WHAT DOES TAX REFORM MEAN FOR HIGH-YIELD DEBT?

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In an earlier post, we highlighted the likely impact tax reform could have on investment-grade (IG) corporate debt. In part two, we turn our attention to the high-yield (HY) market.[1] While a reduction in taxes should benefit all profitable companies, other provisions could lead to tough choices for some less-credit-worthy borrowers. As we've seen during the most recent earnings season, HY still presents a mix of opportunity and risk. Below, we highlight the contrasting impact of lower tax rates and potential changes in the deductibility of interest expenses.

Big Picture: Lower Taxes, Higher Free Cash Flow, Higher Earnings

On net, the proposed tax plan is a positive for high yield. Lower statutory tax rates should result in higher profitability metrics, greater free cash flow and a boost to economic momentum/growth, while extending the credit cycle. While all businesses won't be impacted the same way, we feel comfortable concluding that tax cuts should bias credit spreads tighter for riskier borrowers, on average. Similarly, an increase in economic growth could also push nominal interest rates higher.

What about Revenue Offsets?

While the top-line impacts we highlighted above should be broadly positive, we believe other elements of tax reform warrant closer attention—most notably, the so-called interest deductibility provision. In the current environment, companies choosing to finance themselves with debt are permitted to fully deduct interest payments. As a result, companies have an incentive to finance themselves with debt as opposed to equity. In order to help dampen the fiscal impact of tax cuts on the federal budget, the current proposal would limit the deductible amount of interest expenses to 30% of EBITDA. Fundamentally, this provision should have a much greater impact on the HY market. Given that risky borrowers tend to pay higher interest rates and (all else being equal) tend to deploy more leverage, the 30% cap on deductions should impact a larger percentage of the market. As we show in the chart below, HY companies with leverage of approximately 5.5x would likely be unable to fully deduct their interest expenses. In the second chart, we show that this makes up approximately 40% of the total market.[2]

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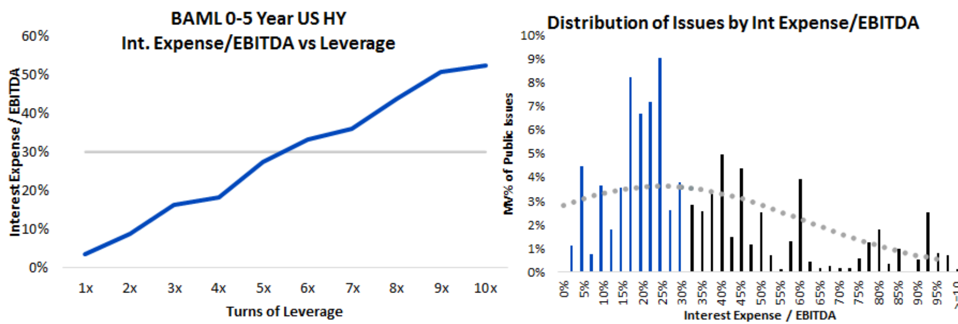

Source: WisdomTree, as of 10/31/17. Past performance is not indicative of future results.

Market Impact

While attempting to draw broad-based conclusions about individual companies can be tricky, a few key points stand out. In our analysis of firms with public financials, we estimate that 91% of CCCs will be unable to fully deduct their interest expenses. As a result, companies that deploy higher leverage, pay above-average borrowing costs and are generally rated lower could underperform. Additionally, while many of these companies are likely unprofitable given their tenuous financial status, the future value of any loss carry forwards decreases along with statutory tax rates. Also, as a result of this interest provision, their businesses would be less efficient (via decreased margins) given that they would be paying a higher cost of debt that cannot necessarily be deducted. Factoring in the net benefits of other changes in the tax code (lower rates), we expect approximately 15% of the Index to be negatively impacted by aggregate changes in the tax code.

On the other side of the coin, we believe that BB-rated borrowers could be among the greatest beneficiaries. In this segment of the market, a large percentage of those firms could see a bump in their overall credit worthiness given the boost to operating profitability, a structural deleveraging/decrease in the supply of debt and an overall increase in economic activity. Should those macro factors prove correct, we would advocate increasing exposures to high yield as it could be possible that high-quality BB borrowers could experience upgrades to IG.

Market Solutions

We still believe that the net impact of tax reform will result in downward pressure on credit spreads (increases in prices) and an increase in nominal yields. For an approach that seeks to isolate returns from credit with zero duration, the WisdomTree Interest Rate Hedged High Yield Bond Fund (HYZD) could make sense. Additionally, given that our research has shown that higher-quality borrowers in HY could see the greatest positive impact from tax reform, our fundamental approach to high-yield indexing could also be a strong beneficiary. With an over-weight to BBs and a 10% under-weight in CCCs, the underlying companies in the WisdomTree Fundamental U.S. High Yield Corporate Bond Fund (WFHY) tend to operate with less leverage because of their dramatically stronger free cash flow.[3]

While the current proposals face an unknowable path to becoming law, we currently believe tax reform is more likely than not (70%). As a result, we believe risky debt could present an opportunity to take advantage of attractive income opportunities that could continue to rise in value despite near-term headwinds.

[1]As proxied by the BofA Merrill Lynch 0-5 Year US High Yield Constrained Index.

[2]Sources: Bank of America Merrill Lynch, WisdomTree, as of 10/31/17.

[3]Source: WisdomTree, as of 10/31/17.

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HYZD seeks to mitigate interest rate risk by taking short positions in U.S. Treasuries, but there is no guarantee this will be achieved. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions. The Fund may engage in "short sale" transactions, where losses may be exaggerated, potentially losing more money than the actual cost of the investment, and the third party to the short sale may fail to honor its contract terms, causing a loss to the Fund.

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DEFINITIONS

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Free Cash Flow : A measure of how much cash is left in the company after taking into account all the necessary expenses, including net capital expenditures.

credit cycle : the process in which the pricing of and access to credit evolves over time.

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Earnings before interest, taxes, depreciation, and amortization (EBITDA) : The net income of a company with interest, taxes, depreciation, and amortization added back to it.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

CCC-rated : Standard & Poor's credit rating that implies the issuer is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.

Cost Of Debt : The effective rate that a company must pay in order to borrow from capital markets.

BB-Rated : The least speculative bucket of non-investment grade status for S&P. These issuers may be vulnerable to adverse business and economic conditions ultimately impacting their ability to meet financial commitments.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

BofA Merrill Lynch 0-5 Year US High Yield Constrained Index : tracks the performance of short-term US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.