The New Game in Corporate Finance

(version 2 - an update of the March 2018 blog)

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Corporate Borrowing and Share Repurchases

There has been a fundamental change in the balance sheet management of US corporations during the last two decades. Gone are the days of conservative balance sheet management.

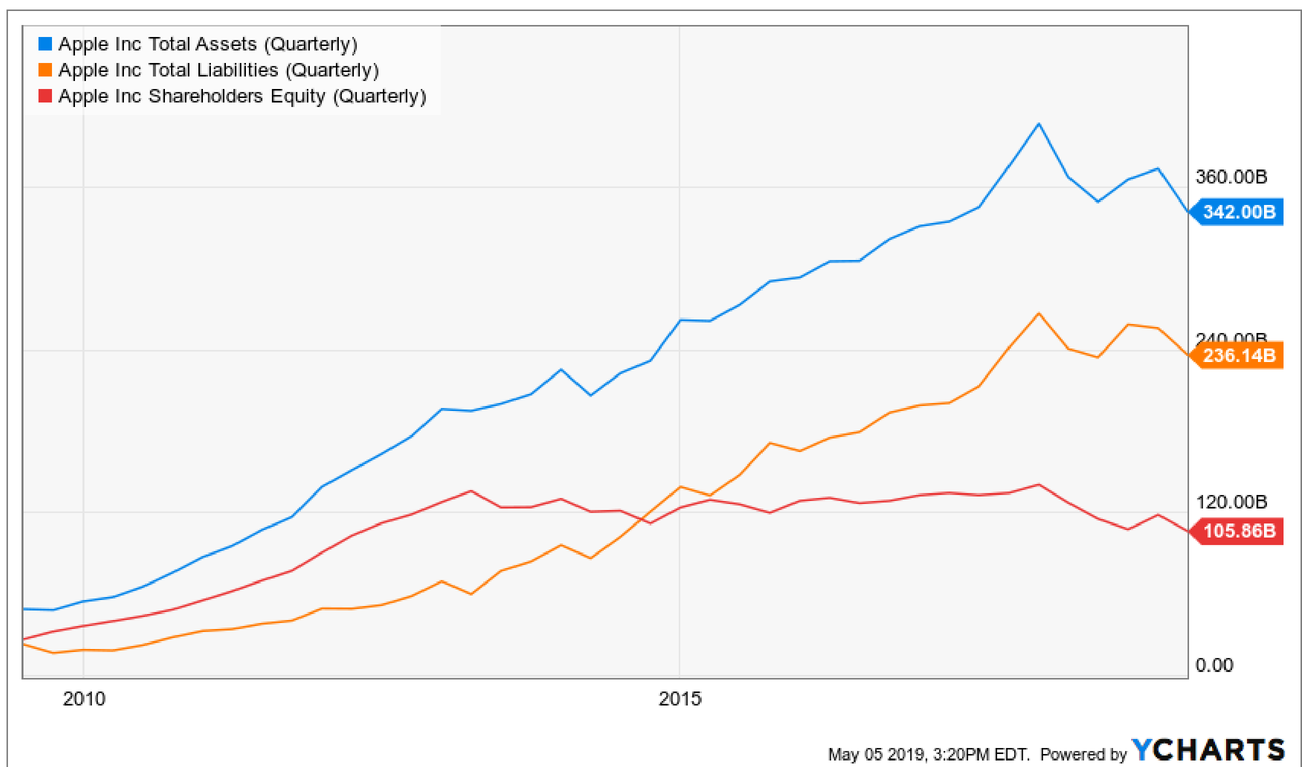
In past decades, debt covenants usually set limitations on how much a company could borrow relative to its shareholder equity, net income and cash flow. Many loans or debt instruments are now referred to as “covenant-light” because there are few restrictions on companies that borrow money. The development of covenant-light loans is attributed to some extent to large private equity groups that have more negotiating leverage due to their size and have been able to execute highly leveraged buyouts. Another reason for the prevalence of covenant-light loans is the ability of lenders to reduce their exposure to individual company loans by syndicating loans that they originate or by selling their loans in the secondary market.

The following graphs for four companies illustrate the changes in corporate balance sheet management during the last two decades. The graphs below show total assets, total liabilities, and shareholders’ equity. While these four companies have better profit growth and cash flow during the last ten years than most companies, their balance sheet management reflects a common financial strategy among US companies in recent years.

