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Debt woes not as bad as they look

With the economy shrinking and credit markets in disrepair, many investors see debt as an unqualified evil. But businesses still see debt as a tool for everything from funding expansion to leveraging profit growth.

Issuing debt is cheaper and (until recently) easier than issuing stock. Used wisely, debt can boost returns and allow companies to make acquisitions or invest in growth initiatives.

There is some justification for investors' worries, though the problems are not as bad as many think.

All nine of the nonfinancial sectors in the S&P 500 Index saw total debt rise in the 12 months ended September. Eight of the nine saw an increase in long-term debt as a percentage of total capital, and seven saw a decline in cash as a percentage of total debt. However, many sectors look fairly healthy relative to historical norms. Outside of the financial sector, long-term debt as a percentage of total capital has fallen over the last year.

Unfortunately, balance sheets can erode rapidly, and a prolonged economic downturn would make it more difficult for companies to cover debt payments out of operating profits.

The credit crunch has also made it more difficult for companies to borrow — a fact that can cause trouble even for companies *not* adding additional long-term debt. Nonfinancial

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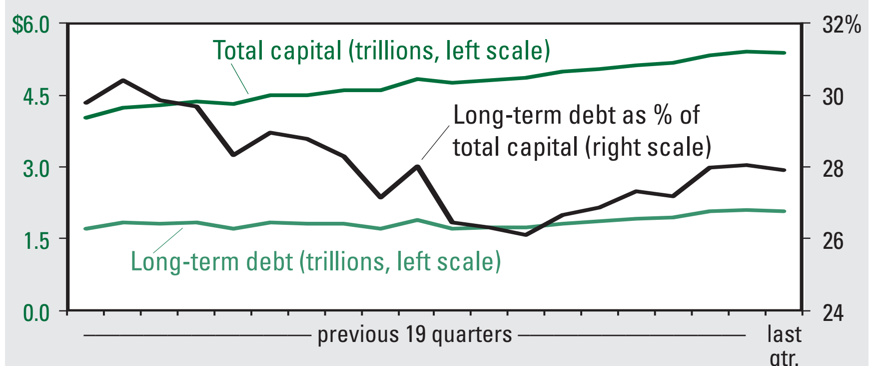
OUTSIDE FINANCIAL SECTOR, DEBT LEVELS APPEAR REASONABLE



While the balance-sheet woes of financial companies have made front-page news, debt levels outside the financial sector are not high relative to total capital. The ratio of long-term debt to capital has declined slightly over the last five years. Data above reflect debt and capital levels for 390 of the 416 nonfinancial companies in the S&P 500. The remaining 26 companies did not have five years of history.

Don't give up on stock funds

With the exception of U.S. Treasury securities, just about all mutual-fund categories lost money in 2008. U.S. stock funds were among the hardest hit, with the average large-cap blend fund down 38%.

While many investors feel snake-bitten, now is not the time to give up on stock funds. In fact, given the stock market's swoon, many investors' portfolios have become underweighted in stocks and overweighted in bonds.

To be sure, a defensive posture seems prudent, at least in the near term. But investors with the discipline to maintain exposure to stocks should eventually be rewarded when the economy — and stock market — rebound.

Traditionally, growth-and-income funds have offered a smoother ride than typical stock funds because of an emphasis on high-quality, dividend-paying stocks. On the whole, these funds invest mostly in large, well-known companies and have sizable exposure to the financial, industrial, and health-care sectors. Balanced funds limit risk by holding both stocks and fixed-income securities, typically investment-grade bonds.

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companies in the S&P 500 Index combined to carry $2.72 trillion in debt in the September quarter, of which $578 million — or 21% — is classified as short-term, meaning that it is probably due within 12 months. All of that debt must be either paid off or refinanced in an unfriendly market.

Most short-term debt falls in two categories: short-term notes payable to banks and other creditors, and the portion of long-term debt due over the next year. Both of those types of debt come with their own problems:

➤ **Short-term notes**. Many companies rely on banks or other creditors to obtain working capital. Such loans must be refinanced frequently, and in the current environment, new money may prove hard to obtain. A loss of short-term liquidity can be devastating. Short-term notes account for about 60% of all short-term debt.

➤ **Long-term debt**. While most companies are covering their debt payments well enough, the trouble comes when long-term loans mature. In 2008, about 10% of S&P 500 companies' long-term debt came due, and even more is slated to mature this year. In the current environment, many borrowers may have trouble refinancing that debt. Fortunately, a government push to loosen the lending market for consumers offers some hope that business lending will also pick up in the year ahead.

