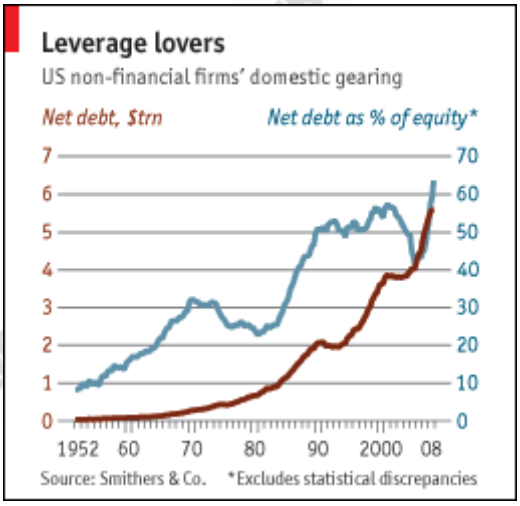
The sensible giants

Big listed firms have surprisingly strong balance-sheets—unlike their private peers.

Illustration by David Simonds

In recent decades running a business or household with a conservative balance-sheet has been a bit like being the only person in an opium den not to inhale. Consumers and financial firms got sky high on cheap debt. Lots of non-financial companies chased the dragon, too. In America corporate gearing is now at its highest level since at least the second world war, says Smithers & Co, a research firm (see top chart). Default rates are near their highest level since the 1930s.



Yet the data reveal a striking oddity: the largest listed firms have disproportionately little debt compared with both smaller listed peers (see bottom chart) and private firms. Of America's ten biggest non-financial firms, no fewer than six, including Microsoft and ExxonMobil, reported net cash positions at the end of 2008. Different accounting conventions make comparisons inexact, but non-financial firms in the S&P 500 index of listed American companies appear to account for only about a third of national corporate net debt, despite contributing a majority of profits. In Europe, with its tradition of bank financing, firms have always been keener on debt, but although overall corporate gearing has risen to "unprecedented" levels, according to the European Central Bank, listed firms have actually steadily cut theirs since 2000.

To grasp why big listed firms are different requires a bit of theory and some history. In theory, chief financial officers spend idle moments admiring charts of the idealised firm's optimal capital structure. From this they are meant to conclude that debt is only moderately attractive. Since interest payments are tax deductible, but dividends are not, some borrowing makes a balance-sheet more efficient. Too much, though, makes a firm too risky, raising its overall cost of capital. It is a fine trade-off, which at most should add 10-20% to a firm's overall value.

In the real world, however, many managers burnt their textbooks long ago and steadily increased their firms' leverage, taking only the occasional breather in tricky economic patches such as the 1970s and early 1990s. This partly reflects their pay, which is often based on measures (such as earnings per share) that are flattered by higher gearing, giving them an incentive to take on more debt than is justified by mere tax planning. More demanding owners and abnormally low interest rates also led firms to take on more risk.

Financial deregulation, too, has played a big role, notes Jeffrey Palma, a strategist at UBS. A series of new debt products enabled even the leakiest corporate balance-sheet structures to stay afloat—for a while. In the 1980s junk bonds opened up credit markets for lower profile firms. In the most recent boom, companies bought by private-equity outfits, the corporate equivalent of subprime borrowers, packaged their debt into collateralised loan obligations, a form of structured credit that is now as toxic as it is hard to explain. The rash of leveraged buy-outs may account for as much as half of the rise in American corporate net debt since 2002.

How were big listed firms, with fallible boards and demanding shareholders, immune from all this? After all, banks, with identical governance structures, worshipped at the altar of leverage. There are several answers. Some big listed firms have powerful founders who like to keep plenty of cash on hand and who resisted the siren calls of the credit markets. This is the case for three of America's ten biggest firms with net cash positions: Microsoft, Google and Apple.

When institutional investors call the shots, they often like firms to run tight balance-sheets less for tax reasons and more because they fear that managers will blow excess cash on vanity deals and pet projects. But successful firms with highly rated executives are given more latitude. When the fearsome Rex Tillerson of ExxonMobil faced calls to pay a special dividend in 2006, for example, he curtly refused to "scratch the immediate-gratification itch". Likewise, Rick Simonson, chief financial officer of Nokia, says it came under pressure to gear up in 2006-07, but that its bosses had "thick skins" and a good enough record to bat away the criticism.

Size helps, too. Even today nearly half of European and American stockmarket value sits in firms worth over $50 billion. Such firms were too big to be a target of private equity, even at its most hubristic. Without predators breathing down their necks, these firms could play it safe.

Yet not all quoted companies enjoyed the benefits of reputation and size: whisper it quietly, but most were just sensible. The boards of medium-sized firms—such as Motorola or Cadbury—successfully resisted pressure from activist investors to gear up as the economy deteriorated. Having had near-death experiences at the beginning of the decade, big industrial firms in Europe, such as Alstom and ABB, were far more cautious this time round.

Many listed firms saw their profits soar to cyclical highs, but chose to distribute them to shareholders using flexible share-buybacks rather than dividends, which are harder to cut when things go sour. And relatively few quoted firms engaged in the kamikaze debt-funded dealmaking of recent years. Certainly the downturn will claim casualties; some firms are now raising equity to restore their finances, ArcelorMittal being the most recent example. But in general most listed companies remembered that the economic cycle existed—unlike many private peers.

All this is likely to change the debate on corporate leverage in two ways. First, the gung-ho and largely erroneous assumption that higher debt means higher risk-adjusted returns will be replaced with a more measured assessment of the limited boost to tax efficiency that leverage can provide. One banker in London suggests that for the next few years, managers will be prepared to take on more debt only to the point where they are sure that they can refinance it if another crisis should strike. That suggests that quoted firms could further reduce their net debt from today's level of about 50% of their book equity.

Second, the psychological scars will run deep for the private firms that bear a disproportionate burden of overall corporate debt. Many face bankruptcy, with the destruction of value that entails. Financial regulators, too, are far less likely to tolerate the sort of capital-market fads that allowed private companies to overload on debt at the top of the economic cycle and infect the banking system as they did so. It used to be that equity, as well as lunch, was for wimps. Not any more.

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