Are corporate bailouts effective?

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(PhysOrg.com) -- Do corporate bailouts actually work? According to a recent study, some bailouts work better than others, depending on the conditions surrounding them.

In a study of post-bailout performance of 104 corporate bailouts in 21 countries between 1987 and 2005, researchers found that in certain circumstances, bailed-out firms eventually recover to a point where their post-bailout performance is at least as good as before the bailout.

Kenneth Kim, associate professor, and Zhan Jiang, assistant professor, both in the University at Buffalo School of Management, and Hao Zhang, assistant professor, in the Rochester Institute of Technology, were somewhat surprised by their findings, because, "bailouts imply rescuing a firm that capital markets are unwilling to serve." But closer investigation revealed the degree to which firms recovered depended upon several factors.

Firms with the best recovery were those that experienced declines in performance less than a year before to their bailout. These "sudden decliners" experienced a recovery of about 117 percent. Firms that had more prolonged declines (one to three years) before being bailed out, only recovered to about 93 percent of their previous value.

Kim and his colleagues contend that sudden decliners probably experienced some type of external shock beyond the firm's control, such as a change in the industry, the 9/11 terrorist attack or the Asian financial crisis.

"This means that it makes more sense to rescue firms that have been otherwise strong than to keep afloat 'prolonged decliner' firms that have been weak or inefficient for some time," says Kim.

In addition, bailed-out firms that were distressed primarily because they had problems servicing their debt recovered better than bailed-out firms that were distressed because they were unprofitable.

"Again, this makes sense," says Kim. "The former were profitable; they just needed a hand."

How companies were bailed out and who bailed them out also impacted bailout success.

Companies bailed out through debt relief had recovery that was 16.7 percent greater than companies that were bailed out with cash injections. The researchers speculate that this is so because cash is easier to mismanage. In fact, the researchers found that in the year after a cash bailout, executive and employee compensation increased.

"Essentially, this suggests that executives of firms that receive cash as part of their bailout almost immediately give their employees and themselves raises," says Kim.

Finally, firms can be bailed by governments, shareholders and, in bank-centered economies such as Germany and Japan, banks can bail out their client firms. Kim and his fellow researchers found that firms recovered more fully from nongovernmental bailouts. They offer three explanations for this finding. First, governments don't monitor firms post-bailout as closely as large shareholders and banks. Second, governments may bail out a firm to keep people employed or to keep the economy going, regardless of the firm's performance. And third, governments are more inclined to bail out firms with government connections.

These findings, the researchers say, provide important considerations for the public and policy makers.

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