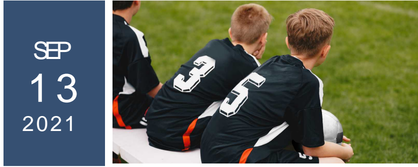


Sidelined Corporate Cash Enters the Game

Kevin O'Neil |

Corporations are flush with cash. Among companies in the S&P 500 alone, cash balances are above $1.9 trillion in total. After record bond issuance in 2020 and profits hitting new highs, many companies are debating “What should we do with all this money?” For simplistic purposes, companies have four main avenues from which to choose:

1. **Shareholder Return:** Repurchase shares and/or pay out a dividend.
2. **Capital Expenditures:** Invest the money back into the business.
3. **Merger/Acquisition:** Grow with a strategic purchase.
4. **Debt Repayment:** Pay back outstanding debt obligations.

Quantifying the Cost of Capital

Obviously, many factors are at play when making such important decisions. Companies across different industries have significantly different growth profiles, causing decisions to vary. Furthermore, some of these factors are subjective, variable, or difficult to quantify. Therefore, the focus of this article is on determining the more quantifiable aspect of the decision: the cost of capital through debt. The market, assuming it is acting efficiently, should provide company leaders with a decent proxy to estimate the interest costs of utilizing debt financing. What is the current market telling them?

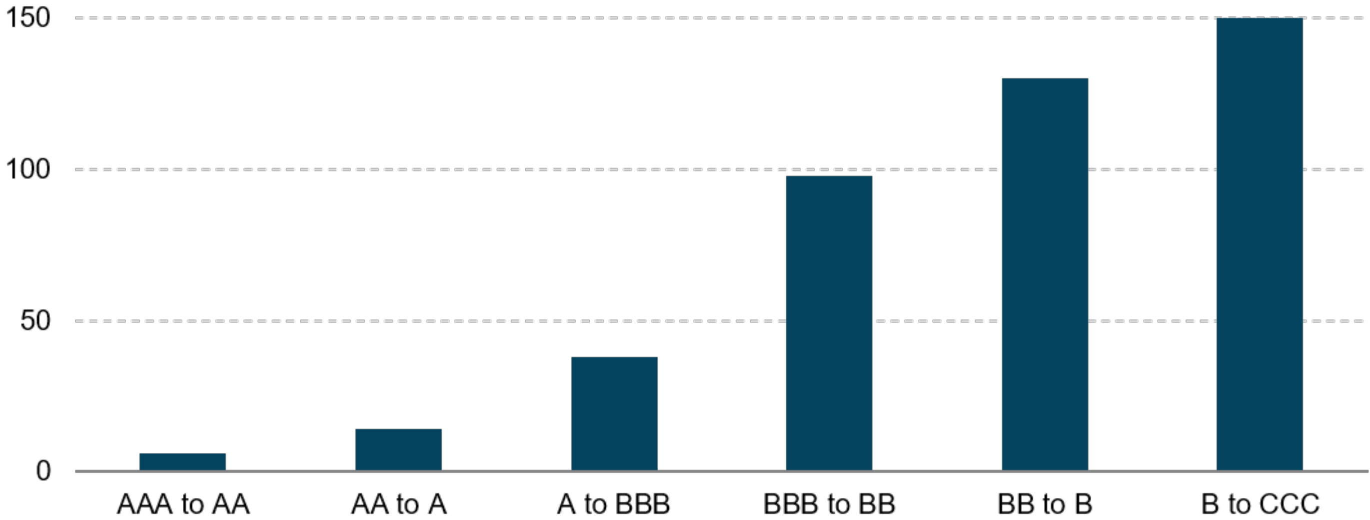
Investment Grade Trend Hints at What Comes Next

The chart below roughly quantifies the increase of interest cost, measured by option-adjusted spreads (OAS), for a company based on its average quality rating from the major credit rating agencies. As the chart clearly highlights, the incremental increase in debt costs becomes greater as you move down in overall credit quality. For investment grade corporate bonds, the consequence is rather muted, with an AAA-rated corporate bond paying only 58 basis points (bps) higher than the lowest-rated segment, BBB. This trend is far from new. Companies have had fewer and fewer incentives to maintain lower debt ratios given high equity valuations and low debt costs. In fact, BBB-rated companies now comprise over 50% of the total investment grade corporate index, and the expectation is that this segment will continue to expand. Therefore, is it really in the best interest of a company and its CFO to maintain a debt ratio consistent with an A-quality profile and use cash balances to pay down debt? The answer is probably not given the modest hike in interest costs for a small decrease in credit quality.

