Capital Markets Bureau
Market Buzz

CORPORATE LEVERAGE TRENDS HIGHER

NOVEMBER 29, 2018

NAIC
National Association of Insurance Commissioners

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Executive Summary

- Corporate debt outstanding has accumulated in recent years given record levels of issuance to take advantage of low interest rates.
- Proceeds have been primarily used for purposes that do not directly contribute to profitability (such as share repurchases and dividends), and as a result, debt to EBITDA[1] ratios have deteriorated.
- In a climate of rising rates, highly leveraged companies could potentially face challenges in meeting debt payments or refinancing maturing debt.
- EBITDA "addbacks" have become more common and can result in issuers appearing less leveraged and less risky than they actually are.

[1] Earnings before Interest, Taxes, Depreciation and Amortization

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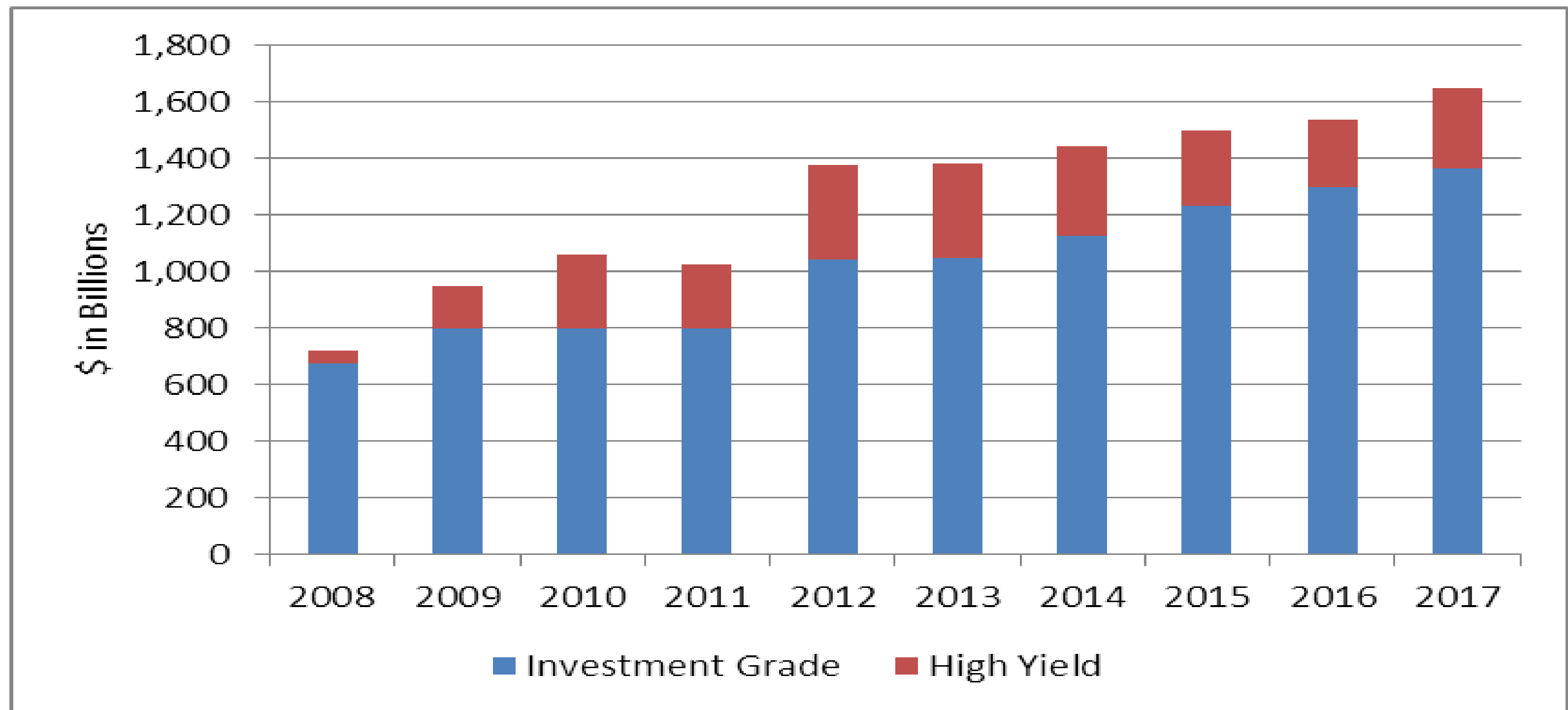
U.S. Corporate Bond Issuance



