Leveraged blowouts: the new LBOs

by Chris White

If the latest casualty reports are anything to go on, then it won't be too long before the financial community's latest acronym, LBO, standing for leveraged buyout, is accorded a new meaning. Pretty soon, it now seems quite possible, we will all be hearing about the new LBOs, leveraged blowouts.

Two more such buyouts began to bite the dust on Sept. 7. They are Robert Campeau's debt-financed takeover of Federated Department Stores, and the biggest takeover of the century, Kohlberg Kravis Robert's buyout of RJR Nabisco. Sept. 7 was the deadline for Campeau to make a $400 million debt service payment to the financiers of what was, when it was concluded, a $6.6 billion takeover by the Montreal-based speculator of the U.S. department store group.

The deadline came and went, no payment was made. Kohlberg Kravis had bad news of a different sort. That company had planned to finance the purchase of RJR, the only takeover ever concluded for more than $20 billion, by selling off the corporation's assets. They completed negotiations for the sale of the Del Monte company's canned and frozen products lines. The price they were offered for the transaction was only half the level they had estimated when the giant deal was cobbled together at the end of 1988.

The problem both deals have run into is this: the cash-flow or revenue stream of the company taken over is not sufficient to generate the funds required to service the debt assumed during the course of the buyout. Campeau and Kohlberg Kravis now join the lengthening list of leveraged buyouts going bad. The first on the list, in the latest round, was the financial services company Integrated Resources, which defaulted on $990 million worth of debt last June. Deals such as the Beatrice Foods takeover, Merv Griffin's acquisition of Resorts International, and Eastern Airlines, are among the list of the buyouts that have gone, or are going, sour.

Overall, more than $1 trillion worth of indebtedness is tied up in the financing put together over especially the period since 1986, to pay for leveraged buyouts. The financing has been made up roughly of one part junk bonds (below investment-grade securities) and four parts other borrowing, whether it be in the form of bank lending, or in the form of funds raised from limited partnerships put together to finance the takeovers. As the quoted value of a company's stock has climbed above the book value of its assets, the buyout packages have been put together supposedly to find ways of turning the difference into that magic substance, cash. The beginning wave of defaults will at least help to clarify some of the associated illusions. After all, there really isn't, any longer, any connection between the market quotation of a company's shares, and what that company is actually worth. No more of a connection, that is, than there is between today's cash-money and actual wealth.

Twenty-five years ago, or so, there were still people around who understood that there is a difference between money and wealth. Not so any longer. The trillion dollars of debt attached to the last years' LBOs, is only one small part of the overall $20 trillion of combined instruments of indebtedness and speculation piled on top of the wealth-producing capacities of the economy. But along with off-balance sheet liabilities of the commercial banks, in excess of $3 trillion, and government-backed mortgage securities, it is one of the relatively small parts which could, over the next weeks, into the first part of October, quite easily bring down the whole. Twenty-five years ago it would probably have still been possible to find people, in positions of relative authority, who could explain why. No longer, for if there were such, what has been permitted to occur over the past 25 years, could not have happened.

An overall economic problem

In this sense the LBOs typify what has happened to the economy and financial system as a whole. Both are as bankrupt as is the corporation RJR Nabisco. The economy, as a productive enterprise, has been bankrupt since the period 1981-82, in the sense that it is no longer capable of physically producing the output required to maintain break-even levels of functioning. Import dependency, collapsing infrastructure, unemployment, and increasing outright poverty are among the symptoms of economic bankruptcy.

Financially, the system has been bankrupt since 1985-86, unable to generate the wealth which would permit debt and interest charges to be paid. In significant degree, the astounding growth in debt—from under $7 trillion in 1984, to over $20 trillion today—is the proof. The debt has grown, not because it is being paid, but because unpaid principal has been rolled over and added to the total, thereby increasing the total outstanding of interest-bearing claims.

Now, as the case of the LBOs demonstrates, a third area of bankruptcy is approaching, when financial bankruptcy turns into actual runs on the banks, starting with the liquidation of supposed assets to generate ready cash to pay debt. If the supposed assets cannot be liquidated, or, alternately, can be, but as Kohlberg Kravis just found out, at a fraction of their book value, then the debt instruments are not worth the paper they are printed on. Then the leveraged buyouts become leveraged blowouts, bringing down bank and other financial institutions' assets in multiples of five times and more the debt directly affected.

The whole mass could conceivably be rolled over again. But the collapsing buyouts are part of the chain of evidence that argues forcibly that such another rollover may well not be possible at all.

RJR Nabisco, for example, is among other things a manufacturing company, and produces a variety of processed foodstuffs, among them pineapples, crackers, cookies, and breakfast cereals, and products like tobacco and cigarettes. The sale of the products is supposed to provide the gross revenues out of which the company covers the costs incurred in maintaining plant and equipment, meeting variable costs and the wage bill, and financing overhead expenses incurred as marketing, advertising, and distribution, as well as research into new product lines, while meeting financial obligations such as debt service and interest payments, tax payments, and also generating a profit in the form of dividends for stockholders, or reinvestment.

When Kravis and his friends insisted that the company could take on an amount of debt requiring service payments in excess of its revenues, they were doing no more than has become the standard for the economy as a whole since 1982. This is what Donald Regan and Walter Wriston once used to call, "creative" or "innovative" financial methods. Twenty-five years ago such methods, no different than Ponzi-style salad oil swindles, would have landed their advocates and practitioners in jail as swindlers and frauds.

Twenty-five years ago, or so, there would have at least been company officials on the production side who would have blown the whistle if the company's financial obligations in the form of debt service and interest were threatening the capacity to produce the products which generated the wealth on which all else depends. Now it has become routine that debt is incurred such that debt service exceeds the company's capacity to generate revenue. Twenty-five years ago, or so, that would have been called "bankruptcy." Procedures would have been activated, under Chapter 11 of the federal bankruptcy code, to protect stockholders, creditors, and employees, by reorganizing the company onto a sound basis. Such a reorganization would, in those days, have begun by recognizing that the productive economic parts of the company were sound and to be salvaged, while the financial obligations could be put on the back burner to allow breathing space for recovery.

The Apollo approach

And, 25 years ago, or so, just as there would have been people at the corporate level who could think in those terms, so too, there would have been old codgers at the national level, remembering the lessons of the 1920s and 1930s, the legacy of Calvin Coolidge and Herbert Hoover, who would have thought of the national economy, if not the world economy, as a special sort of integrated corporation. Such people actually did put together President John Kennedy's Apollo Program, to pull the economy out of the recession it went into in 1957, revive the revenue base of the federal government, deal with the threat then posed by the Russians' earlier Sputnik breakthrough, and more important than any of the above, give the nation a mission and united sense of purpose for the period ahead. The people who did that certainly didn't have any problem with the relationship between money and wealth. The new wealth created by each dollar of federal investment in the Apollo Program brought an estimated return of $14 to the economy as a whole. The return was an increase in real wealth, not the kind of cash-money so-called "returns" that make today's speculators drool.

If such people had been around, the whole disgusting spectacle of the so-called Reagan Recovery would never have occurred. The bankruptcy of the economy would have been recognized before 1982 and remedial measures would have been taken. There was one old codger who did know what was going on, and said so. He also told the Reagan administration, back in 1982, what then ought to have been done, if the mess that has accumulated in the meantime was to be avoided. His name is Lyndon LaRouche, and he ended up in jail, precisely because his reorganization plans offended those who have insisted since 1967, that the methods associated with the Apollo Program were no longer relevant. The collapse of the LBOs shows that their day of reckoning is fast approaching.