TD Asset Management

NEW THINKING

Looking beyond the ratings...

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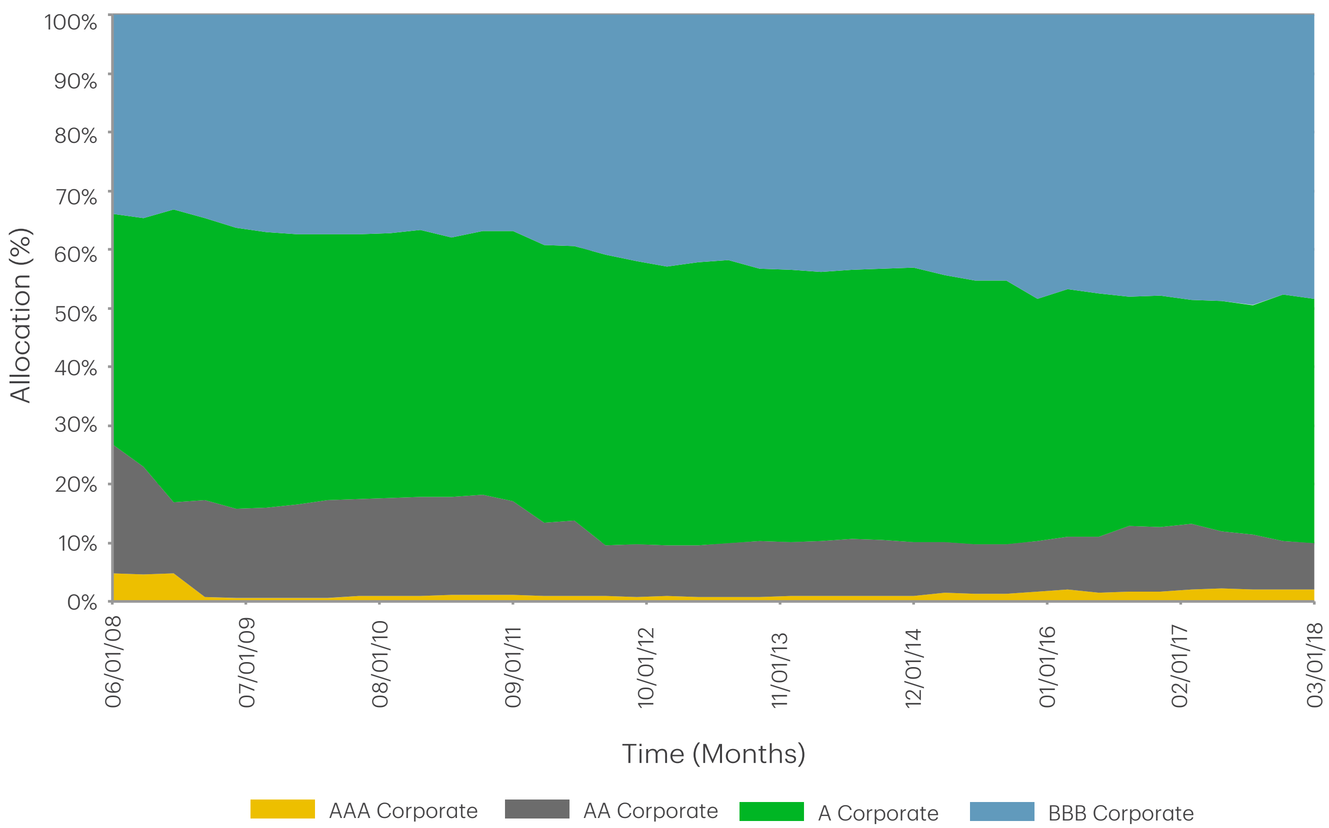
How corporate bond market risk has increased, beyond what the ratings indicate.

The investment grade corporate bond market continues to expand in size, and is now nearing record levels. The Bloomberg Barclay's US Corporate Bond Index, representative of the US corporate bond market, now measures over $5 trillion; nearing its all-time high and further up from its $2 trillion mark in 2008. The BBB-rated segment of the index has experienced significant growth, with it now representing over 50% of the corporate bond market. This paper will focus on the observable growth of the BBB-rated segment, speak to the implications of its changing characteristics and provide a perspective on how we (TD Asset Management or "TDAM") identify quality credit instruments for inclusion in the portfolios and funds under our management.

