SEGALL BRYANT & HAMILL

Entering the Late Innings of the Credit Cycle:

Three Factors to Watch

SBH Fixed Income Research

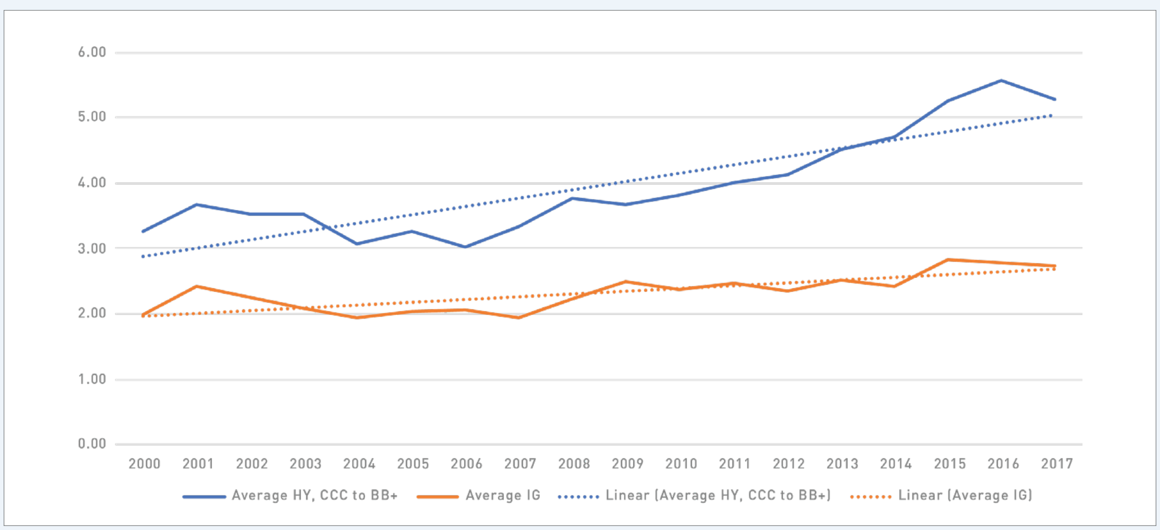
Summer 2018

With summer fully in bloom and the professional baseball season underway, many people will find themselves at the ballpark, enjoying hot dogs and peanuts, thinking about home runs, base hits and innings. We on the SBH Fixed Income team also find ourselves thinking frequently about innings, although our ponderings have nothing to do with the Cubs, White Sox or Rockies. When describing the length and age of the economic cycle, analysts and observers often refer to being in a certain "inning," with the later innings indicating the proximity to the end of the cycle...and the inevitable next economic downturn. We are keeping a close eye on the late-cycle indicators, many of which are showing reasons to be extra cautious in how we construct our portfolios. Specifically, three key factors are suggesting that the game is approaching the later innings, i.e., that the credit cycle is aging steadily. These factors include: 1) the increasing leverage of debt issuers, 2) weakening covenants on new bond issues and 3) the creative manipulation of key metrics such as earnings before interest, depreciation and amortization (EBITDA).

LEVERAGE HAS BEEN INCREASING

Historically, as credit cycles mature, issuers of debt tend to become more aggressive with the amount of leverage they employ in their capital structure, using this debt to pay special dividends, buy back equity, make acquisitions, etc. This trend has been observed by the SBH Fixed Income team and is also evidenced in the chart below. Management teams may become more focused on driving share prices than on conserving their balance sheet strength, especially when debt is cheap, outlooks are rosy and compensation incentives are increasingly geared toward equity performance. This happens gradually, but it becomes apparent in the metrics that can be seen over time. As a current example, the following chart shows how leverage, as measured by total debt divided by EBITDA, has trended upward since 2000 for both investment grade (IG) and high yield (HY) issuers rated at least CCC. Following the recessions of both 2001 and 2008–2009, leverage decreased for a year or two before again beginning to march higher.

