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Is a leverage reckoning coming?

Not yet. Despite rising corporate-debt levels, research shows companies can cover their obligations for now. But they should prepare for a possible downturn by stress-testing their capital structure.

by Tarun Khurana, Werner Rehm, and Anurag Srivastava

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Economic analysts and policy experts have been sounding the warning bell about rising corporate-debt levels for the past few years. For instance, the former chair of the US Federal Reserve Board, Janet Yellen, has warned that companies (non-financial ones, in particular) are taking on too much debt and could have trouble meeting their obligations in the case of another financial crisis.[1]

It's true that in developed-market companies, leverage ratios (expressed as debt to EBITDA[2]) have gone up, as have the share and absolute number of companies earning sub-investment grades from credit-rating agencies like Moody's Investors Service and S&P Global.[3] The analysts and policy experts chalk up these figures to companies' pursuit of share buybacks and other forms of financial engineering.

But a look behind the numbers tells a different story. In fact, our analyses indicate that downgrades of companies' credit ratings have not been significantly widespread, that much of the increase in sub-investment-grade companies is because of changes in newly rated corporate debt, and that most companies can cover payments on outstanding corporate debt as easily as they did ten years ago.

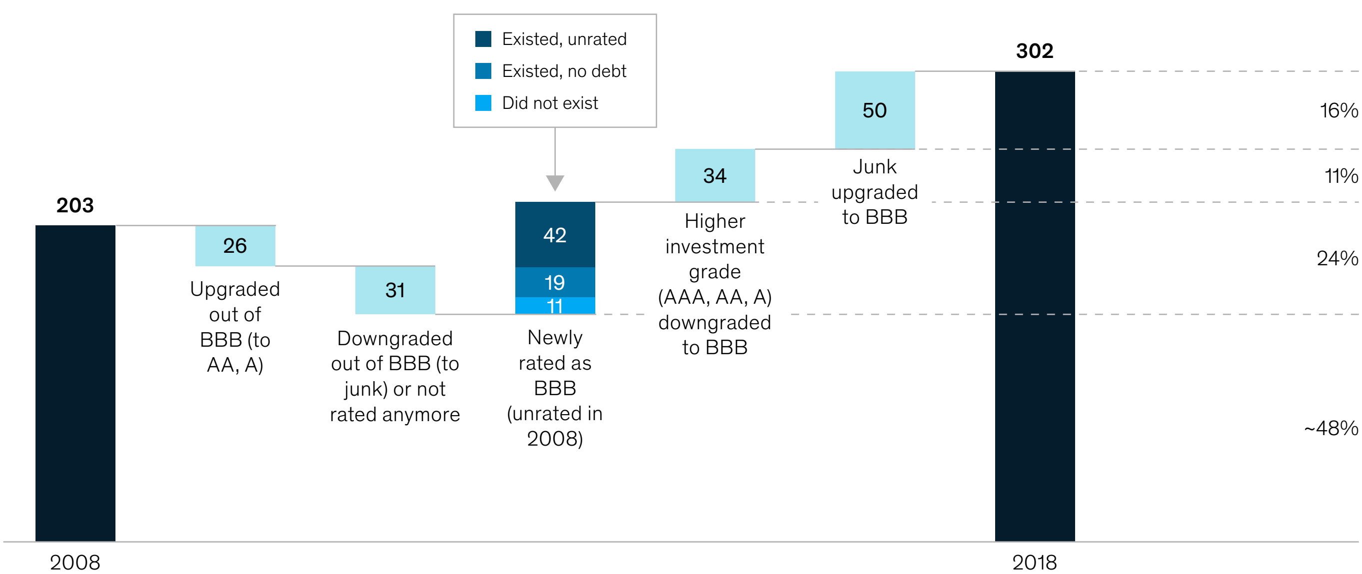
What a look behind the numbers shows

Strong economic growth and historically low interest rates in the wake of the 2008 credit crisis have allowed companies to increase the amount of debt they have taken on. Overall corporate debt in the United States grew from $2.3 trillion in 2008 to $5.2 trillion in 2018. But our research casts a counterintuitive light on discussions about corporate leverage in the United States.

Exhibit 1

Most growth in BBB-rated companies has come from newly rated debt.