Source: SIFMA, Thomson Reuters

- Corporate bond issuance in the U.S. has increased almost every year since 2008.
- In the last ten years, U.S. corporate bond issuance has more than doubled – increasing almost 120% – to reach $1.65 trillion in 2017.
- High-yield bond issuance has been robust in recent years – ranging from 15% to 25% of annual issuance for the 2009 – 2017 period.

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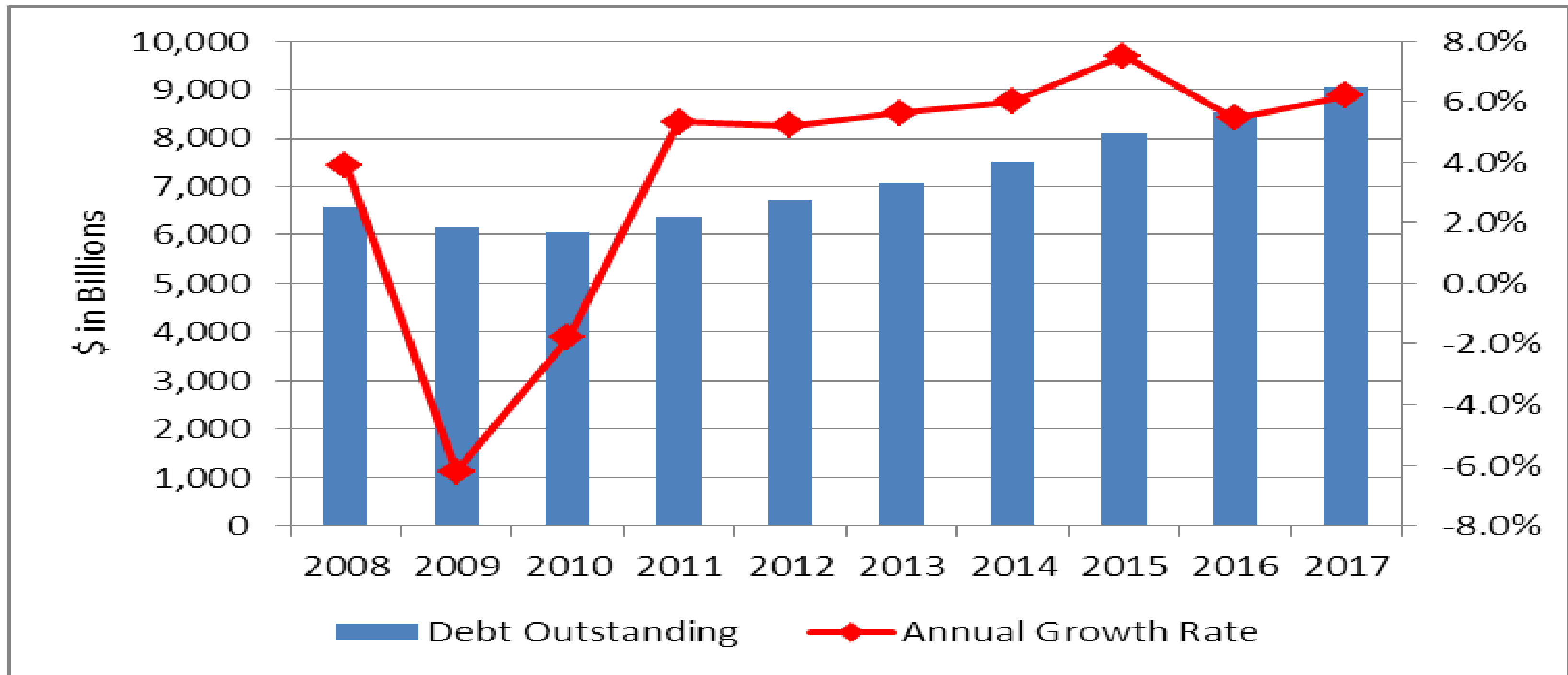
Corporate Leverage Is Rising



