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Corporate debt

In the balance

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How fast will American firms reduce their excessive borrowing?

JUST as Japanese firms did during their country's bubble in the 1980s, American firms spent the late 1990s borrowing up to their eyeballs. Once the bubble burst, Japanese firms continued to raise lots of debt, thus ensuring that the mess they were in got much worse, and remains horrid today (see article). Japanese corporate debt peaked only in 1995, five years after the Nikkei started its dizzying descent. Only in 1997 did debt begin to fall by much; and 13 years after the bubble popped, Japanese firms still have higher ratios of debt to equity than American firms. A growing number of Americans, having noticed the remarkable similarity between their bubble and the Japanese one, now fear that their firms' balance sheets will likewise continue to worsen, contributing to a prolonged economic slump in the world's biggest economy. Are they right to worry?

The borrowing binge by American firms during the bubble was a big reason why five of the eight biggest bankruptcies in the country's history, involving some $375 billion of assets, occurred last year. All things being equal, the more debt a firm has compared with its equity (ie, the more leveraged it is), the riskier it is. Unlike dividends, interest has to be paid, even if the economy sours or interest rates soar. In a bubble, that risk is disguised by inflated share prices, which make leverage appear lower and less threatening than it is.

Last autumn, in anticipation of worsening problems, overall spreads for investment-grade bonds rose, relative to Treasury bond yields, higher than they had ever done. The Merrill Lynch High Yield Index (ie, for “junk” bonds) rose to a spread of 12 percentage points over Treasuries. This, on the face of it, signalled a far worse outlook than was ever projected by Japan's famously inefficient capital markets. To take one by no means unique example, that 12-point spread over Treasuries is some 100 times the spread in 1997 on bonds issued by Chichibu Cement, a struggling firm with a lowly double-B rating, seven years after Japan's bubble burst.

It is still too soon to be certain, but these life-threatening interest rates may have brought matters to a head, helping to bankrupt the worst-offending firms and encouraging the rest to start shaping up. A fast-growing number of American firms have started to reduce debt. In telecoms, Sprint has sold its directories business to pay off debt, Verizon some of its access lines, and SBC stakes in subsidiaries. In electric utilities and power production, Mirant, Dominion, Duke Energy and CMS have all sold assets or issued equity. So has Tyco, a big, troubled conglomerate. Household International, a big financial firm, first raised some $900m of new equity, and then agreed to be taken over by HSBC, a large British-based bank. There would have been far more

activity, except that managers at many firms have so far chafed at selling cheaply in a buyer's market.

Bond investors have of late been persuaded that many firms are now getting serious. Bonds issued by investment-grade firms have tightened against Treasuries by 80 basis points (hundredths of a percentage point) since October 15th, their widest level. This may not sound a lot, but is. Junk-bond spreads have also narrowed.

True, many balance sheets are still in poor shape. And though fewer firms are defaulting than were doing so or threatening to do so a few months ago, the ratio of upgrades to downgrades by Moody's, a credit-rating agency, continues to decline.

However, points out John Lonski, Moody's chief economist, net new borrowing by American firms has fallen sharply, as have repurchases of shares. Free cashflow—revenues that are not spent or distributed to shareholders—is rising sharply, not least because merger activity has been moribund. The result is more money that can be spent on cutting debts.

Overall, then, it does appear that a corner has been turned, and that the turning point came soon after spreads in the corporate-bond market peaked. And this may not be coincidental. Indeed, there are good reasons for thinking that America's sophisticated corporate-bond market may be what saves its firms from the fate of their Japanese counterparts.

Most corporate finance in Japan came from the country's banks, especially the big ones, which were in effect guaranteed by the government. (They still are, although that guarantee may be worth rather less now that the guarantor itself is up to its neck in debt.) With only a couple of important exceptions, big Japanese companies were not allowed to go bust. Interest rates on loans were generally low and rarely varied according to differences in the credit-worthiness of borrowers.

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This indifference among Japanese creditors to the sorts of factors that so agitated investors in America's corporate bond market last autumn continued long after the bubble in stocks and land had popped: banks—and the government—did not want to let companies go bust. Thus they continued to lend, throwing good money after bad. Borrowing remained absurdly cheap even for the many firms that heartily deserved to die. Only in 1997 did credit spreads start to rise somewhat and become a bit more differentiated. But that was too little, too late.

Here is a positive thought, then, with which to start the new year. Just because America and Japan have each experienced a stockmarket bubble does not mean that their companies must suffer equally badly in the aftermath of the burst. Anyway, fingers crossed.

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