The Federal Reserve’s quantitative easing program lowered interest rates and provided an incentive for companies to issue more debt. However, higher interest rates will have an impact on profitability as the interest rates on bank loans adjust upwards and bonds are refinanced upon maturity at higher fixed interest rates. Many US companies are now more vulnerable to a recession or another financial crisis.

Apple (symbol AAPL)

Apple has seen its total assets grow by 620% since the end of the fiscal year ending September 30, 2009. In the past, Apple maintained a conservative balance sheet. At the end of fiscal year 2012, AAPL had no term debt. As of March 2019, AAPL has $11.9 billion of commercial paper liabilities and $100.7 billion of term debt, while total liabilities equal $236.1 billion. AAPL has used the additional borrowing to increase the size of its investment portfolio and to purchase its own shares. Cash and total investments (short-term and long-term) stand at $225.4 billion. To some extent, AAPL is operating as a leveraged hedge fund.

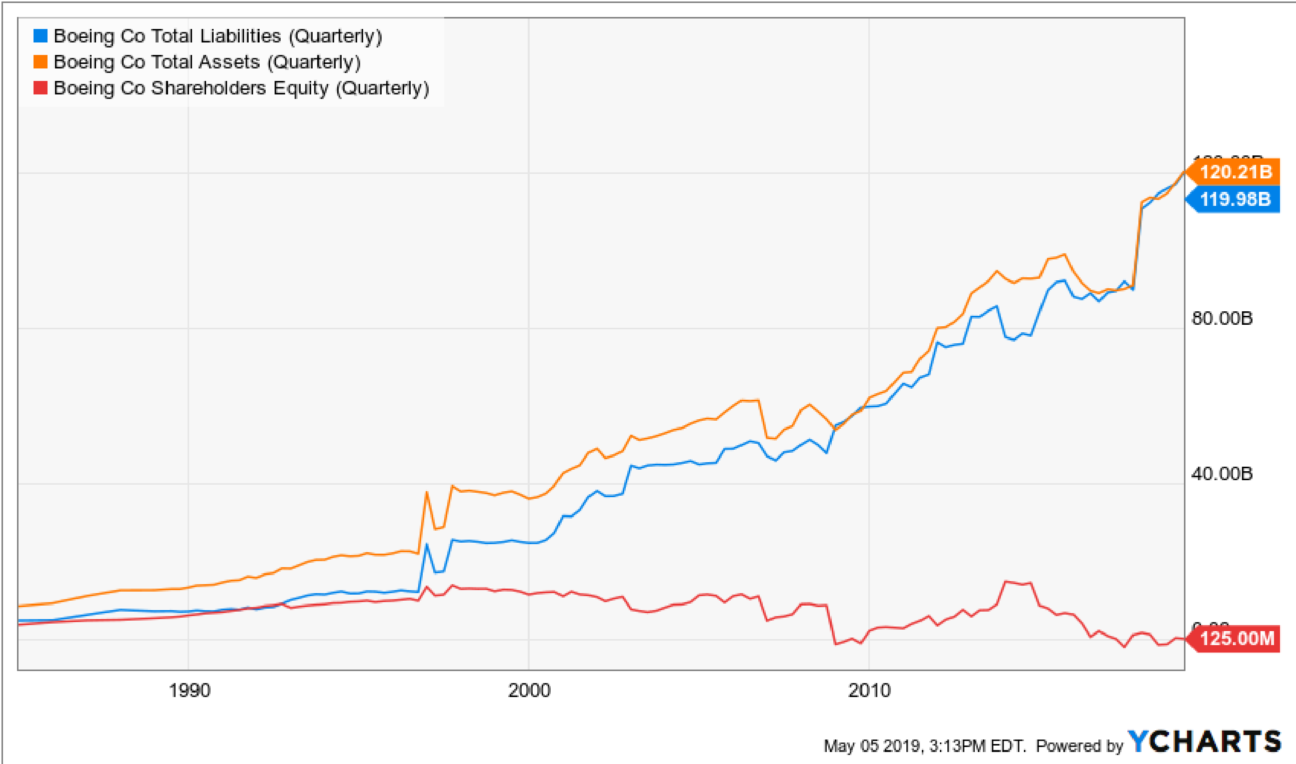


Boeing (symbol BA)

