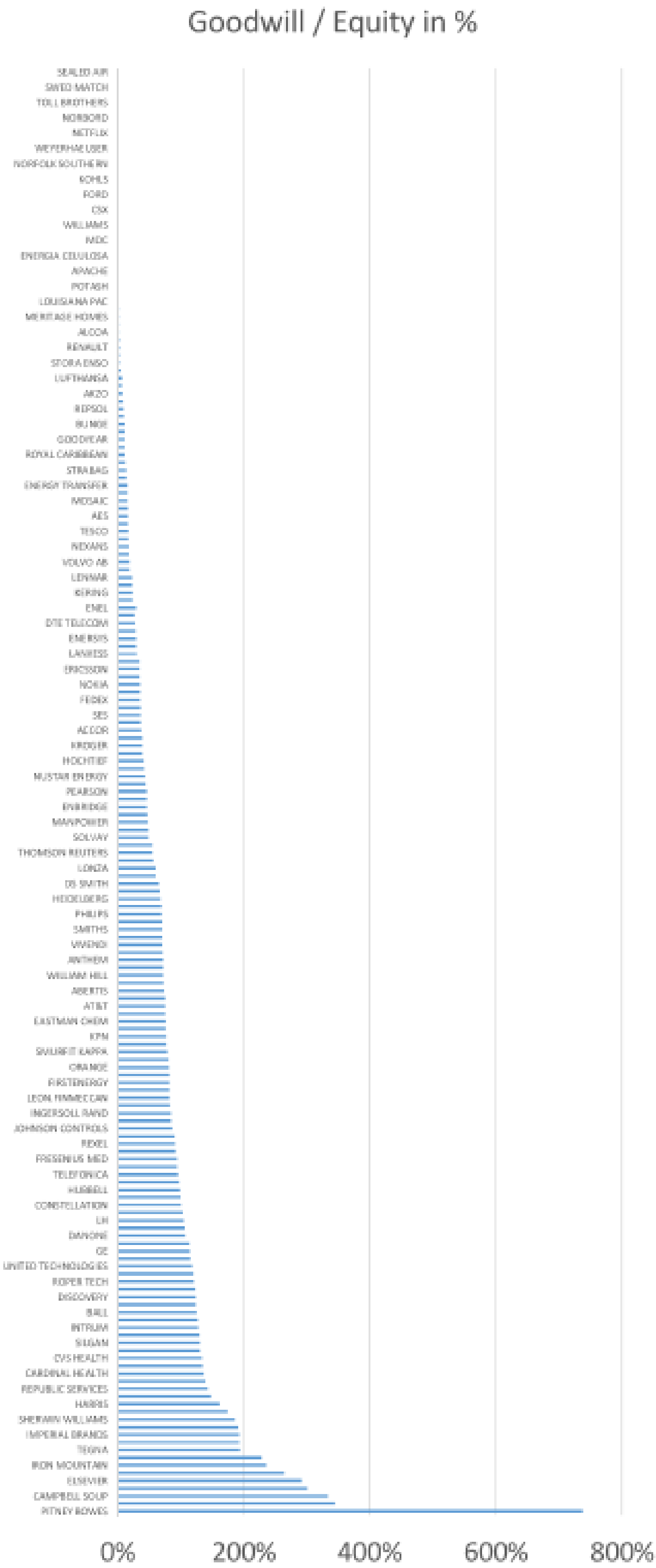
if you interprete Goodwill as we do as fake equity

- If you pay for M&A prices above book value you can activate the difference in your balance sheet, treat it as asset and equity
- You might find this absurd but it is used widely and pervasively in the U.S. and Europe to a degree where it overwhelms historical proportions
- With the frenzy in M&A nurtured by low interest rates, acquisition goodwill has mushroomed or –rather- metastasized

To clarify: By goodwill we do not mean patents and other intangible assets, but plain acquisition goodwill the difference of prices paid for M&A vs. book values of merged/bought assets

Fake Equity

Acquisition Goodwill in balance sheets at insane proportions



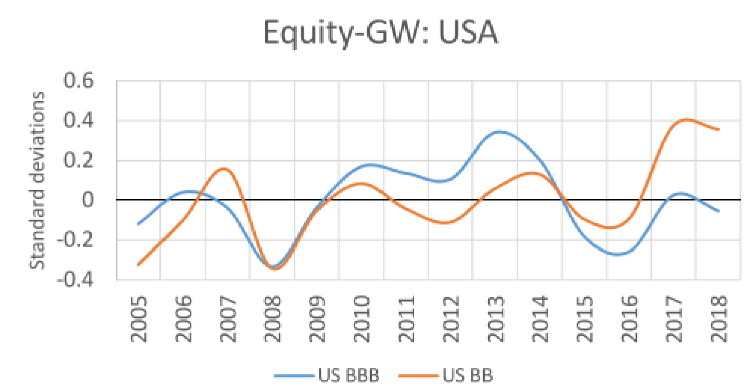
66% (!) of equity is warm air a net 40 of 189 debtors have no (!) equity left when goodwill is deducted

