Life after debt

AMERICANS are still trying to come to terms with the legacy of the debt-happy 1980s. Could anything good have come from the practice, prevalent then, of issuing so much junk debt that borrowers faced the threat of bankruptcy? Federal Credit Department Stores, which owns Bloomingdale's (among other chains), went bust in 1990 after one of the biggest junk financed takeovers, led by Robert Campeau. Speculation that it plans to launch a bid for another firm, R. H. Macy—a rival retailing firm that borrowed heavily during a management buyout and is now bankrupt—has rekindled the debate.

Despite its recent problems, Federated is a more valuable company than it would have been if the takeover had never happened. It was a timely move, says Steven Kaplan, an economist at the University of Chicago.* Before the bid was launched in December 1997, the company was worth $1.35 billion. When it emerged from Chapter 11 bankruptcy in February 1998, after including asset sales and cash retained by shareholders and creditors, the net value of its assets, in 1997 dollars, had risen by $1.6 billion, more than triple. (Nevertheless, for creditors, who paid $1.7 billion for the company, made a hefty loss.)

This increase in value was achieved by unbundling—Mr Campeau raised $3.8 billion by selling off peripheral bits of the business—and by managing assets better, reckon Mr Kaplan. The more he were to invest in paying interest payments on the firm's debt, which exceeded 25% of turnover, put extra pressure on its management to run the firm efficiently. Before Mr Campeau's bid, Federated's performance had been lukewarm.

In short, Federated's assets increased in value during the two years it spent in chapter 11, even after paying for more than $300m in legal and restructuring costs, according to Mr Kaplan. Most other studies have found that chapter 11 leaves firms worth less than before. One reason for this is that both shareholders and creditors must agree to any rescue package, because their interests often conflict. Negotiations can rumble on for years while legal bills, paid out of the firm's assets, mount. In Federated's case, some big creditors were also big shareholders, mitigating such conflicts.

But Mr Kaplan suggests another interpretation: too much debt may be less of a threat than you might think. Remember that borrowing costs extra discipline on managers: in that extent, “too much” debt is actually a good thing. If the firm goes bust as a result, chapter 11, by protecting it from its creditors, may allow it to be sold cheaply to be restructured efficiently while boosting avoid the harm done to a business by the process of going bust. (A firm that went bust for underlying business reasons, rather than because it borrowed too much, would not be so lucky.) Once out of Chapter 11, former junk bond firms can do very well indeed. Any Macy's shareholder thinking of selling should bear in mind that Federated's share price has risen by 50% since it left chapter 11.