S&P Global Ratings

Interest-cover risks are growing for vulnerable corporate credit

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This report does not constitute a rating action.

Corporate Ratings

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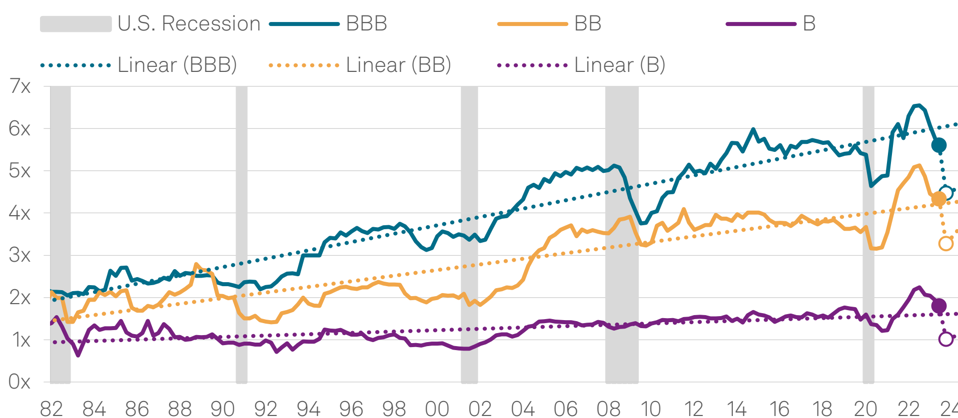
Key Takeaways

- The 40-year uptrend in interest cover ratios for U.S. nonfinancial corporates is likely over. Investment grade and stronger speculative-grade entities are not likely to see cover ratios become challenging, but the risks are much greater for 'B' rated credits where median EBIT interest cover is expected to fall to one this year.
- Interest coverage rose historically during a sustained period of rising profit margins and falling interest rates, boosted by factors linked to deepening globalization. These drivers are likely reversing and structurally lower levels of interest cover will raise its importance a credit risk factor.
- More broadly, the end of financial repression, defined as interest rates being held below the inflation rate, may bring risks from unsustainable capital structures to a head.
- Industries with a significant proportion of entities with trailing EBIT interest cover of less than one include telecoms, tech, media, and pharmaceuticals and biotech.

Chart 1

EBIT interest cover remains elevated despite the sharp downturn recently...

Median, Last 12 Months (LTM) - Rated U.S. nonfinancial corporates



Source: S&P Global Market Intelligence CreditPro®, Compustat, S&P Capital IQ, NBER, S&P Global Ratings
Shows data for the contemporaneous nonfinancial U.S. corporate rated universe through time, excluding real estate. Financial data from Compustat from 1982 to 1994, and S&P Capital IQ thereafter. Last 12 months (LTM) data to Q3. 2023, with last two markers indicating S&P Global Ratings estimate for end-2023 and end-2024.

Nonfinancial corporate interest cover has seen a sharp deterioration. Recent results seasons have seen a rapid fall in interest cover ratios for rated nonfinancial corporations (see Corporate

Results Roundup Q2 2023: Interest payments surge, EBITDA declines, Sept. 6, 2023). This reflects the dual pressures of rising interest payments and rapidly deteriorating profits growth. In a longer run context, however, interest cover still appears comfortable, particularly for higher-rated entities (see charts 1 and 2). Charts 1 and 2 show median 12-month trailing EBIT and EBITDA interest cover respectively by ratings category on a quarterly basis back to 1982 for U.S. nonfinancial corporates rated by S&P Global Ratings.

