Debt adds discipline to management

- If you are managers of a firm with no debt, and you generate high income and cash flows each year, you tend to become complacent. The complacency can lead to inefficiency and investing in poor projects. There is little or no cost borne by the managers
- Forcing such a firm to borrow money can be an antidote to the complacency. The managers now have to ensure that the investments they make will earn at least enough return to cover the interest expenses. The cost of not doing so is bankruptcy and the loss of such a job.

Debt and Discipline

- Assume that you buy into this argument that debt adds discipline to management. Which of the following types of companies will most benefit from debt adding this discipline?

a. Conservatively financed (very little debt), privately owned businesses
b. Conservatively financed, publicly traded companies, with stocks held by millions of investors, none of whom hold a large percent of the stock.
c. Conservatively financed, publicly traded companies, with an activist and primarily institutional holding.

Bankruptcy Cost

- The expected bankruptcy cost is a function of two variables--
  - the probability of bankruptcy, which will depend upon how uncertain you are about future cash flows
  - the cost of going bankrupt
    - direct costs: Legal and other Deadweight Costs
    - indirect costs: Costs arising because people perceive you to be in financial trouble
- *Proposition 2: Firms with more volatile earnings and cash flows will have higher probabilities of bankruptcy at any given level of debt and for any given level of earnings.*
- *Proposition 3: Other things being equal, the greater the indirect bankruptcy cost, the less debt the firm can afford to use for any given level of debt.*

Debt & Bankruptcy Cost

- Rank the following companies on the magnitude of bankruptcy costs from most to least, taking into account both explicit and implicit costs:

a. A Grocery Store
b. An Airplane Manufacturer
c. High Technology company

Agency Cost

- An agency cost arises whenever you hire someone else to do something for you. It arises because your interests(as the principal) may deviate from those of the person you hired (as the agent).
- When you lend money to a business, you are allowing the stockholders to use that money in the course of running that business. Stockholders interests are different from your interests, because
  - You (as lender) are interested in getting your money back
  - Stockholders are interested in maximizing their wealth
- In some cases, the clash of interests can lead to stockholders
  - Investing in riskier projects than you would want them to
  - Paying themselves large dividends when you would rather have them keep the cash in the business.
- *Proposition 4: Other things being equal, the greater the agency problems associated with lending to a firm, the less debt the firm can afford to use.*

Debt and Agency Costs

- Assume that you are a bank. Which of the following businesses would you perceive the greatest agency costs?

a. A Technology firm
b. A Large Regulated Electric Utility
c. A Real Estate Corporation

- Why?