Changes in BBB-rated companies, 2008–18, number, % share[1]



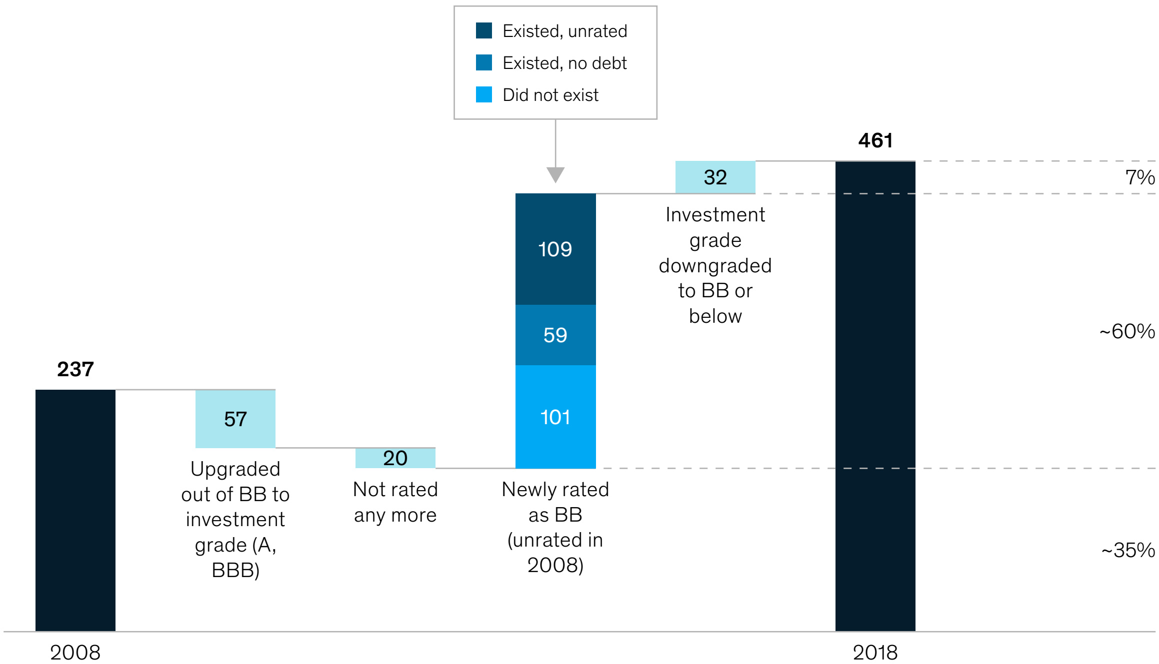
[1] Figures may not sum to 100%, because of rounding.
Source: S&P Global Market Intelligence RatingsDirect

[1] Jeff Cox, "Yellen and the Fed are afraid of a corporate debt bubble, but investors still aren't," CNBC, December 11, 2018, cnbc.com.
[2] Earnings before interest, taxes, depreciation, and amortization.
[3] An investment grade (AAA, AA+, et cetera) is a rating that indicates relatively low risk of default of a municipal or corporate bond. Anything below investment grade (BBB+, BBB, BBB–, et cetera) indicates increased risk of default.

Exhibit 2

Most of the growth in BB-rated bonds has come from newly rated debt.

Changes in BB-rated companies, 2008–18, number, % share[1]



[1] Figures may not sum to 100%, because of rounding.
Source: S&P Global Market Intelligence RatingsDirect

Our analysis of credit ratings, for instance, reveals that the general increase in sub-investment-grade companies is, by and large, not the result of widespread downgrades from credit-rating agencies; rather, it's the result of changes in newly rated corporate debt. Consider that the actual number of investment-grade (AAA through BBB) US companies grew from 311 in 2008 to 445 in 2018. But of the 300-plus investment-grade bonds in 2008, only 36 were downgraded to junk status in the intervening years—five were moved to AA or A status, and 31 to BBB.

Our research also revealed that there were 203 BBB-rated companies in 2008. By 2018, 31 of them were at junk-bond status based on an explicit downgrade in rating, and another 50 junk bonds from 2008 were upgraded to BBB—thereby compensating for any changes (Exhibit 1).

However, more than half of the 72 newly rated companies in our database had debt in 2008 that was not rated. Similar dynamics are at play among BB-rated companies, where the absolute number of BB and below bonds has grown but about 60 percent are the result of newly rated corporate debt (Exhibit 2).

The upshot? The observed increase in BBB and junk-rated companies cannot be attributed to downgrades of traditional large corporations. Most low-rated corporate debt wasn't rated ten years ago, or simply didn't exist. This suggests that many more companies than ever before are tapping into debt markets to take advantage of a strong economy and low interest rates.

