



ZURICH
Resource Center

Real Estate
Insurance for those who want to do more than just
manage their property

[Learn More >](#)

Forbes
.com



Intelligent Investing Panel

Record Bankruptcies Despite De-Leveraging

Madalina Iacob 05.27.09, 4:40 PM ET

More companies are going to default on their debt even though they are in the process of de-leveraging, says U.S. default expert Edward Altman a professor of finance at the New York University Stern School of Business. He adds that the bankruptcy rate is going up at a record level and could reach an all-time high by the end of the year. In total he predicts U.S. corporate high-yield default rates will rise between 13% to 15% this year--the previous high was 12.8% in 2002.

De-leveraging will continue as long as the stock market goes up, as leverage is sometimes measured by the amount of debt divided by market value not book value, according to Altman.

Altman isn't the only one who sees leverage levels getting adjusted south. "Certainly in the short term, leverage levels are coming down because of the credit spreads and availability," says Ken Shubin Stein, head of hedge fund Spencer Capital.

[Follow Intelligent Investing on Twitter.](#)

[Sign Up For The Weekly Intelligent Investing Newsletter.](#)

Distress exchange--issuing new debt or new equity for the old debt--should become very popular as firms try to avoid bankruptcy and will result in a fast de-leveraging. Already nine companies in the U.S. have used this technique in the first quarter of 2009, according to Altman, vs. 14 in all of 2008. His research shows that 50% of these companies end up in bankruptcy anyway. "This is not enough as the problem is more severe than just reducing debt. This is what Chrysler and General Motors are trying to do, and they will end up bankrupt," he says. In a distress exchange, more than 90% of debt holders have to agree to reduce the debt and this is hard to achieve as investors will get on average \$0.50 on the dollar.

On the other hand, tax laws have also made it much easier to reduce debt as the government permits the debt buyers to defer paying taxes for five years on a debt deduction. "A lot of debt is being bought at a discount now," Altman says. "Investors should treat distress exchange as positive if the alternative was to go bankrupt."

Investors should not only look at the leverage levels but also at the nature of the debt--how much is secured and unsecured and how big is the subordinated debt--to better understand what players might influence the future of the company. As companies turn to high-yield debt to finance their operations, the share of senior debt shrinks and junior debt holders have a larger piece of the capital debt structure and a lot of economic clout.

"Even if junior debt holders can't control the assets, they can still put a company into insolvency. They are the 600-pound gorilla in the room and can't be ignored, especially if they bought protection in a form of CDS and might be inclined to push a company into bankruptcy to recover 100 cents on a dollar," says Joel Telpner, partner in banking and finance at the law firm of Mayer Brown in New York.

"Companies are in the survival mood. They are trying to save money to make sure the company gets through the recession," says Campbell Harvey, a professor at the Fuqua School of Business at Duke University. In this tight debt market, supply will eventually win and optimal borrowing will decline as there is less debt supplied by banks and credit is more costly. "This is exactly what happened in the Great Depression. Banks stopped lending, and corporate debt ratios declined," adds Professor John R. Graham, also a professor at Fuqua.

Companies and investors are more interested now in the balance sheet rather than quarterly earnings. Before the recession, Wall Street and investors put primacy on earnings, and this created an incentive for CEOs to borrow more money on a short-term floating rate basis that made their quarterly earnings per share look better, Shubin Stein said.

Now companies are strengthening their balance sheet by paying down their debt, increasing liquidity and lowering their absolute debt levels. Chesapeake Energy, for example, is looking to reduce debt through asset sales and other financing transactions. All together, the oil and gas company sees these transactions raising \$1.5 billion to \$2 billion in 2009 and \$1 billion to \$1.5 billion in 2010, according to reports from Credit Suisse.

Shubin Stein adds that investors should not only focus on earnings but also total debt vs. liquid and non-liquid assets. "They should ask themselves if the company has a balance sheet that will allow it to survive during bad times too," he says. He points out that management is more inclined to take short-term floating rate debt rather than long-term fixed-rate debt because investors overweight quarterly earnings and the management teams think that their options will be worth more if they show better earnings.

Howard Berg, president of Jackson Grant Consulting Group, thinks the last generation of management has been into gaming the system rather than building it. "They want to be winners, they want to be high earners," he says. "And the only way they can do it is to stress the corporation that they're in."

Until we can find an effective system so that shareholders are represented in a meaningful way, we have to change the way boards are appointed, says securities attorney Kord Lagemann. "Rather than just looking at corporate debt, we should look at the economy as a whole," he says. "This thing isn't going to be over until we de-leverage as a nation."

Living With Lower Leverage

Forbes: Are we going to see a great reset for how much firms can borrow? What affect should this have on American competitiveness, vs. the rest of the world? How should investors think about such a reset? And how should such reset be mandated by the powers-to-be?

Ken Shubin Stein: Certainly in the short term, leverage levels are coming down because of credit prices. I think that one of the things that has pushed corporate America in the last 10 or more years has been the combination of this academic belief about an optimal capital structure. This is combined with the academics that supported that you have an "optimal capital structure" combined with regulatory changes that allow for the proliferation of derivatives. So that debt--the risk of lending people money--can be diversified.

