

# HARD LESSONS FROM THE DEBT DECADE

Leverage can give companies a lift—or a letdown. Borrowers are rediscovering the dangers of optimistic forecasts, unforeseen events, and lenders who turn against them. ■ by John J. Curran



OVER THE past decade debt, like hot air, lifted takeover bids, stock prices, and investor returns to the stratosphere. But with the demise of Campeau Corp. (see preceding story), the air has gone out of these balloons. Managers who damned debt were vindicated. Those who praised it felt chastened. But the questions that debt raises about the appropriate use of leverage and the kinds of companies that can employ it best will not float away. Nor should the painful lessons of what happens when you take on too much debt.

The role of corporate leverage has long been debated, and all sides have some claim on the truth. Critics, like American Airlines CEO Robert Crandall, contend that growing indebtedness has hobbled companies and robbed them of their futures. Huge interest payments are draining

resources just when the competitive threat from overseas is greatest. Crandall sees rising leverage as a “serious problem for American companies.”

The critics have a point. During the past decade debt as a percent of total capital at nonfinancial companies has grown to 49% from 34%. A more revealing measure is decreasing interest coverage—the multiple by which corporate cash, defined as earnings before interest and taxes, exceeds interest payments. A multiple of less than one implies that the company is not generating enough cash to meet its interest obligations. In 1980 nonfinancial companies enjoyed cushy interest coverage of 4.6. Today that margin of safety is estimated to be only 3.3.

It is important to note here that this description of cash, known as EBIT, is conservative because it excludes depreciation and amortization and considers only the earnings available for interest. In theory, and all too often in practice, a company could

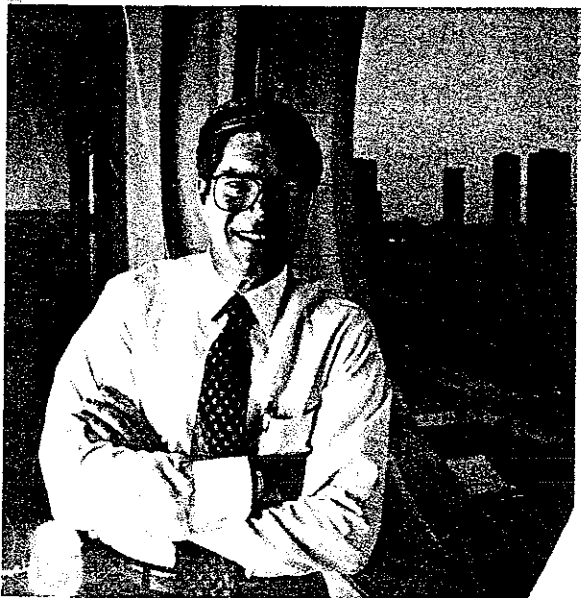
skimp on capital spending and divert the cash it saves from tax deduction on depreciation and amortization to paying interest. But that gambit will undermine competitiveness in the long run.

Among a growing number of companies, the interest-coverage signal is flashing red. Analysts at Moody's Investors Service forecast that defaults will rise to about 10% of all junk bond issuers in 1990—and they are not forecasting recession. The total dollar value of all those defaults would be roughly \$20 billion, a figure that doesn't include the enormous social costs of bankruptcy.

While acknowledging that debt has risks, proponents of leverage argue that it has brought benefits too. During the 1980s stock prices rose 228%, due in no small part to cash flow improvements that higher borrowing helped generate. Higher debt has also improved companies' competitive position by lowering their cost of capital.

But these happy consequences have come from a careful use of leverage and from a realistic sense of the fallibility of financial forecasts on which corporate borrowing is based. The trouble is that in the past few years the sheer plentitude of money has made borrowers too eager to take on mountains of debt, and lenders too willing to supply it. Says Alfred Rappaport, chairman of Alcar Group, a management consulting firm based in Skokie, Illinois: “Too much of what has happened has gone on simply because financing was available. That's going to create some problems.”

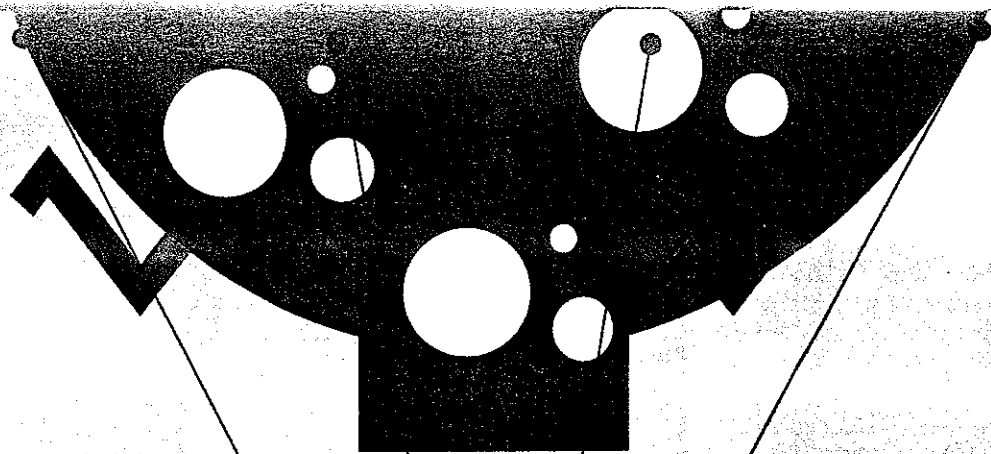
Somewhere in the late



Krebs thinks heavy debt put Santa Fe Pacific on the right track to building value for shareholders.