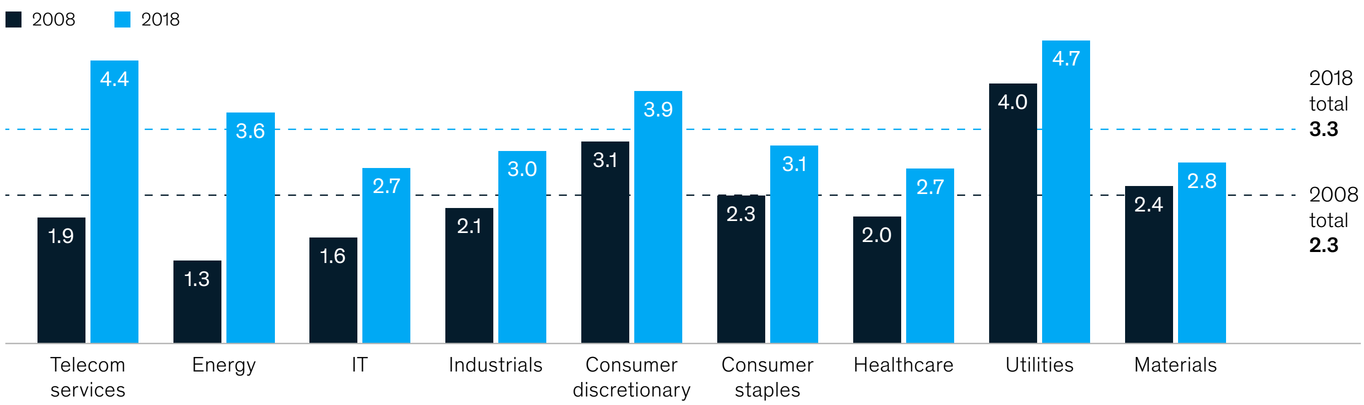
Our research also revealed that between 2008 and 2018, companies' debt-to-EBITDA ratios increased moderately across all sectors, in part because interest rates were so low (Exhibit 3). However, our analyses also showed that median interest-rate coverage, another measure of a company's riskiness relative to current debt or future borrowing, remained almost constant during the same period (Exhibit 4).

A double click on the coverage data shows some variation in the telecommunications and energy industries—for instance, the coverage ratios for top-quartile companies in those sectors were markedly worse in 2018 than they were in 2008. This makes sense given weak pricing in the energy sector and greater consolidation among

Exhibit 3

Companies' debt-to-EBITDA ratios are higher now than in 2008.

Debt to EBITDA[1] by sector, 2008–18, ratio

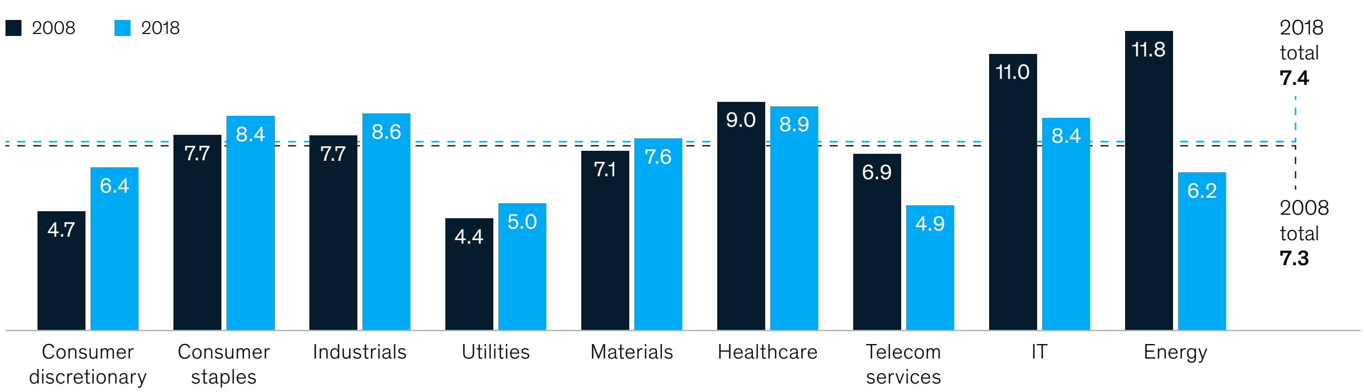


[1] Earnings before interest, taxes, depreciation, and amortization.

