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Crexit Ahead? S&P Global Ratings Analysts Delve Into The Data On Global Corporate Borrowing

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Crexit Ahead? S&P Global Ratings Analysts Delve Into The Data On Global Corporate Borrowing

S&P Global Ratings analysts sat down to review their track record and peer into the future, after publishing their fifth annual report on the medium-term outlook for global corporate borrowing, "Global Corporate Credit: Despite An Inevitable Credit Correction, Debt Demand Will Swell To $62 Trillion Through 2020," published on July 20, 2016. In the report, we forecast that global corporate borrowing demand will reach a record $62 trillion by 2020, fueled by expansive monetary policy. This strongly suggests an unavoidable correction in global credit markets, because nearly half of corporate debt issuers are highly leveraged. In fact, we think the credit correction began in late 2015 and will likely stretch through the next few years as defaults spread into other sectors in certain regions, according to our base case scenario. However, we're not ruling out unexpected developments that might lead to a deeper credit crunch or "Crexit."

Here, we sum up what corporate credit analysts Terry Chan, Diego Ocampo, David Tesher, and Paul Watters had to say about the topic at an S&P Global Ratings webcast on July 21, 2016, "Annual Global Corporate Debt Demand Update," available on replay (see end of article for details).

Overview

- We are somewhat surprised about the recent heady pace of corporate debt acceleration relative to nominal GDP growth, S&P Global Ratings analysts said in a webcast discussing their fifth annual report on the medium-term outlook for global corporate borrowing.
- Of note is the sheer scale and significance of what's happening in China, which now represents 35% of global corporate borrowing with 15.9% credit growth in 2015.
- Similarly, in the U.S., the second-largest market in the world with a 24% market share of corporate debt, corporate demand for credit has been stronger than we have expected.
- We see strong incentives in place to encourage companies to acquire further debt to support growth, despite the role that debt played in the buildup to the financial crisis. For that reason, we believe a credit correction is inevitable.

"What has become very interesting to see is how our previous assumptions and conclusions have fared, especially in light of a dynamic and constantly changing global economic environment," said Mr. Tesher.

These assumptions consist of country-specific forecasts provided by our economics team for nominal GDP and GDP deflators. Then, we take into account where particular countries are in the credit cycle, apply bespoke average "credit intensity" multiples (corporate debt growth to nominal GDP growth) and consider how much flexibility corporate borrowers have to take on additional debt. We apply those assumptions to Bank of International Settlements and central bank stock data to calculate outstanding total nonfinancial corporate debt (which includes both bank loans and bond financings).

In this year's annual report, one of our main observations is the recent heady pace of debt acceleration relative to nominal GDP growth.

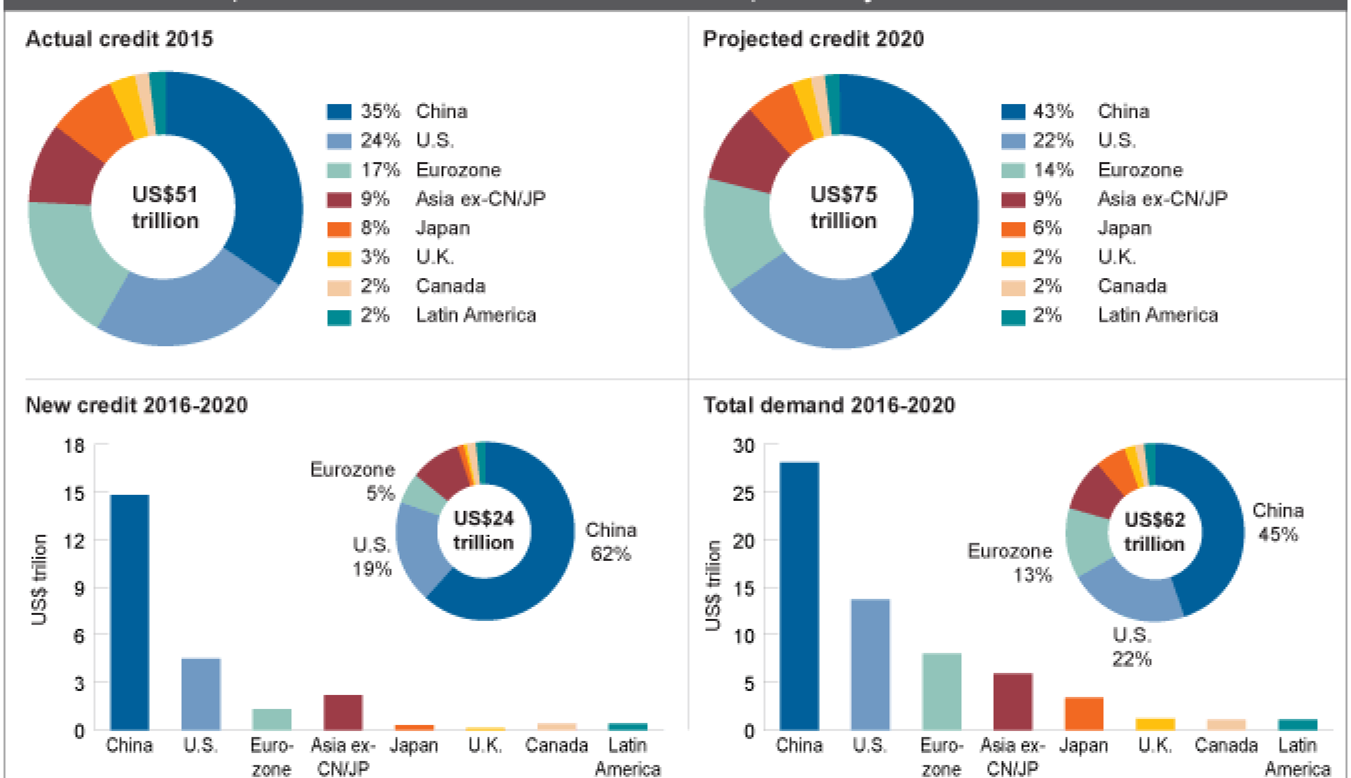
"This has been a bit of a surprise to us, as last year we had expected animal spirits to be somewhat dampened by the turn in the credit cycle in the U.S., a faster rebalancing in China toward a less capital-intensive consumer and service-oriented structure, and constrained capital expenditures globally—cooled by the end of the commodity supercycle," Mr. Watters said.

