

# European Credit Weekly

## A Trend Reversal In Corporate Leverage?

- **Bucking the trend** – After 10 quarters of rising leverage, a rebound in earnings combined with a lower level of net debt drove leverage sharply lower in H2 2013. We examine why below.
- **Why did net debt fall?** – A recovery in earnings with a recovery in the economy is no surprise. But that wasn't what caused the fall in net debt. We find that the two principal factors were translation effects and a drop in net M&A expenditures. And most of that latter was down to just two companies.
- **Will it last?** – Based on analyst expectations and the lack of negative pre-announcements, the improvement in leverage from the earnings side should have continued in H1 2014. But we strongly suspect that the drop in net debt levels will have reversed at least partially as debt-funded non-financial M&A in Europe rose by more than €100bn compared to the same period last year.

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Figure 1. Citi Credit Strategy – Key views & recommendations

	Tactical (View: Long)	Strategic (View: Long)
Cash bonds		<ul style="list-style-type: none"> <li>- Long € &gt; \$ credit</li> <li>- Long Financials &gt; Non-financials</li> <li>- Long subordinated &gt; HY non-fin risk</li> <li>- Releveraged &gt; releveraging credits</li> <li>- Long T2 host CoCos</li> <li>- Long Eurozone &gt; non-Eurozone credits</li> <li>- Long wholesale &gt; deposit banks (UK &amp; US)</li> </ul>
CDS	<ul style="list-style-type: none"> <li>- Sen Fin / Main compression</li> <li>- iTraxx Sub / Sen Fins compression</li> <li>- 1x2 Receiver Spreads</li> </ul>	<ul style="list-style-type: none"> <li>- Long index flatteners</li> <li>- Main / Crossover decompression</li> </ul>
Options & tranches	<ul style="list-style-type: none"> <li>- Sell European vs. US Vol</li> </ul>	<ul style="list-style-type: none"> <li>- Last squeeze to Jun-15 Series 9 Main equity</li> <li>- Buy SenFin, sell Crossover receivers</li> <li>- Sell 1m no-delta straddles</li> </ul>
Combined strategies	<ul style="list-style-type: none"> <li>- Sell equity protection; sell straddles</li> <li>- Flatteners vs. OTM payers</li> </ul>	<ul style="list-style-type: none"> <li>- Short bond, long CDS spread duration</li> </ul>

Source: Citi Research. Note: New recommendations/trades highlighted in bold. Tactical horizon: 1-3 months. Strategic horizon: >3 months. See back pages for options disclosures.

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

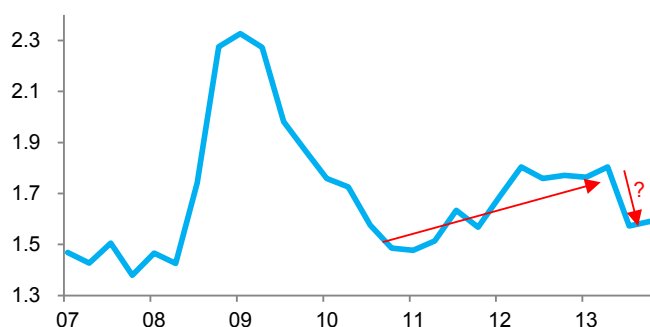
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## A trend reversal in corporate leverage?

What's happening to credit metrics in Europe? In the past we've voiced longer-term concerns about rising corporate leverage. For the period from 2011 to mid-2013 our net debt to EBITDA metric on 284 non-financial companies<sup>1</sup> rose 0.3 turns from 1.5x to 1.8x (Figure 2). A rise in cash holdings was not enough to offset a rise in net debt over the period by 11%, compounded by a 7% fall in EBITDA (Figure 3). Although 1.8x is well below the levels we saw at the bottom of the 2001 and 2009 earnings cycles, it is substantially higher than we have seen outside recession previously.

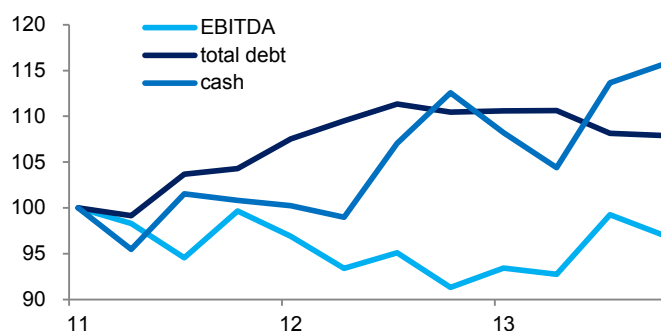
But against our prior expectations, full-year figures for 2013 show a surprisingly large drop in our net-debt-to-EBITDA metric to ~1.6x.

