CORPORATE DEBT

By Greg Varhaug

You see a lot of mention in the press about how corporations worldwide are "hoarding" cash.

Numbers vary, but most estimates exceed two trillion dollars. The notion that most large companies are sitting on sizable cash reserves is cited by Occupy movements around the country. Many people believe that major corporations could save the day by opening up their coffers and investing in American jobs.

But these same companies are also carrying heavy debt burdens, a significant portion of it acquired in the boom years before the 2008 recession and, arguably, encouraged by the Fed. Over the next two years, much of that debt will have to be refinanced, at a time when credit is tight despite very low interest rates.

On balance, corporations are awash in borrowed money, and in most cases their total debt is greater than their cash holdings. One indicator that debt is increasing overall: accounts payable days (i.e., days before a company pays its suppliers) are on the rise in many business sectors. ➡

Why Cash?

Why do companies that owe money also keep large cash reserves on hand? For many reasons, some having to do with potential volatility in the near term.

Cash gives companies flexibility. In volatile times, business owners like to have cash on hand, so that they can respond quickly to emergencies and opportunities. The fact that companies are holding on to so much cash suggests that attractive investment opportunities now are few, or that better opportunities await. For instance, financials companies are stocking up, hoping to cash in on future bargains in the stock market.

Large companies have cash right now because, for most of them, profits for the last two years have been up. Companies are holding cash because the current interest rates are low. Holding a lot of cash is deemed a conservative stance, since it strengthens a company's balance sheet. During the last downturn, those companies with stronger balance sheets fared better.

In 2002, with corporate borrowing already high and corporate borrowing rates expected to fall, the Fed effectively reduced interest rates to near zero. Central banks in Europe, Japan, and China followed suit. Interest rates worldwide have been low ever since.

When interest rates rise, as they eventually will, borrowing companies will be faced with higher debt-service payments. How much debt to carry? How much cash to keep on hand? These are crucial decisions for any business owner. Miscalculating the right debt-to-cash mix for your business can lead to real trouble.

How Much Debt?

How does a company determine how much debt to carry? This goes to the heart of how companies structure their finances. Most large companies, especially corporations, carry some debt – often a lot of it. Corporate debt isn't like individual debt. Debt is how businesses and governments get major projects done. Well-conceived and well-managed projects produce tangible and intangible profits.

When borrowing from lending institutions, large corporations borrow at very low interest. But rather than borrow, corporations are more likely to finance their operations by selling stocks or bonds.

How much debt a company should carry, and its effects on that company, have been studied in detail since the late 1950s. Overall, those studies suggest that it's advantageous for companies to finance a large percentage of their total operations with debt.

The reasons companies choose to carry debt are complicated. Debt is taxed differently from cash. This rule applies not only in the U.S. – most countries offer tax advantages for carrying debt over financing with cash. One reason for all of the mergers and buyouts of the past two decades is the tax advantage to companies. For example, interest payments on debt are tax deductible, but there are other advantages as well.

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A common measure of the advantages of a takeover is how much added debt capacity the acquiring company gains. A large, unused debt capacity can make you a target for takeover from a bigger, credit-hungry company. This reality creates an incentive for large publicly held companies to carry debt.

Corporate debt doesn't particularly frighten shareholders. Empirical studies dating from the '50s prove that a company's debt-to-equity ratio (DER) doesn't determine its overall value. In itself, DER tells you little about the company's cash position. Rather, it offers investors a snapshot of how a company is leveraged. DER's true meaning and value as a measure is frequently debated.

Still, carrying too much debt can affect companies adversely. The mere perception that a company "owes too much" can ignite problems that quickly escalate out of control. Debt complicates things like short-term supply disruptions in a tight credit market.

Conversely, too much cash on hand can cause problems, too. Corporate boards like to limit the amount of cash that officers have on hand. Board members lack the time or expertise to judge the viability of every questionable

scheme their officers may come up with. If they don't have much cash on hand, they have to get credit, consult with shareholders or the board, or sell bonds to finance projects. All of these requirements involve oversight, tend to slow down the process, and help reign in irrationally exuberant CEOs.

