Junk bond collapse triggers leveraged blowout of financial system

History will mark Friday, Sept. 15, as the day the U.S. financial system descended into a spiral of deflationary collapse. On that date, the Campeau Corp. finally defaulted on $450 million of interest payments due the investment house First Boston, and brought down the junk bond market.

The Campeau empire of retail stores had been built on a string of highly leveraged corporate acquisitions, in which enormous amounts of debt were contracted to finance the buyouts. One of the primary means of financing came from the issuance of what the media has dubbed "junk bonds"—below-investment-grade debt obligations that pay premium interest several points above market rates.

The linchpins of the acquisitions were two chains, the Allied and Federated Department Stores, purchased for a total of $10 billion in 1986 and 1988, and including such stellar names as Bloomingdale's, Abraham and Strauss, and Jordan Marsh. These stores, as well as Campeau itself, were saddled with so much debt, that neither the sales of assets, nor the cash flow and profits, were sufficient to service the payment obligations.

The result was the inevitable default that occurred on Sept. 15, a default that sealed the doom of the estimated $220 billion junk bond market. The devalued junk paper is now bringing down to its own level the face value of all interest-bearing paper, and highlights what happens when money is used, through usurious debt, to strangle mankind's capacity to ensure his own survival.

The junk disease's reversed leverage

As with the stock market collapse in October 1987, the unraveling of the junk bond market took the form of a panicked effort to dump that kind of paper, based on the fear that other victims of buyouts would rapidly go the way of Campeau. Set into motion was a deflationary collapse of a significant portion of the approximately $20 trillion worth of claims of debt and instruments of financial speculation accumulated against the U.S. economy, in particular, during the course of the so-called Reagan Recovery of 1982-89. That spiral is plunging us into the century's worst economic depression.

The end of the junk bond boom meant the end of the speculative era of leveraged buyouts (LBOs)—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 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 can meet neither its usual operating expenses nor 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. Throughout the so-called Great Recovery, and especially since 1987, this has fueled, and has reciprocally been fueled by, the continual upward motion of the Dow Jones index, promising vast rewards if new, higher stock values could be cashed in on by selling off companies with lower book values than their stock or other assets.

This has contaminated all financial values. With the collapse of the market in junk debt, all other paper outstanding has effectively been collapsed to the discount already reached in the junk markets. Rather quickly, the deflationary shock wave triggered by the Campeau affair began reverberating throughout the financial system.

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 had 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.

Black Friday the 13th

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. The Dow Jones nosedived 190 points in under two hours, 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, for example, lost 25% of its value, even though it was not even traded. Billions of dollars of unsold bonds piled up in the vaults of investment banks that were forced to swallow them, with billions of dollars more in junk unable to be issued.

A stock market crash was averted only through frantic and concerted efforts over that weekend to rig the New York and Chicago exchanges. Strongarming from banking and exchange officials, and from federal authorities, including the FBI, plus emergency cash infusions from the Federal Reserve and money center banks, all combined to force traders to bid stock and futures prices back up nearly to previous inflated levels.

While such tactics have managed to forestall an immediate collapse of the stock market, 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. Financing for mergers and acquisitions is harder and harder to come by, and new junk issues have sharply contracted. More and more leveraged buyout companies are facing insolvency through escalating losses, led by such stars as Resorts International, which has already filed for bankruptcy, Integrated Resources, and Campeau itself, which is on the verge of liquidating its stores at bargain-basement prices.

Rather than accept the irrevocable devaluation of their speculative paper, the Wall Street Olympians are pouring gasoline onto the fire. Since Oct. 13, for example, corporate officers, directors, and primary shareholders have increasingly been kiting their own companies' stocks, in a throwback to the pre-crash days of 1929. In the 12 trading days following the 190-point drop on Oct. 13, the number of such insiders buying their own company stocks tripled. Not surprisingly, stock prices have gone up. But this time, insiders have been unable to unload these stocks—because if they move to "take profits" and sell the stocks, the fragile market could go into a tailspin again.

