The Credit Market Lens: U.S. Corporate Issuers Can Digest Higher Refinancing Costs

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Concerns about higher yields aren't limited to U.S. policymakers. While the U.S. Treasury announced a buyback expansion amid rising U.S. borrowing costs, credit investors have started questioning whether higher yields will affect corporate borrowers' capacity to service debt via refinancing.

We see limited debt servicing risk for most corporate issuers. Even after normalizing from elevated levels since the pandemic, interest coverage ratios remain robust across both investment grade and high yield.

The risk profile is different for CCC rated borrowers. At the lowest end of the quality spectrum, however, interest rates on maturing debt could potentially double if refinanced at today's index yields. These higher funding costs, combined with mounting late-cycle headwinds, could challenge firms with already weak balance sheets.

The backup in global yields since late February has reignited the debate over the potential knock-on effects for corporate borrowers, particularly through higher refinancing costs and weaker debt-servicing capacity. Many companies used the historically low-rate environment of 2020 and 2021 to re-lever their balance sheets at very low all-in funding costs. Those higher debt loads were manageable when coupons were low, but over the past few years, borrowers have been refinancing that debt at higher yields (for more on recent yield moves, see our 21 August PIMCO Perspectives, "What's Pushing Long-Term Bond Yields Higher?").

In our view, the risks are relatively benign. For example, Figure 1 shows that despite coming down from their post-COVID highs, median interest coverage ratios for U.S. dollar investment grade (USD IG) and high yield (HY) issuers are still roughly 6x and 3x, respectively. Of course, given that interest coverage ratios are based on accounting data, they are backward looking. Thus, the real uncertainty is how large the marginal costs might be to refinance maturing bonds in the future.

While it's difficult to assess exactly how firms will optimize their capital structures on a forward basis, Figure 2 presents a rough approximation based on current market prices. This figure shows the difference between the current index yield and face-value weighted average coupons of the Bloomberg USD IG and HY indices, respectively. The clear takeaway is that the index-level difference is negligible.

That isn't to say that the effects of refinancing at higher yields across the quality spectrum will be evenly distributed. To approximate the funding costs across credit ratings, we calculate the face-weighted coupons for index-eligible bonds maturing in 2027 and 2028 and then compare them to the current yield for the given rating category. The results are shown in Figures 3 and 4 for IG and HY rated issuers.

Interestingly, these figures show that IG issuers with bonds maturing in 2027 and 2028 tend to face larger average marginal coupon increases than their BB rated peers. This may seem unintuitive, but the underlying reason is mechanical. HY firms generally issue at shorter maturity profiles relative to their IG-rated peers, whose investor base is far more comfortable with maturities across the entire curve, including long-dated bonds.

Therefore, given that we are six years past the July 2020 trough in U.S. Treasury five-year yields, most HY issuers have already had to refinance at higher market interest rates. By comparison, IG issuers that have longer-dated bonds maturing in 2027 and 2028 haven't yet refinanced them in the current higher rate environment.

There is one pocket of the market, however, where pressures are more acute: CCC rated issuers. We estimate that current face-value weighted coupons for bonds maturing in 2027 and 2028 could double from current levels, if these issuers refinanced their maturing bonds at today's index yields, as shown in Figure 4. Therefore, if growth continues to slow and late-cycle headwinds create a further drag on earnings growth, higher refinancing costs for these CCC firms present an acute pain point given their weaker balance sheets.

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