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After deflationary shock, market turnaround belies financial collapse

by Steve Parsons

Although the markets were manipulated on Oct. 16 to prevent a repeat of the 500-point dive in the Dow Jones Industrials that occurred exactly two years ago, the financial crash that was supposedly averted after Oct. 13's 200-point drop, is on the contrary, in full swing.

The crash began one month ago, as *EIR* then reported. On Sept. 13, the retail empire of leveraged buyout (LBO) kingpin Robert Campeau failed to refinance a debt payment of $400 million, and two days later defaulted on its loans and junk bonds. This event triggered a collapse in the junk bond market, with dealers hard put to find buyers, and many bonds becoming little more than toilet paper.

The end of the junk bond boom meant the end of the speculative era of leveraged buyouts—the "creative financing" technique where exorbitant amounts of money are borrowed to merge and purchase corporations. These companies are then stripped of their assets, which are sold off for cash to repay the debt. The cash flow from what remains of normal operations is increasingly diverted for more debt payments, and the company cannot meet either its usual operating expenses or its debt obligations.

In the process, the assets of these debt-ridden firms have been valued at many times greater than their actual worth, and almost invariably have been the collateral for further loans for bigger ventures. The Campeau affair a month ago signaled that the game was now over. The bubble had burst, triggering a deflationary shock wave that is now reverberating throughout the financial system.

Reverse leverage

Within days, reverse leverage started unraveling the rest of the financial system. The collapse of junk bonds and LBOs began to hit the mutual funds market, at the same time that collapsing real estate prices were driving highly leveraged real estate ventures and partnerships into insolvency. All of this intersected falling sales in the retail sector of the economy, as the debt-strapped consumer has simply been reaching the limit on his ability to purchase goods.

It was only a matter of time—in fact four weeks—before the stock market was hit by the expanding shock wave. Contrary to the nonsense pouring forth from the "experts" on Wall Street and the idiot-savants in universities and the nation's capital, virtually *all* of the stock market's "recovery" since the 1987 crash has been driven by these LBOs bidding up the "value" of corporate stock. Such "value" was based on hot air speculation, not on any relationship to what these firms actually produced. Such "creative" techniques have destroyed the real wealth-producing value of the targeted companies.

Black Friday for junk. . .

It was the collapse of the United Airlines LBO deal that triggered the near-crash of the stock market on Friday, Oct. 13. When the UAL buyout group announced that it could not arrange $6.75 billion in financing for the deal, a stampede out of the market erupted, as panic set in over the collapse of LBOs and junk bonds. "There were so many difficulties in financing so many of these deals, and this appeared to be the best of the bunch," said one trader.

Several junk bond issues took big losses. One $500 million junk issue of Southland lost 25% of its value, even though it was not even traded. "Now," wrote the *Wall Street Journal,* "dozens of corporations . . . that are counting on at least $7 billion of scheduled new junk financings to keep their highly leveraged takeovers and buyouts afloat, may never get the money."

While the immediate collapse of the stock market was averted over the following week, the fortunes of LBOs and junk bonds have gone into an irrevocable tailspin—despite Wall Street's insistence that the market has stratified into "quality junk" and lesser junk. During the week of Oct. 9-16, major takeover stocks lost a significant percentage of their value, including: AMR (American Airlines), −26%; Ramada, −24%; UAL (United Air Lines), −21%; MGM/UA, −19%; US Air, −16%; and Delta Airlines, −13%.

. . .and the banking system

But the junk/LBO debacle is threatening far more than the stock market. At extreme risk is the weakened heart of the financial system, the banks and investment houses, as a terrified *New York Times* pointed out Oct 16:

"The turmoil in the junk bond market will almost certainly hurt the companies that have short term 'bridge loans' with Wall Street [investment] firms. The rates on these loans,

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which are used in buyouts or other recapitalizations, are almost 15%, or as much as 6 percentage points over the bond yield paid by a high-rated company. If the turmoil in the junk bond market continues, such companies, like Prime Computer and Grand Union," could find it almost impossible to replace these expensive loans with junk bonds.

"And if the companies must then pay higher-than-expected interest rates at a time when the economy may be slowing, some companies could default, leaving Wall Street firms like First Boston, Shearson Lehman Hutton, Salomon Brothers, and Merrill Lynch with non-performing loans."

