Who Pays for Past Sins?

By Barry Blesser @2010
www.blesser.net

Looking at the financial aspects of the radio industry sheds insight on the behavior of its many stakeholders. For those of us who took a basic economics course years ago, we learned that it was a science based on rational assumptions with such concepts as elasticity, supply-demand ratio, and optimized self-interest. The assumptions, with supporting data, could easily be programmed into economic models that would predict the future of a business. Like engineering, models provide predictions. But are they valid?

Recently, the assumption of predictable rationality has been challenged by a group of behavioral economists, who make a compelling case that economic activities, like all human endeavors, is often or mostly irrational. In his New York Times bestseller, the author Dan Ariely writes about "Predictably Irrational." People do not make economic decision using rational assumptions; even the smartest and best trained professionals are emotionally biased by their unconscious cognitive framework. For example, holding a cup of hot coffer or a glass of cold soda influences the decisions that people make 10 minutes later. People are unaware of their unconscious biases and distortions.

Arleily's premise is directly relevant to the current mess in the radio industry. Part of the problem is that human beings tend to extrapolate from the present without realizing that their interpretation of "now" is not a good predictor for the future. Boom and bust cycles arise from our flawed view of the future. Evolution did not design our brains to handle time. Rather, we are designed to handle the opportunities and threats in the present using an often distorted sense of history.

To illustrate the role of the future in economic behavior, let's look at a simplified example of what is called leverage. Assume that an investor has $100 cash to buy a stock or business, and assume that such investments have historically been increasing in value by 10% per year. At the end of each year, the value of the investment has increased by an additional 10%. But what happens if that same investor can borrow $900 from a friendly bank (ignore interest), which allows him to purchase $1000 of stock. At the end of the first year, a 10% return on $1000 of stock produces $100 gain relative to the original $100 cash invested, or a 100% return. At the end of 8 years, the investment is worth $2100, or a $2000 gain on the initial $100 of invested cash, a 20-fold increase. This is the power of leverage: using borrowed money. However, if the investment goes south, the reverse dynamic takes place. If the investment value plummets to $900 in the first year, the investor's original $100 cash is wiped out. If it further decreases to $500, the investor is in debt with no means of salvaging the bad decision.

Leverage is always a two way street and the outcome depends on assumptions about the future. During the boom years of broadcast radio, everyone assumed a growth model, and everyone assumed that this growth would continue indefinitely albeit with temporary ups and downs. Most of the large radio networks were created with borrowed money (leverage) that was used to support mergers, acquisitions, and expanded facilities. The investment banking industry provided loans because they collected healthy fees. The same dynamic played out in other industries.

There is nothing intrinsically wrong with mergers and acquisition because large organizations can raise productivity with economies of scale. This process has been going on for centuries. However, when assumptions about the future prove to be incorrect, someone has to take the loss: stock owners find that their equity has been destroyed, or investment banks find that their loans have to be written-off. The same dynamic is playing out in real estate with homes that are worth less than their outstanding mortgage. The radio industry is now in the early stages of "who holds the hot potato?"

Most countries created bankruptcy laws to allow the courts to equitably distribute the pain of bad decisions among various stakeholders. When assets have less value than liabilities, the organization is at a financial dead end. But there are two types of dead ends. In the one case, the company must be liquidated because there is no way to restore a balance between income and expenses. For example, Polaroid simply disappeared because there would never again be a market for their instant cameras. In other cases, a company can be reorganized to become viable if past liabilities are written off, stock is made worthless, debt holders are forced to become stockholders, and life goes on for employees and customers.

United Airlines went bankrupt in 2002 but through reorganization, they are still flying passengers around the world. This financial dynamic is as old as recorded history. With the boom in railroad construction in the 19th century, holding companies went bankrupt at a regular rate. But the railroads continued to run since they provided a valuable service for transporting freight and passengers. Investors, especially the investment trusts in England, held the hot potato. Bankruptcy washed out the bank loans and investor equity but that did not stop railroads from functioning. Commercial radio stations may well be viability in the long term even with reduced advertising revenue as long as income still exceeds the cost of keeping the station on the air: namely, electricity and minimal labor cost.

What happens if a positive operational cash flow is not sufficient to also cover paying interest on loans and eventually to repay the principle? If nothing is done about continuing deficits, eventually liabilities exceed assets. Something has to give.

There are numerous examples of how this scenario is now playing out. Citadel Broadcasting Inc, which is the third largest broadcast company in the country, renegotiated its loan agreement

twice in the last year, and received a waiver on some of its loan covenants. Even though the company skipped a $2 million dollar payment on its loans, on 20 December, it was forced into a pre-negotiated restructuring (friendly Chapter 11 bankruptcy) that extinguished $1.4 billion of dept. Their massive debt rose dramatically when Citadel acquired Walt Disney's ABC stations in 2006. The agreements are also designed to provide sufficient cash to keep the stations on the air by paying employees to provide real services. The hot potato was cooked and served to the bankers and investors, who had no realistic choices.

Similarly, Emmis Communications Corp. amended its debt agreements twice this year, and Regent Communications Inc. fell into default. Clear Channel Communications is struggling with about $20 billion of debt following a leveraged buyout last year. Robin Flynn, senior analyst at SNL Kagan, commented that "In recent years, radio has suffered from a 'leverage hangover.' Back in 2002, equity [stock] made up, on average, 76% of total market capitalization. However, that flipped in 2008, with 73% of total capitalization representing debt obligations."

If bankruptcy would make the radio industry stable, even at a reduced financial level, why isn't that a good option for the major radio networks with unsupportable debt? The answer is that each stakeholder is in a very different position relative to the past sins. Investors and senior executives would find that their stock became worthless. Investment banks would be forced to write off bad loans and would become owners or radio assets without any knowledge about how to manage those properties. Investment banks and equity owners have therefore taken the only rational path (for them) that could lead to their salvation: squeeze expenses by reducing staff, equipment maintenance, and facilities. Regardless of the damage to the long term viability of radio, "burning the furniture to stay warm" becomes their preferred choice. Conversely, employees who provide valuable and substantive services to listeners would benefit if past financial sins were written off.

Like many others, I believe that commercial radio is, and will be, viable in the long term. But we cannot get to that point until the past sins are paid for by someone. In the mean time, try to protect yourself from the combat among the financial titans, avoiding being an innocent victim of the battle that arose from human foibles of the past two decades among those were in charge. I would not dare to predict who will eat the hot potato because I too have no ability to envision the future. But at least we can watch the show as a perverse kind of entertainment.