Corporate Debt and the Looming Debt Bubble

James A. Kyprios / Originally published by LA Progressive on November 25, 2020

Why the Corporate Debt Level is Important to All of Us

Headlines these days raise concerns about the explosive rise in government debt which has reached record highs as a result of the pandemic. But the real engine of the US economy is the private sector, in which business produces products and provides services for the consumer.

It has been less noticed that corporate debt has been rising for years and continuing unabated even during presently difficult economic times. The London Financial Times recently reported that US corporations and other businesses owe $17 trillion in debt.

Even though we are in a serious economic recession, with huge levels of unemployment and with Covid-19 seemingly out of control, many corporations continue to increase their corporate debt levels.

We are seeing more and more defaults and many more bankruptcies as the months go by. If defaults and bankruptcies become widespread, credit spreads will widen making it harder and more expensive for businesses to borrow. This in turn will cause more defaults and more bankruptcies.

When we bring Covid-19 under control and the economy begins to recover, any recovery will be seriously eroded and lengthened because of the treacherously high level of corporate debt.

It Was Not Always So

There was a time years ago, when people (who had firsthand experience of the Great Depression years) were very leery of borrowing. These conservative attitudes affected all areas of finance not only for individuals but also for corporations and smaller businesses.

My father was a small businessman who prided himself on the fact that he never had to borrow money for his business. Banks were notorious for being stingy with money. A banker, we were told, will only give you money if you don't need it. Or better yet, a banker will only give you an umbrella when it is not raining.

In my early years, I worked for the largest insurance company in the world. We would lend money to a variety of small and medium-sized firms. By today's standards we were very stingy

with our purse. One basic idea was that the owners should have more money in the company than the creditors. This idea seems quaint today.

Beginning in the late 1960s, attitudes started to change. The Great Depression was past history remembered by fewer and fewer people. The general feeling among economists and the business community was that there would be no more depressions because we had discovered tools through both monetary and fiscal policy which would protect us from another lost decade like the 1930s.

Intellectual Foundation Leading to Massive Corporate Borrowing

In 1958, two distinguished Professors (Franco Modigliani and Merton Miller) wrote a ground-breaking paper on corporate finance which revolutionized the field and in effect sanctioned heavy borrowing by corporations. They made the case that the value of a company had nothing to do with the amount of debt on its balance sheet.

They claimed that the value of a company depended primarily on its future earnings power. To them, how the business was financed (whether through debt or equity) was irrelevant.

Now we know that the M&M Hypothesis, like many other grand economic theories, postulated a world that does not in fact exist. But for the last 60 years, students in undergraduate and graduate schools throughout the world have been taught that corporate debt is good—the more the better. These students became bankers, sophisticated investors, CEOs, and CFOs of corporations as well as teachers of finance and economics.

The M&M Hypothesis is the intellectual underpinning of the rise in massive corporate debt including junk bonds and leveraged finance. This became apparent in the 1980s with the rise of Michael Milken and Drexel Burnham.

(Note: The M&M Hypothesis deserves a separate article. For our present purposes, it is sufficient to understand that this has been studied like Scripture by many influential people in business and academia. It is only now with the onset of Covid-19 leading to numerous bankruptcies that the theory is being seriously questioned and challenged).

Economic Reasons Sanctioning Borrowing

Some of us recall the days in the late 1970s and early 1980s when interest rates were over 20%. Obviously, higher rates make borrowing very expensive. The pain was somewhat mitigated because interest expenses were fully deductible until recently for tax purposes.

The high rates of interest were to a great extent the result of the runaway inflation in the economy at the time. When Paul Volker was named to head the Federal Reserve in 1979, he sought to slay the inflation dragon. This he did by drastically tightening money which lowered inflation and then led to a reduction of interest rates. (Why lower inflation leads to lower interest rates is beyond the scope of this article).

Over the past forty years interest rates have steadily trended downward as has inflation. Interest rates are now at record lows. The government can borrow now at less than 1% and strong companies have no problem borrowing funds at 2 to 3%. Lower interest rates obviously encourage companies to keep borrowing. In certain countries, borrowing rates are now at zero. Borrowing no longer punishes a company as it did in the days when interest rates were high.

The Leveraging of America beginning in the 1980s

In the July 10, 2020 issue of the London Financial Times, there was an article exploring the causes and ramifications of "The Leveraging of America" (see page 15 article by Mark Vandevelde). The article explains the rationale behind the rise of junk bonds:

> *"Michael Milken's insight was that lending to risky companies at high interest rates could be more profitable than earning reliable but meager returns from the debt of industrial champions."*

Milken used to say at his famous junk bond conferences in Beverly Hills (which I attended in the late 1980s) that when you buy AAA bonds, some of them will be downgraded and even fail but you are stuck with the same interest rate. If you buy a portfolio of junk bonds, you not only get a premium interest rate on all investments but some of these companies will actually improve and attain a higher rating.