In fact, last year credit intensity grew the fastest globally since 2008, by a multiple of 2.15x. To put this in context, the very long-term sustainable growth rate for credit in developed economies we estimate to be about a multiple of 1.0-1.2x nominal GDP growth.

"The first point I would like to make is that there are significant differences between countries with respect to absolute debt, the rate of growth of corporate debt, and the ability and appetite to take on new debt," said Mr. Tesher. (See chart 1 from the original report.)

Chart 1

Actual Debt 2015, New And Total Credit Demand 2016-2020, And Projected Debt 2020



CN–China, DE–Germany, FR–France, JP –Japan. Percentages may not add up to 100% because of rounding. Source for 2015 outstanding credit data: Bank for International Settlements, Banco Central Do Brasil, Statistics Canada, European Central Bank, Banco de Mexico, U.S. Federal Reserve, and U.K. Office for National Statistics. Source for other data: S&P Global Ratings.

A key feature of this report, spotlighted in our previous reports, is the sheer scale and significance of what's happening in China. The country now represents 35% of global corporate borrowing, according to our study, with 15.9% credit growth in 2015. This is equivalent to a credit intensity of 2.5x--the highest in China since 2009. "Even though economic growth is slowing, we're not seeing a similar "decoupling" or slowdown in corporate credit because Chinese authorities, while seeking to rebalance the economy and consolidate the industrial sector, are still quite dependent on debt-fueled growth to hit their annual economic growth targets of 6%-7%," according to Mr. Chan. "Outside China," Mr. Chan went on to say "we believe credit growth in most of Asia will continue to be relatively subdued, especially in Japan—with but the exception of India where higher-than-average nominal GDP growth will fuel demand."

"That said, we're currently seeing some money come back to Asia because of negative rates in other markets, particularly post-Brexit," said Mr. Chan. "Nevertheless, it doesn't change our forecast for subdued growth in the region."

Similarly, in the U.S., the second-largest market in the world with a 24% market share of corporate debt, corporate demand for credit has been stronger than we have expected. Corporate credit grew 6.8% in 2015--the strongest since 2007--and credit intensity was just shy of 2x. One reason is how companies are using their proceeds. "Given the challenges of organic revenue growth, many companies have chosen to pursue shareholder-friendly activity--financed by debt. So we're seeing proceeds going not only to general corporate purposes but also for stock buybacks," said Mr. Tesher. In addition, M&A activity has stepped up over the past couple of years, most of it fueled by investors searching for yield.

"Europe, by contrast, remains very much stuck in the slow lane," said Mr. Watters, as the region struggles to accelerate the pace of recovery and corporates have remained somewhat cautious about taking on new debt. The corporate market is large with a 20% global share including the U.K., with credit growing only 3.0% in 2015. While this is an improvement from nearly flat credit growth from 2009 to 2013, it still only translates into a credit intensity factor of 1.1.x.