The amount of difficulty companies face in refinancing their debt depends on several factors, most of which are reflected in a table on page 5:

◆ **Debt level.** Lenders may view companies that carry heavy debt as poor risks. High credit ratings have historically been a license to borrow. But, after meltdowns in the balance sheets of highly rated companies last year, skepticism abounds. In general, the *Forecasts* doesn't like to see long-term debt represent much more than 50% of total capital. Capital is the combined book value of equity, long-term debt, preferred stock, and minority equity interests.

◆ **Interest coverage.** Our Quadrix® Financial Strength score considers three measurements of how easily a company can meet its debt payments — interest coverage (income excluding interest expense divided by interest expense), cash flow divided by interest expense, and cash flow divided by total debt. Especially recently, shares of companies weak in these areas have trended to underperform the average stock in many sectors.

◆ **Cash position.** Most companies have more debt than cash. But a large cash balance can change the picture. If a company has enough cash to pay off long-term debt, it does not matter if the debt-to-capital ratio is high.

◆ **Existing credit lines**. Do companies have sufficient credit to cover their needs without arranging new financing? This can be difficult to determine, as disclosure requirements are limited. Even if a company tells you it has a large credit line, it may not tell you how fast it is likely to draw down that credit. You don't have to look far back (think Bear Stearns and Lehman Brothers) to find companies that claimed to be well-capitalized right before the bottom fell out.

The table on page 5 lists *Forecasts* recommendations with solid balance sheets, along with large-cap market leaders that look too risky for our taste. In the following paragraphs, we discuss three attractive options.

Microsoft *($20; MSFT)* broke from tradition twice in 2008. In January, it announced a willingness to take on significant long-term debt to help finance a $45 billion offer to buy Yahoo. This from a company that's never had more than $1 million of long-term debt since 1989.

In September, Microsoft authorized up to $6 billion in debt financing and promptly issued $2 billion in short-term commercial paper. In support of the new program, Microsoft arranged for a $2 billion unsecured credit line, which was untapped at the end of September. Not that Microsoft needs the liquidity.

Cash exceeds $20 billion, comfortably covering current debt and the amount spent on dividend payments and stock repurchases in fiscal 2008

SECTOR ANALYSIS

In the 12 months ended September, most of the sectors in the S&P 500 Index saw an increase in long-term debt as a percentage of total capital and a decline in cash as a percentage of total debt, suggesting higher leverage and more risk of default. However, the picture doesn't look as bleak relative to five-year averages. Data reflect statistics for the capitalization-weighted sectors in their entirety.

	Long-Term Debt As % Of Total Capital			Cash As % Of Total Debt		
S&P 500 Sector	*Now*	*1 Yr. Ago*	*5-Yr. Avg.*	*Now*	*1 Yr. Ago*	*5-Yr. Avg.*
Consumer Discretionary	53.4%	48.9%	51.9%	25.7%	27.0%	23.0%
Consumer Staples	35.2	32.4	36.8	16.3	19.2	20.5
Energy	22.9	22.1	24.2	40.1	43.0	44.2
Financials	75.4	67.0	70.0	NM	NM	NM
Materials	32.1	33.6	37.8	20.1	19.9	21.8
Health Care	26.4	23.8	22.6	71.0	97.1	102.0
Industrials	52.8	50.6	49.8	15.8	10.5	11.5
Technology	19.1	16.5	15.7	165.0	182.9	224.6
Utilities	53.4	53.0	56.5	7.1	8.1	7.4
Telecom Services	40.5	34.8	39.2	4.6	6.4	12.6

NM Not meaningful.

ended June. *Microsoft, slated to release December-quarter earnings Jan. 22, is a Buy and a Long-Term Buy.*

It has been a rough stretch for energy companies, but **Chevron's** *($72; CVX)* robust balance sheet should keep the company upright until it reaches calmer waters. The oil-price boom helped boost Chevron's operating cash flow and cash holdings 36% in the nine months ended September. Chevron has enough cash to retire all its debt — with $4 billion to spare. The cash surplus could also fund continued stock repurchases. Chevron has lowered its share count at an annualized rate of more than 2% over the last three years. Moreover, Chevron has a $5 billion credit backstop available if needed.

In January, Chevron cited lower energy prices in warning that December-quarter earnings would be "significantly lower" than year-earlier results. However, the consensus already projected an 18% decline. Chevron also reported production slightly below guidance for the first two months of the quarter. *Chevron is a Buy and a Long-Term Buy.*

Western Digital *($13; WDC)* is highly liquid and carries little debt. Operating cash flow has risen in 11 straight quarters, helping Western build up cash holdings to $1.22 billion, or $5.38 per share. Aggressive moves to cut costs during the downturn should help keep the balance sheet strong, though Western has enough cash to support research and other operating expenses for nearly two years.

For added protection, Western Digital obtained a $250 million credit line in February. Western Digital earns Quadrix Overall, Quality, and Value scores in the upper 90s. *Western Digital is a Buy.*

THE STRONG . . .