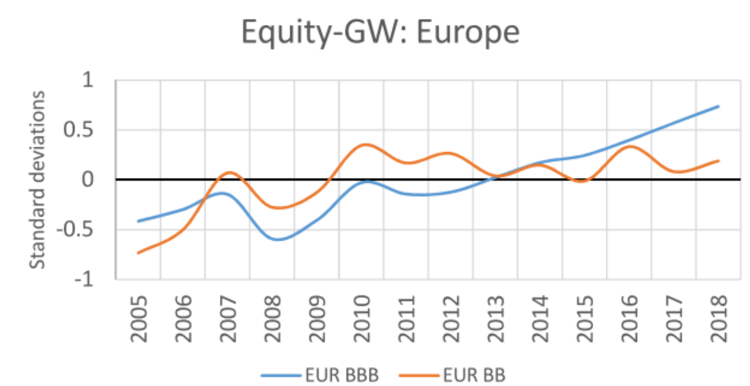
- Only 53 of 189 debtors have an equity portion of less than 10% of equity
- The cancer of goodwill has found its way to virtually all corners of corporate USA and Europe
- Already you hear of anecdotal stress of companies (see GE) having to write off massive and unprecedented amounts of goodwill
- The public is then soothed by the fact that «write offs are not affecting cash flows»; we agree but it destroys the overcollateralisation of debt holders… and the substance of equity holders

Goodwill is now so huge that by investing passively into these markets you essentially buy a time bomb

Fake Equity

How is «sound equity» i.e. equity less goodwill behaving?





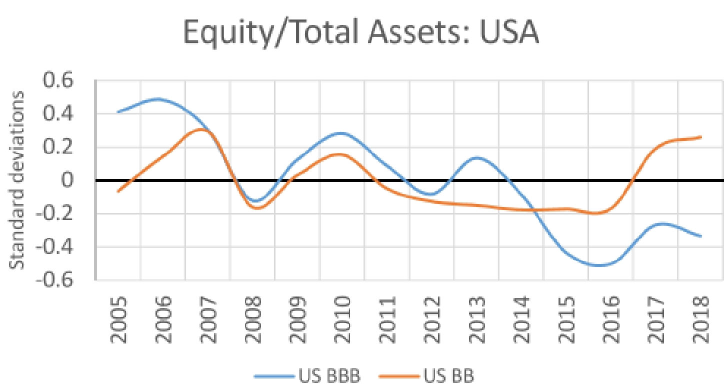
After deduction of goodwill:

A fair part of US BBB equity cushion destroyed

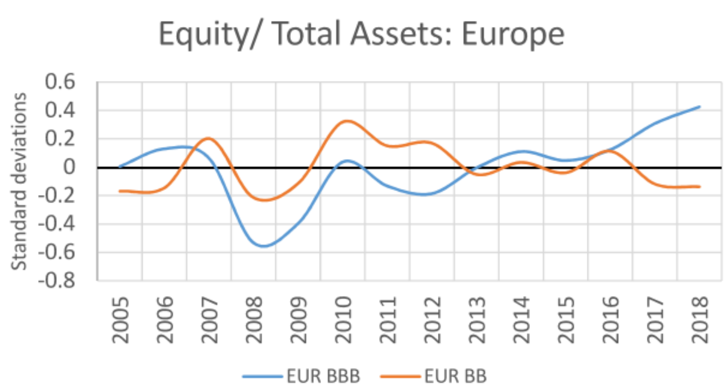
Big differences through the brackets

- In US BBB equity is on average now lower than 10 years ago!
- This notwithstanding skyrocketing debt and liabilities
- US BB looks comparatively better
- In Europe things are different: Growing equity in European BBB and stagnating equity in European BB

Balance Sheet Leverage: Ex goodwil deductions



After deduction of acquisition goodwill



After deduction of acquisition goodwill

What about equity cushion in balance sheets?