Milken proved that a diversified portfolio of junk bonds gave institutional investors better returns (even after losses) than playing it safe with top-rated companies. The result has been an explosion of high yield (junk) bonds all over the world. In 1990, the size of the high yield market in the US was less than $200 million. This has grown to over $1.5 billion in the last 30 years.

The Milken revolution had wide ramifications for a variety of reasons:

- Beginning in the early 1980s, interest rates have steadily declined. As noted, lower interest rates make it more tempting for corporations to borrow.
- There were other incentives to borrow as recounted in the London Financial Times article: "'Equity financing has double taxation: you pay corporation taxes, and then shareholders pay tax on the dividends' says Markus Brunnermeir, an economics

professor at Princeton University. 'Whereas if you pay interest, the expense is tax deductible. There is a huge distortion coming from the tax system, and economists have argued for decades that it is unwise.'" (Note: there is now a limit on the amount of interest deductible on highly leveraged deals).

- The article also quotes Harvard professor Michael Jensen: "…debt financing would keep executives honest by forcing them to meet quarterly payments instead of squandering the company's cash flow on uncertain growth initiatives or personal perks."
- Furthermore, executives would benefit from debt financing. If things went well, the values of their stock options would rise. A professor at the London Business School (part of the University of London) said that the value of stock options "rises if a risky project pays off, but cannot fall below zero if things go wrong. So the CEO has a one-way bet."

The biggest ramification of the M&M Hypothesis and Milken's insight is that solid investment grade borrowers jumped on the bandwagon. They loaded up on debt.

All were on board for a new way to conduct corporate finance. Debt was good. The more the better. Having a lower credit rating was no longer a matter of performance; it was and is a matter of choice in many cases. Today there are only two companies (Microsoft and Johnson and Johnson) which carry a AAA rating compared to over 60 companies in the early 1990s.

By and large, the abundance of lower rated companies today came about as a result of decisions made to borrow more money. Lower ratings were not very often due to the deterioration of the basic business.

Leveraged Buyouts

A major revolution in corporate finance occurred in the 1980s with the advent of Leveraged Buyouts (LBOs). One of the major businesses on Wall Street is mergers and acquisitions (M&A). Traditionally, an M&A transaction would be financed by the acquiring company.

The LBO presented the business world with a new way to buy a company. Typically, a financial investor (i.e., a fund known as a Private Equity Fund) would arrange an acquisition by putting in a small amount of equity to finance the acquisition. The full transaction price would be primarily financed by borrowing on the basis of the credit worthiness not of the acquiring company but of the company to be acquired.

An example will illustrate this. The biggest LBO on record until recently occurred in 1988 when

Kohlberg, Kravis, and Roberts ("KKR") bought RJR Nabisco for the then staggering amount of $25 billion. KKR had a fund with plenty of "dry powder" ready to buy companies. In this case, KKR put in $1 billion of equity and it arranged for RJR Nabisco to borrow the rest based on its own credit worthiness. The $24 billion debt financing consisted of $15 billion of Senior Secured Bank Financing and a variety of high yield bonds totaling $9 billion.

In the past 30 years, Leveraged Buyouts have become a huge business. Since the Great Financial Crisis in 2008, the volume of leveraged loans and high yield bonds has continued to grow. This has in part been fueled by the extremely low interest rate environment all over the world. Investors have been increasingly reaching for yield and a good place to go is in leveraged loans and high yield bonds.

Troubling Aspects of the Corporate Debt Revolution of the last 30 years

To recapitulate: it has been considered smart finance to borrow money. More than half of investment grade companies today have corporate debt ratings at the very lowest rung (BBB).

Furthermore, in recent years, the safeguards afforded to lenders in terms of collateral and covenant protections have drastically deteriorated. The result is that not only are medium and large corporations much more indebted than in the past but also the loans and bonds financing these corporation are much riskier in terms of protecting the investor than in the past. All this does not bode well for the future.

A Stark Warning from the Experts

The warnings were made obvious at a Seminar last Fall at NYU Stern School Business (September 2019) which I attended. The theme was: "where are we in the credit cycle." Speakers and panelists were concerned about developments in the Corporate Loan and Bond Markets (as described above).

They all felt, at that time, that the credit markets were in good shape. But they cautioned that the trend towards over reliance on debt (too much leverage) coupled with the weakening of lender protections would inevitably lead to major problems if and when the credit cycle would no longer be "benign".

They all "knew" that at some point, there would be an economic downturn but could not know exactly when this would occur and how severe it would be or even know what would cause the downturn. They were quite sure that the extreme buildup in corporate debt would exacerbate and prolong a recession. No one could anticipate Covid-19, of course.

The Situation Today

With the onset of Covid-19 in the Spring and the resultant lock downs, the economy went into free fall. To some extent it was rescued by US government spending plans aided by new programs launched by the Federal Reserve. The second quarter showed figures in terms of GDP and employment drops not seen since the Great Depression.

Government action and the temporary taming of the Covid-19 virus during the summer led to a partial recovery in some sectors of the economy. The third quarter showed a 33% annualized increase in GDP while unemployment figures markedly improved.