Figure 2. European non-financial net debt to EBITDA ratio\*



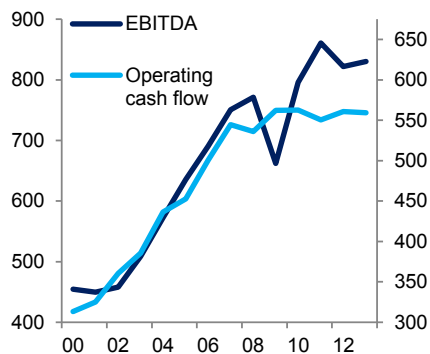
Source: Bloomberg, Citi Research. \* Based on a sample of 284 companies in the EuroStoxx 600 index.

Figure 3. European non-fin. EBITDA, debt & cash, indexed (Q1'11 = 100)



Source: Bloomberg, Citi Research

Figure 4. European non-fin. EBITDA & operating cash flow, € bn\*



Source: Bloomberg, Citi Research. \* Based on a sample of 314 companies in EuroStoxx 600.

So what happened during the course of 2013? Part of it was due to a rebound in EBITDA – considering the recovery in the Eurozone economy at the time that doesn't come as a big surprise. But the more important driver was actually a 7% drop in net debt, which we'll readily admit that we hadn't seen coming.

Interestingly, the EBITDA improvement didn't really feed through to cash flows in 2013. At least, the operating cash flow itself was virtually unchanged from 2012 (Figure 4). So how did the debt reduction come about?

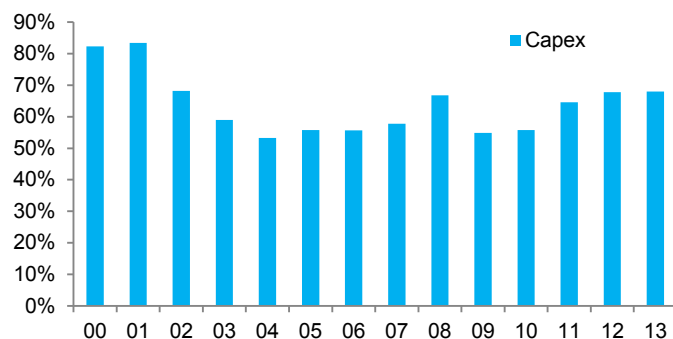
A shift must have taken place further down the cash flow statement – specifically, though a reduction in cash outlays on investing or financing activities. To get a clearer picture, we've broken down the key line items of an aggregate cash flow statement for our universe of non-financial corporates<sup>2</sup> and expressed them as percentages of the operating cash flow:

- It wasn't **capex**. Capex remains the single biggest line item consuming just over two-thirds of the operating cash flow. Again, there was no discernible change from 2012 to 2013, where contrary to common perceptions, the capex share stayed at a 10-year high (Figure 5).

<sup>1</sup> Based on the non-financial corporates in the EuroStoxx index, for which we could obtain a consistent data set. Quarterly EBITDA numbers are annualised (without a seasonal adjustment)

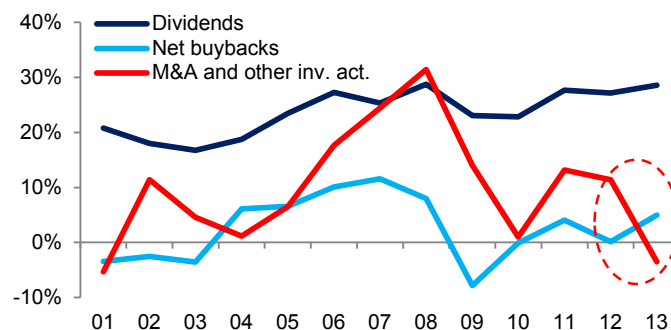
<sup>2</sup> Unfortunately, a lack of detailed disclosure from some companies prevents us from dissecting the discretionary parts of an aggregate cash flow statement quarterly.

Figure 5. European non-fin. capex, % of operating cash flow



Source: Bloomberg, Citi Research. \* Based on a sample of 314 companies in EuroStoxx 600.

Figure 6. European non-fin. dividends, buybacks & M&A, % of operating cash flow



Source: Bloomberg, Citi Research. \* Based on a sample of 314 companies in EuroStoxx 600.