How the banking system is affected

The junk bond/LBO debacle is threatening far more than these paper values. At extreme risk is the weakened heart of the financial system, the banks and investment houses, and their biggest financial underpinning: the real estate market. The financing for the takeovers and deals represented by the LBOs has been extended by the major banks. Generally, for each such takeover, the ratio is in the range of one part junk bonds to four parts other debt. Bank direct lending now accounts for two of the four parts, and indirect lending, through intermediaries such as specially formed limited partnerships, for the rest.

For each dollar of junk debt that collapses, at least four dollars' worth of associated financing comes down too. This is minimally $1 trillion, given the $200+ billion junk bond market. This is about the same magnitude as the amount of stock that was liquidated during the Oct. 19, 1987 panic.

Paine Webber estimates the exposure of banks that have committed more than $1 billion to junk bond financing at about $40 billion. Other estimates, like that of *Financial Times* columnist Anatole Kaletsky, put the exposure at approximately $150 billion. On the low estimate, all banks with more than $1 billion of loans, with the possible exception of Citicorp, NCNB, PNC Financial, and J.P. Morgan, face losses in excess of their paid-in equity from the collapse of the junk bond market, and the collapse of the non-junk paper associated with that paper. On the higher figure, all, with the possible exception of J.P. Morgan, face such losses. Among them are Manufacturers Hanover (bankrupt five times over), Mellon Bank, Bankers Trust, Wells Fargo, Bank of Boston, Chase Manhattan, and Bank of America (bankrupt twice over), First Chicago, Chemical Bank, and Security Pacific (bankrupt once).

The financial pundits say, don't worry. After all, LBO exposure is only about 15% of the total new bank lending of $1 trillion since 1979, and only about 7% relative to all bank lending. Bankers Trust reports that if it has to give up buyout lending it would lose the source of 30% of its earnings over the last years. Bankers Trust does not report what would happen if it had to write off its LBO debt, or face the cost of the devaluation of the paper.

The junk bond market is primarily handled by the large investment houses, among them Drexel Burnham, CS First Boston, Merrill Lynch, Morgan Stanley, and Goldman Sachs. These houses have been left holding not only the devalued paper from the September panic; they are also stuck with billions of dollars in unpayable "bridge loans" which they extended as supposedly interim financing until junk bonds were sold! On top of that, the decline in volume of mergers and acquisitions, and of LBOs and junk bonds, threaten to drastically curtail the lucrative fees that have comprised an increasingly critical margin of income for these houses.

The big blowout: real estate

But the biggest deflationary blowout of all is occurring in the real estate market, with the commercial property sector alone estimated to be at least 100 times the size of the junk bond market. During the 1980s, the rising paper value of U.S. real estate was the bedrock of the vaunted Reagan recovery, and the primary collateral for the myriad "creative financing" innovations. Nominal property values soared, with median home prices, as well as those of commercial properties, doubling and tripling in most parts of the country.

In the last two years, however, real estate markets throughout the nation have softened; and this year, prices began to fall, at a pace which in many areas is precipitous. Most realtors blame this on overbuilding and speculative "demand-push." Half-heartedly, they maintain that things will eventually turn around as they always have. But real estate and construction downturns in the recent past have primarily been caused by credit crunches. The current downturn is due to the fact that prices and rents are outstripping the ability of debt-ridden consumers and businesses to pay.

The speculative real estate boom in the 1980s was fueled by tax breaks engineered to keep going the 1970s inflation in property values. In 1981, the Economic Recovery Tax Act enabled every speculator, from wealthy investors to banks to fly-by-night land syndicates, to buy into real estate and deduct $4 for every $1 invested, while capital gains taxes were lowered.

