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Just say no!

Membership in the world's most exclusive club is not worth the dues.

Just Say No to a Triple-A Rating

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isn't worth the dues.*

By S.L. MINTZ

Industrial companies with triple-A credit ratings command a sense of awe. This very elite group consists of the 13 most creditworthy corporations in the eyes of both Moody's Investors Service and Standard & Poor's. They have nothing if not financial clout. Their collective assets approach \$250 billion, their stock market capitalization exceeds \$295 billion, and they earned more than \$20 billion last year. As Roy Weinberger, head of industrial ratings at S&P, puts it, "Basically, a triple-A industrial is a 12-foot basketball player."

Praise for these companies comes easily, to say the least. Yet nearly all of them can be faulted in one important respect. A triple-A rating goes only to those industrials that use very little credit relative to their assets and earnings. And in a world in which interest payments are tax deductible, failing to borrow saddles shareholders with unnecessary taxes. When it comes to these companies, the bill is truly enormous. If the 13 were to leverage up to a debt ratio of just 35 percent of assets (about midway between double-A and single-A), they could cut their collective tax bill by \$1.9 billion and lift their stock prices by something on the order of ten times that amount.

That is not to imply that these companies are poorly managed. On the contrary, attaining triple-A status also requires that managers manage inordinately well. Eight of the 13 triple-As achieved higher returns on equity than most companies with lower ratings in each year from 1981 through 1986, according to a study by Merrill Lynch. From a lender's standpoint, triple-A signifies unparalleled strength throughout the business cycle. Typically, internal cash flow provides ample funds for capital investment, leaving little or no requirement for debt. That makes what little debt triple-As do issue second only to U.S. government securities in terms of safety.

Almost all triple-A companies are household names.

They form a diverse group, if not a comprehensive cross-section of American business. Five of the 13—Eli Lilly, Bristol Myers, Merck, Pfizer, and Johnson & Johnson—make pharmaceutical and healthcare products. Their lopsided presence among triple-As reflects the high margins and modest capital requirements in this industry. Two, Amoco and Exxon, find and refine oil. Exxon is the senior member of the club, having held its rating since 1926. Emerson Electric and General Electric produce electrical products for consumer and industrial use. IBM builds and services computer equipment. Campbell Soup and Kellogg make food products, and 3M is a diversified company that defies classification.

HOARDING THE CASH

Stature that lets chief financial officers and lenders sleep soundly has a very different effect on stockholders. Adding debt would give the shares of a triple-A a sturdy boost without undermining a solid business. But while the rest of American business was cranking up its debt ratio over the last 15 years, the ratio of debt to capital among the triple-As in the Merrill study actually shrank, from 21.4 percent to 20.3 percent. The ratio for double-A companies rose from 27 percent to 35 percent; for single-As it went from 38 percent to 46 percent.

Triple-As also tend to keep considerably more cash and marketable securities on hand than their lesser brethren, a fact that further reduces their effective debt ratios. Consider Campbell Soup. Its debt is 20 percent of capital, versus an average of 39 percent for the food industry, according to Moody's. Net of cash and marketable securities, Campbell's debt amounted to a trivial 2 percent of capital at the end of last year.

Campbell keeps a viselike grip on its triple-A standing by spurning leverage, but it also deprives shareholders of



CFO Jack Quindlen of DuPont: *Triple-A is in the eye of the beholder.*



Dennis Dammerman of GE: *Straight from a press conference to the rating agencies.*

a free lunch. Like all free meals, this one comes out of the federal kitchen, in the form of tax deductions on interest payments. Modern financial theory holds that the pretax costs of debt and equity are equal (after adjusting for their relative riskiness), making the after-tax cost of debt a bona fide bargain. More traditional theory assumes that even the pretax cost of debt is lower than equity, so that after-tax debt is super-cheap. The point isn't lost on securities analysts. "Campbell's lack of leverage is costing shareholders money," says John McMillin, a food industry analyst at Prudential-Bache.

If anything, tax reform has enhanced the value of leverage, says tax attorney Peter Faber of Kaye Scholer Fierman Fiers & Handler, a New York law firm. As investment credits, tax benefit transfers, and other breaks become scarcer, says Faber, "the benefits of interest deductions take on increased importance."