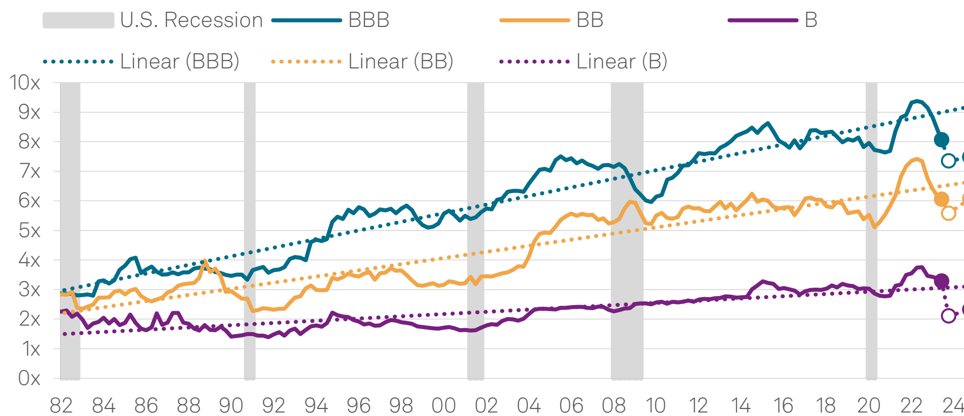
Technical note

The long run data reflects the contemporaneous ratings universe - calculated for companies and ratings as they were at the time, even if no longer in existence, which is essential for reflecting history as it was and eliminating survivorship bias. Using ratings categories to calculate the median ratios also allows us to remove the biasing of overall trends resulting from the changing composition of the rated universe. Since 1982, the number and share of entities with speculative-grade ratings has risen sharply, so financial metric time series for the rated universe overall are not necessarily comparing like-with-like and can create a misleading sense of deteriorating credit quality. Using median data by ratings category ensures like-for-like comparisons, facilitating meaningful assessments over time.

Chart 2

...as does EBITDA interest cover, although weaker credits are more vulnerable

Median, LTM - Rated U.S. nonfinancial corporates



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The secular uptrend in interest cover over past forty years is likely over. Both interest cover ratios shown here have seen a secular uptrend, with the increase strongest for higher-rated entities. Median EBIT interest cover for 'BBB' category U.S. nonfinancial corporate ratings was just over 2x in 1982 and reached a 6.5x peak in 2022. Even after its recent decline, it still stood at 5.6x in Q3 2023. Further down the credit spectrum, the magnitude of improvement diminishes but is still apparent; to 4.3x currently from 2x in 1982 for 'BB' ratings, and to 1.8x from 1.5x for 'B' category ratings.

This year's sharp decline will likely break the uptrend. Estimates from S&P Global Ratings analysts suggest interest cover will see further sharp declines in second-half results for 2023 across all ratings categories. Even though we anticipate a modest recovery in 2024, the break in

trend will likely be decisive given the one-off factors that drove the long uptrend. The decline in cover also brings warning signs for credit risk. Median EBIT interest cover for single 'B' category ratings is projected to fall to 1x this year, and EBITDA interest cover is expected to fall to just over 2x. Under our corporate ratings criteria, EBITDA interest cover can be considered to help develop a fuller understanding of a company's financial risk profile and fine-tune our cash flow/leverage analysis. Cover of less than 2x is considered indicative of a 'highly leveraged' entity in an industry of standard volatility (see 'Corporate Methodology', Nov. 13, 2013).

The long rise in interest cover ratios reflected improving profitability and a secular decline in interest rates, but both trends appear to be reversing. As with interest cover, profit margins have seen a steady uptrend over the past 40 years (see chart 3A), with the improvement strongest for higher-rated entities. Factors explaining this long-run upturn likely include globalization (market expansion and outsourcing), reductions in labor cost inflation, reduced energy intensity, and technology-related productivity improvements. Arguably, many of these factors are moving into reverse due to growing trade tensions, eroding emerging market labor cost differentials, global supply chain reshoring, and the taxation of environmental externalities.