At the end of 1991, Boeing had shareholders' equity of $8.1 billion which exceeded total liabilities. In 1996, total liabilities began to accelerate along with total assets to a level of $120.0 billion at the end of March 2019. Share buyback programs have been largely responsible for the decline in shareholders' equity to a level of only $125.0 million. The

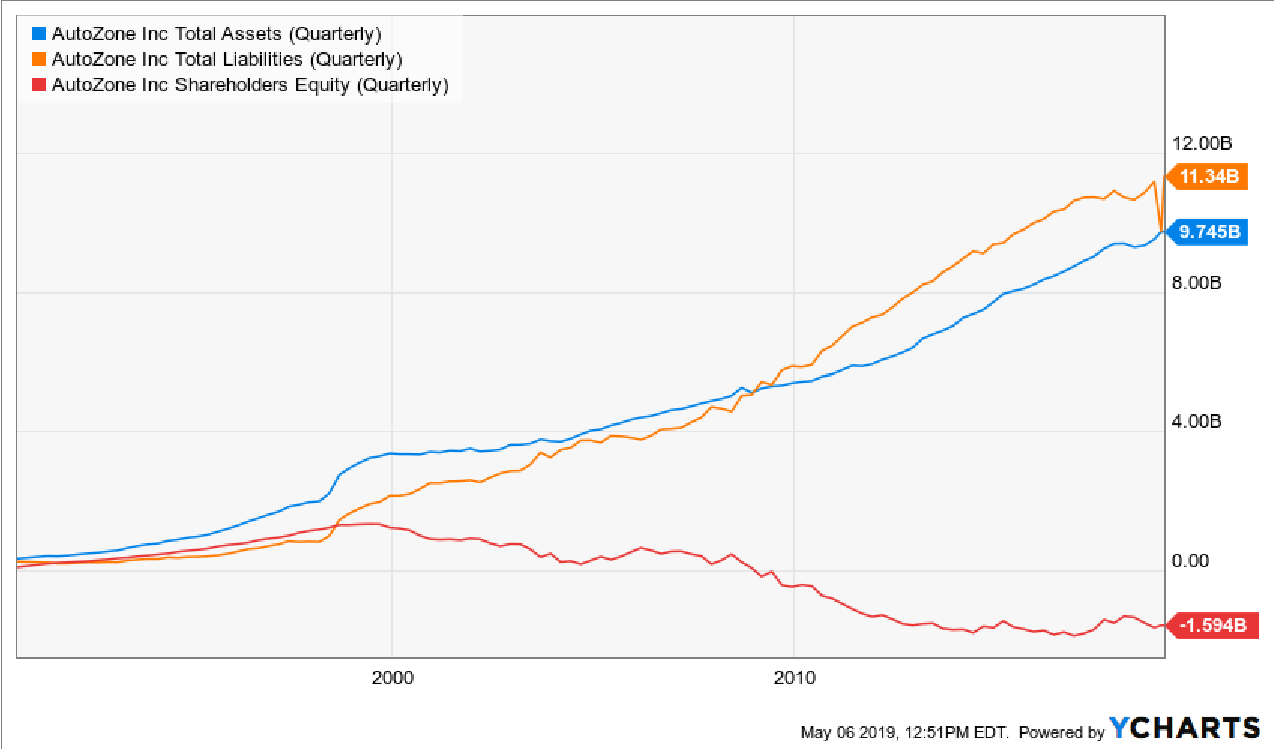
company has been consistently profitable and appears to be capable of servicing its debt. However, the ratio of total liabilities/equity is now 960 and in sharp contrast to 20 years ago.

After the grounding and reduced production of its 737 Max airplanes, Boeing issued $3.5 billion of bonds to provide additional liquidity. The company also entered into a $1.5 billion line of credit agreement with three US banks.



