For release on delivery
June 26, 1989
9:00 a.m. E.D.T.

Economic Competitiveness, Management Accountability and Corporate Leverage

Address by Manuel H. Johnson
Vice Chairman

Board of Governors of the
Federal Reserve System

before

Conference Sponsored by
United Shareholders Association

Washington, D.C.
June 26, 1989

I'm very pleased to be here and to address this distinguished group of corporate leaders and public officials. As the United Shareholders Association clearly recognizes, corporate shareholders will play a critical role in determining whether the United States can compete successfully in an increasingly integrated global economy. For the United States to maintain and strengthen its competitive position internationally, we must ensure that our enterprises are highly innovative and our resources are allocated efficiently. I strongly believe that our capitalistic system of private ownership, profit maximization, and fully competitive markets is the best way to achieve this goal. But this system will be innovative and yield an efficient allocation of resources only if corporate managers have incentives to act in the interests of shareholders.

The formation and growth of the United Shareholders Association reflects a growing concern that conflicts of interest between shareholders and managers, compounded by biases in our tax system, have been eroding the productivity and competitiveness of American corporations. The recent wave of leveraged buyouts and some other forms of corporate financial restructuring can be viewed as the logical response of a vibrant capitalistic system to poor management and tax distortions. Higher leverage has forced management to enhance productivity by trimming unnecessary operating expenses and by curtailing wasteful investments, including the ill-conceived attempts at diversification that were so prominent in the 1960s and 1970s. Furthermore, by reducing the share of income from corporate assets that is subject to double taxation, higher leverage tends to counteract the tax system's bias against the payout of earnings to shareholders.

From my perspective as a central banker, however, I am concerned that these efficiency gains from higher leverage could pose some problems for macroeconomic and financial stability. Although I think that such adverse side effects can be avoided, provided that lenders to highly leveraged firms carefully assess a company's ability to service its obligations in both good times and bad times.

Sources of Efficiency Gains from Higher Leverage

The theory most often cited in support of the view that higher leverage induces more efficient utilization of corporate resources is called the free-cash flow theory of corporate restructuring. This theory posits that many corporations produce more cash flow than needed to maintain themselves as profitable going concerns. But professional managers who typically control these corporations frequently resist paying out such excess corporate resources--the free-cash flow--to shareholders, who can be depended upon to deploy such funds to their most profitable and, presumably, most efficient alternative uses. In part, the failure of corporate managers to release free-cash flow can be attributed to the bias in our tax code against the payment of dividends. But a more basic reason is the absence of incentives for managers to act in the interest of shareholders. In the absence of effective oversight by boards of directors, shareholders' rights are often compromised and the productivity of the overall economy is harmed as managers direct free-cash flow toward wasteful projects, excessive perquisites, and uneconomic acquisitions.

The existence of free-cash flow creates opportunities for what have come to be called "unaffiliated corporate restructurers." They are also called "corporate raiders" by professional managers and "corporate saviors" by shareholders. According to the theory, the restructurer identifies mismanaged companies and promises to direct free-cash flow away from wasteful projects once control of the corporation is achieved. Words and promises, of course, can be worthless. The uniqueness and value of a restructurer's promise, however, is based on the willingness to pay a significant premium to current shareholders for the opportunity to make the promise good. In the vast majority of cases, of course, it is impossible to finance the purchase of a multibillion dollar corporation entirely out of internal resources. Rather, most of the funds necessary for a restructuring must be borrowed. Lenders must be convinced that a heavy debt burden can be carried by diverting the acquired corporation's future free-cash flow away from wasteful projects and towards servicing debt. If the restructurer's assessment of the potential of the corporation is correct and the necessary funds are forthcoming, a more efficient allocation of resources results.

More generally, the validity of the free-cash flow theory as an explanation for the recent wave of corporate restructuring in the American economy depends on the truth of three key assertions: (1) many corporations are, in fact, managed inefficiently; (2) the stock market recognizes inefficient management and, as a result, share prices trade at significant discounts; and (3) lenders correctly judge that the free-cash flow will comfortably support the increased debt burden incurred to finance the upfront payment to shareholders of the acquired corporation.

The history of the oil industry in the early 1980s provides the clearest evidence for the free-cash flow theory and is, no doubt, familiar to many in the audience here today. As oil prices increased tenfold in the 1970s, fuel economization efforts by the public left the industry with substantial excess capacity. Earnings and cash flow were high, but the marginal productivity of resources in the oil industry was low. Conditions in the industry suggested appropriate action would involve cutbacks in exploration and development and a reduction in size. Yet managers continued to fund exploration and development and to maintain the size of the industry. Takeover specialists recognized that value could be created by curbing investment in these less productive areas and returning funds to shareholders. Through takeovers or the threat of takeovers the necessary changes in corporate strategy were implemented. And once takeovers or defensive actions were announced, share values rose substantially.

Indeed, in the oil industry and in other industries such as food products and communications, returns to shareholders of acquired corporations generally have proven quite substantial. Depending on the time period analyzed and the type of transaction, studies find that shareholders earn from 20 to 40 percent in a restructuring. Of course, not all of these gains can be attributed to improvements in efficiency. As I noted earlier, financial restructuring is attractive in part because it allows corporations to transfer excess resources to stockholders in ways that avoid double-taxation. In addition, a portion of the gains to shareholders have come at the expense of bondholders. Indeed, bondholders now routinely protect themselves against "event risk", that is, the risk of restructuring-related losses, by requiring that "poison puts" be included in bond indentures.

