Zombie Companies' Growth and Expansion: Should This Be a Surprise?

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On June 7, 2024, Bernard Condon, an *Associated Press* reporter, authored the article, "*Zombies: Ranks of world's most debt-hobbled companies are soaring, and not all will survive*."

Condon's article details zombie companies (Zs) so laden with debt that they are on the brink of collapse, barely able to pay even the interest on their loans. They are, essentially, just one bad day away from going out of business. But should these recent events come as a surprise?

According to the dictionary, a zombie is a dead person brought back to life. That is the definition of a good restructuring. It is looking into the abyss, developing and executing a plan, and hoping never to be on the brink again.

For most Zs, what was once proper planning, vision and execution, gave way to failure. Look no farther than Rite Aid, Smile Direct Club, Toys "R" Us, and others. Also disturbing are the recent events involving Prospect Medical Holdings and Steward Health Care System, which are discussed below.

While most stakeholders and professionals refer to earnings before interest, taxes, depreciation, and amortization (EBITDA) as the ultimate yardstick, nothing could be farther from the truth. At some point, a company must generate cash flow. Rarely, if ever, does EBITDA produce this. Simply put: If a company spends more than it earns, its prospects for longevity are dismal.

Competent Leadership

Three of the most important traits Z companies' leadership seems to lack are vision, self–awareness and common sense. Interest rates the past decade have been at some of the lowest levels in our country's history. So, while Z companies piled on debt and investors continued to invest, did anybody think that rates would never increase? Or were they so concerned with short-term returns that they just didn't care?

Current federal funds rates are in the 3 to 4 percent range and prime rate is currently in the 8 to 9 percent range. While current interest rates are markedly higher than we have seen in recent memory, it doesn't come close to what we have seen in our lifetime. Again, prudent leaders with some sense of self-awareness should have planned for a rate increase—building up a cash reserve as a buffer, with the hope of never having to use it.

Zs Bring Opportunistic Buyers

During the financial crisis of 2008-2009, when banks shut down or significantly retrenched their lending positions and portfolios, a more limited market of potential "take-out aggressive, non-traditional players" emerged. In today's market, however, new million- or billion-dollar hedge/alternative investment funds appear to be popping up monthly, suggesting that markets are flush with cash. Prospective buyers are very sophisticated, and they won't throw good money after bad. But they will be very opportunistic, and at the right price, there is a robust market.

A Comparable Analogy

While listening to a sports program, one of the hosts commented on how complicated and sophisticated pro football offenses have become. The other host said, "What's so complicated? You throw a football; you catch a football. You hand the football to a person, and they run. Again, what's so complicated?" When thinking about Zs, at some point, the proverbial can cannot be kicked down the road. Take Silicon Valley Bank (SVB) as an example. Here is some more Monday morning quarterbacking:

- How often does a bank/lender not have a chief risk officer?
- One of the first things taught in accounting is to match the longevity of assets and liabilities. That is, buy short-term assets with short-term liabilities and long-term assets with long-term liabilities. Had stakeholders at SVB done this, the bank might still be around.
- Once SVB hit the wall, there was a willing (and likely better operated) buyer who was prepared to purchase it in a very short time frame.
- Going back to the AP article, at Bed, Bath & Beyond—arguably another Zombie company—the pay for the three top executives topped $140 million, according to Equilar. If this is true, this was irresponsible considering Bed, Bath & Beyond's stock price dropped from $80 to zero and thousands lost their jobs.
- Compare the leadership and collapse of these companies as well as Steward Health Care System, which has Massachusetts lawmakers pointing fingers at the hospital operator's landlord, and other companies like them with the likes of the late Steve Jobs and Apple, who, at their core, were not about short-term returns but innovation. How many companies have a CEO like Jobs who knows what the customer wanted before we as customers knew we wanted it?

What can be done in an environment where Z companies seem as prevalent as ever, ill prepared and have a huge debt burden staring them in the face?

- Attract stakeholders who are engaged for the right reasons. Hold executives accountable, and structure their compensation based on achieving performance metrics, goals and objectives. Their individual goals must be consistent and aligned with the organization's long-term goals. Have them clearly articulate their value proposition. Why should we hire you? How are you going to help us return to prosperity and achieve our goals?
- Develop detailed, granular projections, forecasts, and assumptions for two to three years. Granular projections hold feet to the fire and are the foundations for success. Success – financinal and otherwise – should not be measured based on the short term. To use another sports analogy…anybody can have one "career year." True success is based on longevity.
- Assess your product and customer profitability. If you follow the 80/20 rule, there might be room for a price increase and/or to terminate certain clients. Thinning the product line can reduce the breadth of inventory and cut costs.
- What is your organization's mission, that is, its reason to exist? This can be a brutally tough conversation to have but is probably long overdue. If the mission can't be stated honestly and succinctly, it may be time to wind down or sell.
- Identify a lender that truly understands your business, has industry expertise, and is curious. Ask them how they would manage your loan if you hit a bump in the road. Everybody wants to lend you money when you don't need it. How your partners manage situations when the company is not at its best is critical to success. We have two ears and one mouth because we should listen twice as much as we speak.

Sudden Thoughts and Second Thoughts

R & R (not rest and relaxation but restructure and refinance) will be the mantra for the next 18 months. How much life is left in these Z companies? Will their leaders step up, or will they step off a cliff? There is plenty of capital out there. The question remains: Is the bid and ask at the right price? Stay tuned when we update you later this year.

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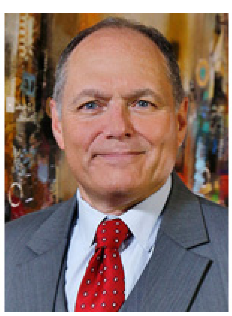

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