Balance sheet safety distorted by goodwill cancer We are worried about U.S. BBB

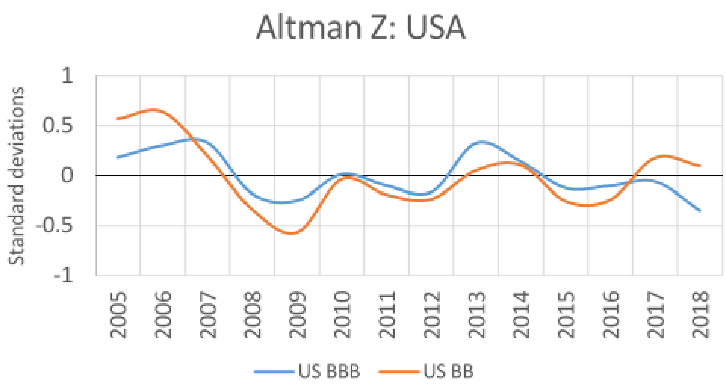
- Equity cushion in U.S. BB looks much better than the dismal BBB-bracket
- We are near the bottom in U.S. BBB post financial crisis
- In Europe Investment Grade BBB looks better than High Yield BB

So far so bad…

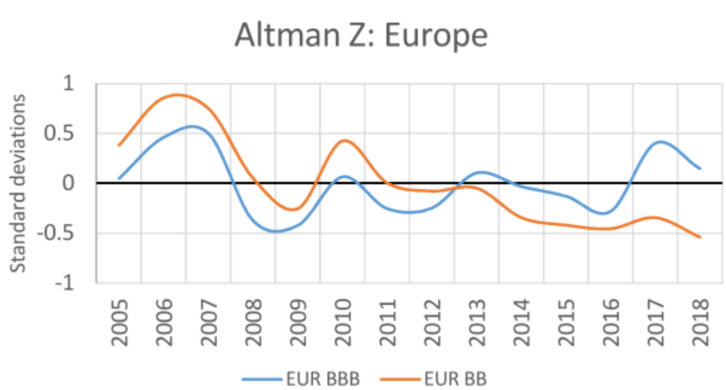
What does that mean for credit quality?

Probabilty of bankruptcy

What is Altman's Z telling us?



The lower Altman Z the higher the probability of bancruptcy



The lower Altman Z the higher the probability of bancruptcy

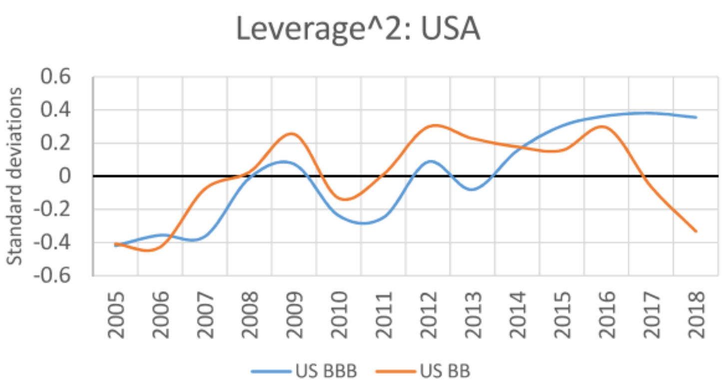
Signals of distress

BBB USA looks menacing

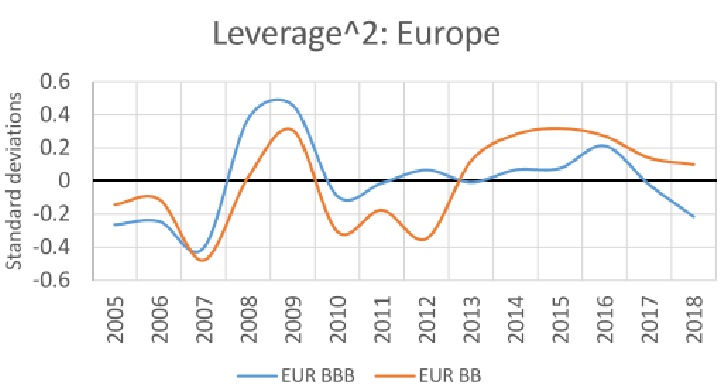
- Altman Z although not exactly new has remained important in our tool box for gauging credit quality
- Compared to other metrics we find here a good correlation to agency ratings
- Altman Z does not take into account the goodwill problem but nonetheless some stress is obvious, especially in US BBB and EUR BB

Total leverage operating + balance sheet leverage

How hich is total leverage?



