Study: Credit crisis, debt load a double whammy for investment

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Firms with heavy long-term debt that came due amid the nation's recent credit crisis slashed investment more than three times as much as companies whose paybacks ducked the meltdown, a new University of Illinois study found.

The findings show that even seemingly minor financing decisions such as debt maturity deadlines can put firms at risk when the economy sours, carving into investments that seed future growth, hiring and profits, the study says.

"Our message is that firms should sweat the small stuff," said Scott Weisbenner, a U. of I. finance professor and researcher for the study. "These companies suffered profoundly, putting them at a disadvantage compared to firms that were just lucky enough to have debt due just a couple of years earlier or a few years later."

Typically, firms can refinance debt, so maturity schedules pose little problem, according to the study, co-written by finance professors Heitor Almeida, Murillo Campello and doctoral student Bruno Laranjeira for a conference on the financial crisis sponsored by Yale University and the *Review of Financial Studies,* a top academic journal.

But interest-rate spreads on borrowing soared when the credit crisis erupted in August 2007, forcing debt-saddled firms to scale back investment on capital projects such as buildings and equipment that create jobs, future profits and help boost the overall economy.

"Investment is really the lifeblood of the firm," Campello said. "In the short run, it provides demand for construction, equipment and the jobs that those investments create. In the long run, curbing investment today means reduced sales, employment and profits later because firms don't have the infrastructure in place to grow."

The study examined more than 1,000 high-quality, publicly traded firms that rely on long-term debt for financing. Of those, 86 had at least 20 percent of their debt due on the heels of the credit crisis.

Overall, companies trimmed investment by an average of 10 percent during the first three quarters of 2008 as the nation slipped into its deepest economic downturn since the Great Depression. But investment tumbled by nearly a third among firms with steep debt due as the credit crisis lingered.

"Because of the recession, it isn't surprising that investment declined in 2008," Almeida said. "But the magnitude of the decline was surprising because you would think firms would manage their liabilities in a way to not get caught by surprise."

The study found that firms often issue debt in a "lumpy fashion," with maturity schedules that require large paybacks in a single year rather than spread out over many, Weisbenner said.

"A key finding is that firms need to keep an eye on how their debt load is staggered," he said. "There's a parallel here with individual investing. We preach to individuals not to put all of their eggs in one basket. That turns out to be true for firms, too. If they can smooth out when debt is due, they may avoid cutting deeply into their lifeblood just to pay it off. "

Weisbenner says those cutbacks also rattle the overall economy because business investment in structures, equipment and software accounts for more than 10 percent of the nation's gross domestic product.

"A decline in investment means less employment - fewer people building new plants, fewer people making new equipment and fewer jobs in the future when those projects are sacrificed," he said.

"This study suggests that debt maturity may be one avenue through which credit shocks move through the economy."

Weisbenner says the study offers insight into long-standing questions about whether financing decisions can impact other business-altering choices that firms make.

"This provides compelling evidence that financial decisions can have real consequences and highlights the risk firms may face by having a large amount of debt coming due at once," he said. "And it's something that is under the firm's control when they set maturity dates under the financial contract."

Source: University of Illinois at Urbana-Champaign (news : web)

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