



## U.S. corporate debt climbing, but so are assets



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### **Debt/GDP is a very misleading metric. What leverage metrics are better to use?**

Corporate debt/GDP (gross domestic product) is often quoted as an indication that Corporate America has taken on too much debt. U.S. non-financial corporate liabilities are now 99% of U.S. GDP, highest since 1960. However, GDP denominator based leverage metrics are very misleading other than for assessing government debt. It is typical for debt relative to GDP to rise over time both at the corporate and household sector. This is because assets tend to rise over time relative to GDP, both at companies and households. Prosperous and growing economies tend to have more income producing assets on the ground like factories, fixed commercial structures and housing stock. We prefer to look at debt relative to assets and be mindful of the value of the assets as influenced by interest rates and supply/demand factors that influence the returns earned by such real economy assets. Even though U.S. non-fin corp Liabilities/GDP is at an all time high, the Liabilities/Assets ratio has been stable and is inline with past two cycles. On page 4 we provide our detailed views on how to apply different leverage metrics.

### **S&P companies took advantage of low long-term interest rates by issuing long-term debt**

S&P firms took advantage of the long period of very low long-term interest rates by using more long-term (LT) debt in their debt mix. LT debt is at an historic high of total debt at 87%. Liquidity is abundant as S&P ex. financials EBITDA (earnings, before interest expenses, taxes, depreciation and amortization) is 10.6x gross interest expense and 11.2x net interest expense. And S&P ex. Financials have 2.9x as much cash as short-term debt. The Fed has hiked overnight rates from 0%-0.25% to 1.25%-1.5%, yet the interest coverage ratios remain strong. We expect small interest expense increases at S&P non-financials on further Fed hikes. But S&P Financial profits should rise upon Fed Hikes. S&P non-financial net debt/mkt cap has been trending down since 1990, except for spikes during recessions. It climbed in 2015-16, mostly at Energy, but remains very low vs. history at 15% vs. a ~25% long-term average.

### **S&P interest expense is small, a 100bp climb in 10yr tsy yields is \$0.40 off annual earnings per share (EPS)**

Interest expense at S&P non-financials is ~\$180bn on trailing 4-qtr, which after-tax is roughly \$140bn or \$16 of EPS. Total long-term debt is \$4.3tr and usually 10-15% of it rolls over each year. If we assume that the effective (real) interest rate rises 100bp on all non-financial long-term debt, the hit to S&P EPS is about \$4, but this would play out over 10 years, so \$0.40/yr. Besides, S&P non-financials have \$1.9tr of cash and ample debt capacity to help optimize their capital structure. We expect the yield curve to continue to flatten upon 4 more Fed hikes in the next 12 months, as we don't expect the 10yr treasury yield to climb above 3.5% for the rest of the cycle. If this outlook holds, then a ~60bps rise in 10yr yield from here will only negatively impact S&P EPS by \$0.25. If the climb in rates is mostly from higher inflation, then this likely boosts sales and the profit impact will be positive. The S&P's operating leverage is structurally lower today than history with a non-GAAP (non generally accepted accounting principles) net margin ~12% vs. ~7% in mid 1990s. A climb in interest rates causes a lesser percentage impact to profits today because of higher margins.

### **The bond market doesn't seem to think U.S. companies are over leveraged**

Since 2014, net debt/EBITDA of S&P ex. financials rose from 120% to 160%, Fed has hiked the overnight rate by 25bps five times, but U.S. corporate spreads at both investment grade (IG) and high yield (HY) remain very stable and tight (IG 100-150bps and HY 350-400bps) except for the spikes in Energy spreads in early 2016, both IG and HY are now close to the lower bounds of these ranges. The bond market suggests confidence that U.S. corporates can fare well around some Fed Funds rate normalization. Many multinational companies had cash stranded overseas and issued domestic debt to fund their dividends and buybacks to avoid paying incremental repatriation taxes. Given the new tax law, companies can use repatriated cash to retire some of this debt while also being able to boost dividend and buyback payouts.

### **Small cap leverage spiked during the oil rout, but on slow recovery to normal levels**

Net debt/EBITDA of Russell 2000 spiked to dangerously high levels in early 2016 with small cap Energy/Materials/Industrials companies' quickly deteriorating operating results on the oil collapse. They have since recovered gradually to the normal mid-cycle levels. With less cash buffer and more earnings cyclical, we think small caps are more susceptible to large borrowing cost jumps. But again, such scenarios are unlikely as we expect only gradual climb in yields.

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## **KEY LEVERAGE METRICS**

### Balance Sheet

**Net Debt / Book Equity:** Debt to book (D/B) is a popular leverage metric, but other than for Financial companies, it is not one of our favored metrics. D/B fails to consider a company's economic profits. Just as companies with high returns on capital deserve a higher P/B than companies with low returns, companies that have demonstrated sustainably high returns can support higher D/B ratios. This metric is sometimes perceived to be more conservative and thus more appropriate for leverage analysis. We disagree, as all too often highly indebted firms have recurring or full-cycle subpar returns on capital.

