Buttonwood

Debtors' prison

Companies made a fashionable mistake

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CHIEF executives get no credit in good times if their companies have good credit. Back in 1980 more than 60 American non-financial companies qualified for the ultra-chic AAA rating from Standard & Poor's (S&P). Now there are just six.

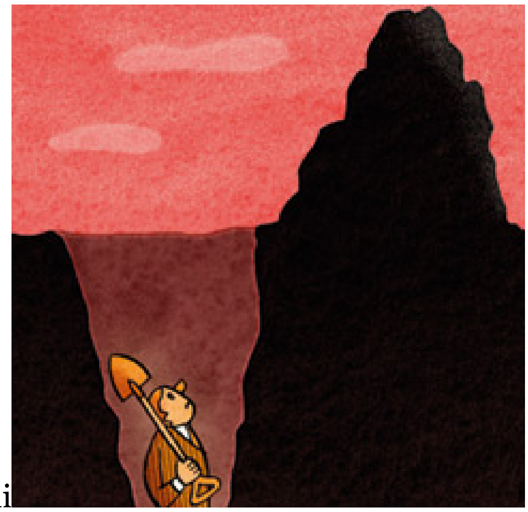
Illustration by S. Kambayashi

That change is not just a reflection of the financial crisis or the recession. The decline in credit ratings has been remorseless over the past couple of decades. In 1987 just 38.1% of issuers in the American bond market were rated as speculative, or “junk”. In 2007 junk-bond issuers made up most of the market for the first time. The number of lowly-rated CCC issuers has almost tripled over the past 21 years.

The intellectual fashion has been for companies to have “efficient” balance-sheets. If cash is not immediately needed to reinvest in the business, it should be handed back to shareholders, who can use it more profitably elsewhere. Hoarding cash for a rainy day was seen as a failure of executive imagination.

Corporate-finance theory may state that the value of a company should not be affected by its decision to finance itself with equity or debt. But, in practice, interest payments are generally tax-deductible; dividends are not. That gives companies a big push in the direction of debt.

So has the state of the financial markets in recent years. Measures of stockmarket valuation, such as price-earnings ratios, never recovered to the peak levels of 2000, even when share prices were rising during 2003-07. In contrast, corporate-bond investors quickly forgave issuers for the failures of Enron and WorldCom in 2002; spreads fell to historic lows. It was easier to issue debt than equity.

In addition, debt was credited with operational benefits. The need to meet regular payments imposes a discipline on corporate executives, ensuring they keep a lid on costs. This is one of the arguments used to extol the merits of private equity, which relies heavily on debt finance.

But these strategic reasons for taking on debt may have played second fiddle to a more basic motive: managers' self-interest. Using cash to buy back equity boosted earnings per share, making it easier for companies to meet quarterly profits targets. Meanwhile, executives are motivated by share options. Favouring debt over equity made the share price more volatile, and the more volatile the shares, the more valuable an option becomes.

Debt was also often used to finance acquisitions. Again, deals may be in the executive's self-interest; bigger companies mean bigger salaries and it is much better for the executive if his company is perceived to be predator, not prey. Moreover, outside advisers, such as investment banks, have an incentive to recommend debt issuance and acquisitions, both of which generate fees. Activist shareholders such as hedge funds pushed companies to pay out surplus cash.

It is only in recessions that this enthusiasm for debt reveals its dangers. The default rate is now rising rapidly and S&P is forecasting that nearly 14% of bond issuers will fail to meet their obligations this year. It is difficult to roll over new debt, given the credit crunch. Meanwhile, suppliers demand instant payment from companies with weak balance-sheets and equity investors downgrade the shares.

Were there no voices for caution? To be fair, it was households rather than business that piled up the bulk of the debt in recent years. Strong profits allowed many companies to rely on internal funds for their investment needs. However, in a few industries, carmaking, for example, debt has been pushed very high. And many public companies that were taken private in recent years are now struggling to cope with their debts.

Companies will naturally now seek to issue shares to repair their balance-sheets. Sometimes this will mean selling equity, a galling experience for those who spent a fortune on share buy-back programmes just a year or two ago. That ought to cast doubt on the financial acumen of the executives concerned.

A bigger problem is that the best time to issue shares is when stockmarkets are soaring, not languishing. Figures from Absolute Strategy Research, a consultancy, show that the peak period for European issuance was in 1998-2000, in monetary terms, or in 1986-88, as a proportion of market value.

In recessions, rights issues can seem like chucking good money after bad. And as the banks have already discovered, the more a rights issue appears to be imminent, the bigger the fall in the share price and the harder it is to get the issue away. The “efficient” balance-sheet can be a disorderly death sentence.

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