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TEN MYTHS ABOUT LEVERAGED BUYOUTS

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ITEM: October 15, 1987. Ways and Means Committee approves a $12 billion tax bill denying the tax deductibility of interest expense for borrowing to undertake what are called "hostile" acquisitions of corporations.

ITEM: October 16, 1987. *The New York Times* reports the Dow Jones plunged more than 58 points and "came the day after the record drop of 95.46 points amid growing signs of anxiety among institutional and individual investors."

ITEM: October 19, 1987. The stock market crashes. The *Wall Street Journal* reports the "Dow Jones Industrial Average plummeted an astonishing 508 points, or 22.6% to 1738.74. The drop far exceeded the 12.8% decline on the notorious day of October 28, 1929, which is generally considered the start of the Great Depression."

ITEM: December 16, 1987. The Ways and Means Committee bows to rising pressure and eliminates the provision limiting the interest deduction for corporate takeovers.

ITEM: December 17, 1987. *The Washington Post* reports the Dow Jones average "soared in the final hour of trading to post a 32.99 point gain and closed at 1974.47. In the past eight sessions, the Dow has risen nearly 208 points, or 11.9 percent."

Can Congress learn from history?

Is Congress risking a repeat of the October 19, 1987, stock market crash, after it had proposed anti-buyout tax legislation and thus startled investors and helped trigger the free fall of stock prices?

It appears so.

Sentiment is mounting on Capitol Hill to "do something" about the alleged problem of leveraged buyouts, the financing mechanism often used in the headline-grabbing acquisitions and mergers of huge American firms. No less than nine congressional committees have scheduled hearings on the subject of leveraged buyouts, commonly known as LBOs. Among the proposals being considered by congressional leaders: the elimination or scaling back of interest deductibility for certain LBO debt, greater regulation of buyouts and bank finance, and sweeping reforms of United States security laws.

Playing with Fire. Yet, if recent history is any guide, government interference with business takeovers is playing with fire. On December 13, 1987, the *Washington Post* reported that senior Wall Street officials attributed panic selling in the stock market to pending anti-takeover legislation in Congress.[1] Wrote the *Post*:

> On Wall Street, many senior officials still refer to the proposal as 'the spark' that lit a firestorm of panic in the financial markets on Oct. 19th. They say that the proposed tax revisions, which if enacted would make many corporate takeovers prohibitively expensive, had a profound effect on professional stock investors during the week before Black Monday, triggering a reaction that eventually spiraled into panic...
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> The issue, simplified, is whether news of the tax proposal during the week of Oct. 12 caused professional speculators to engage in massive sales of takeover-related stocks, pushing the market down and generating a broader panic. Proponents of this theory say fears that the takeover market would be quashed by the tax proposal even affected the stock of companies not involved in active merger deals. The prices of these other stocks, some Wall Street executives argue, were supported by valuation theories that depended on a booming takeover market.
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> "It wasn't an accident. This was what knocked the props out from underneath the market," said Guy Wyser-Pratte, head of arbitrage trading at Prudential-Bache Securities. "Somebody pulled the plug on one of the major reasons for the bull market -- the restructuring of corporate America. Somebody found the Achilles heel... It was irresponsible."

The degree to which the takeover tax proposal was a factor in the 1987 market crash will never be determined with certainty. But evidence of such a link is strengthened by a comparison of "takeover" stocks and the Dow Jones

1 Steve Coll and David A. Vise, "What Killed the Stock Boom? Some Point at Tax Idea," *The Washington Post*, December 13, 1987, p. H-1.

industrial average of 30 blue-chip issues. As the idea of a tax to end the alleged "merger mania" of 1987 began to gather strength on Capitol Hill, the combined prices for potential takeover stocks started falling before the rest of the market did — and fell faster. The drop in the takeover market immediately after the tax proposal was passed in committee was no coincidence, nor was the upsurge in the market December 16th, the day that the Ways and Means Committee voted to strip the tax change from the final tax bill.

