Mitch on the Markets

Is the Corporate Borrowing Binge Out of Control?

By Mitch Zacks
Portfolio Manager

Earlier in the year I wrote about corporations taking on a record amount of debt, and the storyline has not changed in the few months since I penned that piece. New corporate debt issuance is set to eclipse $1.5 trillion – that's right, *trillion* – this year, and a majority of the new debt is coming from the hottest sector in the economy, technology. Tech companies are on the hook for $451 billion, which marks a 42% increase from a year ago. Mutterings are starting to surface that this could be the next shoe to drop.

Just looking at the numbers and the patterns, it admittedly feels a bit "bubble-worthy." And, I do think there are risks depending on two factors – 1) the discounts that risky companies are getting when issuing debt, and 2) the tendency of companies using borrowed money to boost shareholder value through buybacks and M&A. I wouldn't think of these risks as systemic, however. I think they're company-specific, which makes stock-picking even more important in this phase of the bull market.

Here are three factors investors should keep in mind when looking at the debt side of a corporation's balance sheet:

1) **Is the Return on Equity Greater than the Borrowing Rate? –** If a well-capitalized growth company can borrow money at 3% and earn 5% on it by investing in labor, capital, or new market entry, then it makes economic sense for that company to borrow away. The same applies for any government or retail investor. There is a stigma around borrowing because we're taught to believe debt is bad. But if you can earn more on borrowed money than the interest you're paying on it, that's called leverage.
2) **Is the Corporation Using Borrowed Money as a Band-Aid? –** Beware the CEO that issues debt and then uses the raised money to repurchase shares. In some cases, the prospect of future growth is bleak, and

executives will use stock buybacks, dividend increases, and M&A as alternate methods to boost shareholder equity and therefore keep shareholders happy. At the end of the day, however, a corporation has to grow to survive, and to grow it has to invest money (capex).

3) **Are Risky Companies Issuing Debt at Discounts? –** Since interest rates are so low and the market is starved for yield, investors are increasingly allowing higher risk companies to issue debt at lower rates. This is a negative, as it shows investor tendency to ignore risk – which is how bubbles ultimately form. As investors, it is important to assess whether the yield you're getting for buying debt compensates you for the underlying risk of the corporation to pay you back.

Bottom Line for Investors: Perform Your Due Diligence

Before buying stock in a company, there are a multitude of factors to consider. But when it comes to corporate debt and borrowing, you should ask yourself the three questions above as you examine a company's position. It is also important to look at debt to equity ratios and to focus on quality. In a rising interest rate environment, borrowing costs could start to increase incrementally, and you want to make sure the company is prepared financially to handle it. While it's likely that investment-grade companies and companies at the stronger end of speculative-grade spectrum will be able to adjust to higher rates, some companies on the other end of the spectrum will not. But, only time will tell how this story unfolds…

-**Mitch**

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

Zacks
INVESTMENT
MANAGEMENT