The higher the graph the higher total Leverage



The higher the graph the higher total Leverage

Red flag in US BBB Calm in other brackets

- We combine operating Leverage and balance sheet leverage into a single metric which we call «Leverage^2»
- We see high leverage in US BBB and a clear deceleration elsewhere

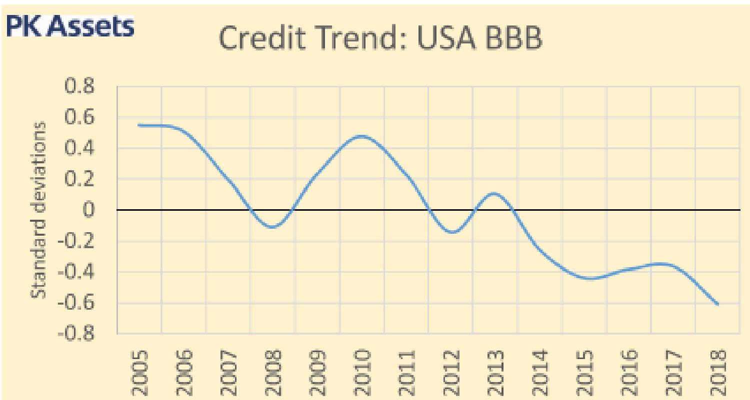
The b
uilding stones of
our total credit
quality metric

Our credit quality gauge consists of following building stones: Sector «Industrials»:

- Equity cushion
- Risk adjusted EBIT margin
- Net Free Cash Flow
- Altman Z
- Sales/Liabilities
- Goodwill
- Leverage^2
- Interest Cover
- Enterprise Value/Debt

Credit trend US BBB

Worrying!



Our sample consists of 82 corporate issuers:

ABBOTT, ALLERGAN, ANTHEM, APACHE, AT&T, AUTOZONE, BOSTON SCIENTIFIC. BUCKEYE PARTNERS, BUNGE, CAMPBELL SOUP, CARDINAL HEALTH, CBS, CELGENE, CONAGRA CONSTELLATION, CORNING, CSX, CVS HEALTH, DEVON, DISCOVERY, DOMINION, DR HORTON, EASTMAN CHEM, EBAY, ENBRIDGE, ENERGY TRANSFER, ENTERPRISE PRODUCTS, EQT, EQUIFAX, FEDEX, FIRSTENERGY, FORD, FRESENIUS MED, FRESENIUS SE, GATX, GE, GEN. MILLS, HARRIS, HUBBELL, INGERSOLL, RAND, JM SMUCKER, JOHNSON CONTROLS, KELLOG, KOHL,S KROGER, L3 TECH, LH, MACY'S, MANPOWER, MARTIN MARIETTA, MC DONALD, MCKESSON, MONDELEZ, MOSAIC, NATIONAL FUEL GAS, NEWELL BRANDS, NEWMONT MINING, NISOURCE, NOBLE ENERGY, NORFOLK SOUTHERN, NORTHROP GRUMMAN, POTASH, QUEST DIAGNOSTICS, REPUBLIC SERVICES, ROPER TECH, ROYAL CARIBBEAN, RYDER, SHERWIN WILLIAMS, STARBUCKS, THERMO FISHER, TIMEWARNER, UNITED TECHNOLOGIES, VALERO, VERIZON, WEYERHAEUSER, WHIRLPOOL, WILLIAMS WPP, ZIMMER BIOMET

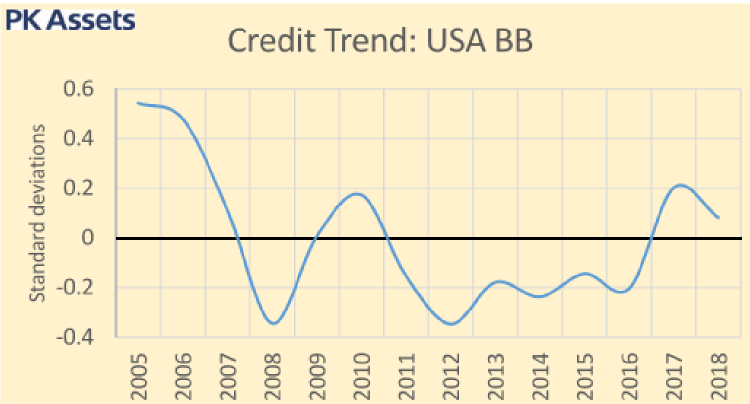
Credit trend going south in BBB USA

Several weak spots

- The companies are getting bigger with respect to assets, sales, equity, earnings and cash flows
- But operating leverage and cash flows to equity holders are soaring
- Liabilities are growing dynamically
- A cause for huge concern is Goodwill:
- On average goodwill/equity is at a whopping 72%
- After deduction of acquisition goodwill not less than 25 out of 82 companies have a negative equity, in some instances massively so
- Equity cushion is at the lowest point since 2005…
- …so is Altman Z
- And Leverage^2 is higher than ever
- Conclusion: The credit trend is gloomy

Credit trend US BB

Relaxed!