The expansion of the corporate bond market can be attributed to the presently prolonged, low-interest rate environment and favorable tax-treatment afforded to interest rate expenses. This has resulted in the increase of company debt, which in turn has been used by company management to fund stock repurchases; with the aim of increasing a company's stock price. The result of these actions is the degradation of a company's credit rating over time and the gradual expansion of a lower-tiered credit segment (i.e. BBB-rated) of the corporate bond market.

An illustration of the gradual expansion of the 'BBB-rated' credit segment



Time Frame: June 2008 to March 2018
Source: Bloomberg Finance L.P. (June 2018)

Do more BBB's fully reflect risks?

While the expansion of the BBB-rated segment is mainly due to credit migration, that is, higher-rated companies (AAA, AA and A) moving down into the BBB-rated segment; our analysis has led us to a more nuanced realization, that BBB-rated credits are presently weaker than they have been historically.

In assessing the investment grade segment of the corporate credit market over a decade (2007 to 2017), there has been a material change in the quality of the financial metrics associated with the credit rating assigned to corporate bonds; an observation seen when reviewing the median *Debt-to-EBITDA*[1,2] ratios for all companies within a specific rating category. Debt-to-EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) is a commonly used metric for assessing the amount of debt a company has versus its cash flows. The higher the ratio, the more indebted a company is considered, all other things being equal. Typically, a BBB-rated corporate bond will have a higher Debt-to-EBITDA ratio than an A-rated or AA-rated bond. From the table below, in 2012 the median Debt-to-EBITDA ratio for a BB-rated corporate bond was 2.7x, while the median for BBB-rated corporate bond was 2.2x, and 1.3x for a single-A corporate bond. This intuitively makes sense, as the higher the debt amount relative to the cash-flows available, the weaker one's credit profile would be.

[1] The median Debt to EBITDA ratio is used as a base credit rating indicator to assess broad trends within the credit market, for this paper.
[2] The Debt to EBITDA ratio is a key financial ratio used in assessing the creditworthiness of a company both by rating agencies and in debt-financed takeovers. It is also an indicator of a company's ability to service any debt it holds, ignoring factors of interest, taxes, depreciation and amortization.

Annual median Debt-to-EBITDA ratio for each corresponding credit-rating segment, over a decade.

Debt to EBITDA											
	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007
BB	3.6	3.3	3.2	3.0	2.8	2.7	2.7	2.6	2.7	2.5	2.6
BBB	2.8	2.7	2.6	2.3	2.2	2.2	2.2	2.2	2.3	2.2	2.0
A	1.6	1.5	1.3	1.1	1.2	1.3	1.3	1.4	1.3	1.3	1.2
AA	1.6	1.6	1.0	0.7	0.6	0.6	0.9	0.8	0.8	0.7	0.5

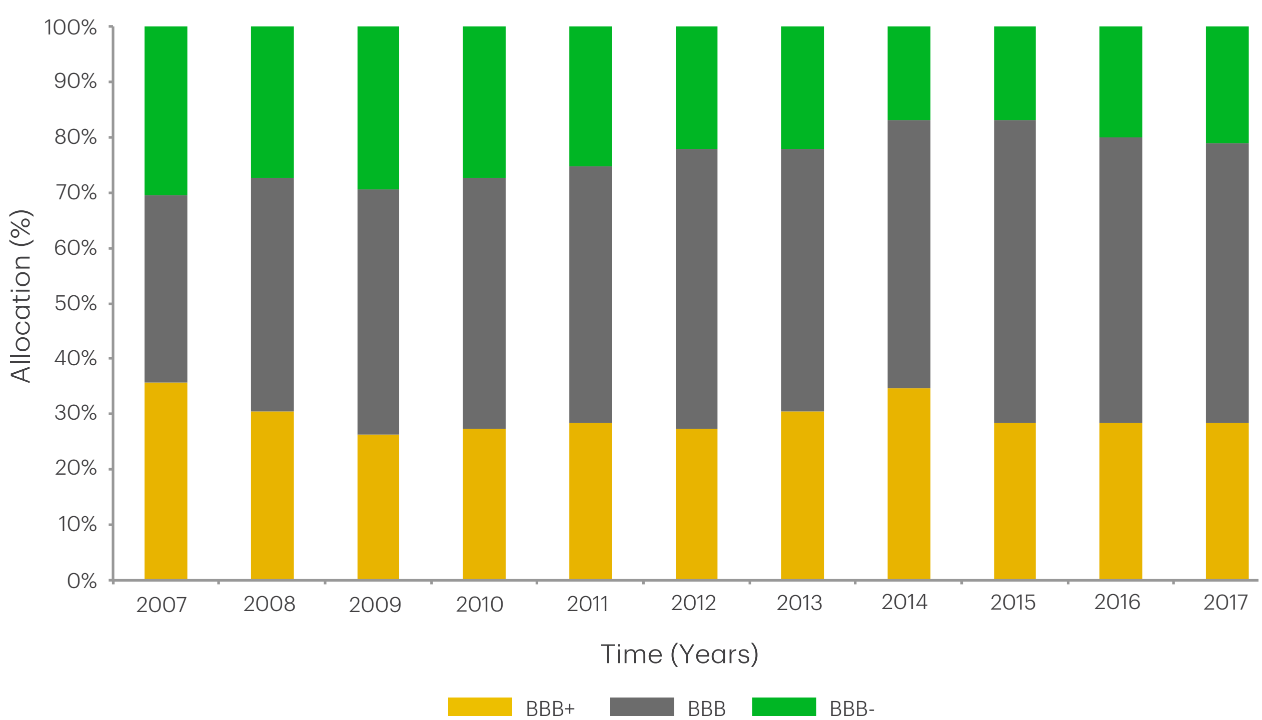
Source: S&P Capital IQ. June 2018.

