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Out of Balance

The lamest business excuse of 2009: "We're a good company with a bad balance sheet."

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Some people think that the problem with America is that not enough people and institutions are failing. Lou Holtz, the former football coach turned ESPN analyst, indicated that this shortage of failure might impel him to run for Congress. "There are no winners and losers," he told the Wall Street Journal. "Everybody gets a trophy."

Don't worry, coach! There are plenty of losers in the business world. Chapter 11 bankruptcy filings rose 69 percent in the 12 months ended March 31, 2009, from the prior year. Through mid-July, according to Standard & Poor's, there were 130 corporate defaults in the United States, up sharply from 2008.

Businesses fail for lots of reasons: technological change, paradigm shifts, tough competitors, fraud, flawed strategy, and bad luck. In most instances, the failure can be attributed to the fact that the company had the wrong business plan for the climate in which it operated. But this year, there's a new excuse for failure. Companies are going under not out of any fault of their own, but because of a faceless force that everybody hates: finance. There are no bad businesses or managers. Just bad balance sheets.

After Creative Scrapbooking filed for bankruptcy late last year, company President Asha Morgan Moran told Minnesota Public Radio: "Our balance sheet had gotten out of wack. We have a very good business with a bad balance sheet." When clothing retailer Eddie Bauer filed for bankruptcy in June 2009, President and CEO Neil Fiske proclaimed that "Eddie Bauer is a good company with a great brand and a bad balance sheet." Of Six Flags, the long-struggling amusement park company, CreditSights analyst Christopher Snow said, "It is a good business with a bad balance sheet; what we have seen is that, surprisingly, they have held up relatively well given what is going on in the economy." The company filed for Chapter 11 in mid-June. EuroMoney magazine dubbed Premier Foods "the classic good business with a bad

balance sheet."

Part of this is typical CEO rah-rahness. Whether you've just been hired for a turnaround, or have been at the helm for two decades, or have just acquired a company out of bankruptcy, it's counterproductive for a CEO to announce that the company has foundered for a good reason, or that customers hate its products, or that the staff is third-rate.

But this balance-sheet excuse just doesn't hold water. The Minnesota Public Radio article about Creative Scrapbooking, whose business model revolves around the sale of materials for creative scrapbooking, notes that the employee-owned company spent lots of money buying back stock from employees who quit (to cash out) or who were laid off. And sales had been falling since 2004. Was this a "bad balance sheet"? Or poor human resources management and retailing?

Six Flags was saddled with debt before Daniel Snyder, the wunderkind owner of the Washington Redskins, acquired it. New management's efforts to clean up the parks and attract new sponsors were snuffed out by a high debt load. Six Flags may have been unsalvageable. But Snyder didn't take the necessary steps—injecting more capital, paying down debt more quickly—that would have given the turnaround strategy time to work.

Like Six Flags, clothing retailer Eddie Bauer was forced to file for bankruptcy because of unsustainable debts. In 2008, its quarterly interest bill amounted to about \$7 million, not a huge amount. But Eddie Bauer's retail operations weren't generating enough cash to pay its operating expenses and cover the debt. If you earn \$400,000 a year, it's easy to stay current on a \$500,000 mortgage. If you make only \$40,000, not so much.

The balance sheet can't be divorced from the underlying business. Any business plan has to take into account the ability of a company to service its debt, just as any household's budget plan has to take into account the ability to stay current on the mortgage. If the enterprise is managed in such a way that it falls behind on payments, perhaps there was something wrong with the way it was managed. Iceland sustained an admirable quality of life through the use of debt that it couldn't service. Is that a case of a good country with a bad balance sheet? Or of a poorly managed economy? Many builders overpaid for lots, borrowed money to build high-end homes with fancy finishes, and then

failed when buyers didn't materialize. Are they good builders with bad balance sheets? Or did they misread the market?

What's more, during the credit boom, there were plenty of occasions when the balance sheet was the business plan. When private-equity firms bought companies, they didn't always pursue returns by coming up with better long-term plans to make widgets, sell mattresses, or run hotels. No, they figured they could use the acquired company's balance sheet to engineer short-term gains by, for example, having the company issue bonds and pay its owners a big dividend. Many publicly held companies have used cash to buy back stock rather than to invest in new businesses or to save for a rainy day.

Balance sheets are tools, not people or forces of nature. And a good craftsman never blames his tools.

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