Source: Federal Reserve

- Based on Federal Reserve data[1], debt held by non-financial U.S. companies has been increasing steadily in recent years.
- Debt outstanding increased almost 50% from 2010 to 2017, to reach just over $9 trillion at year-end 2017.

[1] Federal Reserve Statistical Release “Financial Accounts of the United States” Second Quarter 2018

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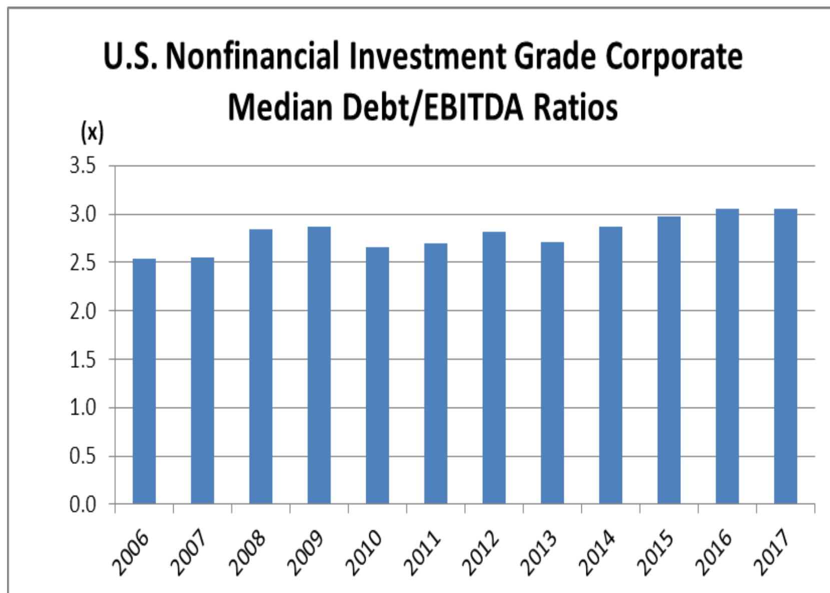
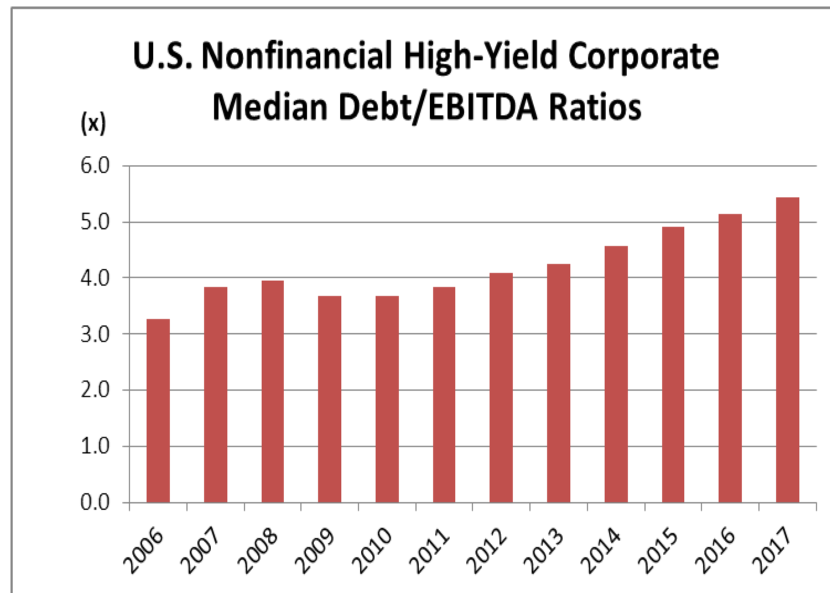
High-Yield Companies Add Greater Share of Leverage