Risking Disaster. This episode should give pause to today's policy makers considering proposed anti-takeover legislation. Yet Congress is considering disturbingly similar ideas to stop debt-financed takeovers such as last November's $25 billion leveraged buyout of RJR Nabisco by Kohlberg, Kravis, Roberts, & Co. (KKR). Many lawmakers, analysts, and, apparently, ordinary Americans think these buyouts are dangerous to the economy, expensive for the taxpayer, and that they need to be stopped. Wall Street investment advisor Henry Kaufman, for instance, notes that over the past five years the debt of U.S. nonfinancial corporations has gone up by an estimated $840 billion, while total business equity has contracted by nearly $300 billion.[2] This increased indebtedness, says Kaufman, makes American business far more vulnerable to failure in the next recession.

Before Congress risks a repeat of the 1987 stock market crash, however, it should recognize that the discussion of leveraged buyouts and the purported business debt crisis is enshrouded in myths — at least ten of them. If Congress is to enact an enlightened policy toward debt and corporate restructuring, it should distinguish clearly between fact and fiction and recognize that precipitous action could spell disaster for the stock market and millions of American investors.

Myth #1: Leveraged buyouts do not increase company growth or profitability.

Testifying before the Senate Finance Committee, Federal Reserve Board Chairman Alan Greenspan refuted this popular notion, arguing that Congress should not attempt to restrain the leveraged, or debt-financed, buyout boom because it has "generally enhanced operational efficiency."

Numerous studies of companies following takeovers substantiate what Greenspan says. They confirm that there are dramatic increases in returns on operating assets, greater productivity, and higher efficiency. In a study of 80 takeovers of *Fortune* 500 firms, for example, University of Chicago economists Robert Vishny and Andrei Shleifer discovered that "friendly" takeovers are often "synergistic" and motivated by a desire to use combined

2 Henry Kaufman, "Bush's First Priority: Stopping the Buyout Mania," *Washington Post*, January 1, 1989.

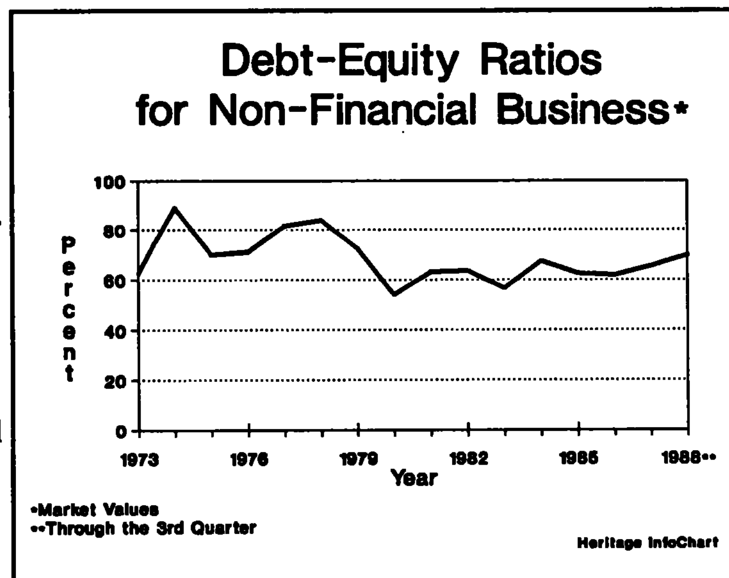
resources more efficiently.[3] "Hostile" takeovers, by contrast, usually are targeted to poorly performing companies. Such takeovers are particularly useful and beneficial, say the economists, because "they attempt to impose discipline from outside on a company that has been performing poorly when the internal control mechanism — the board of directors — has failed."[4]

The truth is that either form of takeover — hostile or friendly — is a valuable market mechanism to assure that business assets are being used productively and in the shareholders' interest.

Myth #2: Leveraged buyouts have increased business debt to crisis proportions.

Dire warnings about a business debt crisis simply overlook the facts. These warnings typically are based on single entry bookkeeping — focusing only on business debt and ignoring the assets and equity values that offset these liabilities. To be sure, debt has soared. According to the Federal Reserve Board, nonfinancial business debt since 1980 has increased from $1.4 trillion to nearly $3.2 trillion, or a 128 percent increase.

But this is hardly a "debt bomb," since the Dow Jones industrial average of stock prices has risen even faster — up nearly 140 percent over the same period. A comparison of business debt-to-equity is one of the best measures of debt burden, because stock values are the best indicators of future corporate earnings; as such, stock prices indicate the level of earnings the market anticipates will eventually be earned by the firm to meet its debt obligation. According to the Joint Committee on Taxation of the U.S. Congress, the debt-to-equity ratio is not particularly high by recent standards, and it is well below the level of the late 1970s (see Chart).