Any optimism about the economic situation must be tempered by the following factors:

- With Covid-19 once again accelerating in many parts of the US and with colder weather coming, economic activity will be negatively affected.
- Certain smaller businesses have shut down their doors forever.
- Certain industries (airlines, hospitality and many retail businesses) will not be improving until there is a definite end to Covid-19 which still seems far away.
- Any vaccine that becomes available will not be widely available for many months. Many Americans will not take the vaccine when it is available, at least not until the vaccine has been shown to be free of unacceptable side effects.

With stabilized financial markets, larger corporations now are borrowing at record levels. In effect, we have an ongoing recession (for many it is a depression) and yet the bond markets and the stock markets are flourishing. Corporate bond issues for 2020 are expected to exceed $1.6 trillion which is more than twice the amount raised in 2019. Investment grade as well as junk bond issues are headed for a record year.

We clearly have two economies – the financial economy is booming while the real economy is suffering. Things will certainly not get better for the real economy while Covid-19 reigns. Much has been made of the fact that GDP had a record rebound in the third quarter. But GDP for the first nine months of the year was down by 5%. This was a steeper drop than that experienced during the worst period of the Great Recession in 2008 and 2009.

We also know that the recovery, although faster than expected, has been noticeably slowing down. And it is expected to slow down further and possibly go into negative territory as the months progress. We must remember that to a great extent, Covid-19 is still calling the shots.

In recent days, we have seen that Covid-19 is out of control in most parts of the country. There will be more lock downs. It is possible and likely that the economic situation will deteriorate. As

of now, there seems to be little possibility of additional government relief to assist the economy.

The Effect of Too Much Corporate Debt is Showing in the Record Number of Bankruptcies This Year

A partial list of bankruptcies for this year includes the following formerly credit worthy companies:

- Dean & Deluca,
- CMX Cinemas,
- Rubie's Costume Company,
- J. Crew,
- Gold's Gym,
- Neiman Marcus,
- JC Penney,
- Pier 1 Imports,
- Hertz,
- Le Pain Quotidien,
- GNC,
- Brooks Brothers,
- Lucky Brand,
- Cirque du Soleil,
- Lord & Taylor,
- Town Sports International,
- Century 21 Department Stores,
- Ruby Tuesday and Friendly's Restaurants.

Summary and Conclusions

One of the favorite arguments against too much borrowing used to be that you have to put something aside for a rainy day. The corporate debt binge that went on for so long and continues unabated in many sectors of the economy has been met not by a rainy day but by a tsunami. Defaults are on the increase. More and more companies are going bankrupt.

Some will be reorganized in bankruptcy while others will be liquidated. The many companies which will be reorganized can only remain viable by cutting back on expenses including employment. Other companies (particularly the smaller ones) are and will be closing their doors forever.

Some of the damage was unavoidable due to Covid-19. But things have been made much worse because of the heavy debt load of most medium and large companies today.

The state of the credit markets was benign last year. The recession and (in some areas of the economy) the depression are here. Nobody can predict the future but we can be sure that the damage would be less severe had companies not been so reckless in their financial policies.

Professor Edward Altman of NYU Stern (the guru of junk bonds and leveraged finance) has recently expressed himself quite clearly on the present situation.

In a webinar (given by Kroll Bond Rating Agency) held this past August, he made the following observations (my words summarizing his thoughts): we are in a situation now where there are rising default levels in the bond market; but despite this, there is a rapid increase in new bond flotations. We have never seen a situation like this before. This is a sign of a bubble and is very dangerous according to Altman. He made it very clear that we are in an unsustainable situation.

The corporate finance experts know very well that the present situation (so much corporate debt) will lead to more bankruptcies and defaults and will have the effect of deepening and prolonging the recession. And yet the party goes on—the borrowing continues.

Last week (see Wall Street Journal of November 17, 2020 "Falling 'Real' Yields Drive Investors to Junk Bonds") it was reported that an investor today putting their money in ten-year investment grade bonds would receive a "real" yield of zero. This is because the bubble in bonds has increased the price of the bonds to premium levels. The only alternative is for "yield hungry" investors to put their money in junk bonds.

Make no mistake about it—we are in a financial bubble where bond and stock prices are going up making it easy for larger corporations to obtain "cheap financing." At the risk of belaboring the obvious, I will say it again: these are bad times for the economy and yet the incentives are there for companies to keep borrowing. We do not know how it will all end, but it is likely not to end well.

There is one important mitigating factor: historically low rates give savvy companies the opportunity to increase borrowings at very low interest rates. In many cases, they can lock in the low rates for longer periods. Those companies which do not take these steps run the risk of incurring higher interest rates when the economy rebounds and/or when inflation rears its ugly head.

The Federal Reserve was forced earlier in the year to come up with an arsenal of tools (lower interest rates and support of the financial markets to an unprecedented degree) in order to save us from a certain depression. The medicine worked. But as always there are consequences and side effects.

Making things much worse is the simple fact that Covid-19 does not seem to be cooperating.