E Q U I T I E S

How Costly Is Financial (Not Economic) Distress?

October 1, 1998

This paper studies 31 highly leveraged transactions (HLTs) of the 1980s that subsequently became financially distressed. At the time of distress, all sample firms had positive operating margins and most of the margins were greater than the median for the industry.

Therefore, we consider these firms financially distressed, not economically distressed. The net effect of the HLT and financial distress is a slight increase in value — from pre-transaction to distress resolution, the sample firms experience a marginally positive change in (market- or industry-adjusted) value. This finding strongly suggests that, overall, the HLTs of the late 1980s succeeded in creating value. We also present quantitative and qualitative estimates of the direct and indirect costs of financial distress and their determinants. Our preferred estimates of the costs of financial distress are 10% of firm value. Our most conservative estimates do not exceed 23% of firm value.

Operating margins of the distressed firms increase immediately after the HLT, decline when the firms become distressed and while they are distressed, but then rebound after the distress is resolved.

Consistent with some costs of financial distress, we find evidence of unexpected cuts in capital expenditures, undesired asset sales and costly managerial delay in restructuring. To the extent they occur, the costs of financial distress that we identify are heavily concentrated in the period after the firms become distressed, but before they enter Chapter 11.

eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.