FINANCIAL TIMES
MONDAY 25 NOVEMBER 2019

OPINION

Markets Insight

Beware the dawn of the corporate dead

Companies kept alive by low borrowing costs could make a downturn more gruesome

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Zombies continue to stalk the corporate landscape, and the horde is growing.

The number of businesses in industrialised countries whose interest costs are in excess of their annual earnings — "zombie companies", as they are sometimes known — has reached a level not seen since the global financial crisis. Bank of America Merrill Lynch estimates that there are 548 of these zombies in the OECD club of mostly rich nations, against a peak of 626 during the crash.

These zombies have been kept alive by years of cheap borrowing costs, created by investors chasing whatever yield they can find in a long bull market for government bonds. This helps to explain why there are five times more zombies today than during the late 1990s, when interest rates were significantly higher worldwide.

Property group WeWork, which continues to suck in ever more capital merely to stay afloat, must be the poster-zombie. But, as recent research from Morgan Stanley highlights, there are plenty of other large companies with heavy debt loads that do not have enough earnings to cover their interest payments, such as Telecom Italia and Greece-based lottery company Intralot.

Numbers have been rising especially among US small and midsized companies, in Europe and particularly the UK. Staples of the British high street, swamped by debt, have been foundering with ever greater frequency and the economic consequences of Brexit are likely to ensure that more will follow the likes of travel group Thomas Cook into trouble.

Rising corporate debt loads are a natural consequence of central banks' easy money policies, which have kept interest rates rooted at low levels. It is easy to see the cause of growing leverage in the real cost of debt. Companies' borrowing costs, viewed through the inflation-adjusted yield on eurozone investment grade corporate bonds, are about minus 1 per cent. And the story is similar in other parts of the world.

Companies have responded to this environment by rebalancing their sources of financing. Nowhere is this more apparent than in the US, where since 2009 companies have borrowed more than $3.1tn through debt securities and loans while buying back $4tn of equities, according to US Federal Reserve data.

In most movies about the undead, zombies can still be killed. More companies may also meet a grisly end if profit margins come under further pressure because of trade conflict and a general global economic slowdown. Corporate credit quality has been steadily deteriorating for decades now. In the 1990s, the median corporate debt rating from S&P Global, a rating agency, was solidly investment grade. Now it is just one notch above junk.

That is a big concern for the health of the wider stock market. An economic slump raises the prospect of a sudden, dramatic cascade of downgrades. Many large investors are restricted to holding investment grade debt, which means having to sell holdings that drop to junk rating. This would cause serious indigestion in the relatively illiquid high-yield bond market, as remaining buyers struggle to absorb the additional supply.

A watering-down of traditional investor protections makes a sudden crisis more likely still. As recently as 2011, virtually all European corporate loans were issued with solid covenants — the minimum financial thresholds that help ensure a company will be able to meet its obligations.

Now, more than 80 per cent of debt sold by the largest companies is classed as "covenant lite", offering negligible protection to creditors.

Those of us who invest in distressed assets and special situations are paying close attention to the fact that 6 per cent of European junk bonds are trading at "distressed" levels, or more than 10 percentage points above government bonds, according to Deutsche Bank. That distressed proportion is up from only 3 per cent a year ago. It is a similar story in the US where 9.3 per cent of the benchmark high yield index is trading at distressed levels, from a low of 3.5 per cent in September 2018.

By contrast, the majority of bond investors seem complacent. The average yield for a junk bond in Europe is just 3.1 per cent, down 1.2 percentage points from a year ago. The 20-year average is much higher, at 8.5 per cent.

Central bank intervention has propped the corporate sector up for much of the past decade and can continue to do so until inflation starts to rise. Meanwhile, a loosening of fiscal policy and a relaxation of trade tensions could spur profits.

But when a business cycle becomes as long in the tooth as this one, the odds start to tilt towards a downturn. The signs are that the slump could start in the corporate debt market.

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