People forget that airlines are cyclical businesses, says Crandall, who believes that many carriers have too much debt to stay aloft.



1980 prudence disappeared and auction fever took over. The size of a loan began to be set not by the company's ability to repay but by a takeover price generated in a heated bidding war. To accommodate borrowers who had gone to excess, Wall Street devised new forms of indenture. Zero-coupon bonds and pay-in-kind securities delay interest payments in return for creating an ever-deepening debt hole for borrowers to climb out of.

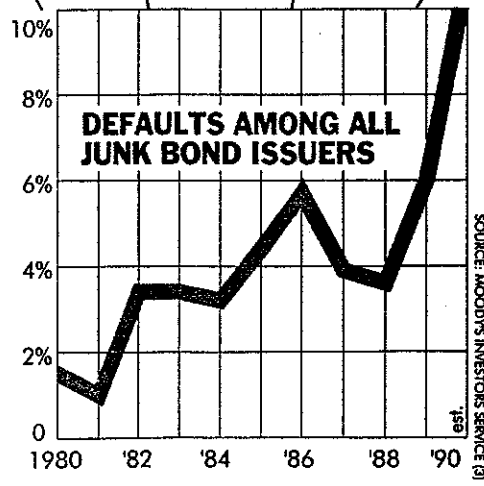
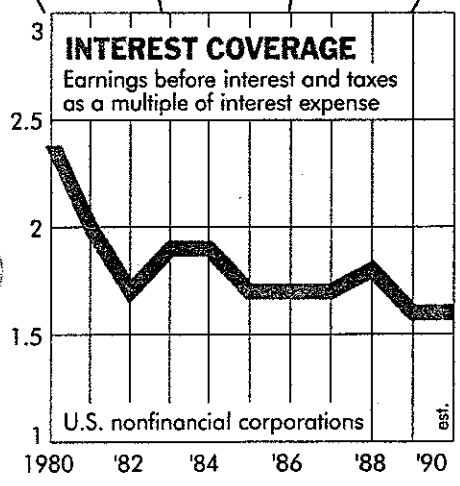
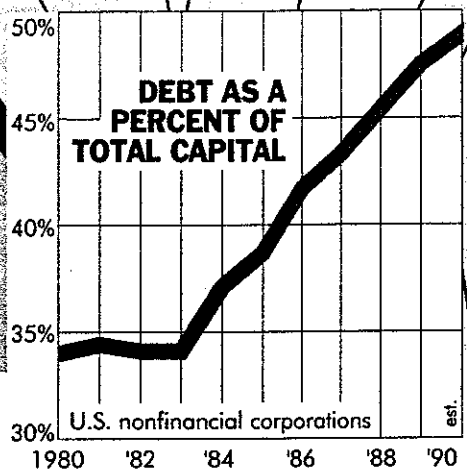
Leverage, alas, is not a science, but an imponderable balance of math, intuition, fear, and greed. The gains that accrued to shareholders in recent years have come at least in part because these forces were in accord. But by the end of the 1980s they were no longer. Borrowers and creditors are greeting the new decade with a terrific debt-induced hangover.

It's no secret what debt can do for corporate performance. It boosts a company's return on shareholders' equity. But there was another reason managers chose to leverage up their firms: debt's privileged status in the corporate tax code. Interest payments to lenders are tax-deductible, whereas dividends to stockholders are not. The break on interest makes debt a far cheaper way to finance growth than equity. Hence, more debt, within limits, means a lower cost of capital.

The tax savings from interest deductions

can enhance shareholder value in much the same way that your deduction for mortgage interest raises your net worth—by putting more cash in your pocket. Money the company does not spend in taxes can be paid to shareholders in higher dividends or plowed back into the company as retained earnings. Either way, the tax savings should