Companies with extra cash have a few basic options. They can either invest in projects, issue dividends, pay debts, or buy back stock. Cash, in itself, doesn't generate any returns, and if it simply sits idle, inflation will erode it.

Of course, cash isn't allowed to sit idle. Most corporate cash isn't kept in bank accounts; U.S. bank accounts are only insured by the FDIC for $250K. In fact, most corporate "cash" isn't actually cash. Large companies keep their "cash" in money-market funds, government and corporate securities, and certificates of deposit. These are safe, short-term financial instruments.

Short-term Projections

The latest economic projections for 2012 aren't promising. The Fed shows no signs of increasing interest rates anytime soon. A new round of stimulus from the Federal Reserve, in the form of bond purchases, is in the works. News of the proposed stimulus was cited as helping to drive up oil prices.

Unemployment in the U.S. is expected to remain high. Internationally, advanced economies are expected to grow at a rate of less than 1.5 percent through 2013. Developing economies, which typically grow at much higher rates, will also see their growth slow proportionally.

A few projections for the global economy see daylight around 2015, but such longer-term projections assume no major problems coming out of Europe, which may not necessarily be the case.

The European Debt Crisis

Any economic projection for 2012 is certain to mention concerns over the European debt crisis. Daily headlines track its effect on the prices of stocks and precious metals. Reports abound that it's affecting companies' decisions on hiring and layoffs. Floor traders in New York are on the edge of their seats, waiting for the next pronouncement from Draghi, Merkel, or Cameron.

Right now, front pages across Europe are ablaze with speculation that the euro could collapse. What's needed, they claim, is for the European Central Bank to loosen its monetary policy generally, including collateral requirements, and for the ECB to sign on as the lender of last resort for the EU, a role it has resisted.

The ECB is the only institution capable of averting the disaster. ECB is located in Germany, and the German Bundesbank is its largest member bank. (Banque de France is the second largest.) The hope in Europe is that the ECB will agree to purchase bonds from troubled member countries Spain and Italy. Greece has already received a small bailout.

WHERE DO CORPORATIONS KEEP THEIR CASH?

A look at one of Apple Inc's recent 10-Q filings with the SEC gives a good example of how large companies may store their cash and cash equivalents. (Apple also lists a category of "Non-U.S. government securities.")

Money-market funds – Often confused with money-market accounts, money-market funds are highly liquid, low-risk securities. These are a form of mutual fund and are usually invested in securities from governments and large corporations. Shares in these funds are not federally insured.

Money-market accounts – These accounts also offer high liquidity but only very low returns; a little more interest than a standard savings account. If it's opened with a bank, it's FDIC-insured.

Mutual funds – Asset portfolios are usually composed of stocks and bonds. Investors purchase shares, similar to stock.

U.S. Treasury securities – Bonds, bills, and notes are negotiable instruments; that is, they can be spent like cash. These are backed by the full faith and credit of the U.S. government. They can be purchased in the primary market, at government auction, or through brokers in the secondary market.

U.S. Agency securities – Bonds issued by U.S. government agencies like Sallie Mae, Fannie Mae, and Freddie Mac.

Certificates of deposit and time deposits – Accounts that pay a fixed interest rate for a fixed length of time. Some allow withdrawal after giving written notice, with penalties for early withdrawal. A favorite means of storing cash for a short time.

Commercial paper – Unsecured securities issued by corporations, with terms limited to 270 days. The SEC restricts what the issuing company can spend this debt on, which protects investors.

Corporate securities – A very broad category that could include stocks, bonds, mutual funds, futures, options, profit-sharing agreements, and royalties.