The deregulated S&Ls jumped onto the magic real estate carpet, as did the usually more conservative insurance companies and pension funds. Commercial properties in particular were overbuilt; investors paid attention to the tax breaks and price run-ups, with little regard to future income generation of the properties.

From 1980 to 1985, the amount of money put into real estate limited partnerships, to cite just one type of investment operation, increased sixfold, from about $2 billion in 1980 to $12.7 billion in 1985. But for the last year or so, vacancy rates are way up, rents are down, and the bottom is dropping out.

Standard and Poor's Rating Group says that a whopping 40-60% of these partnerships are in trouble. The only reason that these syndicates and their properties haven't completely blown yet is that the general partners of such ventures—those who proposed and managed them—have been paying expenses out of their own pockets, hoping for a turnaround. Now, they are nearly out of money.

Over the edge

On Sept. 1, the Dallas-based Lomas Financial Corp., which until last spring had been the largest mortgage banker in the United States, defaulted on $145 million in notes, immediately triggering a cross-default on $1.45 billion of senior debt. Lomas finally filed for bankruptcy on Sept. 25, suspending indefinitely payments on $2.1 billion in debt held by 47 unsecured lenders, led by Chase Manhattan and the Bank of New York.

The Lomas debacle coincided with three major New York banks writing off $4 billion in bad Third World debt. Lomas's chief creditor, Chase Manhattan, already battered by Texas real estate losses, is starting to write off non-performing Arizona real estate investments.

Until the end of this year, conventional wisdom held that the real estate collapse in Texas and other Sun Belt states was the "isolated" exception caused by regional factors, like the sharp fall in oil prices or bad investment decisions; other areas with soft markets were also "isolated" exceptions. Now, all that remains is for the hot air to blow away the pile of paper debt and overvalued property titles. But as of year end, most banks and mortgage companies, trying to delay the inevitable, have written off only the tiniest percentage of the bad real estate debt that is about to drown their books in red ink.

The bellwether home real estate market in metropolitan New York is indicative of what lies ahead in 1990. From 1982 to 1988, the market went through a stupendous speculative price surge. The median sales price increased 160%, from $70,500 to $183,500. A two-bedroom Manhattan condominium has gone from $220,200 to $476,000. Now, this housing is beyond the reach of even yuppies, let alone most families. On Long Island, homes listed for sale are up 30% over last year, while actual sales are down 15%. Sellers throughout the region are already taking 10-20% cuts in their prices. "The New York area is simply tapped out in terms of income and buying power," said one regional economist.

A recent study by Lomas and Nettleton showed that homebuilding in each of the past 11 quarters has been lower than in the same quarter of the preceding year, with the decline in the second quarter of this year occurring despite lower mortgage rates.

One of the most ominous signs for commercial real estate is that leveraged purchases of New York City office buildings are blowing out. One firm, Broadway Management Co., has lost control of about a dozen properties because it is unable to meet debt payments, because vacancies are rising and property values falling. Broadway is one of a number of highly leveraged companies that bought everything in sight at a time when prices were soaring, and are now getting hit with huge debt payments amid falling cash flow.

All of this sets the stage for what could be the next deflationary shock: the collapse of the $400-500 billion market in mortgage-backed securities, dominated by banks like Citicorp and investment houses like Salomon Brothers. The Federal Housing Administration, Federal National Mortgage Association, and Federal Home Loan Mortgage Association, the agencies which in theory guarantee mortgages and mortgage-backed securities, have nowhere near the assets to handle the real estate crisis, even on paper. As an example, on Sept. 27, the General Accounting Office told Congress that the Federal Housing Administration insurance fund lost a record $4.2 billion in 1988. When the real estate tidal wave hits, the federal insurance programs will be instantly swept away.

The Wall Street junkies are both financially unable and politically unwilling to take the hit of a half-trillion dollar real estate blowout. As usual, they will do all they can to make sure that the average American taxpayer, rather than Wall Street, gets stuck with the bill.