Coronavirus Shutdown and the Worldwide Corporate Debt Crisis

Corporations Are Broke. It's Time to Cut Up Their Credit Cards. This time, any industry bailouts must place corporate investment under public control.

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Global Research, March 30, 2020
Jacobin 26 March 2020
Region: USA
Theme: Global Economy

After a decade-long, worldwide corporate debt binge, the bill has come due: huge swaths of the corporate world are now at risk of default, with only governments able to save them. This time, any bailouts must place corporate investment under public control.

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The coronavirus shutdown is hammering supply and demand across the globe. That has forced the real economy into a sharp recession and triggered a rolling financial crisis. Below is a primer on one key piece of this mess: the crisis in corporate debt markets. This branch of finance is vitally important because even healthy companies often need access to credit. If they do not get it, they go under.In 2008, the vector of crisis ran from mortgage-backed securities to the rest of the financial sector and then to the real economy. This time, the real economy is being hit directly, and the damage is reverberating back into financial markets. The failing markets, in feedback-loop fashion, further threaten the real economy as corporations find it harder to borrow. As the corporate debt markets sour, major companies will go bankrupt. Unemployment is skyrocketing. Some analysts expect the economy to contract by an annualized rate of 30 percent during the second quarter of 2020.

Already, US financial markets are on public life support. The Federal Reserve has committed to unlimited purchases of all sorts of assets: US Treasuries, mortgage-backed securities, car loans, municipal debts, and, in a historic step, both short term and long-term corporate debt. But the crisis will require more than a financial rescue.

The key political question now is: What sort of controls will come with the state intervention? Corporate greed and self-dealing need to be checked not merely in the name of fairness but also to make sure public bailout money is actually invested in the real economy rather than just gambled away, as it was after the 2008 crash and rescue.

The Rise of Corporate Debt

Since 2008, household debt levels have actually declined and are now lower than they were going into the last crash. But not corporate debt. Measured as a firm's "net debt" compared to its EBITDA (earnings before interest, tax, depreciation, and amortization), corporate debt has doubled since the last crash. In 2009, the average American company owed $2 of debt for every $1 in earnings. Today, the average firm carries net debt to EBITDA of 3 to 1, and many firms — like Ford Motor, CarMax, Harley-Davidson, and General Motors — carry ratios

ranging from 8 to 1, to as high as 15 to 1. Boeing, a special case because of its 737 MAX crisis, carries a ratio of 37 to 1.Over the last two decades, corporate America's credit rating has collapsed. In the early '90s, more than sixty companies held AAA credit ratings. Today, only two US firms are AAA rated: Johnson & Johnson and Microsoft. In 2001, fewer than one in five "investment-grade" firms were rated BBB. Today half of all investment-grade corporate debt belongs to firms rated "triple-B" (BBB) or lower. A third of those firms are rated triple-B minus (BBB-), one notch away from speculative or "junk" status.
Already many triple-B-rated corporate bonds are trading on secondary markets at unusually low prices and high yields, often above 5 percent; that means even "investment grade" bonds are being treated as junk. Soon many triple-B-rated corporations will be formally downgraded to junk. That will drive up their borrowing costs and restrict their access to credit. Even healthy companies often need access to ready credit. If they do not get it, they go under.The rating agency Moody's estimates the default rate for "speculative-grade" debt — companies with ratings lower than Baa from Moody's Investors Service, or a rating lower than BBB from Standard & Poor's — might reach 10 percent this year, up from 2.3 percent last year. The consequences of all this will reverberate throughout the wider economy, deepening and extending the recession.

Total global corporate debt, including bonds and loans, is approximately $66 trillion; more than double what it was a decade ago. For comparison, the combined gross national product of all economies was estimated at $80.27 trillion in 2017. About a quarter of that is the US economy.

What They Did With the Money

After the 2008 crash, the world's central banks, with the US Federal Reserve in the lead, spent the next decade pushing money into the financial markets by way of super-low interest rates and the direct public purchase of financial assets from the private sector via quantitative easing (QE).The cheap credit encouraged lots of corporate borrowing in the form of loans from banks and massive issuance of corporate bonds. Unlike loans, which can be routinely extended, or sometimes abruptly terminated, or have interest rates that float up and down, corporate bonds are debt instruments issued by a company committing to repay borrowed money on a specified schedule at a specified, usually fixed, rate of interest.