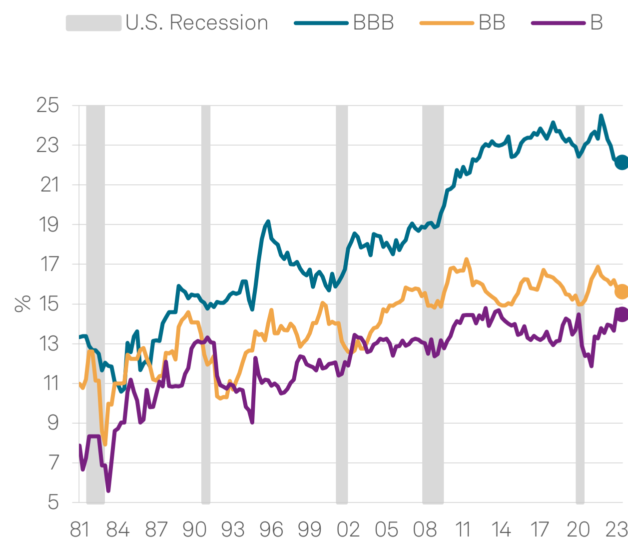
Similarly, interest rates fell on a sustained basis (see chart 3B) from the early 1980s onward, as economic policy got to grips with the inflation surge that took hold in the 1970s, and significant geopolitical changes reinforced disinflationary trends. These included the end of the Cold War and the integration of former communist countries into the world economy, deepening trade relationships that facilitated outsourcing and cost reductions (e.g. NAFTA), and - most importantly - the rise of China as a manufacturing nation, which massively increased the global labor supply. It remains too early to say whether central banks will succeed in re-anchoring inflation expectations back to levels prevailing before COVID stimulus and the war in Ukraine, but the structural forces that caused interest rates to fall are much diminished.

Chart 3

Profit margins rose and interest rates trended lower for many years, but that process may be reversing

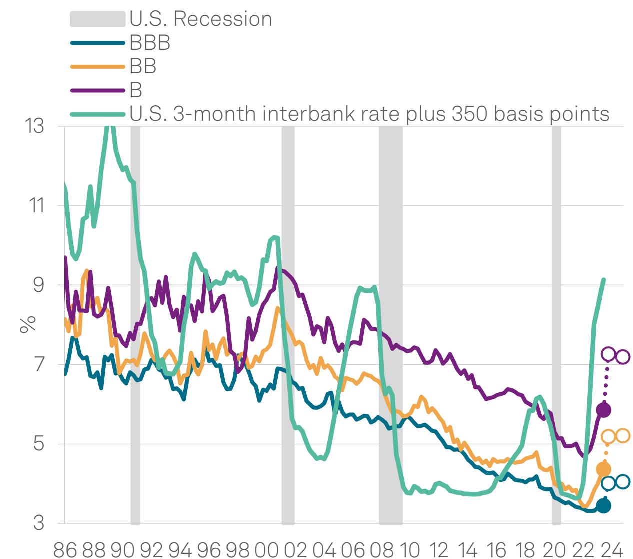
A) EBITDA margin

Median, LTM, Rated U.S. Nonfinancial Corporates



B) Cash interest paid/total debt and three-month U.S. interbank rates plus 350 basis points