Exhibit 4

Companies can cover payments as easily today as ten years ago.

EBITDA[1] to interest by sector, 2008–18, ratio



[1] Earnings before interest, taxes, depreciation, and amortization.

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telecom companies. But based on our findings, it looks like most companies today can cover payments on outstanding debt as easily as they did ten years ago.

Moreover, companies' financial engineering is less of a factor in their leverage scenarios than industry pundits would have you believe. Our research shows that stock buybacks contributed to fewer than 20 percent of companies' downgrades between 2008 and 2018. M&A has been a factor in half of the downgrades for investment-grade companies, and the presence of higher business risk (for instance, lower oil prices and weak retail spending) has been a factor in about a quarter of the downgrades. For junk-rated bonds, the weakening business environment has been a primary driver, according to our figures.

Finding balance

The evidence suggests that companies are not overleveraged—at least not yet. But what if interest rates increase again quickly? What if predictions of a sharp downturn in the economy in the next three years come true? (See "Building up for leaner times," forthcoming on McKinsey.com.) As Janet Yellen and others have warned, there is always the possibility that holding such high leverage could create difficulties for some companies. Our research, however, suggests that most companies have enough of a cushion to withstand economic or interest-rate shocks in the near term.

We estimate that about 75 to 80 percent of total corporate debt is in the form of corporate bonds, which tend to be fixed-rate investments. These are not typically affected by interest-rate changes until refinancing, and our estimates suggest that fewer than 35 percent of outstanding corporate bonds will need to be refinanced within three years. Overall, about 40 to 45 percent of the total outstanding corporate debt could be affected by higher interest rates by 2020 (if they come).[4]

Still, it's never a bad idea for companies to stress-test their strategic plans and investment strategies, keeping leverage in mind. Senior management should feel comfortable in the business's ability to service current corporate-debt levels under different scenarios.

Consider the case of a global consumer company: For many years, it had traditionally held little debt; its debt-to-enterprise-value rate was less than 10 percent. Over time, the company increased its debt levels to about 25 percent of its total enterprise value in order to make several crucial acquisitions. Once the dust settled on those deals, executives had to decide whether it would be

[4] To assess the impact of corporate debt on company resilience and risk in the event of a downturn, we considered two scenarios for the economy. One modeled continued growth, with 4 percent growth in earnings before interest, taxes, depreciation, and amortization (EBITDA) and the US Federal Reserve Board instituting aggressive interest-rate hikes. The other modeled extreme recession, with a decline of 13 percent in EBITDA, as experienced in 2008 and 2009, and increased interest rates.

more advantageous to return the company to its previous low levels of corporate debt or hold it stable at the higher level.

The company followed a standard process for pressure-testing its capital structure. That is, it built scenarios looking three to five years out that forecast market momentum as well as a potential downside case (to adjust for the uncertainty of the economic environment, and future cash flows). For each scenario, it estimated financing deficit or surplus and a target credit rating. After plugging these data into cash-flow models, the company was able to determine the level of leverage that made the most sense and readjusted its mix of borrowing, repayments, dividends, and share buybacks and issuances to reflect its post-M&A reality.

In the shadow of recession, the "right" corporate-debt levels and capital structure will, of course, look different for different companies. Some may decide to issue very long-term fixed-rate bonds to ensure near-term predictability of interest expense and maximum operating flexibility in case of a downturn. Others may want to look at bond covenants—defining coverage ratios, for instance, or establishing restrictions on issuers' ability to take on more corporate debt.

For those companies that are dealing with borderline investment-grade ratings, it might be best to press pause on any increases in leverage for now, or to use cash flow to reduce leverage. Those businesses with low ratings might indeed struggle in recession. They may end up as targets for the larger, healthier companies that have both the debt capacity and war chest to pursue a countercyclical M&A strategy.

Like the analysts and economic forecasters, finance and business executives should heed the flashing red and yellow lights. They should use this time as an opportunity to pressure-test their investment strategies and financials. In fact, such pressure tests should be conducted regularly—because regardless of the economic climate, executives who have a fine-grained understanding of where they hold leverage will inevitably make better business decisions than those who don't.

Tarun Khurana (Tarun_Khurana@McKinsey.com) and **Anurag Srivastava** (Anurag_Srivastava-NYO@McKinsey.com) are consultants in McKinsey's New York office, and **Werner Rehm** (Werner_Rehm@McKinsey.com) is a partner in the New Jersey office.

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