

# Re-Leveraging Corporate America, Part 2

## Compensation for Leverage

- Leverage for the average company in the high grade market is creeping up, ever so slightly, as we discussed in Part 1 of Re-leveraging of Corporate America.
- Leverage across sectors varies significantly, so for comparison's sake, we look at average cash spreads per turn of gross leverage. We find that holders of tech paper likely aren't being paid for the increasing leverage, but energy investors are likely being compensated.
- We suggest this sector rotation as, in addition to the incremental compensation per turn of leverage, investors pick up outright spread while average leverage is actually lower for energy names.
- Even within sectors, spread per turn of leverage can vary significantly. In this publication we provide **ADD** and **REDUCE** candidates based on this metric, coupled with our fundamental view on the credit. In most cases, our ADD candidates provide higher spreads while reducing leverage.

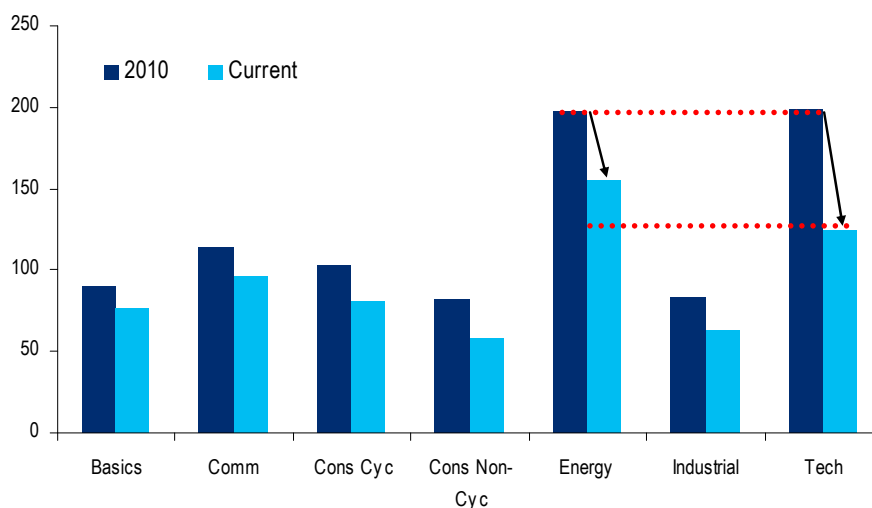
### Single Name Credit Strategy

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Figure 1. Spread per turn of leverage, Q2 10 and now (bp)



Source: Citi Research, Bloomberg

### See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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## Re-leveraging of Corporate America, Part 2

### Compensation for Leverage

In [Re-leveraging Corporate America, Part 1](#), we discuss corporate leverage and how it is ever so slightly ticking up. But we recognize that leverage stats for the average (or median) credit do not tell the whole story, as trends can and do vary dramatically across sectors. One of the most interesting takeaways from our sector level analysis was the overlay of valuations on leverage over time. This gives us a sense of how much compensation per turn of gross leverage is currently available for each sector, and how this has changed over time.

When looking at the change in average spread by sector, we see that spreads, across the board, are significantly tighter now than they were two years ago. What strikes us is how the compensation per turn of leverage has performed differently across sectors. To illustrate this difference, we took a look at the energy and tech sectors, and while we recognize the apples-to-oranges comparison, we argue that both have recently been out of favor and are hampered by a weak outlook for global demand.

**Figure 2. Spread per unit of leverage**

	Spread		Leverage		bp	
	3Q 10	2Q 12	3Q 10	2Q 12	3Q 10	2Q 12
Basic Materials	173	142	1.9x	1.9x	90	77
Communications	181	161	1.6x	1.7x	144	96
Consumer, Cyclical	159	124	1.5x	1.5x	103	81
Consumer, Non-Cyclical	124	99	1.5x	1.7x	83	59
Energy	205	144	1.0x	0.9x	198	156
Industrial	157	117	1.9x	1.9x	83	63
Technology	178	126	0.9x	1.0x	199	124

Source: Citi Research

Note: Change is from Q3 2010 – Q2 2012. Our sample set consists of credits with financial data available for the entire period under review. Leverage = average total debt / average EBITDA

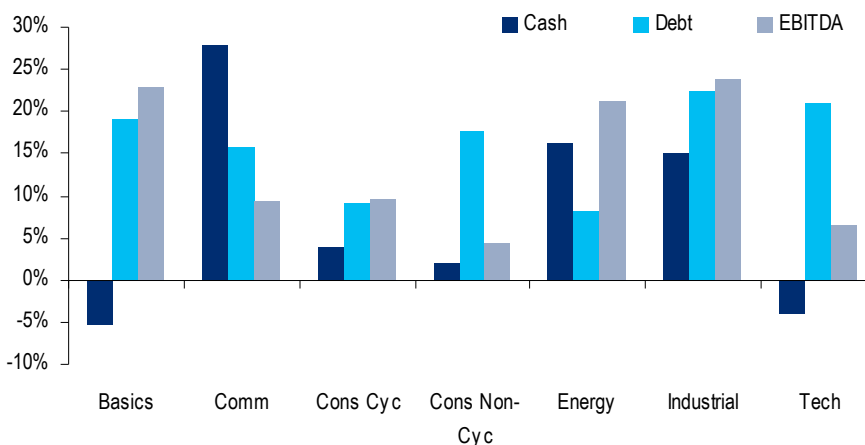
### Sector Rotation: Out of Tech and into Energy

We recommend reducing exposure to tech names and to increase holdings of energy credits, based on the following considerations:

1. Fundamental outlook: We have cautious fundamental outlooks on both the tech and energy sectors. The story is the same – lower global demand for end products is putting pressure on revenue and margins. However, we believe that investors are now being compensated for the weakening fundamentals and lowered earnings expectations in energy, whereas we think tech investors haven't fully assessed the likely pressure on the companies. Further, tech companies have shown that they are more likely to placate equity investors with shareholder-friendly transactions to the detriment of their balance sheet.
2. Total Leverage: while leverage for both the energy and tech sectors are low at around 1.0x, the average energy company has decreased leverage, as EBITDA has increased faster than debt. Conversely, the average tech company's debt has grown over 20% (Figure 3) while EBITDA has posted less than half that amount, resulting in higher leverage over the past two years.