Our sample consists of 30 corporate issuers:

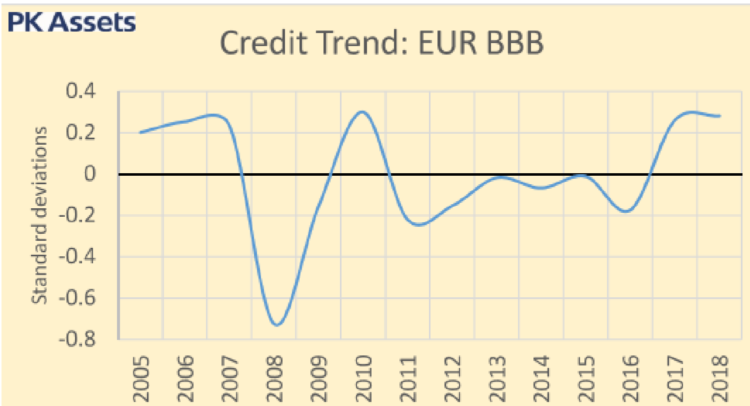
AES, ALCOA, AVIS, BALL, CROWN HOLDINGS, DCP MIDSTREAM, ENERSYS, FREEPORT MCMO, GOODYEAR, HUNTSMAN, IRON MOUNTAIN, LENNAR, LOUISIANA PAC, MDC, MERITAGE HOMES, MGM, NETFLIX, NEWFIELD EXPLO, NORBORD, NUSTAR ENERGY, PITNEY BOWES, RANGE RESOURCES, SEALED AIR, SILGAN, STEEL DYNAMICS, T MOBILE HY, TEGNA, TOLL BROTHERS, UNITED RENTALS, XEROX

No stress but… the devil is in the details (heterogenous, small sample)

- The companies are getting bigger with respect to assets, sales, equity, earnings and cash flows
- Operating leverage is not rising
- Liabilities are growing dynamically however
- We do not like the stagnating free cash flow net of dividends and share buybacks
- A cause for huge concern is Goodwill:
- On average goodwill/equity is at a whopping 62%
- After deduction of acquisition goodwill not less than 9 out of 30 companies have a negative equity, in some instances massively so
- Equity cushion remains ok on average but with heavy outliers
- Altman Z is comforting
- While Leverage^2 has decreased significantly
- Conclusion: On average ok

Credit trend Europe BBB

Good!



Our sample consists of 60 corporate issuers:

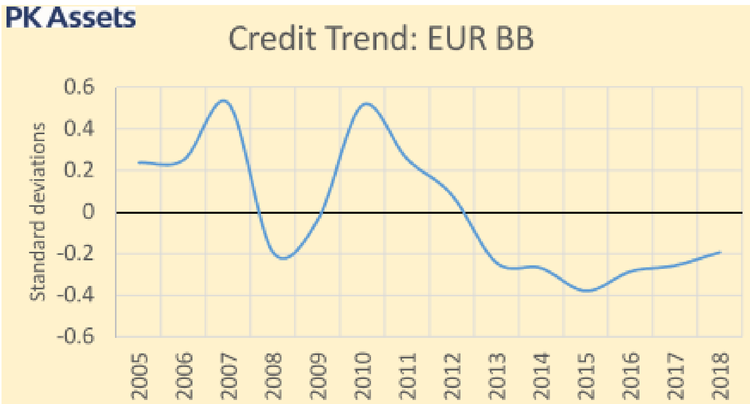
ABERTIS, ACCOR, ADECCO, AKZO, APMAERSK, ARKEMA, BARRY CALLEBAUT, BAT, BAYER, BUZZI, CAP GEMINI, CARREFOUR, CONTINENTAL, DANONE, DS SMITH, DTE TELECOM, ELSEVIER, ENEL, EON, EUTELSAT, GERDAU, HEIDELBERG ,HOCHTIEF, IBERDROLA, IMPERIAL BRANDS, KERING, KPN, LAFARGE, LANXESS, LONZA, LUFTHANSA, METSA, ORANGE, PEARSON, PERNOD, PHILIPS, PUBLICIS, RENAULT, RENTOKIL, REPSOL, RWE, SES, SMITHS, SNAM, SOLVAY, STGOBAIN, STORA ENSO, STRABAG, SÜDZUCKER, SWED MATCH, TELEFONICA, TELIA, THOMSON REUTERS, UPM KYMMENE, VALEO, VEOLIA, VIVENDI, VODAFONE, VOLVO AB

Broad improvement few negative outliers

- The companies are getting bigger with respect to assets, sales, equity, earnings and cash flows
- Operating leverage is decreasing!
- Both gross and net FCF are growing
- Stable liabilities
- A cause for huge concern is Goodwill:
- On average goodwill/equity is at a whopping 52%
- After deduction of acquisition goodwill not less than 6 out of 60 companies have a negative equity, in some instances massively so
- Nonetheless: Equity cushion remains ok
- So is Altman Z
- And Leverage^2 has decreased significantly
- Conclusion: Strong credit trend on average

Credit trend Europe BB

Low!



