Companies are dangerously drunk on debt

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Robert Armstrong, *The Financial Times*, May 6, 2020

6 mai 2020

An increasing number of companies are reaching for more debt to stay afloat © Ingram Pinn/Financial Times

Homer Simpson once proposed a toast “to alcohol, cause of and solution to all of life’s problems”. For global companies that have drunk deep of debt, his line captures a nasty irony. The pandemic poses especially big economic hazards to companies with highly leveraged balance sheets, a group that now includes much of the corporate world. Yet the only viable short-term solution is to borrow more, to survive until the crisis passes. The result: companies will hit the next crisis with even more precarious debt piles. The cycle needs breaking.

In the US, non-financial corporate debt was about $10tn at the start of the crisis. At 47 per cent of gross domestic product, it has never been greater. Under normal conditions this would not be a problem, because record-low interest rates have made debt easier to bear. Corporate bosses, by levering up, have only followed the incentives presented to them. Debt is cheap and tax deductible so using more of it boosts earnings.

But in a crisis, whatever its price, debt turns radioactive. As revenues plummet, interest payments loom large. Debt maturities become mortal threats. The chance of contagious defaults rises, and the system creaks.

This is happening now and, as they always do, companies are reaching for more debt to stay afloat. US companies sold $32bn in junk-rated debt in April, the biggest month in three years. Junk and near-junk rated companies that added to big debt piles last month include cinema operator AMC, Boeing and Carnival Cruise Line — all of which could see permanently reduced demand after the crisis. The bond issuance has been dwarfed by credit line drawdowns at US banks, which Autonomous Research estimates at $550bn.

The US government has stepped in to make borrowing easier. The debt market was buoyed by the Federal Reserve's announcement that it will buy $750bn in corporate debt, and the main street lending programme will make $600bn in loans to midsized companies.

The moral hazard is obvious. When governments help indebted companies avoid bankruptcy, investors conclude that the government will always absorb debt's tail risks. The price of debt goes down and its amount rises, yet again.

In a better world, bailouts would provide prudent companies with the liquidity they need to see them through crises, while heavily indebted companies' shareholders would be wiped out and their debt restructured. In both cases, the underlying businesses would keep operating and paying employees.

But in this world, with the US's cumbersome bankruptcy processes, a big crisis could overwhelm the legal system. The need to get cash to companies fast makes it impracticable for bailout programmes to carefully sort the prudent from the reckless. Bailouts, in the US and elsewhere, were necessary.

The Fed and the US Treasury did put leverage limits on main street loans, saying they would not provide loans that push a company's total debt past six times its earnings before interest, taxes, depreciation and amortisation. But it quickly became clear that applying this rule rigidly would exclude too many companies. The government backed off, allowing loose definitions of ebitda that would let more companies participate.

The problem of excessive corporate debt needs to be solved not while the crisis rages, but after it passes. It will not be enough for central banks to be more hawkish on rates and unwind asset-buying programmes. The main reason debt is cheap is not central bank policy but low growth. As the world ages and productivity slows, there are more savings and less demand for investment. Savers can charge less for lending their money.

Containing corporate debt by regulating lenders is also unlikely to work. After the financial crisis, bank capital requirements were made stiffer. The leverage merely slithered off of bank balance sheets and re-emerged in the shadow banking system. A more promising step would be to end the tax deductibility of interest. Privileging one set of capital providers (lenders) over another (shareholders) never made sense and it encourages debt.

The time for reform may finally have come. The 2017 US tax law limited the deductibility of corporate debt to 30 per cent of income. The deduction should be scrapped altogether with a decrease in corporate tax rates to compensate, so the net effect on bottom lines is zero.

Next, executive bonuses should be tied to pre-leverage return measures, such as return on assets or on total capital, rather than after-leverage measures such as return on equity or earnings per share. Debt can increase EPS, but not the value of a business. Bosses should not be paid more for borrowing more.

These changes may not be enough. As the economist Andrew Smithers points out, if companies are going to deploy more equity, someone has to want to buy it — even as an ageing population pushes portfolios towards debt. Investors' preferences will have to change; this may mean a rethink of the way public and private pensions are structured.

Changes in debt taxation, bonus rules and pensions will meet resistance from those who make money from the iniquities of the current system. But at some point, hard as it is, the drinking has to stop and a more sober life must begin.

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