3. Spread Compensation / leverage: In Figure 2, we show how much an investor is compensated per term of leverage. Currently, the average energy company offers 156bp, which is 32bp more per turn than what technology offers (124 bp). In 2010, investors were paid nearly 200bp per turn of leverage in both the energy and tech sectors, while today that relationship has compressed by 75bp in tech but only 42bp in energy. This signals to us that tech may not offer enough compensation given the balance sheet risk.
4. Spread pickup: in terms of absolute spread levels, the typical bond in energy is trading at 144bp versus 126bp in tech (pickup of 18 bp). We are more positive on energy valuations, and to us tech credits seem to trade too tight given the near term outlook.

Figure 3. Change in leverage components since Q2 '10 by sector



Source: Citi Research, Bloomberg  
Note: As of Q2 2012

## Opportunities within Sectors

Within sectors, we found that average compensation per turn of leverage varied widely across credits. We recognize that some of this differential could be explained by differences in maturity profiles for the credits but by and large the averages give us an easy way to compare credits based on their leverage. We also note that leverage is not the primary driver of spreads, and that spread per turn of leverage may look exaggerated due to very low gross leverage.

In the table below, we've identified credits that provide a significant amount of spread per turn, and have listed these as ADD candidates. Conversely, we also show those credits that provide minimal compensation, and as such we suggest selling these. We note that the ADD and REDUCE candidates are reflective of relative value opportunities within the sector, not necessarily outright long and short ideas.

In most cases, by selling the REDUCE candidates and buying the ADD candidates, leverage is reduced and outright spread is increased. To us, the trade is attractive, because as we noted in Part 1 of this series, with leverage on the rise we would prefer to own credits that compensate investors for that leverage.

Figure 4. ADD and REDUCE candidates whose spreads are not reflective of leverage

Company	Spread	Leverage	Spd / Lev	Company	Spread	Leverage	Spd / Lev
ADD				REDUCE			
Basic Materials							
FMC Corp	174	1.1x	162	Air Products	60	1.8x	33
Monsanto	81	0.6x	146	Alcoa Inc	325	4.0x	82
Newmont Mining	193	1.2x	155	Du Pont	51	2.5x	20
Potash Corp	85	1.0x	84	Sherwin-Williams	25	1.2x	22
<b>Average</b>	<b>133</b>	<b>1.0x</b>	<b>137</b>		<b>115</b>	<b>2.4x</b>	<b>39</b>
Communications							
CenturyLink Inc	353	3.0x	119	Cisco Systems	63	1.3x	50
News Corp	176	2.3x	76	Walt Disney Co	39	1.4x	27
<b>Average</b>	<b>265</b>	<b>2.6x</b>	<b>97</b>		<b>51</b>	<b>1.3x</b>	<b>39</b>
Consumer Cyclical							
Gap Inc/The	278	0.8x	350	Macy's Inc	151	2.0x	77
TJX Cos Inc	83	0.2x	351	Target Corp	90	2.5x	36
<b>Average</b>	<b>180</b>	<b>0.5x</b>	<b>350</b>		<b>120</b>	<b>2.2x</b>	<b>57</b>
Consumer Non-Cyclical							
Eli Lilly & Co	71	0.8x	89	Kellogg Co	97	3.7x	27
Humana Inc	207	0.8x	262	Teva Pharma	65	2.3x	28
Tyson Foods	200	1.6x	128	WellPoint Inc	135	2.2x	61
<b>Average</b>	<b>159</b>	<b>1.0x</b>	<b>160</b>		<b>99</b>	<b>2.7x</b>	<b>38</b>
Energy							
Halliburton Co	112	0.7x	150	Baker Hughes Inc	91	1.2x	79
Marathon Oil	127	0.7x	177	Kinder Morgan	148	4.7x	32
ONEOK Partners	157	2.9x	55	Plains All American	123	3.9x	32
Williams Cos	274	3.0x	92				
<b>Average</b>	<b>167</b>	<b>1.8x</b>	<b>119</b>		<b>121</b>	<b>3.2x</b>	<b>47</b>
Industrial							
FedEx Corp	104	0.3x	338	Caterpillar Inc	48	3.5x	14
Ingersoll-Rand	110	1.8x	62	Deere & Co	53	5.9x	9
L-3 Communication	166	2.3x	73	Honeywell Intl	57	2.1x	27
				United Parcel Service	74	1.6x	46
<b>Average</b>	<b>127</b>	<b>1.4x</b>	<b>158</b>		<b>61</b>	<b>3.2x</b>	<b>27</b>
Technology							
Intel Corp	76	0.3x	253	IBM	47	1.3x	37
Lexmark Intl	391	1.1x	354	Texas Instrument	34	1.0x	33
Microsoft Corp	46	0.4x	119	Xerox Corp	172	3.0x	57
<b>Average</b>	<b>171</b>	<b>0.6x</b>	<b>242</b>		<b>85</b>	<b>1.8x</b>	<b>42</b>

Source: Citi Research, Bloomberg

Note: Spread reflects the average for the issuer; gross leverage is used.

# Appendix A-1

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