Our sample consists of 20 corporate issuers:

CASINO GUICHARD, DUFRY, ENERGIA CELULOSA, ERICSSON, FAURECIA, HORNBACH, INTRUM, K+S, LEON.FINMECCANICA, NEXANS, NOKIA, PIAGGIO, REXEL, SAIPEM, SMURFIT KAPPA, TELECOM ITALIA, TESCO, THYSSEN, WILLIAM HILL

Weak credit quality stabilisation at low level

- The companies are getting bigger with respect to assets and sales
- But equity and earnings are not growing dynamically
- Operating leverage is decreasing
- Both gross and net FCF are growing
- Liabilities are growing dynamically
- A cause for huge concern is Goodwill:
- On average goodwill/equity is at a whopping 59%
- After deduction of acquisition goodwill 4 out of 20 companies have a negative equity, in some instances massively so
- Equity cushon is at the lowest point since 2005…
- …so is Altman Z
- And Leverage^2 is higher than ever
- Conclusion: Weak!

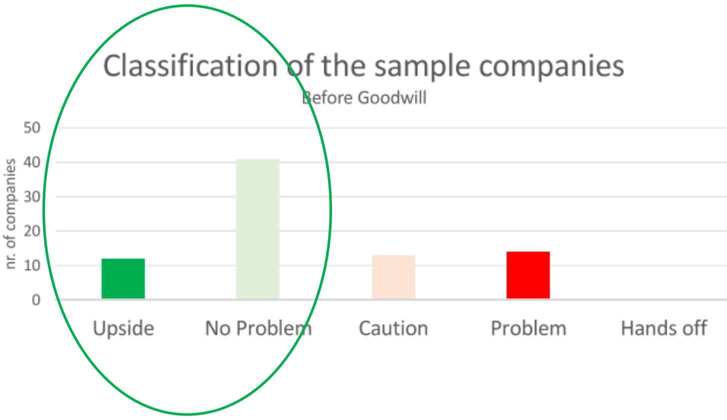
These were all average figures…

Where should you invest on a case per case basis?

US BBB

For sceptics: Hard to get a diversified portfolio

If you do not care about goodwill



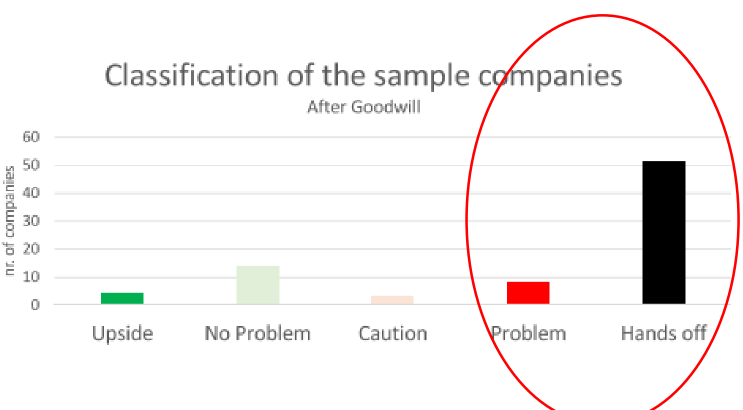
If you do not care about goodwill there is plenty of investment opportunities

- Based on the credit quality trend we classify the company into following brackets: Upside / No problem / Caution / Problem / Hands off
- In US BBB 60 of 90 Issuers are clear to invest, based on the trend in credit quality

How do we treat Goodwill:

- 0-10% Goodwill/Equity: No downnotch
- 10-20% Goodwill/Equity: 1 downnotch (e.g. from «no problem» to «caution»)
- 20-50% Goodwill/Equity: 2 downnotches
- >50% Goodwill/Equity: «Hands off»

If you care about goodwill



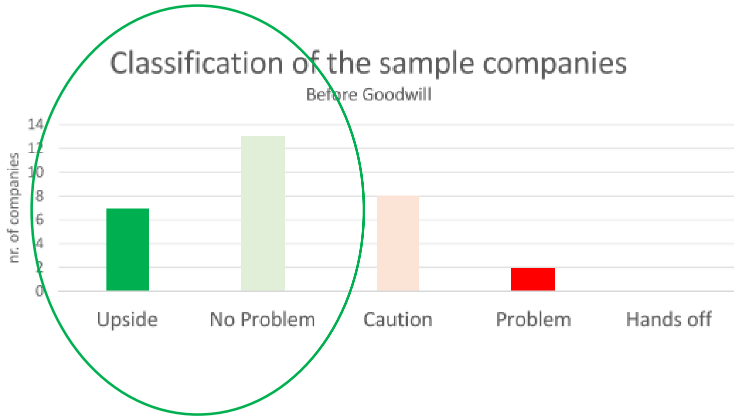
We do care for goodwill, that makes things difficult:

- In the BBB sample 3 out of 4 companies' debt deems currently non investable, given a poor trend or too much goodwill
- The investment universe is shrinking drastically

US BB

For sceptics: No way to get a diversified portfolio

If you do not care about goodwill



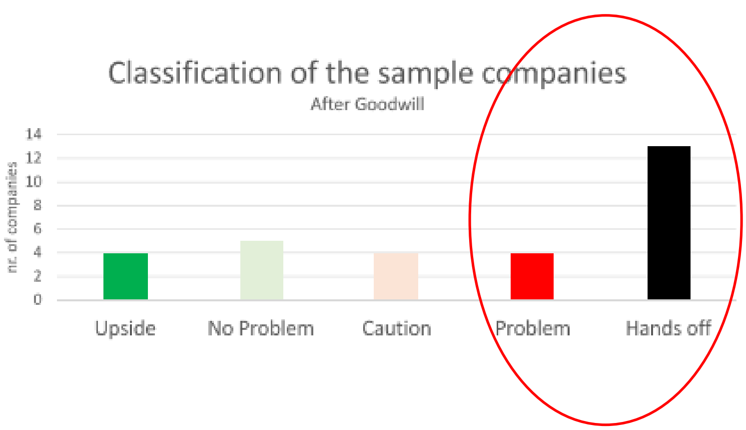
If you do not care about goodwill there is plenty of investment opportunities

- In US BB 20 of 30 Issuers are clear to invest, based on the trend in credit quality

How do we treat Goodwill:

- 0-10% Goodwill/Equity: No downnotch
- 10-20% Goodwill/Equity: 1 downnotch (e.g. from «no problem» to «caution»)
- 20-50% Goodwill/Equity: 2 downnotches
- >50% Goodwill/Equity: «Hands off»

If you care about goodwill



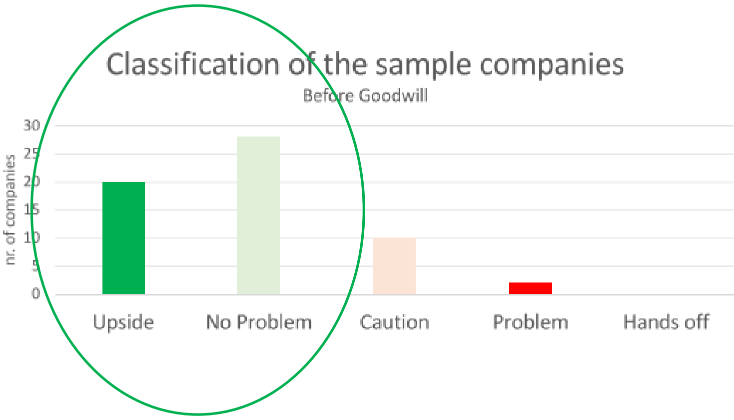
We do care for goodwill, that makes things difficult:

- In the BBB sample 1 out of 2 companies' debt deems currently non investable, given a poor trend or too much goodwill
- The investment universe is shrinking drastically

Europe BBB

For sceptics: No way to get a diversified portfolio

If you do not care about goodwill



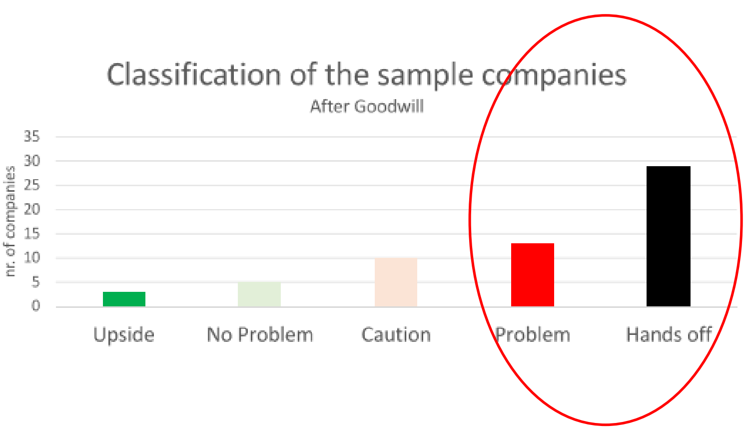
If you do not care about goodwill there is plenty of investment opportunities