By contrast, Japan has been stagnating for many years. Corporate credit actually has been contracting in U.S. dollar terms, by an annual 0.7% since 2009. Last year, Japanese credit growth remained lackluster at 0.2%.

The Next Five Years

"Overall, we see strong incentives in place to encourage companies to acquire further debt to support growth," said Mr. Tesher. "This may seem somewhat surprising given the role that debt played in the buildup to the financial crisis."

The reason is largely that major central banks (perhaps with the exception of the U.S. Federal Reserve) continue to adopt ever more creative monetary policy measures to support economic growth or re-anchor inflation expectations. On the back of accommodative monetary policy, we anticipate that corporate borrowing will continue to outpace nominal GDP growth in both the Asia-Pacific and the U.S. Specifically, we believe that credit intensity will likely stay relatively high at about 2x in 2016.

Further out, we anticipate that as inflation normalizes, nominal GDP will increase. Credit growth may slow as the credit cycle turns down and companies try to improve their financial risk profiles, in China and the U.S in particular. In other words, we expect credit intensity to tail off toward 1.3x by 2020.

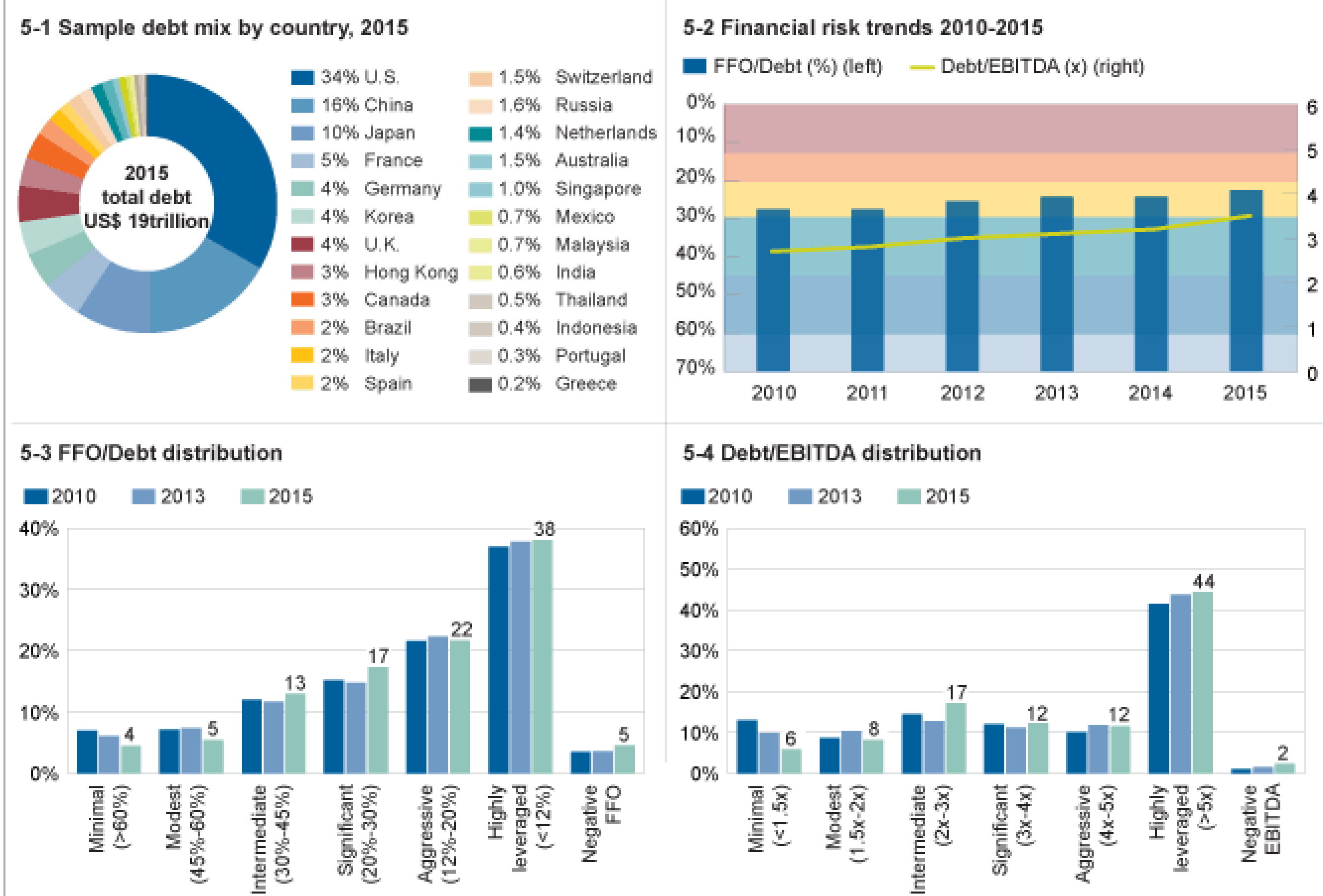
In terms of numbers under this base-case scenario, we project global corporate credit demand (flow) of $62 trillion over 2016-2020, with new debt representing two-fifths and refinancing the rest. Outstanding debt would expand by half to about $75 trillion, with China's share rising to 43% from 35%.