Other measures of corporate liquidity, such as interest charges compared with pre-tax profits, which indicates the capacity of businesses to pay for current interest expense, indeed have increased significantly in the 1980s. But the main explanation for

3 Larry Arbeiter, "Aims and Aiming in Corporate Restructuring," Chicago Graduate School of Business Magazine, Fall 1988, p. 18.
4 *Ibid.*

this is that businessmen and women are borrowing heavily for new investment assets. These new investment projects, once they are completed, will begin to generate the profits that will bring the interest expense-to-profit ratio more in line with historical averages. Improved economic growth, high productivity, and fast rates of business investment all point to the conclusion that business borrowing is being used for income-enhancing investment.

Averting Bankruptcy. Some industries, admittedly, are seeing large increases in debt. Example: the petroleum and natural gas industries. But these were among the least debt-burdened industries of the 1970s. Their increases in debt simply bring their debt burdens into line with historical average. In many cases, these increased debt burdens reflect economic adjustments or downturns in certain industrial sectors; for example, the increased debt burden in the petroleum industry is a consequence of the drop in oil prices, not part of an economy-wide trend toward greater debt. Buyouts, moreover, have occurred in many of these depressed sectors and thus have been tested in bad times in these industries. Not only have LBOs experienced very few bankruptcies, according to Harvard Business School economist Michael Jansen, but those LBOs that do get into trouble "usually are reorganized in a short period of time (several months is common), often under new management and at apparently lower cost than would occur in the courts."[5]

Underscoring the point that debt burdens are continually fluctuating throughout various sectors of the economy is the fact that the five most highly leveraged industries in 1969-1974, according to a Princeton University study, all experienced declining debt-asset ratios through the 1980s.[6] In short, policy makers should not look at increases in debt in some highly visible sectors of the economy and conclude that debt is increasing in the economy as a whole, anymore than they should look at decreases in debt in other industries and assume the reverse.

Considering all sectors of the economy, there is no indication that the distribution of debt among firms has become dangerously lopsided or concentrated in some sectors of the economy. Therefore there is no evidence that an economic downturn would be more hazardous to business today than in previous postwar years.

Myth #3: American business and manufacturing firms are vulnerable to an economic downturn.

The fact is that the industrial sector has been one of the least debt-laden sectors of the U.S. economy. As even critics of LBOs acknowledge, there has

5 Michael C. Jensen, "Is Leverage An Invitation to Bankruptcy?" *The Wall Street Journal*, February 1, 1989, p. A-14.
6 Ben S. Bernanke and John Y. Campbell, "Is There a Corporate Debt Crisis?" in William C. Brainard and George L. Perry, eds., *Brookings Papers on Economic Activity* (Washington, D.C.: The Brookings Institution,1988), p. 115.

never been a business debt crisis in America, not even in the 1982 recession when real interest rates reached record heights. Today, the debt burden of American businesses is about half that of Japanese firms and well below West European companies.

Important Role for Banks. Many commentators are worried that sharp increases in interest rates could undercut the solvency of many leveraged buyouts. But Harvard's Michael Jensen points out that many LBOs now protect themselves against such a possibility by setting an upper bound on the interest rates they will pay or by issuing debt that can be converted from floating rates to fixed interest rates.[7]

Jensen argues that even where bankruptcy occurs, it can perform a very important control function "to replace what seems to be a failed model in which the public board of directors monitor management and its strategy directly."[8] The presence of greater debt in takeovers gives banks a more direct control over management, essentially permitting another check on corporate managers in the case that they pursue flawed strategies. In case of bankruptcy, bondholders can then more quickly replace the management and pursue a different business strategy under a reformulated company. In this respect, Jensen feels that the U.S. may be moving closer to the Japanese model, where banks perform a more important role in supplying capital and management direction to the business community.

Myth #4: Leveraged buyouts generate mega-conglomerates.