1

Cost to Move Down in Quality

Basis points, As of 8/31/2021

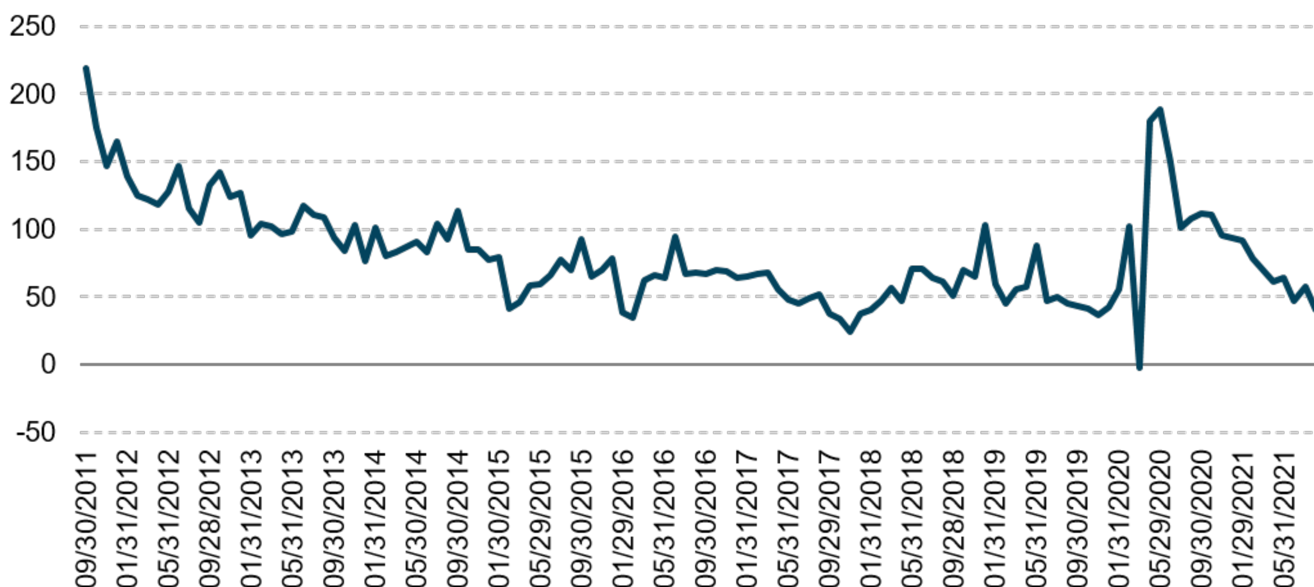


Source: Bloomberg (© 2021, Bloomberg Finance LP)

It is not just in the investment grade segment that this environment exists. Credit spreads between low-end investment grade (BBB-) and high-quality high yield (BB+) are below 50 bps and nearing a low point, excluding the March 2020 anomaly (see **Chart 2**). Gone is much of the stigma associated with being a "junk bond" company, as simple math dictates companies are incentivized to run higher debt levels given the limited consequences—and costs.

2 OAS: BBB- versus BB+

Basis points, As of 8/27/2021



Source: Bloomberg (© 2021, Bloomberg Finance LP)

Where does that leave us with our original question? Given the limited impact to interest costs, I would expect high-quality companies to exhibit fewer bondholder-friendly spending habits. Instead, dividends will be increased, and stock buybacks will come back in full force.

Implications for Bond Investors

Typically, corporations have shareholder interests as their top priority, while bondholder alignment only becomes significant when it is monetarily incentivized. Therefore, the motivation for lower-quality companies to pay down their debt levels using available and future cash is one determining factor why Brandywine Global continues to allocate to high yield companies despite the segment having aggregate spread levels that are not overly appealing. The combination of earnings growth and lower aggregate debt levels should sustain a subdued default environment for the foreseeable future. From an overall perspective, elevated corporate cash positions do provide some comfort for now, but ultimately what companies end up doing with their cash is what will matter for bondholders.

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