THE RANKS ARE THINNING

That may explain why membership in the triple-A club has been dwindling. In 1981, 18 companies qualified, and they included only nine of the present members. Most of the dropouts left voluntarily when management opted for a more aggressive profile. Beatrice took on a lot of debt buying Esmark. DuPont bought Conoco. Kellogg, which has since regained its triple-A, dropped out for two years following the repurchase of 20 percent of its shares in 1984. "Leveraging provided those companies with better profit opportunities," says Sam Gordon, senior vice president of Moody's corporate department.

The benefits of leverage were abundantly clear at Coca Cola, where managers perceived the conflict between a triple-A rating and providing the highest returns to shareholders. "We could not maximize shareholder value without putting on an appropriate amount of leverage," says Murray Friedman, Coke's vice president for finance.

The company lost its rating in 1986. That year its debt reached \$1.6 billion, or 31.9 percent of capital, up from a meager \$232 million, or 9.3 percent of capital, in 1981. Today debt is \$2.7 billion, or nearly 46 percent of capital, and Coke is more profitable than ever. Meanwhile, the

credit rating is so unimportant to George Thompson, a leading soft drink analyst at Prudential-Bache, that he wasn't aware until interviewed for this story that Coke had fallen from grace two years before.

Coke typifies companies that sacrifice top ratings for strategic reasons. It borrowed to buy Columbia Pictures in 1982, but what precipitated the downgrade was management's decision to acquire a number of Coke bottlers under the banner of Coca-Cola Enterprises. That decision cost \$2.4 billion, most of which came from debt. Says Harold Goldberg, chairman of the ratings committee at Moody's: "Coke gave up a few basis points for a chance to enhance shareholder returns."

Friedman is quick to confirm Goldberg's assessment. "We started with the basic premise that we would do things to increase value," he says. That meant setting business strategies first and then structuring the balance sheet to support them. When it came time to present plans to the rating agencies, Coke was braced for their response. "They asked us how we felt about not being triple-A," Friedman recalls. "We said, 'If that's where we are, then that's where we are.'"

DuPont was a triple-A credit until 1981, when it bought Conoco for \$7.8 billion, at the time the biggest merger ever. CFO Jack Quindlen doesn't find life as a strong double-A borrower any different. "As a practical matter, it hasn't cost us anything," he declares, adding that the company accepted the downgrade without a fuss. "Lenders have not paid any attention to the fact we are double-A," he says. A double-A hasn't even hurt DuPont in markets outside the U.S., Quindlen insists, mainly because triple-A companies don't borrow nearly enough to sop up even the most risk averse lenders' cash.

"The lending community views the triple-A club as much bigger than the ones that carry the initials," Quindlen says. His claim is difficult to corroborate without two bonds, one issued by DuPont and another issued by a comparable triple-A, that are similar in maturity and coupon. But if DuPont issued notes today it would pay a slight premium at most, according to Richard Wilson, manager of corporate bond analysis at Merrill Lynch.

The 13 triple-A industrials use only 12 percent of their debt capacity.

DuPont's credit may or may not be as sound as ever in the eyes of lenders, but regaining a triple-A "is not a strategic objective," Quindlen says. The company has no debt ceiling, and Quindlen likes that freedom. "It would be a mistake to handcuff yourself with financial strategies that are too rigid," he says. "All other things being equal, return on equity is improved by higher leverage. If a triple-A borrows and invests effectively—a big assumption—it will reap the benefits of lower cost money. That's simple textbook theory, but it works."

Not simple enough to impress diehard triple-As. Their refrain usually goes as follows: We recognize the value of leverage, but we want to be ready for rough times or to take advantage of unexpected opportunities. Sensible enough, but these managers lose sight of the crucial distinction between investment decisions and financial structure. One certainly has an impact on the other, but they are not the same. Absent investment opportunities with sufficient returns, management can always adjust financial structure by repurchasing shares. That shouldn't close the door to future investments. If Campeau Corp. can be leveraged to its eyeballs and still raise almost \$7 billion to purchase Federated Department Stores, then an investment-grade company should be able to add considerable leverage without sacrificing flexibility.