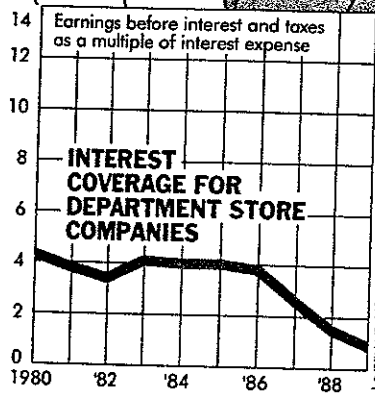
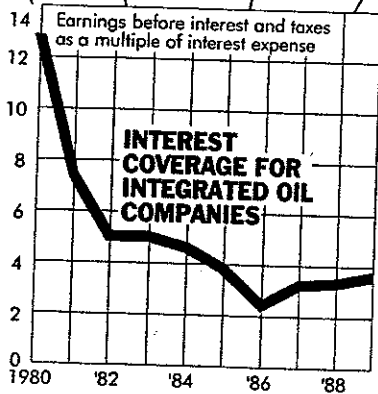
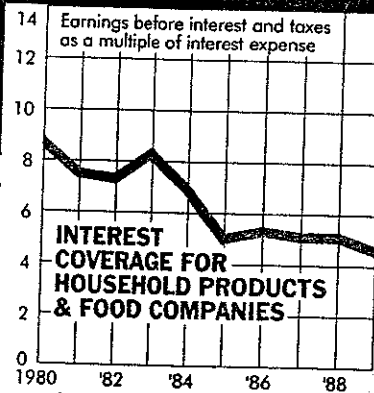
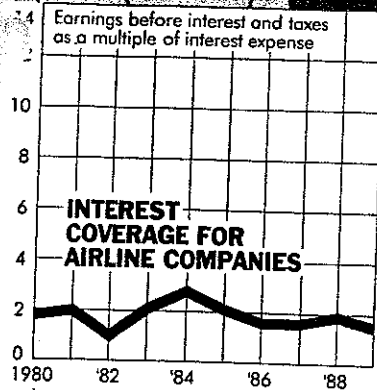
raise the shareholders' total return. Many companies figured it was better to forsake the tax breaks in order to have a top-flight credit rating that would guarantee access to the credit markets even in the roughest times. But deregulation of the financial markets changed the credit worry from one of availability to one of price. The



**AS DEBT RISES, CASH IS SQUEEZED AND DEFAULTS SOAR**

Corporations went cheerfully into hock in the Eighties, increasing their debt from 33% to nearly 50% of total capital. This load makes it tougher to meet interest payments, as shown by declining interest coverage. At the furthest reaches of the debt scale, the junk bond market, defaults are up sharply.

SOURCE: MOODYS INVESTORS SERVICE (SI)



SOURCE: DUFF & PHELPS (A)

## WHERE LOFTY LEVERAGE MAKES CASH SEEM SMALL

These industries have borrowed so aggressively in the past decade that their comfortable cash cushions are eroding. For purposes of the chart, the interest computation comprises not only cash and non-cash interest on debt but part of the rental expense paid on such assets as airplanes and stores.

To meet those enormous outlays, managers maximize the company's cash by draconian staff cuts, speedy sale of sluggish divisions, and a religious commitment to cost controls. The raider expects the net result will be a leaner firm that is worth much more than when he bought it.

This approach to value creation, called the wolf-at-the-door strategy, terrifies managers into forgetting about their traditional targets—revenue and earnings-per-share growth—and focusing on generating cash to pay down debt. Such strategies can unleash substantial changes at an organization that will result in much higher shareholder value—at least in the beginning. Or so the dramatic returns of 30% or more annually that Kohlberg Kravis Roberts and other leveraged-buyout firms used to achieve would suggest.

**T**HE WOLF has also done the trick at companies that have remained public but taken on mounds of debt in leveraged recapitalizations. In 1987, Santa Fe Pacific was a lumbering conglomerate with assets in railroads, real estate, mining, and oil and gas. A hostile takeover attempt by the Henley Group's Michael Dingman later that year pressured the company's managers to borrow \$3.7 bil-

sources of funds seemed much more secure once there was a flourishing junk bond market and banks could attract deposits with competitive rates.

Says James McTaggart, president of Marakon Associates, a Greenwich, Connecticut, management consulting firm: "In the deregulated environment high-quality companies have come to learn that they could live with more leverage than they'd thought." The sands began to shift. Triple-A companies like Coca-Cola kissed their credit halo goodbye and started to borrow. In 1986, Coke's credit rating was cut to double-A.

Valuable though it is, there are limits to how much the tax break from leverage can do for shareholders. As a company increases its borrowing, it also increases its

REPORTER ASSOCIATE Joshua Mendes

risk of default, which means the market will charge more for the debt and equity capital it provides. At some point, which differs for every company, the tax benefits are outweighed by the higher capital costs, and shareholder value begins to shrink. According to financial analysts at Marakon Associates, 20% or so is the maximum increase in shareholder value that a company can expect to draw from debt's tax benefits before the tradeoff kicks in. So it's not worth risking the ranch chasing deductions.

When corporate raiders offer fat premiums of 40% or more over a stock's market price in a takeover bid, they expect to get an even bigger payoff from loading up with debt. Leverage in large doses confronts a complacent management with a demanding performance schedule in the form of quarterly interest and principal payments.