Just the opposite is true. Business "de-glomeration" is underway. Leveraged buyouts in recent years typically have led to the sale of subsidiaries. In fact, a very valuable effect of LBOs is that they undo the failed acquisition strategies of many large corporations in the 1960s and 1970s, when inflation caused many corporate assets to be undervalued and thus ripe for absorption by larger firms. Concludes a recent Securities and Exchange Commission study: "One source of value in many corporate takeovers, especially hostile takeovers, is recoupment of target equity value that had been lost because of the targets' poor acquisition strategies prior to the reception of their bids."[9]

At the same time leveraged buyouts are reducing business concentration, they are also strengthening accountability by turning managers into owners. This appears to benefit the stockholders. University of Chicago economists Andrei Shleifer and Robert W. Vishny and University of Alberta economist

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7 Jensen, *op. cit.*

8 *Ibid.*

9 Gregory A. Robb, "S.E.C. Study Links Bad Acquisitions to Later Takeovers," *The New York Times*, December 5, 1988, p. D-2.

Randall Morck find that increasing management ownership in a firm tends to increase the value of a firm.[10]

Myth #5: Leveraged buyouts cost the U.S. Treasury billions of dollars in lost revenue.

The purchase of RJR Nabisco, claims *Business Week*, was subsidized by the U.S. taxpayer to the tune of $5 billion.[11]

Business Week reached its conclusion by estimating the first-year deductible interest expense involved in the deal, which saved the company $682 million in taxes. In a far-fetched line of argument, *Business Week* then put the total subsidy at $5 billion, figuring the $682 million tax saving was sufficient to pay the interest expenses on $5 billion of junk bonds. Applying this same logic, a $100 dollar pay hike should actually be considered a $1,000 income boost, because that level of additional income could support a $1,000 loan at a 10 percent interest rate.

Not only was *Business Week's* arithmetic embarrassingly misleading in itself, but the magazine overlooked at least four streams of new revenue that flowed to the Treasury from the deal and offset the alleged loss to taxpayers:

1) **RJR Nabisco's deductible interest expense is matched,** dollar for dollar, by taxable interest income to the new bondholders. Even if only two-thirds of the bond income eventually flows into the hands of taxable institutions, about $500 million in new taxes will be paid on interest income.

2) **At least another $30 million in tax revenue will** be generated from taxes paid on buyout fees charged by investment bankers and lawyers.

3) **The largest revenue gain,** again completely ignored by *Business Week*, is the tax on over $12 billion in realized capital gains resulting from the takeover bid's doubling the value of the stock. Since the stock was purchased by KKR at a much higher price than the original stockholders paid for the stock, those stockholders selling stock to KKR will pay at least $3.4 billion in capital gains taxes as a result of the stock turnover.

4) **RJR Nabisco is expected to sell off** between $5 billion and $6 billion in assets. Substantial taxes on the capital gains from these sales will be paid to the Treasury, adding as much as $1 billion to Treasury coffers, based on a 34 percent corporate capital gains tax rate.

The result: The RJR takeover actually could produce more than $4 billion in net additional revenue to the Treasury.

And what is true of the RJR deal is also true generally of other leveraged takeovers. In fact, to use *Business Week*'s bizarre method of calculation, there

10 Arbiter, *op. cit.*, p. 19.
11 Laura Saunders, "How the Government Subsidizes Leveraged Takeovers," *Business Week*, November 28, 1988, pp. 192-196.

would be a benefit of $30 billion to the U.S. government as a result of the buyout, since a $4 billion tax revenue windfall would pay the interest on $30 billion in U.S. Treasury bonds.

Myth #6: Leverage buyouts hurt existing bondholders.

Studies show stock price gains at buyout announcements typically are between 10 percent and 20 percent.[12] Some critics of LBOs claim that this shareholder gain results simply from a transfer of wealth from the existing bondholders of the target firm, since the new debt increases the risk for existing bondholders and reduces the value of their asset.

Yet most studies show that existing bondholders suffer only small wealth losses. One recent major study finds no significant change in bond prices during a short period surrounding the buyout announcements.[13] One reason why: bondholders protect themselves through "protective bond covenants." These are contracts between management and new bondholders outlining the legal obligation of corporate management to run the firm in an agreed-upon fashion as a precondition for receiving funding from the bond issue. The covenants prevent the company's management from undertaking harmful actions against bondholders, such as issuing senior debt, selling off assets, or paying too generous dividends.

Myth #7: Junk bonds are excessively risky and force companies to sell off the best parts of their assets to service the bonds.