Median, LTM, Rated U.S. Nonfinancial Corporates



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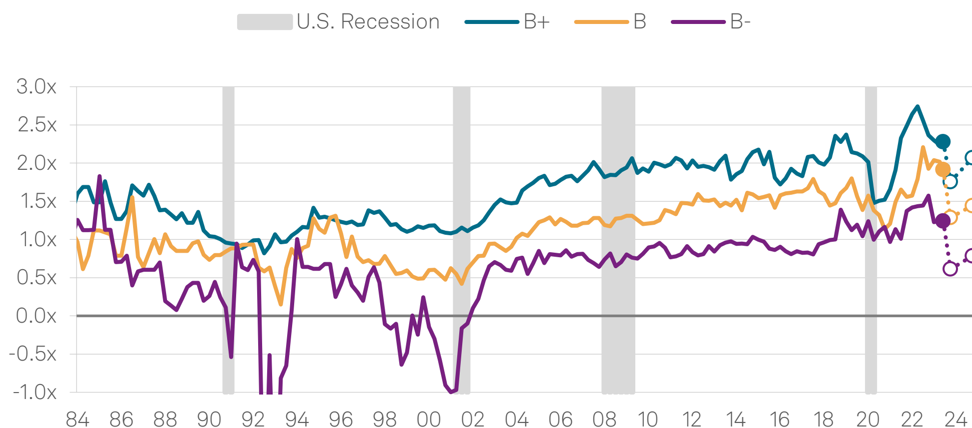
Shows data for the contemporaneous nonfinancial U.S. corporate rated universe through time, excluding real estate. Financial data from Compustat from 1982 to 1994, and S&P Capital IQ thereafter. LTM data to Q3 2023, with last two markers in chart 3B indicating S&P Global Ratings estimate for end-2023 and end-2024.

Weak credits are most vulnerable to interest cover pressures. While the long uptrend means it would take a very dramatic deterioration in economic and financial conditions for this measure to be an active concern for investment-grade ratings and the stronger end of speculative-grade ratings, this is not the case for more vulnerable credits. Chart 4 focuses on U.S. nonfinancial corporate entities in the single 'B' category, and while all have seen an improvement in cover over the long run, the increase has been relatively modest and is vulnerable to changed financial conditions. This is particularly the case for 'B-'-rated entities, where we estimate median EBIT interest cover will drop below one by the end of this year to 0.6x, its lowest level since Q3 2004, and remain below one in 2024.

Chart 4

Median EBIT interest cover for 'B-'-rated corporates will likely fall below 1x this year

Median, Last 12 Months (LTM) - Rated U.S. nonfinancial corporates



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To identify potential areas of vulnerability by industry, Charts 5 and 6 show the share of U.S. nonfinancial corporates with last-12-months EBIT interest cover less than one by industry for speculative-grade entities as a whole and for 'B' category rated entities. Industries with a significant share of uncovered interest are concentrated in telecoms (more than 50% in both cases), technology hardware, software, media, and pharmaceuticals and biotech.

Chart 5

Share of speculative-grade entities with EBIT interest cover less than 1x

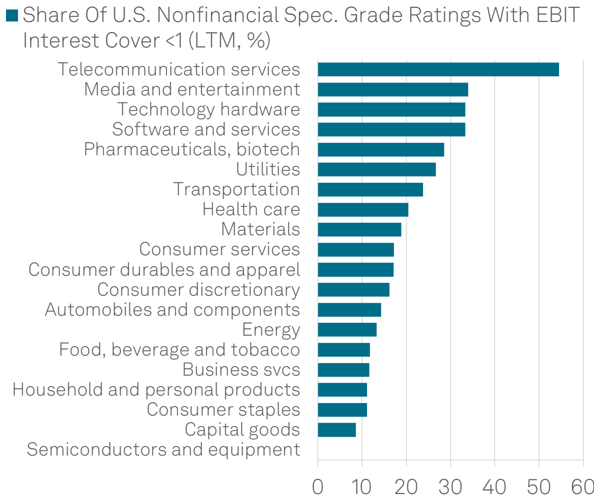
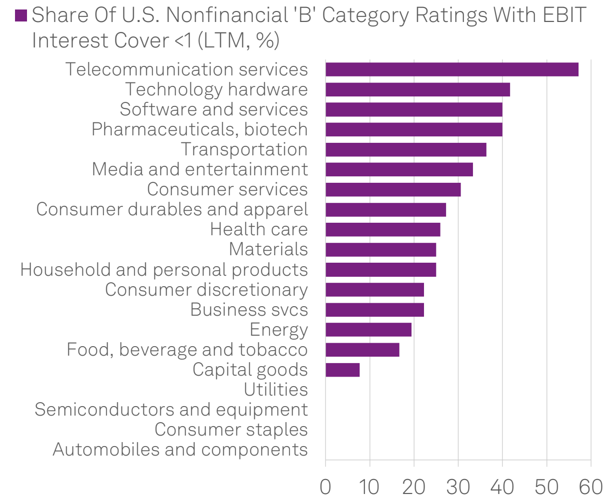