That's exactly what has been happening over the last month, and emphatically so in the week after Friday the 13th. In fact, the big $1.1 billion junk bond offering for Grand Union could not generate enough interest, despite the traveling road show presentation by its investment banker, Salomon Brothers, which had scoured the country looking for investors. Salomon now holds $32 billion in Grand Union stock, and has made a $130 million short-term bridge loan to the company. If they can't market the junk, Salomon gets stuck with a bad loan, which they will then convert to even more equity in the company's increasingly worthless stock.

Like Salomon Brothers, Shearson Lehman Hutton is desperately trying to find investors to buy $150 million of junk issues of R.P. Scherer & Co. Shearson is now stuck owning 95% of the company's equity and also has a $116 million bridge loan to it, which could well go the way of the Salomon bridge loan. Prudential-Bache Capital Funding is in a similar bind with York International, having had to postpone a junk offering because of what it says is the "deteriorating" market. It too has both equity and short-term bridge loan overexposures, to the tune of $57 million and $180 million, respectively.

Another case is the investment firm of Kidder Peabody, which can't find any buyers for a mere $156 million of jund bonds of Ethan Allen & Co., a furniture dealer. Kidder also can't market issues of V Cable Inc., which were registered last spring and have not moved out of Kidder's vault since then.

As for new LBO purchases, Kohlberg & Co. has sent a letter to its limited partner investors on how its investment banker—none other than Drexel Burnham—has failed to come up with funds to finance Kohlberg's buyout last summer of Colorado Prime Corp. What this means is that the limited partners of Kohlberg must now finance that buyout by *themselves* coming up with a bridge loan to Colorado Prime! Kohlberg then told his partners that he hopes to be able to pay them back through a junk bond issue by the end of the year.

Other LBO-acquired firms are slipping deeper into irretrievable bankruptcy, as potential buyers vanish. On Oct. 17, Moody's lowered the credit rating of food-processing giant Beatrice, which has been seeking to borrow more money to meet $983 million in debt obligations coming due soon. Moody's said the proposed recapitalization may "limit the company's ability to realize its profit potential" and could squeeze "basic business operations."

Even worse, Integrated Resources, which defaulted on debt payments in June and helped trigger the junk bond crisis, has had yet another planned asset sale collapse. The company announced yesterday that a deal to sell its core financial businesses to an unidentified buyer had fallen through, and that its second-quarter losses would exceed the previously announced $600 million. Earlier, a $310 million deal with the Bronfman's Whitehall Financial Group fell through.

To top the insanity, mutual funds are also strung out on junk, with some even having borrowed money to buy them. As the junk bond market continues its slide, the mutual funds that use leverage to buy junk bonds could be forced to sell these and other bonds from their portfolios to raise the cash to pay back their borrowings. Shares of one such fund, the New America Fund, have declined 42.5% this year, while the value of its bond portfolio has declined 18%. The closed-end junk bond funds are down sharply this year, with the 13 funds falling an average of 19%.

Furthermore, as Reuters reports in the Oct. 17 issue of *Investor's Daily,* big banks may be losing the means to fund LBOs, due to problems with Third World debt and domestic real estate. Banks will be forced to cut back their lending, and leveraged takeovers may have to be cut back, analysts say.

"The wherewithal to finance leveraged buyouts is shrinking rather dramatically," said analyst George Salem at Prudential-Bache. "When the money center banks added to Third World loan-loss reserves, capital fell, which will result in banks originating fewer deals."

"The banking industry has reduced capital to lend," said Richard Bove at Dean Witter Reynolds. "In the last 10 days, about $3.5 billion has been cut from the banks' equity from reserve-adding. In theory, this cuts lending."

The pool of institutions which can fund such deals is shrinking. "Not only are the Japanese less enthusiastic buyers, but also U.S. regulators have told thrifts they can hold fewer junk bonds and fewer highly leveraged loans," said Norman Jaffe of Fox-Pitt Kelton.

"U.S. banks will have to increase their holdings of senior debt with the withdrawal of other players," said Salem. "Money center banks will be stuck with larger portions as deals are refinanced and other players wriggle out."

And there won't be much help from Europe. "I hope that Europe will be effective in insulating itself against American financial speculation," a former Swiss bank chairman told *EIR*. "But I also hope that stock market speculation in Europe becomes less. We need a return to more traditional banking instead. We have had enough of financial market liberalization. It had a certain role to play, but that role is now over."