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Junk is hazardous to our health

Alarming signs exist that we could be hit with 1920s-style defaults in the woolly-bully "junk bond" markets.

On July 11, a group of international financiers led by Britain's Jacob Rothschild and Sir James Goldsmith launched a hostile takeover bid of Britain's elite BAT Industries, for an eye-popping $21 billion. It was the second-largest hostile takeover bid in history, coming some eight months after the record $25 billion takeover of RJR Nabisco in the United States.

Behind both events is a little-understood phenomenon of our superheated financial world: high-risk securities, or, as they are more accurately dubbed, "junk bonds." The BAT bid was the first attempt to take over a British company using junk bonds.

Junk bonds were not invented by Ivan Boesky or his Beverly Hills chum Michael Milken at Drexel Burnham Lambert. The last boom in high-risk corporate bonds was during the Roaring Twenties, just before the October 1929 crash. Alarming today is the fact that now, more than 20 months after the October 1987 stock market crash, highly speculative junk bond ventures are assuming a size comparable to the entire GNP of many medium-sized nations. What's the risk?

First, the term "junk" implies a high risk. When a first like KKR, a Jimmy Goldsmith, or another raider makes a bid for a huge rival, they are allowed by U.S. authorities to do it almost entirely on borrowed money.

A typical leveraged buy-out (LBO) hostile takeover is 90% from borrowed money. This means some Boone Pickens or Ivan Boesky who has the backing of big money, can take over and literally rip apart any company in the country. The victim company then assumes this awesome debt on top of its previous liabilities. The takeover bidder issues new bonds, "junk," at very high interest from the new company, in order to pay off his bank creditors.

Usually the victim corporation is "asset-stripped" to raise further capital, with severe manpower cuts made to cut costs. No new net productive investment is involved; it's pure speculation in paper assets changing hands. Wall Street investment banks such as Salomon Brothers, Goldman Sachs, or Merrill Lynch earn such huge advisory fees from the game, that they dare not stop the debt casino.

Most junk offerings include a revealing disclaimer: In effect, if the borrower defaults or goes bust, the holder of the bonds loses all, with no bankruptcy claim—it's unsecured paper. No one dares predict what could happen if the U.S. economy spins into even a "mild recession" with reduced consumer spending, and one big buyout collapses, such as Campeau Corp., a huge department store chain, or even RJR Nabisco. Everyone is trying to look the other way and pray it doesn't. But there are signs it will.

On the day of the $21 billion BAT bid, the bond rating agency Moody's warned that the high level of "special situations" such as debt-financed mergers and leveraged buy-outs is responsible for their downrating of 124 U.S. companies since January. The Federal Reserve estimates that since 1984, some $900 billion of corporate debt has been added to U.S. corporations in such takeovers.

Already in December 1987, a study by the Congressional Research Service warned about the move into lower-quality debt used in LBOs, and the inflated prices paid for LBO companies, as well as the growing trend for Wall Street investment banks to put their own money into LBO deals. The study warned that "the composition of debt outstanding [of U.S. companies] has shifted markedly towards short-term borrowing—mainly in form of floating rate financing."

Under U.S. tax laws, "debt" is more profitable than stock equity for companies, since the former is tax deductible. In a January study of the problem, Goldman Sachs admitted that "the increase in debt use by corporations over the last six years has been phenomenal." And 43% of this debt is short-term.

The Paris-based Organization for Economic Cooperation and Development also sounded the alarm in its annual *Economic Outlook* published in June. It reports that for U.S. corporations—unlike those in Japan, Germany, or France—"a considerable part of the sharp growth in debt has involved LBOs which increase a company's debt servicing obligations without expanding its capacity to produce through new investment. . . . Financial markets are becoming highly integrated, so that stability in one segment may depend increasingly on stability elsewhere."

A senior City of London financial insider told me that this is one of the principal concerns of the Federal Reserve right now. And well it should be: On July 17, Merrill Lynch released a study of junk bond performance showing that interest rates on junk bonds compared with government Treasury bonds was the highest since the 1982 "recession." That is a flashing red light for investors to dump.

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