The Coming Credit Correction

"Our base case, which sees credit continuing to grow faster than income, is indicative of weaker credit quality," said Mr. Chan. Indeed, over the past five years, we found that credit quality has slipped, and about 43% to 47% are now highly leveraged, in our study of more than 14,400 rated and non-rated nonfinancial corporates globally (see chart 5 from the original report). What's more, 2%-5% are experiencing negative earnings or cash flows. This has increased incrementally since 2010.

Chart 5

Financial Risk Trends And Distribution Of Global Corporate Sample Of 14,403 Totaling US$19 trillion



In Chart 5-1, 0% indicates less than 1% of total sample debt. FFO – funds from operations, calculated as EBITDA less net interest expense and income tax expense. Financials were translated at constant 2015 USD. Ratios are debt-weighted when totaled. Background colors denote FFO/debt thresholds: light blue, minimal risk; blue, modest; green, intermediate; yellow, significant; orange, aggressive; and red, highly leveraged. Bracketed numbers in headings above chart refers to the number of companies and 2015 total debt (in US$ trillions) in sample. Source for financial statement data: S&P Global Market Intelligence. Other data source: S&P Global Ratings.

Does this mean a credit correction is inevitable? "Yes, we believe so," Mr. Chan said. "A credit correction is a form of renewal: credit growth slows and bad debt is written off, that sets the stage for further expansion." We have particular concerns about the indebtedness of Chinese corporates that has continued to grow despite the slowdown in real GDP growth, as well as for U.S. speculative-grade borrowers, whose leverage ratios are approaching pre-financial crisis highs.

"Regarding U.S. rated speculative-grade borrowers, what happened was that a constantly expanding universe of these companies has been able to capitalize and tap the capital markets under extremely favorable terms and conditions since the financial crisis--given the search for yield alternatives," said Mr. Tesher. "We're now seeing leverage ratios across our rated universe of U.S. speculative-grade issuers approaching pre-financial crisis highs."

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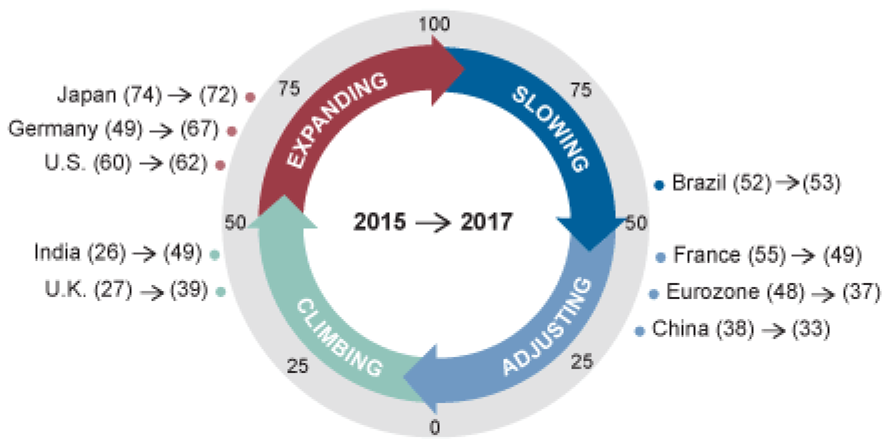
When the market corrects, it's going to be more challenging for weaker borrowers needing new financing. When risk is repriced, some borrowers that had been able to opportunistically tap the market won't be able to obtain new financing. "The positive is that it's not going to be a refinancing issue but a new financing issue," said Mr. Tesher.

It's difficult to pinpoint when the correction will happen, but as the credit cycle turns down, credit risk inevitably rises (see chart 3 from the original report). For example in the U.S., we believe the downturn in the commodity cycle that has sparked defaults has the potential to spread contagion to other sectors, mainly through tightening financial market conditions that could challenge more vulnerable companies seeking new financing.