And, therefore, theoretically, minimized across large groups of people. This has led to lots of corporations taking on more debt, sometimes pushed by their shareholders to do so. Certainly the CEOs have an incentive to do so. Because, you know, the more their options are based on the equity part of the capital structure, not the debt part of the capital structure. And they're confident that if the stock goes down, they'll get new options at lower prices.

Then if the stocks go up, they get the retainer and it's re-invested, and do so into a lower capital structure that should have more juice in the good time. All of this is OK in theory and works really poorly in practice. The government makes the rules. And the capitalists, you know, are supposed to play by the rules. So, if we have the wrong rules, we'll incite the wrong behavior. I think there's plenty of blame for all of us to share. I would just say that going forward, I think that people we will probably have lower debt levels. We certainly are coming down now, because of the capital constraints in the credit market.

But, long term, I think leverage levels may come down for a while. Now, I mean, the incentives are going to increase leverage levels; the incentives of shareholders who are short-time owners, the company, the incentive of CEOs who are getting options. Those incite people to take more risks because of the agency issues involved, of the CEOs. But I do think going forward, when people borrow money, it's most conservative if you borrow less rather than more. If you borrow money on a longer-term basis, rather than a shorter-term basis. And if you borrow money at a fixed rate, rather than a floating rate. Even though it's expeditious to borrow short-term, floating rate debt. Because short-term, floating rate is cheaper and therefore makes your quarterly earnings per share look better. But long term it's much safer and better for the health of the business to have the exact opposite.

Forbes: Now is there anything in the regulatory pipeline that will address the screwed up issues of how much leverage corporations can take out now? I mean, now it's hard to get loans. That's one thing. But are there any firm and smart proposals you see anywhere that address correcting these problems?

Shubin Stein: Not that I'm aware of. Nor do I think more regulations are necessarily an answer to solve this problem.

Forbes: What will?

Shubin Stein: Regulations can cause as much harm as good. You know, either they're poorly thought out or because of hard to imagine unintended consequences. So, I think what will solve this problem is--I think one of the things that would solve this problem is allowing owners to have more of a say in the way corporations are run.

In theory, the board of directors reports to shareholders. And the board of directors oversees the management team. In practice, that does not happen very often. These boards are often entrenched and very friendly with the very people they're supposed to

be supervising. That is very hard for them to perform their primary role pursuant to critically examine and monitor the management team on behalf of the owners of the company. What could help are regulations that allow shareholders to have more of a voice in the board.

Forbes: But that's very general, though. That can help a lot of things. It wouldn't necessarily help this issue though.

Shubin Stein: Well, it would help people act like owners. One of the problems we have is, because it's hard to get shareholders to get good representation on the board because the boards are entrenched, by and large. So, the boards and the management team have agency bias right, they're agents. But they don't feel a lot of recourse from the risk. Therefore, it's perfectly logical if you get the upside, but not the downside to take on more risks in the form of either poorly constructed debt, meaning short-term, floating rate in recourse. Vs. long-term fixed rate, in non-recourse, or limited recourse. You know, your intent is to give things that are expeditious but not long-term smart.

Howard Berg: Yeah, I think that the last generation of management has been into gaming the system more than they have into long-term management, for a lot of reasons. You know, the response to quarterly earnings, the narrow and very short-term outlooks by a lot of investors. And then, the change in the '90s where there was a lot of emphasis put on compensation in the options ... The options were reset every time it came down. And I saw that that was happening here again in a couple of brokerage firms recently. So a lot of our policies, a lot of our management philosophies are, I think, responsible for this, where they're gaming rather than building.

Forbes: What can be done, Howard, to again, you know, make something like a specific leverage reasonable and more safe?

Berg: I think Ken was right when he said it's not something you can do with regulations. You have to get it into a reasonable and rational management philosophy. As he says, there's no penalty for these people performing the way they do. Now we've had the ultimate penalty going on here the last 18 months. But I think it's hard to get these people to change. Because they are competitive. They want to be winners, they want to be high earners. And the only way they can do it, is to stress the corporation that they're in.

Kord Lagemann: I think Ken's point about boards is absolutely spot on. I would just add, that of course, boards are basically appointed by management. So, you get to choose your own regulators, your own supervisors, is the way board system works, always has. So, it's not going to work. And maybe there's some way we could, I mean, I'm sorry to regulate or put a law.

And say that there has to be a certain number of people who basically represent the shareholders in some meaningful sense. How you do that, I don't know. But, I think until you do that, if we don't change the way boards are appointed, nothing is going to change. Finally, let me just add one other thing. I think we have to take a somewhat broader picture. Rather than just look at corporate debt. I think we have to, you know, looking at the markets, or the economy as a whole. I mean, there are those who say, and I happen to agree with them, that this thing isn't going to be over until we de-leverage as a nation.

And by nation, I mean, not only the corporations, but the people. I mean, no more "no money down" houses. I mean, to see advertisements on baseball games saying you should buy a Chrysler Ram Truck with no cash down, and 450 horsepower's, and 10 miles to the gallon, is counterproductive. It's insane.

We shouldn't be encouraging people to take on more debt. Indeed, the people are not as a whole, doing that. Which is, I think, an encouraging sign. But I think it's going to be a long, painful process. But we are going to have to de-leverage, and it's not just going to be the corporations or the banks. It's going to be society too.

[See More Intelligent Investing Features.](#)