

Rising Corporate Debt Could Bankrupt Firms, Crash Market by 2013

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Wall Street's love of leverage is threatening to turn around and bite it in the assets, as many companies find their issuance of debt could potentially become their undoing. Massive amounts of corporate debt issued between 2003 and 2007 will come due over the next four years, and companies' inability to refinance their debt will leave them stuck with high interest payments, dragging down corporate earnings and forcing some companies into bankruptcy.



Standard & Poor's estimates that 807 speculative grade issues were originated in the U.S. from 2006 through 2009, and while only 82 (11%) of those bonds have defaulted, an alarming number of these issues still have below investment-grade ratings and are very much at risk of default.

The Debt Tsunami

The rapidly rising debt tsunami that threatens the U.S. bond market is outlined in an S&P report written by a group of analysts, including Diane Vazza, Managing Director, Head of Global Fixed Income Research, issued on Friday:

Based on the maturity schedules of all rated U.S. fixed- and floating-rate corporate bonds and bank debt, we estimate high-yield refunding needs of \$42 billion in 2010, growing to \$87 billion in 2011, \$159 billion in 2012, and \$244 billion in 2013. If revolvers are included, the total exposure is \$53 billion in 2010, rising to \$120 billion in 2011, \$198 billion in 2012, and \$277 billion in 2013. The share of speculative-grade rated debt to total rises to 45% by 2013, up from 11% in 2010, 21% in 2011, and 27% in 2012.

Considering banks' reluctance to extend financing to companies in today's "liquidity-favorable" environment, it's hard to imagine their extending credit in 2013, in an environment where 45% of all loans could be speculative. That has all the makings of Credit Crisis: The Sequel.

"You have too much debt coming due, and not enough money to refinance it," says John Lekas, president and CEO of Leader Capital Corp., which operates a short-term bond fund. Lekas says another debt crunch is coming, and it will likely send stocks crashing again, just as the liquidity crisis that began in September 2008 did. Lekas expects larger companies to have a better chance at refinancing debt in the short term, and smaller companies to be shut out, especially when interest rates begin to rise and spreads begin to widen.

"Greenspan gave everybody a nice window" to refinance debt, he says. "The companies that didn't take advantage of it are going to be carnage on the next move down in equities."

S&P Less Bearish

In its report, S&P was not as alarmist as Lekas about the problem of debt coming due, projecting a 5% default rate for speculative grade debt in 2010, with a worst-case scenario default rate of 6.9%. The default rate for 2009 was 10.9%.

"The projected drop in the corporate default rate appears to reflect a number of distressed issuers having been able to postpone default in the near term, as a result of lenders' willingness, by using strategies that include bond-for-loan takeouts, loan extensions, covenant amendments or resets, and equity issues," the report said.

While the report pointed out several signs of an improving economic environment, it emphasized that these low-rated highly-leveraged companies may have postponed dealing with their debt but haven't escaped the consequences. "Without a revival in top-line earnings and growth, many of the surviving leveraged issuers originated during 2003–2007 could face renewed default risk," Vazza said in a statement. Companies in the property-related or consumer discretionary sectors of the economy are particularly at risk.

Trouble Ahead

Lekas predicts problems for the intermediate bond market, particularly junk bonds and intermediate corporate bonds, once the expected debt comes due. He also warned that the U.S. and many municipalities face the same challenge of having too much debt coming due

and being unable to finance it, which will make matters even worse.

"You're going to see more downgrades, and spreads are going to re-expand," Lekas warned. "The light at the end of the tunnel is a train."