The term "junk" bond is very misleading — "junk" bonds are not "junk" at all. In fact, over the past six years, junk bond defaults have averaged below 2 percent; historically, that is a manageable rate and not much different than so-called quality bonds. Junk bonds have simply given smaller businesses the same access to capital markets that huge *Fortune* 500 corporations have always had. This new access to capital markets by the small and medium-sized corporations should be welcomed as a positive development that has aready increased economic growth, job creation, and productivity in the U.S. economy.[14]

Moreover, individual banks and other institutions keep only a small portion of their buyout loans on their books. The rest is sold or paid back through asset sales to other financial institutions, such as other banks, pension funds, and insurance companies.

12 Arbeiter, *op. cit.*, p. 20.
13 See, for example, Laurentius Marais, Katherine Schipper, and Abbie Smith, "Management Buyout Proposals and Corporate Claimholders: Explicit Recontracting and Differential Wealth Effects," Working Paper, University of Chicago Graduate School of Business, September 1987.
14 Michael Quint, "The Rapid Growth of 'Junk' Bonds," *The New York Times*, November 17, 1988, p. B-1.

Thus buyout debt is not concentrated in the banking sector, threatening problems in the financial industry if the default rate were to rise. Buyout debt differs enormously in its pattern of distribution from that of oil industry or farm debt, which has caused problems for banks and savings and loans. Junk bonds, in fact, account for well under 10 percent of nonfinancial corporate debt.[15] And the savings and loan industry holds only about 1 percent of its assets in junk bonds.[16]

Myth #8: Leveraged buyouts are driven by tax laws, causing an overextension of debt by companies.

U.S. tax laws do favor debt over equity, since interest expense is deductible while dividend payouts are not. This creates problems for the economy because it discriminates against savings. But it is not a problem specifically associated with LBOs. Nor does this explain why the value of LBOs increased tenfold over the past eight years. Business interest expenses have been deductible for many years. Indeed, the 1986 tax reform act actually reduced the tax benefits of leveraged buyouts by eliminating special depreciation breaks for acquired companies and by reducing corporate and individual tax rates. So if tax considerations have been encouraging buyouts, the rate of buyouts should be falling, not climbing.

Even before the new tax law, studies of 93 buyouts between 1982 and 1986 by University of Chicago economists Katherine Schipper and Abbie J. Smith conclude that tax gains were not a major motivation for most of the buyouts.[17] New York University economist Yakov Amihud agrees: "The argument that management buyouts are motivated only by tax benefits needs more support than is currently available."[18] Adding to the puzzle is the fact that inflation usually is seen as a spur to debt-financing, since debtors pay back their debt in cheaper dollars. Yet the low-inflation 1980s have coincided with a high rate of debt-financed takeovers.

Willing Investors. A more plausible explanation for the rise in LBOs is the stability and prosperity of the U.S. economy. When managers feel that interest rates will stay relatively low, and corporate profitability will be healthy in the future, companies are more willing to issue debt and investors more willing to lend money.

It is wrong, moreover, to assume that debt need be "bad" and equity need be "good." Some corporate finance economists postulate that the value of a company has little to do with its structure of debt and equity. Certainly there is little evidence on which to conclude that there is some optimal

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15 Bernanke and Campbell, *op. cit.*, p. 124.
16 Jerry Knight, "Regulators Worry About Risk in Financing of Big Takeovers," *Washington Post*, November 28, 1988, p. A-1.
17 Arbeiter, *op. cit.*, p. 21.
18 Yakov Amihud, "Management Buyouts and Shareholder's Wealth." Presented at the Conference on Management Buyout, New York University Graduate School of Business Administration, May 20, 1988.

combination of debt and equity in any business sector or for the economy as a whole. Some experts even speculate that debt actually holds real advantages over equity, irrespective of the tax consequences.

Concentrating Accountability. Economists long have recognized, moreover, that there may be a conflict of interest between managers and stockholders in corporations where managers hold a small equity stake in the company. This conflict occurs because the managers do not suffer a direct wealth loss if their decisions adversely affect share prices. Individual shareholders in such companies also have little incentive to monitor the decisions of managers since the cost and time involved in monitoring corporate management may be prohibitively high.

Some scholars argue that a major reason for management-led leveraged buyouts is to concentrate accountability into the hands of one owner or a small number of owner-managers. Because ownership is not as diffuse as before, the consequences of business decisions are then borne directly by the owner-managers. In short, by making managers into owners, leveraged buyouts help overcome any conflict in managerial incentives and stockholders' interests. For these reasons, many economists argue that these transactions create stockholder wealth gains and enhance productive efficiency.