The truth is that financial managers lack a systematic means for determining debt capacity, says Ennius Bergsma, a partner specializing in corporate finance at McKinsey & Co. "The appropriate way to think about debt capacity has nothing to do with historical relationships of debt to equity," he says. "You have to look at underlying cash flows." With that in mind, McKinsey has developed a formula for calculating debt capacity.

Its analysis is keyed to minimum expected cash flows, using management's internal projections. But for purposes of illustration, the calculations can start with expected cash flow based on past results. To find the cash flow available for debt service, subtract from expected cash flows: (1) a safety cushion based on the variability of historical cash flows, (2) gross investments consistent with expenditures over the past ten years, and (3) projected dividends. Then discount the remaining cash flows at an expected borrowing rate to estimate a company's total debt capacity. Unused debt capacity is total debt capacity plus marketable securities and minus current debt.

Applying this method, Bergsma estimates that the 13 triple-A industrials use only 12 percent of their debt capacity. Their total outstanding debt came to \$29 billion at the end of fiscal 1987, but their holdings of cash and marketable securities reduced net debt to just \$12.8 billion. As a group, says Bergsma, they could borrow another \$89 billion or more without substantial risk of having to reduce capital expenditures or cut their dividends even in the leanest of times.

Letting debt capacity go idle to save a few basis points and preserve a white-shoe image seems absurd to staunch proponents of leverage like Chance Bahadur, who became treasurer of Beatrice shortly after its 1986 leveraged buy-out. "Triple-A is a very luxurious status to have," he says. "The price of foregone shareholder value seems excessive to me." Amar Bhide, an assistant professor at the Harvard Business School, is even harsher. "It's my opinion that

most triple-A companies are nuts," he says. Bhide challenges financial managers to wake up to the cost of unused borrowing capacity, which he measures by the taxes a company wouldn't pay if it substituted debt for equity. He sees no more reason to tolerate unused debt capacity than to allow physical inventories to clutter a warehouse.

MULTIPLYING THE SAVINGS

The tax savings from leverage are so valuable because they recur each year that a company pays interest. Thus, the stock market reacts to an increase in leverage the same as it would if assets increased enough to produce earnings equal to the tax savings. In other words, a company's market value should increase by the capitalized value of the tax savings. At a 10 percent interest rate, the capitalized value is 10 times the annual tax savings; at 9 percent, it is 11.1 times the annual savings. When it comes to triple-As, the potential savings are vast (see tables).

Such arithmetic doesn't sit easily with managers of triple-As. Even DuPont's Quindlen labels this an exercise in gimmickry. "Tax savings takes you from the gross cost of borrowing to the net cost of borrowing," he says, dismissing the idea that the savings can be capitalized.

But there is strong indirect support for the theory in what happened when companies began switching en masse from FIFO (first-in, first-out) to LIFO (last-in, first-out) in-



PHOTO BY MICHAEL N. PARAS

Harold Goldberg of Moody's: *The benefits of leverage are worth a few extra basis points.*

GE will part with its vaunted rating for the right investment opportunity.

ventory accounting in the Seventies. Many corporations were reluctant to make the change because it clobbered reported earnings. But investors recognized that the companies would save taxes and thus have higher cash flows. As a result, stock prices rose by roughly the capitalized value of the tax savings.

Adding leverage won't do much, however, for companies that already pay low taxes. Johnson & Johnson, for example, paid just \$40 million in federal taxes last year on the \$434 million it earned domestically—equivalent to a 9.2 percent tax rate. Operations in Puerto Rico will keep the company's taxes low through 1999, when tax relief under Operation Bootstrap expires. Were it not for the alternative minimum tax, Johnson & Johnson could virtually eliminate its taxes by boosting leverage from 16.6 percent of assets to just 35 percent.

Most triple-A companies deserve kudos for their skill at tax avoidance. They paid lower effective tax rates than more highly leveraged double-A companies from 1978 through 1986, according to the Merrill Lynch study. But their 1986 composite tax rate of 39 percent still left room for plenty of improvement from more leverage.