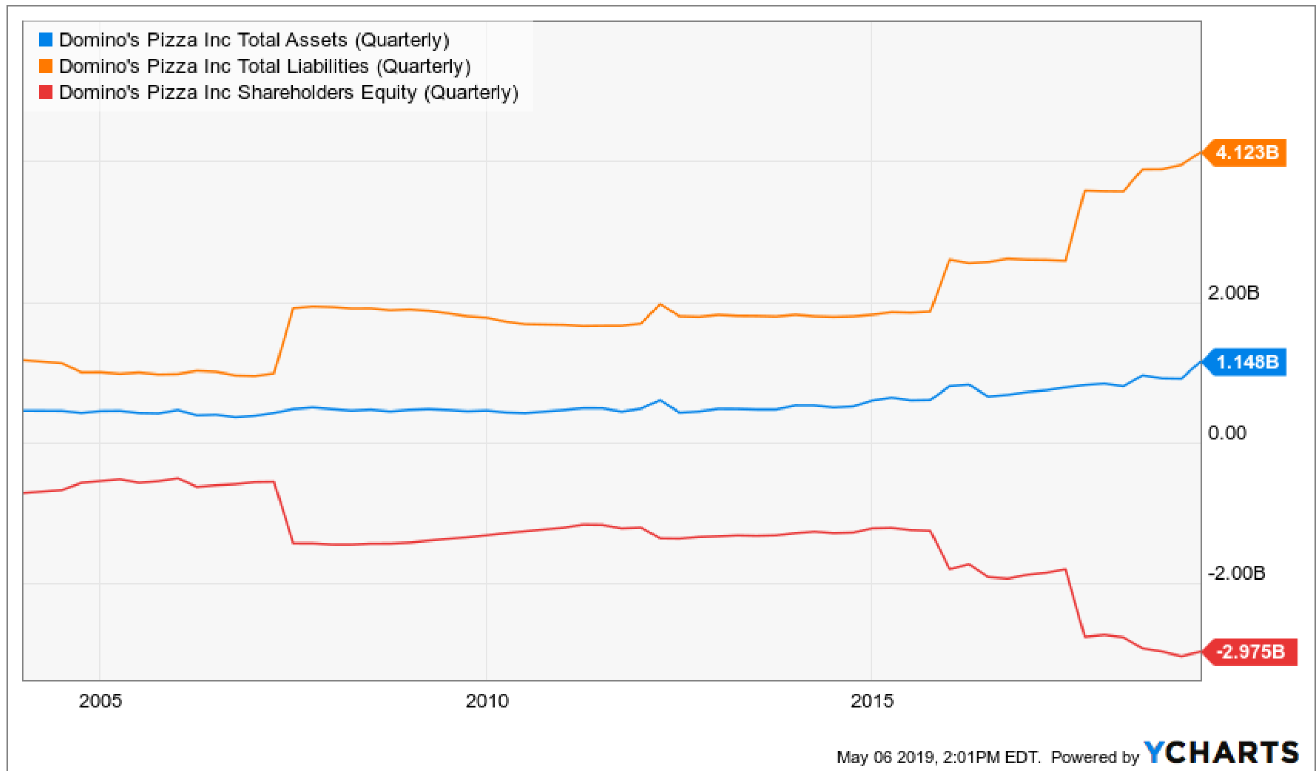
Autozone (symbol AZO)

Autozone had shareholders equity that exceeded total liabilities prior to 1998 when its shareholders equity stood at $1.3 billion. Since then, the company has relied heavily on debt to fund the company's operations. AZO has shown steady, profitable growth and appears to be able to service its debt properly. Debt proceeds have been used to repurchase shares so aggressively that the company now has negative shareholders' equity of $-1.59 billion.



Domino's Pizza Inc (DPZ)

At the end of December 2003, Domino's Pizza Inc (DPZ)had negative shareholders' equity of $ -718 million. DPZ has had steadily rising profits and positive cash flow but it has continued to issue more debt and shareholders' equity has declined further due to share repurchases. In 2017, the company had net debt issuance of $972 million and purchased $1.06 billion of its own shares. In 2018, DPZ had net debt issuance of $366 million and purchased $591 million of its own shares. As of March 2019, DPZ had negative shareholders' equity of $2.98 billion.



Conclusion

The Federal Reserve's policies have impacted the financial management of corporations. Influenced by an extended period of low interest rates, many companies have modified their financial management policies. Some of the effects include the following:

1) Some companies have substituted debt for shareholders' equity on a large scale.
2) Companies that have adopted these higher debt levels are more vulnerable to the next recession.
3) The risk profile of common stock of companies that have taken on higher debt levels has changed. Stock prices and valuation levels have benefitted from share repurchase programs but there is now more downside risk.
4) Investors in the debt of corporations with high debt levels do not have the benefit of a financial cushion that capital from common stock shareholders can provide. Creditors are assuming investment risks that are more equity-like in nature.
5) For the most part, debt issuance proceeds of the four companies discussed above have been used for share buyback programs to reduce equity capital committed to the business rather than increasing productive capacity.