However, we have recently noticed that those medians have drifted away from their longer-term ranges; the present state being that what was once appropriate for a non-investment grade company (BB-rated) is now the norm for an investment grade company (BBB). Referring back once more to the table, notice that for BBB-rated corporates, the Debt-to-EBITDA ratio stayed stable at 2.2x from 2010 to 2013; having rarely moved off that mark until recently. Now, it is at 2.8x, a measure that would have resulted in a BB-credit rating a decade ago.

Taking a deeper assessment

So what is the basis for this drift in quality? It wasn't due to the weakening of ratings within the category. For example, a BBB credit can also be rated as BBB+ or lower at BBB-. Has the BBB category shown movement towards lower ratings? No, we see no evidence of this, as the amount of BBB+/BBB/BBB- credits remain virtually unchanged over time. The chart below illustrates the dispersion amongst the BBB-rated segment, for the time period in focus. In conducting our assessment, we made sure to factor in the impact of rating changes that would have occurred over the years. Even companies that have had unchanged BBB-ratings for the past ten years have shown increased levels of debt leverage.

An illustration of the rating dispersion within the BBB-rated segement over a decade



Source: Bloomberg Finance L.P. (June 2018)

Another question to be raised was, is this occurrence particular to any one industry? When looking at the energy sector, the falling oil prices that existed from 2015 to 2017 did have an effect on the debt leverage of energy companies; as sharply lower oil prices hurt the earnings (the 'E' in EBITDA) of oil companies. However, when taking a broad view of each sector, there was an overall increase in leverage.

The table on the right details the average 5-year change in the Debt to EBITDA ratio for each individual sector in the BBB-rated segment. We note that the increase in leverage has been widespread.

Sector	Avg 5-yr chg
Healthcare	1.01
Energy	0.97
Telecommunication Services	0.88
Consumer Discretionary	0.68
Consumer Staples	0.66
Information Technology	0.64
Materials	0.51
Industrials	0.27

Source: S&P Capital IQ. June 2018.