Corporations have been borrowing for a variety of reasons that range from shrewd arbitrage to stupid and reckless asset stripping. For a struggling and unprofitable company, for example JCPenney, debt can be a lifeline. For a profitable firm, borrowing money can be a way to raise capital without diluting existing shareholders' claim on the company's profits, which would happen if the firm issued stock.

Even some profitable firms with piles of cash borrowed rather than spend their cash, in part for the firepower effect: letting other competitors and market entrants know that the firm has enough money on hand to buy out any threatening start-ups, and showing the world the firm is ready to ride out any economic crisis.

Some firms used their borrowed money to buy other firms. This helped fuel a post-2008 wave of mergers and acquisitions (M&As). Deloitte reported "more than $10 trillion in [M&A] domestic transactions since 2013." Targeted companies borrowed to stockpile cash as a defense against such takeovers.

Firms also borrowed to fund CEO compensation, distributions to investors via dividends, and stock buybacks. Companies buy back their own stock so as to boost its price. A rising stock price is useful in many ways: it can keep away hostile raiders by making a targeted company too expensive to take over, but it can also draw in friendly suitors because (with some creative accounting) a rising stock value can make a weak firm appear more profitable. Corporate executives like a rising stock price because compensation packages are both tied to stock performance and almost always include some payment in company stock, so the higher the stock price, the higher the executives' payout.

Sometimes, firms even invested their borrowed money in actual production. The capital-intensive oil and gas industry did that, but as we explain below, it still faces a crisis, perhaps more salient than other sectors.

Bad Credit as Perverse Incentive

The end result of all the borrowing was declining corporate credit-worthiness: corporate debt soon badly outpaced their earnings growth and cash balances. This led to widespread credit-rating downgrades.Perversely, lower credit ratings did not slow the borrowing binge, but rather spurred on further lending and borrowing, because as corporate credit ratings slipped, the interest rate that the downgraded firms had to pay on their loans and bonds increased. And, thus, so too did the lenders' profits.

Corporate debt and stock prices entered into a twisted dialectic, each driving the other. As the stock market continued to inflate over the last decade, it provided the confidence investors required to continue their purchases of risky corporate bonds.

Keep in mind that many of the lending banks and asset funds were actually or essentially borrowing from Uncle Sam at inflation-adjusted rates close to zero, then lending to companies with triple-B and triple-B minus ratings at 5 percent interest. Profits like that meant there were always banks and asset funds eager to lend to debt-burdened corporations.

Investors could directly purchase specific corporations' bonds, or, as is more often the case, invest in mutual funds or exchange-traded funds (ETFs) that target an array of corporate bonds. High-risk loans were also sliced and diced and repackaged into bundles called "collateralized loan obligations" (CLOs), a class of securities backed by an underlying portfolio of corporate loans.

According to the Federal Reserve Board of Governors, the majority of American CLOs are held by US institutional investors, including insurance companies, mutual funds, and depository institutions. This means that when the debt is unable to be serviced, the pain will be absorbed within the US economy, much of it by the unassuming customers of these financial behemoths.As was the case with the mortgage-backed securities of the 2008 crash, these funds helped "distribute risk" and thus gave an appearance of safety. The logic was that owning 1 percent of a hundred different loans would be safer, even if some loans went bad, than owning the entirety of a single debt security. The logic is not entirely wrong. And that is part of the problem: it encouraged yet more lending. As long as the economic forecast was optimistic, there was no reason for the debt spree to let up.

Zombies and Others

Corporate debt, like much of the economy, is a story of disparities. Not every corporation is burdened by debt. Some firms are actually awash in cash. Microsoft, Berkshire Hathaway, Alphabet Inc, and Apple each sit on more than $100 billion in cash. As a whole, corporate America has been sitting on record amounts of cash in recent years. But at the same time, Morgan Stanley Investment Management estimates that one in six US companies cannot cover even the interest payments on their debts.At the heart of the problem are "leveraged loans" and so-called zombie firms. Leveraged loans are a type of expensive, high-risk credit extended to already heavily indebted companies. Since the 2008 crash, the leveraged loan market has doubled to $1.2 trillion. Now, leveraged loans in the United States are being re-sold at only 84 cents on the dollar, their lowest price since August 2009. The majority of leveraged loans — more than half — are in the form of the aforementioned CLOs. In the fourth quarter of 2018, there were $617 billion of CLOs outstanding.