Municipal securities – Usually bonds, issued by a municipality or county. Can also be issued by school districts, utility districts, and airports. Bonds are usually sold to fund specific capital-intensive projects. Municipal bond sales must sometimes be approved by voters. N

From this side of the pond, the European crisis looks similar to our situation with this summer's debt-ceiling showdown – a solution has been on the table the whole time, requiring only that an agreement be made. Just as a debt default in the U.S. was unthinkable, as long as there was a viable way to prevent it, so is the collapse of the euro also unthinkable. Still, it's not impossible.

Joachim Fels, writing in Morgan Stanley's *Global Outlook 2012*, models "our bear case: full-blown global recession" as follows: "We assume that, contrary to our base case assumptions, the U.S. Congress fails to extend the payroll tax cut and the extended unemployment benefits into 2012, which would result in a fiscal tightening of a little more than one percent of GDP. In Europe, our bear case assumes governments do not come up with a convincing fiscal solution on December 9th and bond yields in response push higher still."

The December 9th EU summit produced an intergovernmental treaty in which governments committed to greater fiscal discipline. Not enough, some said, with a collapse of the euro still possible. A week later, Moody's Investors Services and Fitch Ratings announced possible credit-rating reductions for troubled Eurozone countries.

Since then, the ECB has loaned 489B euros in three-year bonds at one percent interest to European banks. Italian bond yields are now back up above seven percent, Spain's above five percent.

Morgan Stanley's *Global Outlook 2012* also describes its "Super-bear case: you don't really want to know," a scenario in which no agreement was reached at the December 9th summit, the ECB refuses to step in, and the euro breaks apart.

Recession in Europe in 2012 seems inevitable. A best-case scenario for Europe entails widespread austerity, which may work in the long term but will involve a lot of short-term pain in Europe and internationally. Imposing austerity during a recession will lead to unavoidable problems.

The recent uncertainties in Europe have strengthened the U.S. dollar at a time when our economy may not need it. A rise in the dollar's value leads to less demand for American exports in Europe. A lower-value dollar makes America a more attractive location for

new manufacturing jobs. And so much for the U.S. Treasury's being hurt by last summer's ratings downgrade.

The "Corporate Debt Wave"

In 2010, Standard and Poors warned of a "wave of debt" coming for corporations here and abroad, as debt incurred during the LBOs just before the 2008 crash comes due. Much of this debt must be refinanced, and not everyone will get the funding they need to survive.

Standard & Poor's managing director John Bilardello has said, "We believe that many borrowers at the low end of the ratings scale will encounter serious hurdles to their refinancing needs in 2013 and 2014." Some companies will fail when they can't obtain financing, and will become attractive buys for competitors with money.

Quantitative Easing

The Fed and the Bank of England are following an "unconventional monetary policy" with programs of quantitative easing (QE). QE, in which a central bank increases the money supply by buying financial assets with newly created money, was first used by the Fed in 2008.

The idea is to encourage banks to lend, but it doesn't always work. Japan tried this strategy in 2001 with questionable results. Federal Reserve chairman Ben Bernanke is at pains to distinguish the Fed's QE from that of Japan seven years earlier.

The ECB's efforts are being called "quantitative easing through the back door." The ECB hasn't created any new money, despite having the option to do so. The ECB still hasn't pulled out the "bazooka," an unlimited buying of bonds.

China is considerably calmer, even though Europe is China's main export market. Recession in Europe will certainly affect China, but they believe they're sufficiently insulated from Europe's troubles that their economic growth for the next few years won't be threatened. With its huge and growing domestic market, China is following what it calls a "moderately easy monetary policy."

The "New Normal"

Huge uncertainties loom in today's business environment. The financial press teems with talk about the new world we're living in, how the old rules don't apply, and how central banks are focused on simply keeping the world economy afloat because governments can't manage their current debts.

Inflation, a persistent scourge in past decades, isn't a great threat for now. Deflation, negative growth, is the more urgent threat. Fear of deflation is why the Fed is, as a matter of policy, shooting for an annual inflation rate above two percent for the next decade.

For the near term, large companies have plenty of reasons to stay liquid, and keep their options open. N

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