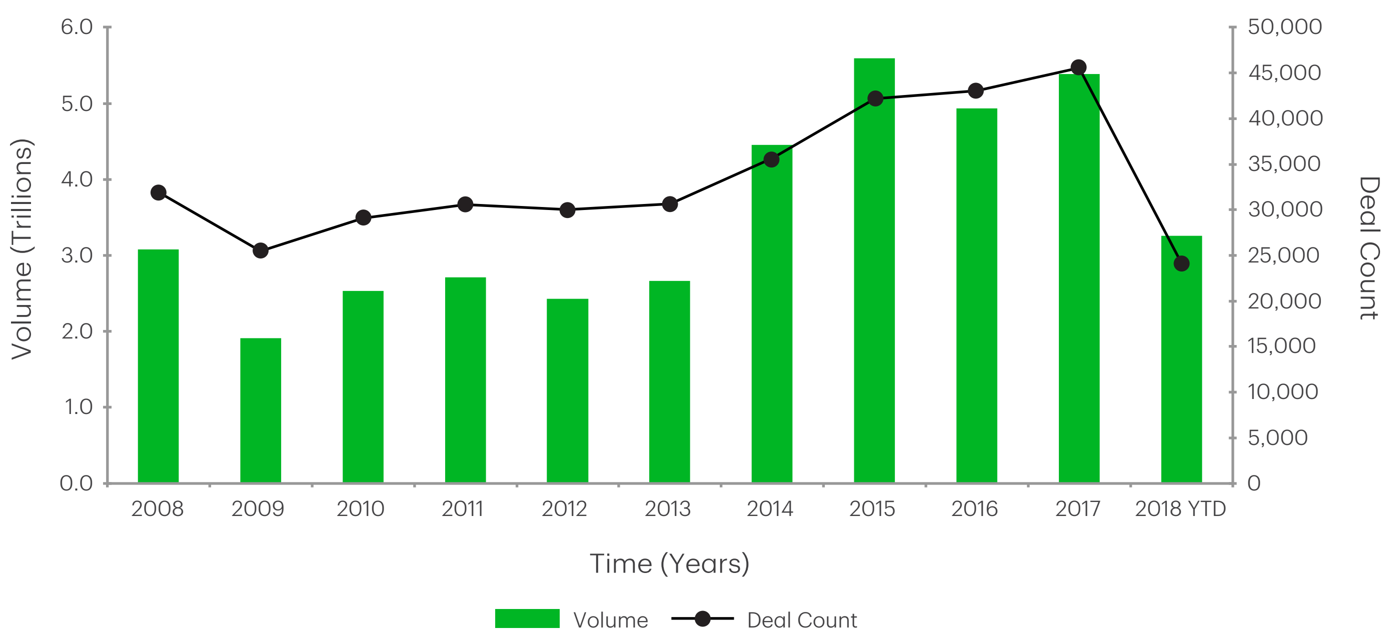
Why have metrics drifted?

We believe it is due to increased mergers and acquisitions (M&A) activity.

There has been a heightened amount of M&A activity, especially within the healthcare, telecommunications and consumer staples sectors, over the past several years. Typically, a company will borrow money to make the purchase, but promise the rating agencies that they will pay down their debt in the near-term, attempting to retain their existing credit rating. Some of these deals have been so large; they are skewing the median credit ratios referenced earlier. Why has there been so much corporate merger activity? The prevailing low-interest rate environment makes debt-funding attractive, but as higher interest rates from the Federal Reserve and Bank of Canada begin to take effect; companies are accelerating their purchase plans.

Furthermore, technology advancements are disrupting the business outlook for many industries (i.e. Amazon versus all 'brick and mortar' retailers, drugstores, etc. or Netflix versus media/entertainment companies). In turn, these companies believe solidifying their product offerings and market share will make them more competitively positioned. The recent ruling in the AT&T purchase of Time Warner, allowing for more 'vertical mergers', promises to usher in more mergers in the near future.

North American merger and acquisition activity, from 2008 to year to date



Source: Bloomberg Finance L.P. (June 2018)

Where are the rating agencies?

We do not think the rating agencies have changed their parameters in measuring corporate credit risk. We believe they are still following their normal course procedure of allowing companies to de-leverage over the short-term to earn back their current debt ratings, as they have always done in the past. Credit Rating Agencies tend to rate 'through the cycle' and for a longer-term outlook. It is up to investment managers, such as TDAM, to assess a company's track record on how it treats its balance sheet and determine if they will indeed bring debt levels back in line with their ratings. However, we do believe that the sheer amount of large M&A activity that has occurred recently has overwhelmed the market; to the point of causing us concern that the recent decline in the credit quality of the investment grade bond market has not been adequately addressed.

Conclusion

Though the BBB segment of the investment grade bond market has experienced significant growth recently, the implied quality behind the rating segment is not wholly supported by its current debt ratings. TDAM's research suggests that the increase in merger activity has been a strong contributor for the change in the credit ratings within the BBB segment and their underlying credit evaluation metrics. The implications of this being, numerous companies are being rated at their de-leveraged potential future, than their currently, highly leveraged present.

To be clear, we are not stating that rating agencies have changed their surveillance, but that the sheer volume of M&A activity in the market has overwhelmed their usual tolerance for allowing a company to de-leverage.

Within TDAM, independent assessment is a crucial component of our fixed income evaluation process. Our credit team helps assess the risks involved in forward looking ratings and management's willingness and ability to meet their stated de-leveraging promises. By taking a holistic and pragmatic approach, we are able to identify underlying risks and help our portfolio manager's demand greater compensation for BBB-rated instruments; where the risks may be above what is implied by the rating.