**Net Debt / Market Equity:** We prefer to compare debt to the market value of equity (D/E) as this captures the current and future outlook for returns on capital vs. the cost of capital. This metric is sometimes criticized for its reliance on the market to fairly value equity. This is a valid concern and reason for investors to be mindful of the PE underlying observed market cap. Be careful using this metric on high growth companies with high PEs and high capex relative to D&A. This will make servicing debt on current earnings and current cash flow more difficult than the Net Debt / Market Cap metrics suggests. If the cash balance is very high, use Net Debt / (Market Cap - Cash).

**Net Debt / Enterprise Value:** This metric (D/EV) is similar to D/E, in that it reflects market values and future outlook. When comparing leverage across companies, using D/E or D/EV will produce the same relative ordering. We like the way D/EV is expressed from 0-100% as this is easy to conceptualize. However, the linear nature of D/E makes it more useful in regressions and beta leveraging and deleveraging formulae.

**Net Debt / EBIT:** This metric (D/EBIT) is similar in nature to D/EV, however it only includes the portion of EV that is attributable to today's earnings. This is a useful measure for determining how much debt high growth companies or companies prone to cyclically depressed earnings can handle. These are important considerations in determining the best type of debt for a company.

### Interest Coverage

**EBIT / Net Interest Expense:** Interest coverage ratios offer the most clarity on the ability of a company to service near-term interest expense. Much attention is paid to coverage ratios by rating agencies, investors, and the issuers themselves. We value the clarity of interest coverage ratios and EBIT to Net Interest Expense (EBIT/NIE) is the coverage ratio most strategic in nature. But other important considerations include corporate FCF and debt term structure.

EBIT/NIE can mask some important financial risks and we advocate considering Debt/EBIT and other metrics simultaneously. For instance, a company using lots of low interest rate short-term debt will often have strong EBIT/NIE coverage even if its D/EBIT is dangerously high. The company might be easily servicing its interest today, but trouble will come if short-term rates rise and earnings are not commensurately higher. Thus, D/EBIT can be insightful when short-term and long-term interest rates significantly differ. Similarly, considering Debt/EBIT in addition to EBIT/NIE can help capture the economic cost and claim of any convertible debt in the capital structure.

### EBITDA and other cash flow leverage based metrics

**Net Debt / EBITDA and EBITDA / Net Interest Expense.** These EBITDA based leverage and interest expense coverage metrics are similar to the EBIT based metrics above, but adding back D&A helps to gauge how well interest expense can be covered over a short-time if maintenance capex can be delayed. This measure and the many other variations of it are suitable short-term tolerable debt measures. Other areas of temporary sacrifice include: R&D, marketing, cash compensation, pension plan funding contributions, etc.

**Surplus FCF / Net Interest Expense.** Surplus FCF refers to FCF after dividends. Covenants often specify that dividends can't be paid unless interest payments are up to date, but company's committed to ensuring their current dividend payment should consider this measure. Because dividends and share buybacks can only be funded by domestic FCF, unless companies repatriate foreign earnings and pay any incremental US taxes due, companies that take on extra debt should have dividends well covered and be flexible in share buybacks.

### Misleading leverage metrics

**Debt to sales.** If revenue is the only data you have on a company then it is perhaps best not to lend to it or buy its debt. If sales are the only non negative operating measure the company produces then its debt might be too risky.

**Debt to GDP.** This is an extremely misleading metric to use in macroeconomic analysis other than for government debt. It is typical for debt relative to GDP to rise over time both at the corporate and household sector. This is because assets tend to rise over time relative to GDP both at the corporate and household sector. Prosperous and growing economies tend to have more income producing assets on the ground like factories, fixed commercial structures and housing stock. We prefer to look at debt relative to assets and be mindful of asset values as influenced by interest rates and supply/demand factors that influence the returns earned by such real economy assets.



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## Definitions

Earnings per share (EPS) is calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

EBITDA is an accounting measure calculated using a company's net earnings, before interest expenses, taxes, depreciation and amortization are subtracted.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

High-yield (HY) bonds are high-paying bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds.

An investment-grade (IG) rating by a rating agency such as Standard & Poor's indicates that a bond has a relatively low risk of default.

Non-GAAP earnings are an alternative method used to measure the earnings of a company, and many companies report non-GAAP earnings in addition to their earnings as calculated through generally accepted accounting principles (GAAP).

Read more: Non-GAAP Earnings <https://www.investopedia.com/terms/n/non-gAAP-earnings.asp#ixzz59wuv9TuL>

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The Russell 2000 Index tracks the performance of the 2,000 smallest stocks in the Russell 3000 Index (which consists of the 3,000 largest U.S. companies as measured by market capitalization)..

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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