Corporate Confidence. Harvard economist Lawrence Lindsay offers another possible explanation for the growth of leveraged buyouts, namely that businesses believe they can safely take on more debt as a result of their experience in 1982, when the combination of indebtedness, recession, and high interest rates did not lead to a major increase in defaults. "Perhaps corporate managers and their bondholders have come to realize in the wake of the 1982 experience," says Lindsay, "that corporations can hold more debt than one might initially have expected without facing critical liquidity or solvency problems."[19]

Yet another explanation for the LBO is that it reflects a cash surplus within the target firm. A recent study of 284 publicly traded companies that went private discovers that these takeovers tended to be of firms with low growth prospects and substantial cash holdings.[20] As such, takeovers disgorge cash buildup from low-growth firms and prevent capital from being wasted on less efficient investments.

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19 Bernanke and Campbell, *op. cit.*, p. 134.
20 Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance and Takeovers," *American Economic Review*, May 1986, pp. 323-329. See also, Kenneth Lehn and Annette Poulson, "Free Cash Flow and Stockholder Gains in Going Private Transactions," Working Paper, The Securities and Exchange Commission, December 21, 1988.

Myth #9: Capital that should be used for productive capital expenditures is diverted toward unproductive debt.

Borrowed funds used for leveraged buyouts are not "lost" or withdrawn from the productive economy. These funds go to buy out the stock of existing shareholders. These former shareholders then can use their proceeds for other investments, savings, stocks, bonds, or consumption. In any event, the borrowed funds are funneled right back into the productive economy, most often into the pension funds and insurance companies who hold a large percentage of stock.

Myth #10: In leveraged buyouts, capital which should be used for research and development, or investment, is diverted to pay back heavy debt burdens.

There is no evidence that the pressure of paying off debt crowds out funds for new investment or research and development. University of Chicago economists Schipper and Smith have studied buyouts from many perspectives, and have found "no indication of reductions in discretionary expenditures, that is research and development, maintenance, repairs, or advertising." They also discovered that increases in debt are correlated positively with increases in the return on operating assets. Smith's conclusion: "I agree with the hypothesis that in mature industries, precommitting cash flow to debt may not be such a bad thing."[21]

Investment, productivity, and job growth, moreover, have surged strongly in the last eight years, at the same time that leveraged buyouts have increased tenfold. There is no indication that leveraged buyouts have prevented corporate managers from committing funds for long-term investment and research.

CONCLUSION

U.S. tax policy long has favored debt over equity, since interest payments are deductible while dividend payments are not. This tax bias, however, has existed for decades and thus cannot be the cause of the recent upsurge in leveraged buyouts. A more likely explanation for the surge is that LBOs are a bullish manifestation of American economic health and a welcome antidote to the empire building of the 1970s – when inflation made mergers and acquisitions more profitable than new investment. For more than six years, a surge in business confidence has helped generate strong growth and investment with enormous job creation and opportunity.

Dangerous Solution. To be sure, a tax code that is neutral between investment and consumption is a worthwhile goal that should be vigorously pursued. Experience shows, however, that eliminating the interest deduction

21 Arbeiter, *op. cit.*, p. 21.

for corporate debt would be a very dangerous way of moving toward such neutrality, and that it likely would have virtually no impact on the rate of buyouts. It could, in fact, trigger a stock market panic by raising the cost of corporate capital. This almost surely is what happened in October 1987. And this may be what Federal Reserve Board Chairman Alan Greenspan was hinting at last month when he urged the Senate Finance Committee not to tamper with the tax deductibility of corporate interest payments because it would have "too many potential adverse side effects."

Natural Mechanism. Leveraged buyouts may make life uncomfortable for some corporate executives. LBOs may end the business-as-usual atmosphere in some industries. And LBOs may grab headlines. But LBOs are not a problem for the American economy. They neither reflect nor create a crisis of business debt. Instead, leveraged buyouts are a natural mechanism which disciplines wasteful business practices and increases productivity.

The U.S. currently is financing record new investment and strong productivity gains. Congress should not impede this progress by trying to micromanage decisions best left up to business men and women with their own money on the line.

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