General Electric paid \$804 million in U.S. taxes on earnings of \$2.9 billion last year. That isn't enough to send CFO Dennis Dammerman running for cover behind interest deductions. Not that Dammerman isn't as familiar as anyone with the benefits of leverage. General Electric Financial Services has a debt to capital ratio of around 80 percent. But GE's consolidated debt to asset ratio, net of cash and equivalents, is less than 14 percent. "It's not that we're blind about the issues," Dammerman says. "We just love having a strong balance sheet." GE is using its cash hoard instead of new debt to pay for most of its recent \$2.3 billion purchase of Borg-Warner's chemical division.

Dammerman insists that GE isn't married to triple-A, and will part with its vaunted status for the right investment opportunity. But when the next opportunity comes along, GE isn't likely to give up its triple-A without a fight. Dammerman was so concerned about the rating when GE bought RCA for \$6.4 billion in 1985 that he jumped into a car after the press conference announcing the deal and went straight to the rating services.

"We worked very hard so that we could keep a triple-A," he says, and argues that the energy was well spent. GE borrowed \$3.8 billion at an average cost of only 19 basis points above U.S. Treasury securities. Some of the debt was pegged at 51 basis points *below* comparable Treasuries. Dammerman figures that GE would have paid another 25 basis points, or \$9.5 million a year, if it had borrowed as a double-A.

A strong aversion to leverage used to be part of the corporate culture at many triple-As. For decades, the brass at Eastman Kodak wouldn't do anything to offend the memory of founder George Eastman, and Eastman abhorred debt. That, and many other aspects of the Kodak culture, began to crumble when the company lost its hegemony in the film business and film itself began losing out to electronic imaging. A triple-A until 1986, Kodak now has \$5.1 billion in debt and a lower rating.

A SEA CHANGE

Chief financial officers at other belt-and-suspenders companies insist that triple-A is the byproduct of business strategies, not an objective in itself. Says Campbell CFO Edwin Harper: "If the right opportunity came along, we wouldn't rule it out simply because it would change our rating to double-A or single-A." The company has yet to take a step that would jeopardize its rating, however. Though Campbell recently bid \$200 million for Freshbake Foods PLC, a British manufacturer of frozen food products, it has \$387 million in short-term investments on hand.

Emerson Electric seems to flirt with its rating, but only after careful calculations. Weinberger of S&P says that although Emerson has made a string of acquisitions in recent

THE HIGH COST OF CONSERVATISM

The following tables show how much triple-A corporations could reduce taxes, and boost share prices, by increasing their total debt to a still conservative 35 percent of assets. One company, Johnson & Johnson, theoretically could eliminate its federal income taxes by raising debt to 35 percent of assets. The annual tax savings, 34 percent of interest paid on the new debt, are capitalized at a 10 percent discount rate.

BRISTOL MYERS

Assets	\$4,732
Debt	434
1987 Taxes	270
New Debt	1,223
Capitalized Tax Savings	416
Tax Savings Per Share	1.44
Share Price	40.50
Percentage Gain	3.6

CAMPBELL SOUP

Assets	\$3,090
Debt	474
1987 Taxes	136
New Debt	608
Capitalized Tax Savings	207
Tax Savings Per Share	3.18
Share Price	25.75
Percentage Gain	12.3

AMOCO

Assets	\$24,827
Debt	4,232
1987 Taxes	464
New Debt	4,457
Capitalized Tax Savings	1,512
Tax Savings Per Share	5.88
Share Price	75.75
Percentage Gain	7.8

ELI LILLY

Assets	\$5,255
Debt	604
1987 Taxes	111
New Debt	1,235
Capitalized Tax Savings	420
Tax Savings Per Share	2.88
Share Price	83.25
Percentage Gain	3.5

James Cozad of Amoco says a company needn't be triple-A to rank in the uppermost echelon.

years, "the timing was such that they could always stay within calling range of a profile we would expect of a company in the triple-A category." That said, Weinberger adds that the rating wouldn't stop Emerson if the right \$2 billion acquisition came along.