Chart 3

Stage of Corporate Credit Growth Cycle, 2015 → 2017



Numbers shown above are our credit growth index, where '100' indicates peak and '0' trough for the 15-year period of 2001-2015, where the first number is the past two years' average for 2015 and second number is our projected two-year average for 2017. Source for 2014-2015 outstanding credit data: Bank for International Settlements, Banco Central Do Brasil, Statistics Canada, European Central Bank, Banco de Mexico, U.S. Federal Reserve, and U.K. Office for National Statistics. Source for other data: S&P Global Ratings.

"In any case, our base case calls for an orderly credit slowdown stretching over several years, what we're calling our 'slow burn' scenario," said Mr. Chan. This assumes a moderate pick-up in real growth, coupled with moderate disinflationary forces and a gradual normalization in financing markets. The end result should be slower corporate credit growth rather than any material improvement in financial risk profiles.

Is A "Crexit" Ahead?

"We can't rule out a series of major economic or political shocks, like the recent Brexit vote in the U.K., which could trigger a much more disruptive, system wide, credit contraction," said Mr. Chan. Our concern is that these unforeseen events could quickly destabilize credit markets with higher price volatility, pushing investors and lenders to exit riskier positions—or what we call "Crexit." If mishandled, this could result in credit growth collapsing as it did during the global financial crisis in 2008-2009.

What About Europe?

We believe credit growth in the eurozone, apart from the U.K., will remain relatively constrained, mainly because of the lack of confidence in the strength of the eurozone recovery. That said, there are wide differences across the region. Spanish and Italian corporates are less keen to borrow additional debt. On average in the eurozone, we see slow growth in borrowing, as well as lackluster capex growth, though mergers and acquisitions could provide an upside surprise.

"Playing into this are political and geopolitical uncertainties about the future shape of Europe, as well as lingering concerns over the risk of deflation, which is obviously not a good thing if you have debt on your balance sheet, and which is why the ECB is responding so aggressively in its conduct of monetary policy," said Mr. Watters. This backdrop is encouraging companies to remain quite disciplined regarding financial policies.

In the U.K., clearly the uncertainty around the timing of Brexit and the form it will take is likely to dampen private-sector borrowing until some clear negotiated exit route takes shape. "It's going to take potentially years to get clarity on this point. This situation, again, is going to dampen down borrowing for investment and other growth-friendly type of activity," Mr. Watters said.

We expect the ECB to continue to buy up to €80 billion a month in bonds under its asset purchase program in the EU, with about €60 billion going to the government market. Because much of that market is offering negative yields, there's a limit to how much the ECB can buy, so it's likely that corporate bonds could make up some of the difference.

The Bank of England has also announced that they will start purchasing corporate bonds in late September with an initial target volume of £10 billion in investment-grade bonds to be bought over the next 18 months.

Latin America

Credit dynamics in Latin America generally mirror the global picture, where almost 50% of corporate issuers are highly leveraged. "I would say the trend started at least one year ago and is more evident in countries like Brazil and Venezuela where obviously economic conditions and credit conditions have worsened more dramatically," said Diego Ocampo. On the other hand, other countries in the region are still in an expansion phase, such as Mexico, Peru, Columbia, and Chile, and we expect credit there to keep on expanding in real terms, perhaps at slower rates than before. In Argentina, the economy isn't booming but corporates have been absent from the markets for about a decade and are far less levered. Even though conditions for credit aren't very favorable there, we expect a more active debt market.

In Brazil, corporate debt grew at a compound annual growth rate of 18% from 2010-2015 in U.S. dollar terms, compared with a rate of only 2% for EBITDA. This shows that credit was probably growing too quickly and was too cheap, and that the assets haven't yielded the profits they were supposed to yield. So a correction was expected and that's what's been happening since 2015. Appetite for Brazilian issuance and credit has diminished substantially, and new issuance is more expensive, in a recalibration of the risk-return equation. However, the good news is that corporate debt outstanding to GDP is relatively low, at 40%. We think capital market activity will remain subdued as companies refocus on increasing capacity utilization.

Writer: Rose Marie Burke

Related Research

- Global Corporate Credit: Despite An Inevitable Credit Correction, Debt Demand Will Swell To $62 Trillion Through 2020, July 20, 2016

For a publicly available version of the "Global Corporate Credit" report and access to the replay of the "Annual Global Corporate Debt Demand Update" webcast, go to www.SPRatings.com/corporateresearch.