Zombie firms are defined by the Bank for International Settlements as heavily indebted, well-established companies that have failed to be profitable over an extended period and have low expected profitability in the future. In other words, heavily indebted start-ups do not qualify as zombies. The most threatened sectors are energy, automotive, insurance, capital goods (meaning equipment and machinery), telecoms, aerospace and defense, and some parts of retail.

The bull market of rising, often overvalued, stock prices allowed many uncompetitive and unprofitable companies to appear healthy based solely on their stock's performance. Even before the markets started to crash on March 9, some analysts were prescient enough to call the market's bluff at the beginning of the year.

But in this rapidly developing crisis, firms all across the economy may soon find it impossible to meet their liabilities. With the coronavirus breaking supply chains and forcing massive constrictions in consumer demand, corporate earnings are contracting fast, which in turn will badly hurt corporate debt servicing.

Like a hypertrophied organ rupturing, the putrefaction of unsustainable corporate debt now threatens to create a generalized economic sepsis that will hurt even healthy firms.

Profiles in Debt

Airlines. The top six major US airlines spent enormous sums to buy back their stock over the last decade. US airlines (as a whole) spent 96 percent of their borrowed money on buying back stock. Now, revenue from flights is plummeting. United Airlines' bookings have fallen by 70 percent. Back in 2011, American Airlines filed for Chapter 11 bankruptcy with $29 billion in liabilities; today, they have over $34 billion in debt. Yields on some of their bonds reached a whopping 12 percent, a particularly distressing sign as interest rates have been slashed by the Fed in an effort to relieve credit markets.*Energy.* Even before the effects of coronavirus eviscerated demand for fossil fuels, US energy companies were suffering due to high fixed costs and low energy prices. In the last five years, 208 US energy companies have declared bankruptcy. Energy prices have been pushed down by the fracking revolution, the rise of renewable energy, and oil overproduction due to struggles between large producers like Saudi Arabia, Russia, and the United States.

Now the coronavirus shock is pushing firms over the edge. Occidental Petroleum — which has $40 billion in debt, while its market value (the value of all of its stocks combined) is less than $11 billion — recently had its debt downgraded to junk.

Energy mutual funds reveal the crisis in the energy sector as a whole. Vanguard Energy

Fund, considered one of the top four oil mutual funds, has lost over 41 percent of its value since the beginning of the year. Of course, the biggest oil companies, the "Oil Majors" (such as BP, Exxon Mobil, and Royal Dutch Shell) have enough resources, market power, and government support to survive the crisis. But the effects on the less established firms stretch beyond the energy industry itself.

Lenders. As the oil and gas firms go into crisis, the banks that extended them credit may also face defaults. Loans outstanding to the petroleum sector from regional banks in North America exceed $100 billion. Banks financing oil companies in Texas and Oklahoma saw their share prices drop nearly 30 percent. In oil-dependent states, public budgets will hurt as tax revenues decline sharply.

Retail. A number of important retailers carry net debt to EBITDA ratios that are too high to be sustainable under current conditions. For example, Rite Aid owes $15.80 for every dollar it earns. For JCPenney, the ratio is $8.30 to $1; for Walgreens Boots Alliance, it is $5.80 to $1. Office Depot owes $4.60 compared to every dollar earned.

Beyond Bailout

Bailing out distressed companies, even taking them under public ownership for a while, may staunch the bleeding. And the bubble can eventually be reinflated with enough effort. But a replay of the 2008 bailout, which involved lots of public money but very little public regulation and planning, will only mean a long slump followed by a bubble for the rich.The American economy is a sick beast. It needs not only government handouts and ownership — which it is getting — it also needs planning.

Oil, airlines, and cruise ships — these are high-emission industries that, in the face of climate crisis, must be radically transformed or cease to exist. With government ownership and planning, these industries could be unwound and their resources redeployed.

Although COVID-19 set off our current recession, it was the indulgence of the 1 percent built into the 2008 rescue that is responsible for the depth and severity of our current economic crisis. Without guidance, money was poured into the financial system. Not surprisingly, it blossomed alongside the mutually reinforcing dynamic of artificially inflated stock prices and ballooning corporate debt.

Capitulation to the gluttony of financiers is deeply unjust. But it is also unworkable in purely technical terms. Without constraints on greed, there will be another bubble and crash and a longer slump, more suffering, greater inequality, and more social instability. We have to force government to use its legal and financial power to steer the American economy toward more egalitarian, socially rational, and environmentally sustainable purposes. We have to make this bailout work for the majority of us.

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