Barry Friedberg, director of investment banking for Merrill Lynch Capital Markets, detects "a sea change" in the willingness of financial managers at triple-A companies to consider a downgrade. That's the prevailing sentiment at Johnson & Johnson, which was rated for the first time last summer in advance of two \$250 million bond issues, its first public debt. Early this year the company tried to buy Playtex, but the deal fell through. Had Johnson & Johnson succeeded, the triple-A might not have made it to a first birthday. "We made that offer realizing that it was possible we might be downgraded to double-A," says CFO Clark Johnson. The risk didn't disturb him at all. "We think a double-A is a good, solid, secure company too." Such confidence encouraged the company to file a shelf registration in June for \$500 million of debt that it will use to repurchase stock; Moody's immediately reaffirmed the triple-A rating.

Vice Chairman James Cozad of Amoco also endorses the view that a company needn't be a triple-A to rank in the

uppermost echelon of U.S. business. "I'd like to feel that other triple-A companies are not passing up a lot of opportunities simply to keep debt at a lower level," he says. Triple-A since 1966, Amoco risked—but kept—its status last March by paying \$4.1 billion for Dome Petroleum, an overextended Canadian oil producer.

Right now, all the signs point to further shrinkage in the triple-A club. Only an end to the free lunch that leverage provides is likely to reverse the trend toward higher debt. But it seems safe to assume that at least a few companies will continue to cherish the gilt-edged rating. "I don't think any of the U.S. industrials with triple-A would be happy about losing it," says Goldberg of Moody's. Weinberger of S&P agrees that none of these companies would forego its rating without a fight.

But Goldberg and Weinberger have different ideas about how small the club can get. Weinberger says that S&P "would not maintain triple-A to the death," noting that there no longer are any triple-A electric utilities. "Theoretically, the same could happen to industrials," he says. Goldberg disagrees. "It's incomprehensible. We will always have triple-A." That should reassure shareholders who wear raincoats and carry umbrellas on sunny days, just in case. ■

EMERSON ELECTRIC Assets \$4,868 Debt 917 1987 Taxes 252 New Debt 787 Capitalized Tax Savings 268 Tax Savings Per Share 1.06 Share Price 30.875 Percentage Gain 3.4	IBM Assets \$63,688 Debt 5,487 Taxes (4-year average) 970 New Debt 16,803 Capitalized Tax Savings 5,713 Tax Savings Per Share 9.57 Share Price 114.375 Percentage Gain 8.4	MERCK Assets \$5,680 Debt 1,012 1987 Taxes 209 New Debt 970 Capitalized Tax Savings 332 Tax Savings Per Share 2.17 Share Price 55.375 Percentage Gain 3.9
EXXON Assets \$74,042 Debt 7,878 1987 Taxes 776 New Debt 18,022 Capitalized Tax Savings 6,133 Tax Savings Per Share 3.38 Share Price 44.25 Percentage Gain 7.6	JOHNSON & JOHNSON Assets \$6,546 Debt 1,089 1987 Taxes 40 New Debt 1,177 Capitalized Tax Savings 400 Tax Savings Per Share 2.09 Share Price 79.375 Percentage Gain 2.6	3M Assets \$8,031 Debt 699 1987 Taxes 332 New Debt 2,112 Capitalized Tax Savings 718 Tax Savings Per Share 3.16 Share Price 63.50 Percentage Gain 5.0
GENERAL ELECTRIC Assets \$38,920 Debt 5,601 1987 Taxes 804 New Debt 8,021 Capitalized Tax Savings 2,727 Tax Savings Per Share 2.94 Share Price 42.75 Percentage Gain 6.9	KELLOGG Assets \$2,681 Debt 442 1987 Taxes 193 New Debt 496 Capitalized Tax Savings 169 Tax Savings Per Share 1.10 Share Price 54.25 Percentage Gain 2.0	PFIZER Assets \$6,923 Debt 964 1987 Taxes 147 New Debt 1,459 Capitalized Tax Savings 496 Tax Savings Per Share 3.00 Share Price 52.50 Percentage Gain 5.7