NASHVILLE NOTES

Know what you own and own the numbers

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Scott Minerd, the Global Chief Investment Officer of Guggenheim Partners, has offered some strong opinions about corporate credit recently. He said corporate leverage "is now so extreme, any attempt to rein in credit expansion is going to ultimately blow up." And in reaction to General Electric Co.'s accelerating train wreck, Minerd was blunt: "The selloff in GE is not an isolated event. More investment grade credits to follow. The slide and collapse in investment grade debt has begun."

Wall Street now knows where Minerd, a significant corporate credit manager, stands.

The consensus seems to be forming that it is downhill from here for corporate credit, although perhaps not as dark as Minerd apparently sees it. The Federal Reserve has begun to express concern, although I think a not-unreasonable analogy is that of an arsonist calling the fire department after starting a fire. The other credit-related consensus seems to be that the next credit cycle will see much greater stress among corporate borrowers — unlike 2008 to 2010, which was focused on consumers, real estate and financial institutions.

No one should be surprised. Corporate America was highly incented to shift its capital structure to reflect more debt and less equity when interest rates were squashed by the Fed for years after the financial crisis. Plus, interest is tax deductible — unlike dividends, which are paid with after-tax income. Retail and institutional investors were incented to facilitate the leveraging process, too. With safe assets such as CDs, money markets and the upper rungs of investment-grade bonds yielding little, investors were incented to pile into leveraged loans, high-yield bonds, and the lowest rung of investment-grade-rated bonds (BBB-/Baa3).

So, are the high-yield and lower-rated portions of the investment-grade corporate bond market ready to blow along with the leveraged loan market? I am not so sure, even though the current expansion is long by historical standards. How the economy performs over the next year or two and the magnitude of capital flows out of (or into) higher-risk credit markets will be the primary arbiters of the corporate credit cycle.

For investors I see a few takeaways aside from increasing an allocation to cash, assuming Minerd is right.

The first is to know what you own and to "own" the numbers. To own the numbers is to have a deep understanding of a subject company's income statement, balance sheet and cash flow statement, what drives each and, as it relates to the balance sheet, what contingent liabilities exist that may claim corporate cash flow.

Why? Because leverage may be greater and earning power may be less than assumed given a heavy focus by equity and even credit investors on adjusted earnings and revenues. The practice is reasonable to an extent to understand underlying trends, but I think it easily leads investors to an alternate reality for something that has not occurred. For equity investors, this can be important because heavily adjusted earnings can create a bridge to next year's higher earnings and therefore a more reasonable forward valuation than can be justified based upon reported results.

The comparative analogy for credit investors is a company that is not as levered relative to EBITDA (as an imperfect measure of corporate cash flow) to the extent that adjustments push it higher.

A few months ago, I was chatting with an executive of a privately held healthcare company who told me their private equity sponsors were planning to take the company to market (M&A) soon. I asked about EBITDA and adjustments to it they were crafting for the pitch book. The executive chuckled and then expressed surprise at how high the sponsor was able to push adjusted EBITDA versus the reported number.

I wasn't surprised. While a potential acquirer may look past the adjustments or offset the aggressive positive adjustments to EBITDA with various deductions, I am not convinced that is the case in the public markets where many investors are passive or focus on earnings and revenue momentum. Upside earnings and revenue surprises (as adjusted) can drive a stock until reality sets in.

The second takeaway is that investors should focus on earning power (i.e., normalized earnings through a business cycle) rather than adjusted earnings. That concept tends to fall out of favor in bull markets because investors are highly focused on consensus earnings over the next four quarters and whether the consensus will rise or fall. The downside of what some call "margin of safety" investing is that stocks will look expensive vis-à-vis the multiple on adjusted earnings. For bank investors, normalized earnings will be lower than current earnings, whether as reported or as adjusted, because credit costs are very low and will increase even without a recession.

Another takeaway for bank investors is a question: What risks exist if the consensus described above is correct? A sizable amount of corporate credit extended to levered entities over the past decade resides on investor balance sheets rather than bank balance sheets. An implosion that Minerd envisions will hit investors, but there will be collateral damage among some commercial banks.

It is not yet clear which banks, but those active in syndicating leveraged loans are likely suspects. Knowing what you own and owning the numbers may not explicitly answer the question, but it should help lessen the probability of an out-of-the-blue surprise such as the difficulties Opus Bank disclosed in late 2016 after a period of rapid growth.

Finally, corporate America may have a sense that investor sentiment is shifting to favor less leverage. Perhaps that is true with the rating agencies, too. At the margin, debt is less favorable today than a few years ago given higher borrowing costs and the reduction in the tax shield from being able to deduct interest expense following the sizable drop in federal corporate tax rates. Companies may respond by directing cash flow from equity buybacks to debt reduction — a move that would be good for credit investors, but not so good for equity investors in the short run.

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