- Based on S&P Global Ratings data[1], the median debt to EBITDA ratio (a common measure of leverage) of their rated borrowers reached 4.4 times in 2017 from 2.9 times in 2006.
- High-yield companies in particular took on more debt, with their median debt to EBITDA ratio climbing to 5.4 times in 2017 from 3.3 times in 2006.
- The median debt to EBITDA ratio of investment grade companies increased modestly to 3.1 times in 2017 from 2.5 times in 2006.

[1] S&P Global Market Intelligence report "When The Cycle Turns: Leverage Continues To Climb – Has It Finally Peaked?, October 9, 2018

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Why Has Leverage Increased?

Ample Funding Availability

Investors have been more willing to take on risk due to the prolonged low interest rate environment. So borrowers, particularly lower-rated ones, have taken advantage of the ease of credit and have issued record levels of new debt.

Low Cost of Borrowing

Funds primarily used for…

- Mergers and Acquisitions
- Shareholder Friendly Actions
  - Share Repurchases
  - Dividends

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What is the Impact of Rising Leverage?

Exposes Financial and Operational Vulnerabilities

To …

- Turn in the Credit Cycle
- Rising Rates

Limits Financial Flexibility

Can lead to …

- Credit Rating Downgrades
- Defaults

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What are EBITDA Addbacks?

Adjustments to EBITDA

- Make EBITDA appear stronger thus reducing the measure of leverage: Debt/EBITDA
- Typically utilized when issuing new debt or entering a financial transaction
- Have become more common in recent years as companies, especially highly leveraged ones, issue record amounts of debt to take advantage of low interest rates

Examples of Addbacks

- Post-Acquisition, -Divestiture or -Merger Cost Savings/Synergies
- Restructuring Costs
- Non-Recurring Operating Costs
- Deferred Income Costs
- Inventory Adjustments
- Intangible Asset Impairments

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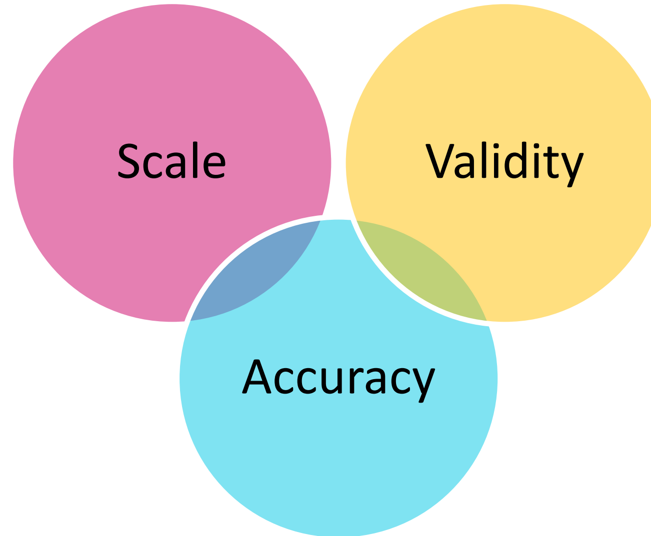
Risks of EBITDA Addbacks

EBITDA addbacks should be verified for…



Aggressive or unrealistic addbacks can result in…

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Questions to Understand Leverage Risk in Insurance Company Investment Portfolios

- What is the insurer's bond/loan exposure as a percent of total assets to companies considered high-yield? As a percent of capital?
- How does the insurer's high-yield exposure compare to the U.S. insurance industry average of 5.5% of total bonds[1]?
- Is there a significant concentration in high-yield bonds/loans?

[1] As of year-end 2017

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