Critics of corporate restructuring have gone so far as to assert that all of the gains to shareholders represent transfers of wealth from other parties with claims on corporate assets, rather than real improvements in productivity. Available empirical evidence, however, does not support this criticism. Several recent studies have carefully examined the pre- and post-leveraged buyout performance of public companies that were taken private in the early and mid-1980s. Evidence from the studies confirmed that the operating income of these companies increased following the buyouts, both absolutely, and, more impressively, relative to other firms in the same industry. The improvements in operating income were accompanied by declines in expenditure on new capital and some employment cutbacks. Although these studies cannot be considered definitive because of data limitations, I am confident that as more data become available, they will demonstrate efficiency gains.

Effects of Higher Leverage on Macroeconomic Stability

While it seems fairly clear that the leveraging of corporate balance sheets has improved the productivity and competitiveness of many firms, the greater use of debt also makes them more vulnerable to adverse unanticipated economic events, such as an economic downturn or a rise in interest rates. For the corporate nonfinancial sector as a whole, standard measures of debt service burdens have risen sharply in recent years. For example, the ratio of gross interest payments to corporate cash flow before interest provision is currently about 35 percent, close to the 1982 peak when interest rates were much higher and profits were weak owing to the recession. Moreover, these increased debt service burdens have been highly concentrated, largely among those firms that have actively sought the benefits of higher leverage. Indeed, in the past several years, the group of large, publicly-owned firms with highly leveraged balance sheets reported interest expenses increasingly in excess of their pre-tax operating income. They have no cushion of safety.

By cutting into earnings, an economic downturn would place further pressure on these firms by reducing their cash flow, while higher interest rates would add to debt service burdens at those firms that finance themselves with short-term or variable-rate obligations. Such companies are obviously relying on asset sales to meet their debt obligations, and adverse macroeconomic events would further increase pressures to liquidate assets. What concerns me most about this strategy is that the liquidity of the markets for corporate subsidiaries or other assets could shrink considerably during such periods.

More generally, I am somewhat concerned that the positive incentive effects of debt, such as assuring that management will not waste cash flow on low-productivity projects, tend to operate better in an environment where the risk of bankruptcy is low. If bankruptcy is likely, however, managers often are tempted to take excessive risks to avoid bankruptcy and the loss of their jobs. Furthermore, companies near bankruptcy may find it difficult to persuade potential workers, suppliers, and customers to enter into long-term relationships. While bankruptcy can in principle be avoided by renegotiation of debt terms, for example, in reality bankruptcies will occur. Renegotiations are sometimes blocked by the need of creditors to maintain a reputation for toughness or by the difficulty of getting various classes of creditors to compromise their divergent claims and interests.

In addition to the risks incurred by individual firms, high debt levels have the potential, however remote, to contribute to macroeconomic instability. If there were a significant negative shock to the economy, high debt levels could lead to a succession of bankruptcies, causing, in turn, a crisis of confidence. Like banks, nonfinancial corporations often have assets which are relatively illiquid compared to their liabilities. These corporations count on being able to roll over liabilities as they come due. If there were a crisis of confidence, creditors might stop lending to highly leveraged corporations. Fortunately, most of the restructured firms thus far appear to be in mature, stable, noncyclical industries. For such businesses, a substantial increase in debt may raise the probability of insolvency but only to a relatively small level. Nonetheless, roughly two-fifths of merger and acquisition activity, as well as LBOs, have involved companies in cyclically sensitive industries that are more likely to run into trouble in the event of a severe economic downturn. It is these companies that have the potential to cause systemic problems. The Federal Reserve, of course, is sensitive to possible systemic liquidity problems like the stock market break on October 19, 1987 and would incorporate such events into monetary policy decisions.

<u>Highly Leveraged Financings by Banks</u>

At the Federal Reserve, we have been particularly concerned about risks to U.S. banking organizations from their participation in highly leveraged financings. As I'm sure you are aware, many of the largest U.S. banking organizations have been very actively involved in financing the restructuring of corporate America. Because these large banking organizations play a central role in our credit and payments systems, widespread losses on restructuring credits could weaken our country's macroeconomic and financial stability.

Accordingly, the potential risks to the banking system from highly leveraged credits have received our close attention for some time. The Federal Reserve first issued supervisory guidelines for assessing LBO-related loans in 1984, and following an intensive review, we updated our guidelines earlier this year. In issuing these guidelines, we have not in any way attempted to arbitrarily restrict bank financing of corporate restructuring. However, because high leverage increases the vulnerability of borrowers to adverse economic and financial developments, we have actively urged bank managements to exercise caution and apply especially rigorous lending standards to participations in LBOs and other highly leveraged transactions. In this regard, we simply have underscored and supplemented our existing loan review procedures.

The new guidelines place special emphasis on the importance of evaluating the adequacy and stability of the corporate borrower's current and prospective cash flow under varying financial and economic conditions, including the possibility of higher interest rates or recession. As I noted earlier, I am especially concerned about loans whose repayment depends on the sale of assets or subsidiaries. The guidelines note that our examiners will not only scrutinize carefully the methods used to determine asset valuations and projected sale proceeds but also carefully assess the extent to which highly leveraged borrowers are protected against interest rate increases. Most large banking organizations, I am happy to report, now require highly leveraged borrowers to purchase interest rate caps or enter into swaps to limit their interest rate exposure.

Conclusion

In conclusion, I am confident that with the appropriate lending policies and procedures in place at U.S. banks and other major lenders to leveraged enterprises, we can avoid the potential adverse macroeconomic consequences of corporate leverage, while we enjoy the associated gains in productivity and competitiveness. And with corporate assets deployed efficiently, I am confident that we can continue to improve our competitive position internationally, as we must if the United States is to maintain its leadership position.