- **Dividends?** Companies didn't hold back on paying dividends either. At 29% of operating cash flows, dividend payments last year were the highest on record. European companies may be more conservative about payouts than US peers, but that's still 10 percentage points higher than a decade ago (Figure 6).
- **Equity buybacks** (net of issuance) were small, but actually rose from 0% to 5% of the operating cash flow in 2013, thus tending to add to net debt (Figure 6).
- So the principal driver of debt reduction last year was **M&A and other investing activities**. For the first time since 2001, the net amount spent was negative. In other words, a surplus of disposals relative to acquisitions actually added to European corporate cash levels. The shift from 2012 was no less than €80bn in absolute terms or 15% of the operating cash flow (Figure 6). Impressive, except that almost €60bn of the total came from just two companies – Vodafone and Nestle.

However, an additional benefit of €30bn or 5% of the operating cash flow came from a change in net debt that wasn't reflected in the net change in financial position at the bottom of the cash flow statement. The discrepancy is most likely down to translation effects. During 2013, the euro appreciated by about 6.5% in trade weighted terms, which implies that debt denominated in other currencies would be worth less when calculated in euro terms (though arguably, the effect on corporate leverage should be reduced by a similar effect on EBITDA).

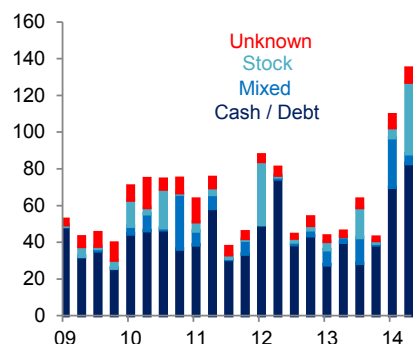
Undeniably, this data sits rather uneasily with our argument that corporate leverage is on a rising trend. But how much should one extrapolate from two quarters where debt fell due to one-off actions by two companies and translation effects?

### The upcoming earnings season

That's what makes this upcoming earnings season particularly interesting. Too many companies don't provide detailed disclosures in the quarterly filings, but with the half-year results we should get enough information to see how the leverage is developing in 2014.

We suspect that the improvement in earnings will also be sustained in our sample universe. If anything, earnings trends should continue to remain slightly supportive.

**Figure 7. M&A by European acquirers by funding type (announced, quarterly), €bn**



Source: Bloomberg, Citi Research

S&P Capital IQ estimates that Q2 earnings per share in the S&P Europe 350 will be up 7.1% measured in dollars. That equates to about a 2% gain in € terms. The absence of negative pre-announcements and the usual tendency for actual numbers to beat expectations a bit suggests that that we should expect a bit more than that. Yet, as EBITDA tends to move less than EPS, the improvement in the denominator of the leverage ratio should still be modest.

It is probable that some of the earnings improvement will start feeding through to operating cash flows and in turn debt levels. However, further down the cash flow statement the arrows are pointing in the opposite direction.

For one, the 2.5% fall in the euro in H1 2014 ought to unwind some of last year's translation benefit on the debt.

However, the big shift is in M&A. European non-financial companies acting as acquirers announced M&A transactions<sup>3</sup> worth €244bn in H1 2014, compared to just €89bn in H1 2013. Of that €155bn increase, €106bn was either solely debt- and cash-funded or funded with a mixture of cash, debt and equity (Figure 7). Now those figures are based on a different sample to the universe of companies discussed above, so the figures aren't directly comparable.

Even so, we expect that net debt levels will rise fast enough that leverage will start to tick higher again.

### Where do spreads go then?

Leverage trends matter, but only over the very long term. During the last couple of years credit markets happily ignored leverage signals, and the reporting season will in all likelihood continue to take a back seat.

For the time being, markets remain preoccupied with the macro events and the technicals we discussed in the last Weekly ([Stakes rising in the game of musical chairs](#)). Although this week has seen several unforeseen and tragic events that raise near-term geopolitical risks, in market terms we suspect that credit is closer to the end of the unwinds, which have been weighing on spreads. Moreover, the supply pipeline appears to be waning.

So for the coming three-four weeks credit just might see the kind of carry-driven squeeze that most had anticipated going into the summer. But with the US labour market data still surprising on the upside and even Yellen sounding a little less universally dovish than previously, we would still regard it as an opportunity to get a little closer to home.

### The week ahead (Joseph Faith)

Aside from the geopolitics, next week sees several top-tier data releases and the earnings season moving into full-gear.

Consensus expects June's US CPI reading, out on Tuesday, to decline slightly, from 0.4% to 0.3%, but the YoY reading should stay at 2.1%, close to the Fed's target.

EU foreign ministers meet in Brussels on the same day to decide on additional sanctions on Russia, following those announced this week.

