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Paying the Price for Living on Credit

Lisa Clifford

By LEO C. O'NEILL

IF the recession is ending — or indeed, even over — that may provide some relief for American corporations plagued by sluggish demand and declining production and for cities whose tax revenues for much-needed services fall below budget forecasts.

But how much relief will the recovery provide for the scores of corporations and municipalities that have incurred substantial debt in recent years? Probably not much.

Since the recession began in mid-1990, Standard & Poor's has downgraded a record $650 billion worth of corporate debt obligations and upgraded only $115 billion — a troubling ratio of 5.6 to 1. In the 12 months before the beginning of the recession, that ratio was a much lower 2.4 to 1. Obviously, there has been a significant decline in corporate credit quality. And the number of rating downgrades is likely to exceed upgrades at least through the rest of this year and probably well into 1992. Although the picture is a bit better in the municipal sector, downgradings continue to exceed upgradings.

The level of debt in American corporations today is so high that the median rating on United States corporate bonds is now BB — a high speculative grade rating. Only 10 years ago, the median was A — a solid investment-grade rating. Although the vast majority of municipalities still carry investment-grade ratings — Bridgeport, Conn., and Philadelphia are notable exceptions — the need of governments to maintain those ratings probably will generate painful — albeit necessary — decisions to cut city services and spending. New Yorkers can attest to this.

This weakness in American credit quality is troublesome for investors who hold these securities — and for corporate managers and government administrators charged with operating these entities in a fiscally prudent manner. They must find a way to overcome the effects of the excessive borrowing and spending of the 1980's.

Most of the credit damage has occurred — and will continue to occur — in the already devastated "junk bond" market. Despite periodic flurries of positive news, junk bonds represent a veritable minefield for the individual investor.

Between now and 1993, many high-yield bonds that now pay interest in additional securities will have to begin paying interest in cash, while others will be maturing. With many of the companies issuing these bonds not generating sufficient cash flow, the likelihood is that they will default, creating further disruptions in the weakened high-yield bond market.

There are some bright spots in the credit picture. Corporations with investment-grade ratings have a brighter outlook. In the first half of this year, these companies have tapped the bond market for some $70 billion of long-term capital — compared with only about $85 billion for the entire year of 1990.

Most of this has been used to repay short-term debt and to finance much-needed investments in plants and equipment. This is a good sign. Over time, this conservative, and traditional, approach to long-term debt capital is the best way for corporations to invest in their operations. And this is important: Access to such capital will be increasingly critical to the competitive positioning of corporations, and companies committed to retaining financial strength will be poised to compete most effectively.

On the municipal front, state governments with budget woes face a huge challenge: balancing the need for low-cost capital (which comes with a high rating) against the need to provide essential services at reasonable tax rates.

Unfortunately, government leaders still have not reached a consensus on how to do this. Many believe that the political price for making these necessary and painful choices is just too high.

The recession's end isn't likely to help cities and corporations with debts left over from the 80's.

But political leaders can use the recovery as an opportunity to achieve long-term budget balance — an opportunity squandered during the boom days of the 80's, when budget surpluses were popularly regarded as ripe for spending.

The likelihood is slim that corporate and municipal credit quality will improve just because of the recovery. Indeed, cyclical economic factors like recession or recovery will not affect credit quality. The only way to do that is to have corporate managers and political leaders recognize the lasting benefits of financial conservatism.

For corporations, this means using borrowing capacity to invest in projects and businesses that lead to improved economic returns — not engaging in the financial "engineering" practices of the 80's.

For states and municipalities, it means that realistic spending priorities must be set to reflect their constrained ability to raise taxes. ■

Illustrations by Alison Seiffer

Leo C. O'Neill is president of Standard & Poor's Ratings Group in New York, part of McGraw-Hill.