Chart 6

Share of 'B' category rated entities with EBIT interest cover less than 1x

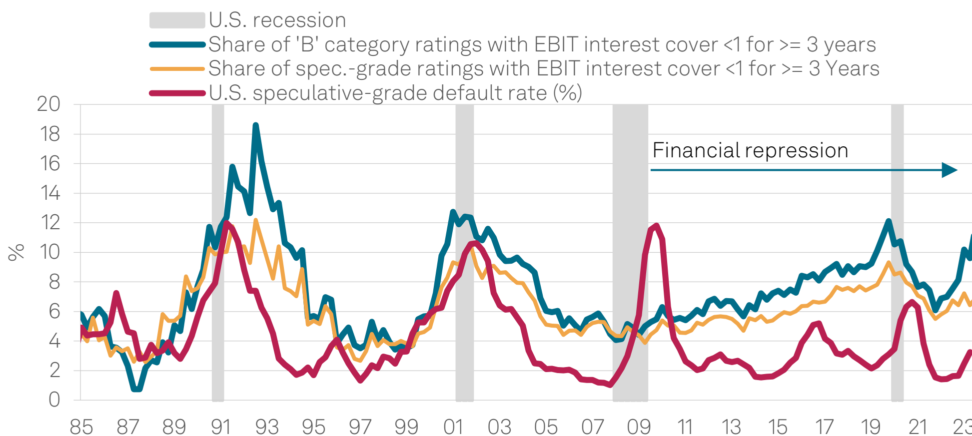


Source: S&P Global Market Intelligence CreditPro®, S&P Capital IQ, S&P Global Ratings. LTM data as of Q3 2023.

The end of the long uptrend in interest cover may signal a more profound shift in financial risks. EBIT interest cover is one measure used to assess the sustainability of capital structures. Specifically, one definition of heightened capital structure risk is companies with EBIT interest cover of less than one for more than three years (see BIS Quarterly Review, September 2018) which illustrates a persistent inability to service debts. Chart 7 shows the share of U.S. speculative-grade rated entities with uncovered interest for three years or more, and the same trend for 'B'-rated companies, alongside the trailing-12-month default rate.

Chart 7

The end of financial repression may bring unsustainable capital structure risks to a head



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Before the Global Financial Crisis (GFC) of 2007-2008, there was a good correlation between the proportion of speculative grade entities with persistent problems servicing debt and the default rate. Corporate excess was linked to corporate defaults. This wasn't the case prior to the GFC, when nonfinancial corporate strains were modest, an indicator of how the location of systemic stress was to be found elsewhere, principally in U.S. housing markets and financial institutions. Since then, the correlation between sustained corporate capital structure stress and defaults has weakened. There was a steady rise in the share of companies with capital strains from 2009 on, up to the onset of the pandemic, but no matching surge in defaults.

In our view, this is a likely consequence of the prolonged period of ultra-low policy rates which followed the GFC, sometimes characterized as a phase of financial repression, which can be defined as interest rates being held below the inflation rate. The surge in refinancing during and beyond the pandemic reduced capital structure strains, but it is concerning to note the sharp rise in prolonged interest cover deficits for single 'B'-rated entities over the past couple of years, even if not matched in the speculative-grade universe as whole. **With economic growth set to remain subpar and effective corporate interest rates rising as cheap debt is replaced by more expensive borrowing, weaker corporate borrowers appear particularly vulnerable to interest payment pressures and elevated levels of capital structure strain.**

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