'Fire sales' preferable to corporate bailouts: economists

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Corporate bailouts impose severe costs on society and may be an overused way to handle companies on the brink of collapse, two economists argue in a new research paper, raising questions about the effectiveness of federal bailout funds in response to the COVID-19 pandemic.

In the paper, published in early December in the *Journal of Applied Corporate Finance*, authors Jean-Marie Meier, an assistant professor at the University of Texas at Dallas, and Henri Servaes, a professor at London Business School, suggested that it's better in many circumstances to allow companies to sell physical assets in a "fire sale" rather than use taxpayer dollars to prop them up.

Companies that buy the distressed assets, they found, actually end up benefiting in the long run; returns to buyers from fire sales were approximately two percentage points higher than returns from regular mergers and acquisitions. For the average buyer, this translates into a $29.7 million increase in market value above the increase experienced by acquirers in normal acquisitions.

For the purposes of the study, the researchers defined a transaction as a fire sale if the seller was in bankruptcy or liquidation at the time of the deal; or if they were undergoing private debt restructuring that imposed a loss on creditors.

Meier and Servaes used the Securities Data Company database to create a dataset of all completed acquisitions between 1982 and 2012, then removed transactions not involving U.S. companies or involving a private buyer. For acquisitions of entire companies, the buyer also had to own more than 50% of the firm after the sale and less than 50% prior to the sale, with a purchased stake of at least 50%. Finally, the researchers removed deals for which the transaction was less than 1% of the market value of the buyer.

In total, the sample used by Meier and Servaes included 21,850 acquisitions.

“Overall, our analysis considered a large number of stakeholders that could be negatively affected by fire sales, but finds little evidence of such negative effects,” the researchers wrote.

In addition, the costs to society of corporate asset fire sales, such as plant closings and job losses, appear “considerably lower” than previously thought, Meier and Servaes found — contrary to the findings of previous studies, the job losses from fire sales are no more than those from the bankruptcy and closure of a company.

“We are just saying fire sales are not as bad as generally thought because buyers’ gains cancel out a seller’s losses,” Meier said.

What the researchers said their findings do not prove is that fire sales lead to greater improvements in operating performance for buyers when compared to regular transactions, or that fire sales are more or less successful based on news reports about the transaction.

“The buyers are not able to operate these assets that they are buying any better than the original owner,” Meier said. “They also don’t seem to be able to operate them any worse, either. So, you know, it’s just in some sense business, maybe as usual, as good or as bad as before.”

When comparing government bailouts of companies to fire sales, though, Meier and Servaes said bailouts may actually be counterproductive in trying to protect the value of distressed companies and assets.

“Not only is there a direct cash injection financed by taxpayers, but bailouts also create moral hazard and can undermine trust in the political system if voters get the impression that ‘Wall Street’ gets a bailout, while ‘Main Street’ does not,” the researchers wrote.

Additionally, government bailouts are not always distributed fairly and can depend on the political connections of potential recipients, the researchers said, as seen last year when the speaker of the Ohio House of

Representatives was arrested on racketeering charges related to a $1.5 billion bailout of two nuclear plants.

“Finally, once bailout funds have been allocated, there may be some quid pro quo by the recipients in favor of the politicians who allocated the bailout funds in the first place,” the researchers wrote.

Bailouts may also incentivize risk, the researchers said. “After all,” they wrote, “if companies know they will be bailed out in the future, they may as well borrow more today, pay out the proceeds as dividends or use the funds to buy back their shares. The taxpayer stands by to pick up the pieces in case things fall apart.”

Still, Meier said, government bailouts are necessary in some cases, though policymakers need to ensure they’re not overindulging the private sector. For example, Warren Buffett, whose company Berkshire Hathaway is famous for making investments and doing well during economic downturns, said in May that he didn’t see anything attractive to invest in because of how many companies were supported by the federal government at the start of the COVID-19 pandemic.

“Obviously I think there was some need for bailouts, or at least emergency measures given the scale of the crisis,” Meier said. “But the very fact that one of the largest potential investors in struggling firms is actually increasing cash holdings instead of investing them is suggestive evidence that the bailouts are maybe a bit too large, because they really prevented private sector investment from happening."

Meier is currently working on additional research about bailouts that have occurred during the coronavirus pandemic, especially toward the beginning, analyzing how effective and efficient the government measures were.

The key takeaway, Meier said, is that tax rates are lower for bailed-out companies than for companies that were not bailed out. Additionally, he noted, the number of years it would take a bailed-out company to repay the government through tax payments would be 135 years on average.

"And I think that's something that's been missing in the general debate about bailouts," Meier said. "The bailouts are large because the crisis is large, I obviously get that. But the deficit that the U.S. government has been running in 2020 is unseen. … At some point, this debt has to be paid back."

The study "The Benefits of Buying Distressed Assets," published Dec. 9, 2020, in the Journal of Applied Corporate Finance, was authored by Jean-Marie Meier, University of Texas at Dallas; and Henri Servaes, London Business School, the Centre for Economic Policy Research and the European Corporate Governance Institute. It draws heavily on a paper previously published by the researchers in Review of Financial Studies in 2019.