- In US BB 48 of 60 Issuers are clear to invest, based on the trend in credit quality

How do we treat Goodwill:

- 0-10% Goodwill/Equity: No downnotch
- 10-20% Goodwill/Equity: 1 downnotch (e.g. from «no problem» to «caution»)
- 20-50% Goodwill/Equity: 2 downnotches
- >50% Goodwill/Equity: «Hands off»

If you care about goodwill



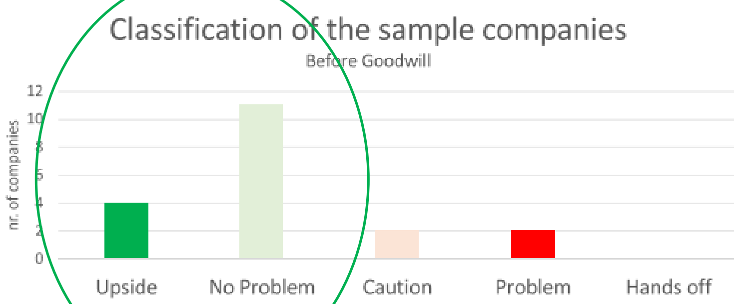
We do care for goodwill, that makes things difficult:

- In the BBB sample 2 out of 3 companies' debt deems currently non investable, given a poor trend or too much goodwill
- The investment universe is shrinking drastically

Europe BB

For sceptics: No way to get a diversified portfolio

If you do not care about goodwill



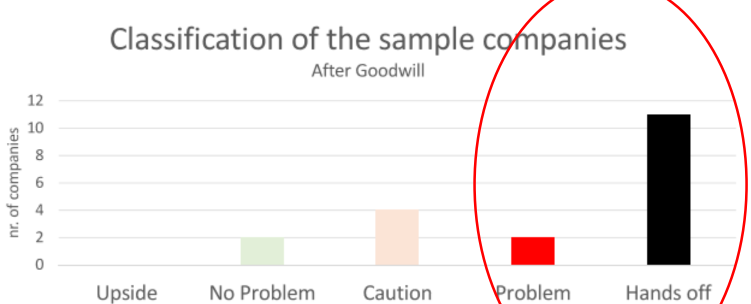
If you do not care about goodwill there is plenty of investment opportunities

- In US BB 15 of 19 Issuers are clear to invest, based on the trend in credit quality

How do we treat Goodwill:

- 0-10% Goodwill/Equity: No downnotch
- 10-20% Goodwill/Equity: 1 downnotch (e.g. from «no problem» to «caution»)
- 20-50% Goodwill/Equity: 2 downnotches
- >50% Goodwill/Equity: «Hands off»

If you care about goodwill



We do care for goodwill, that makes things difficult:

- In the BBB sample 2 out of 3 companies' debt deems currently non investable, given a poor trend or too much goodwill
- The investment universe is shrinking drastically

Conclusion:

Be ruthless by sorting out bad apples

Caveat emptor

- There seems to be a malaise, but concentrated on U.S. BBB; US BB as well as Europe BBB und BB show better trends
- However with U.S. BBB the biggest and most important sector of our short study is exhibiting the worst and most worrying credit quality trend with the biggest portion of fake equity
- If you do not care about goodwill– as do rating agencies, most analysts and investors- then you find an intact environment to build well diversified portfolios
- If –as we do- you care for fake equity (Goodwill), hidden debt (Leasing) and for the entirety of liabilities– instead of mere financial debt- then the range of investable debt shrinks significantly
- If you are investing into a broad field of corporate debt – say e.g. into BBB/BB global corporate debt- then you should not struggle too much to get a diversified portfolio
- If your mandate is to concentrate into one of our brackets then you have to make concessions for credit quality with regards to either credit trend or goodwill or both
- Mind you, the financial market at this stage is not overly concerned with the main points of our analysis:

«More companies have been getting upgraded to investment grade than getting cut to junk, a trend that's expected to continue this year, according to Barclays PLC»

Bloomberg 3/19

«Yes, BBBs are as structural risk, but not this year. USD and EUR IG markets have added USD2.5 rn of BBB rated non-financial bonds since the peak of the last expansion. (…) However a few Watch Negative ratings and a focus on balance sheet improvement should keep Fallen Angel risk low for the next few quarters»

BNP 3/19

*«The rise in Non Financial corporate leverage and the increasing share of low-BBB borrowers implies a structurally higher Fallen Angel risk than at any point in the past two decades. This suggests a longer, although not necessarily deeper, credit downturn at some point.
That Point, however is unlikely to be in the next several quarters»*

BNP 3/19

Your feedback is very much appreciated

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