AVERAGE LEVERAGE OF CORPORATE ISSUERS
2000-2017



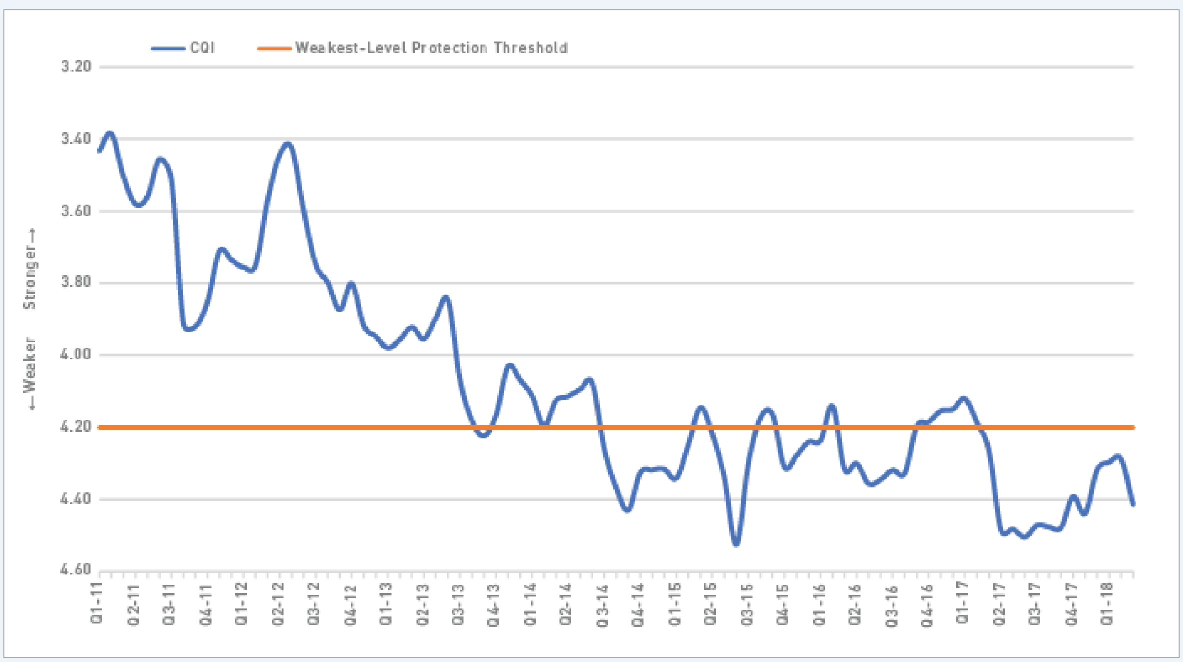
Source: S&P Capital IQ, Segall Bryant & Hamill

This tendency toward more debt being issued by already-indebted companies is also captured in the credit ratings of outstanding corporate debt. According to S&P Global, the median corporate credit rating today is BBB-, just one notch above junk status, and lower than the last major downturn in 2008–2009.

COVENANTS HAVE WEAKENED

Following an economic downturn and the related pain in the credit markets caused by defaults and downgrades, bond investors like us naturally go through a phase of demanding more protection through stronger covenants—that is, the legal guidelines and limits on what the bond issuer can do. These limits include how much debt the issuer is allowed to incur, or whether the issuer may pledge the same collateral for future debt, among others. As the cycle matures, that protection tends to drift as investors demand less protection and management teams may take advantage of the reduced restrictions. Moody's uses a methodology to track and score the covenant quality of individual issuers, and per their Covenant Quality Index (chart below), bond covenants have trended downward since at least 2011. As in many aspects of bond investing, this trend may not be too damaging until something causes investors to wish they had better protection, at which point it may be too late to conserve the assumed value in the assets/collateral/cash flow.

MOODY'S COVENANT QUALITY INDICATOR (CQI)
Three-month rolling average moves deeper into weakest level in May



Note: CQI includes all high-yield bonds, including high-yield lite. High-yield-lite bonds lack a debt incurrence and/or a restricted payments covenant and automatically recieve the weakest possible CQ score of 5.0.

Source: Moody's High-Yield Covenant Database

EBITDA HAS BECOME INCREASINGLY DISTORTED

Another trend we have observed recently is the increasing tendency of management teams to distort the meaning of the metrics they report. A common culprit is EBITDA, the denominator in the leverage equation referenced above. EBITDA is often "normalized" by excluding non-operating items, one-time gains and losses, asset writedowns, etc. These are fairly common and may be easily explained, and many analysts have stories of management teams' tendency to tweak definitions and make questionable adjustments. The problem arises when taken to an extreme and used to mask a slowdown in a company's growth, earnings or general financial health. S&P Global recently reported that in the 4th quarter of 2017, over 25% of the reported M&A and LBO deals showed EBITDA adjustments greater than 0.5x the amount of debt held by the reporting company. This has the effect of artificially boosting growth rates and reducing reported leverage—the same leverage that, as discussed above, has been trending higher despite these adjustments.

CONCLUSION

Here at SBH, we are looking forward to a summer full of many innings of baseball. We are also paying increasingly closer attention to what inning we are playing in the economic cycle. While there is a lot we don't know about the future, there is one thing we know for certain: markets move in cycles, and we are closer every day to the next downturn. And just as a baseball game typically lasts only nine innings, or can go into extra innings when a game is tied (the longest in MLB history lasted 26 innings!), we realize the credit cycle can also extend. With that in mind, we are watching these danger signs and avoiding companies that are taking on too much leverage, reducing covenant protection and unreasonably distorting EBITDA. We believe this focus and discipline will benefit our clients over time, regardless of when the game ends.

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