

What Does Tax Reform Mean for High-Yield Debt?

Published November 16, 2017

Bradley Krom

U.S. Head of Research

Josh Shapiro, CFA

Quantitative Strategist

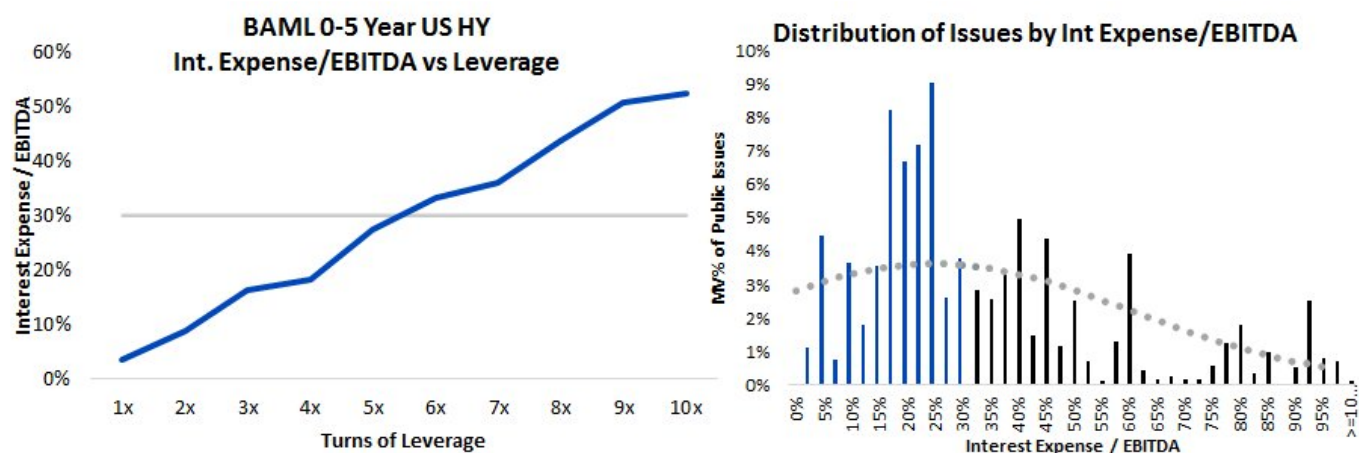
In an earlier post, we highlighted [the likely impact tax reform could have](#) on investment-grade (IG) corporate debt. In part two, we turn our attention to the high-yield (HY) market.¹ While a reduction in taxes should benefit all profitable companies, other provisions could lead to tough choices 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



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.

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

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

³Source: WisdomTree, as of 10/31/17.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. High-yield or “junk” bonds have lower credit ratings and involve a greater risk to principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer’s ability to make such payments will cause the price of that bond to decline. While the Funds attempt to limit credit and counterparty exposure, the value of an investment in the Funds may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Funds’ portfolio investments. Due to the investment strategy of certain Funds, they may make higher capital gain distributions than other ETFs.

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.

Please read the Fund's prospectus for specific details regarding the Fund's risk profile.