Debt in and of itself is not a bad thing. But in a climate of tight credit, weak profits, and ongoing doubts about the accuracy of credit ratings, stocks with low debt, solid growth, and high credit ratings have an edge. All nine of the recommended stocks in the top table have solid balance sheets and high Quadrix Financial Strength and Overall scores. The Financial Strength score considers debt levels, interest coverage, and profit margins. The 11 stocks listed in the bottom table, all components of the S&P 500 Index, have problems with debt. The *Forecasts* does not recommend any of these stocks, and subscribers holding them should be wary of deterioration in the balance sheet.

	Debt (Millions)		% Of Total	Cash Plus Available	Long-Term	LT Debt As % Of	Cash As %	Cash Flow As %	Quadrix Scores *		Interest	
	Long Term	Short Term	Debt Due Next Yr.	Credit (Mil.) **	Debt Rating	Total Capital	Of Total Debt	Of Total Debt	Financial Strength	Overall	Coverage Ratio	Advice
Accenture *($34; ACN)*	$1	$1	51%	$4,484	A+	0%	NM	NM	94	90	142.1	Focus Buy †
Biogen Idec *($50; BIIB)*	1,042	10	1	1,925	BBB+	15	149%	143%	87	93	26.8	Focus Buy †
Chevron *($72; CVX)*	6,129	832	12	15,983	AA	7	158	453	89	96	134.8	Buy †
Exxon Mobil *($78; XOM)*	7,383	2,881	28	38,434	AAA	6	374	590	84	90	47.6	LT Buy
Microsoft *($20; MSFT)*	0	1,975	100	22,722	AAA	0	1049	967	95	85	NM	Buy †
National Oilwell *($26; NOV)*	1,493	19	1	6,206	A-	11	117	143	88	97	30.4	Buy †
Schlumberger *($43; SLB)*	3,528	2,211	39	5,593	A+	16	61	124	91	83	26.0	LT Buy
St. Jude Medical *($31; STJ)*	197	1,205	86	1,079	A-	5	41	73	89	77	38.7	Focus Buy †
Western Digital *($13; WDC)*	462	45	9	1,465	NA	14	240	292	84	96	30.7	Buy

. . . AND THE WEAK

	Debt (Millions)		% Of Total	Cash Plus Available	Long-Term	LT Debt As % Of	Cash As %	Cash Flow As %	Quadrix Scores *		Interest	
	Long Term	Short Term	Debt Due Next Yr.	Credit (Mil.) **	Debt Rating	Total Capital	Of Total Debt	Of Total Debt	Financial Strength	Overall	Coverage Ratio	Sector
AES *($8; AES)*	$17,690	$954	5%	$4,402	BB-	69%	20%	11%	14	81	1.3	Utilities
Caterpillar *($41; CAT)*	19,794	14,370	42	5,911	A	66	6	17	39	81	3.5	Industrials
CMS Energy *($11; CMS)*	6,108	649	10	1,152	BBB-	69	3	NA	18	60	1.8	Utilities
Deere *($41; DE)*	13,899	8,521	38	4,254	A	68	12	9	46	74	2.2	Industrials
Embarq *($36; EQ)*	5,838	2	0	1,083	BBB-	99	1	30	66	84	2.6	Telecom Services
Ford Motor *($2; F)*	156,793	0	0	46,766	CCC+	100	23	5	8	6	0.9	Cons. Discretionary
General Electric *($15; GE)*	329,915	218,748	40	78,677	AAA	73	3	8	21	43	1.6	Industrials
General Motors *($4; GM)*	37,947	7,208	16	20,574	CC	NM	36	NM	1	0	NM	Cons. Discretionary
Qwest Commun. *($4; Q)*	12,815	1,240	9	1,436	BB	97	4	21	36	64	1.6	Telecom Services
Textron *($14; TXT)*	9,384	550	6	1,654	BBB+	73	4	11	28	62	3.1	Industrials
Windstream *($9; WIN)*	5,371	24	0	455	BB+	91	2	20	58	83	2.0	Telecom Services
S&P 500 Nonfinancials ‡	**2,095**	**198**	**9**	**NA**	**NA**	**32**	**25**	**45**	**62**	**69**	**5.8**	

NA Not available. NM Not meaningful because Microsoft has no long-term debt, Accenture has just $2 million in total debt, and General Motors has negative values for total capital, income before interest, and operating cash flow. † Also qualifies as a Long-Term Buy. ‡ Median stock.
** Quadrix scores are percentile ranks, with 100 the best. ** Available credit data taken from company filings in most recent quarter (usually September quarter). Data will not reflect borrowings since quarter end and may not reflect all credit available to a company.*