The data out of Europe next week should highlight the risk of more subdued economic activity in the latter part of the year. On Wednesday, Eurozone Consumer Confidence (July advance reading) is expected to decline slightly to -7.7, the second drop in a

<sup>3</sup> Transactions larger than €20mn. Source: Bloomberg.

row. On Thursday, the June Preliminary Eurozone PMI readings are expected to show a slight decline. Similarly, the IFO surveys, out on Friday, are expected to decline from last month, confirming the weakening in this week's ZEW surveys.

The preliminary reading for the HSBC China Manufacturing PMI will be out on Thursday. Consensus expects this to rise to 51.0, the strongest reading since March last year, following this week's better-than-expected GDP figure.

The IMF will release an update to its global economic outlook on the same day. Earlier this month IMF Managing Director Christine Lagarde signalled that its growth forecasts would be cut, with risks remaining in the US and investment still weak.

The UK's Q2 GDP figure will be out on Friday, with the consensus forecast of a 0.8% QoQ expansion maintaining the pace of last quarter. Our economists are more optimistic, at 0.9% QoQ. They believe that the expansion in jobs, incomes and business investment has become self-fuelling, and they expect GDP growth of 3.5% in both this year and in 2015.

Only a few companies have reported so far, but they have mostly surprised on the upside in both the US and Europe, and next week will provide a test of whether the positive momentum can be maintained. Two of the biggest names in the US Tech sector report earnings next week and consensus expects profits to have increased for both: Apple reports on Tuesday, with earnings growth expected to be fuelled by steady iPhone demand. Facebook's earnings, out on Wednesday, are expected to have been boosted by increasing mobile phone advertising revenues.

#### Key Economic Indicators (21 July - 25 July 2014)

<b>Tuesday 22 July</b>	<b>Consensus Forecast</b>	<b>Last</b>
US CPI (MoM, YoY)	0.3%, 2.1%	0.4%, 2.1%
<b>Wednesday 23 July</b>	<b>Consensus Forecast</b>	<b>Last</b>
US New Home Sales	480k	504k
Eurozone Consumer Confidence	-7.7	-7.5
<b>Thursday 24 July</b>	<b>Consensus Forecast</b>	<b>Last</b>
Eurozone Manufacturing PMI	51.7	51.8
Eurozone Services PMI	52.7	52.8
Eurozone Composite PMI	52.7	52.8
HSBC China Manufacturing PMI	51.0	50.7
<b>Friday 25 July</b>	<b>Consensus Forecast</b>	<b>Last</b>
IFO Business Climate	109.5	109.7
IFO Current Assessment	114.5	114.8
IFO Expectations	104.3	104.8

Source: Bloomberg

#### Earnings Releases (21 July - 25 July 2014) Earnings Releases (21 July - 25 July 2014)

##### Monday 21 July

America Movil, Klepierre, Stora Enso, Philips, Halliburton, SunTrust, Hasbro, Texas Instruments, Netflix

##### Tuesday 22 July

Credit Suisse, Comcast, McDonald's, Enagas, Gecina, Beazley, Coca Cola, El du Pont de Nemours, Kimberly-Clark, Travelers, United Technologies, State Street, Lockheed Martin, Verizon, Ingersoll-Rand, Altria, Microsoft, Grupo Bimbo, Harley-Davidson

##### Wednesday 23 July

Telenor, Akzo Nobel, ABB, Daimler, Abertis, Unibail-Rodamco, AT&T, Mercalys, Iberdrola, Provident Financial, Grupo Espresso, ABB, Boeing, Dow Chemical, Northrop Grumman, Whirlpool, PepsiCo, Gilead,

##### Thursday 24 July

BASF, Unilever, Gas Natural, Caterpillar, Thales, Valeo, LVMH, 3M, Bristol-Myers Squibb, Edenred, Hammerson, Terna, Luxottica, Danske Bank, Societe Fonciere Lyonnaise, Nokia, Banco de Sabadell, Jarden, BES, Bankinter, Danske Bank, Starwood Hotels, Eli Lilly, Noble, Union Pacific, Quest Diagnostics, KKR, Potash, Ford, Raytheon, Chubb, Starbucks, Nucor, Lazard

Source: Bloomberg

Recent Research Publications	Author	Date
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<a href="#">Credit Brief: A Rally Curtailed</a>	<a href="#">Joseph Faith</a>	<a href="#">July 2 2014</a>
<a href="#">Global Credit Survey: A Warning Signal</a>	<a href="#">Joseph Faith</a>	<a href="#">July 1 2014</a>
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Source: Citi Research

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## Appendix A-1

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