IN THESE TIMES

By John B. Judis
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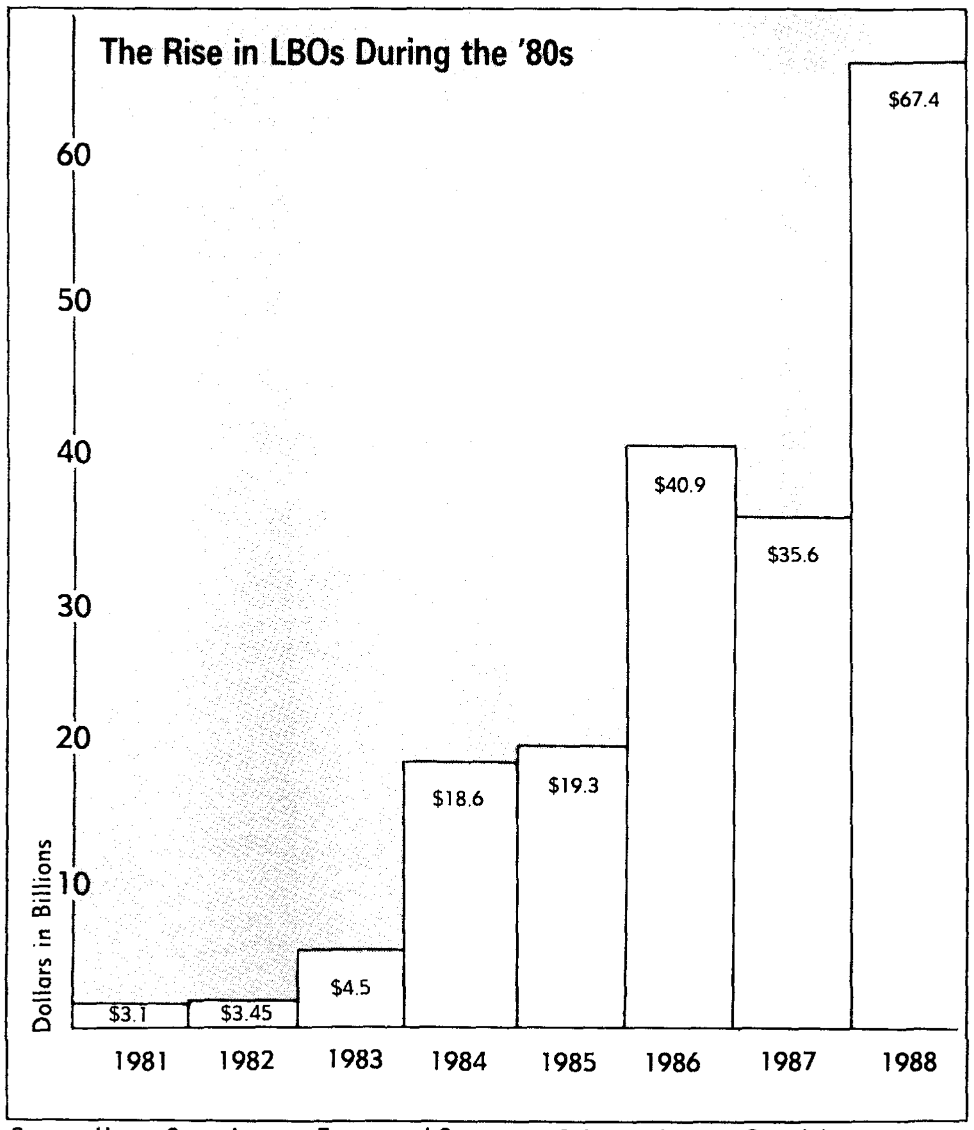
Manic rush of LBO debt threatens world depression



Source: House Committee on Energy and Commerce, Subcommittee on Oversight and Investigation.

The similarities between the economy of the '20s and the economy today are increasingly more striking. Both periods suffered from a breakdown of the open trading system, a shaky international monetary system, intractable international debt (German then, Third World now) and rising internal debt. Most important of all, Americans suffered in both periods from a surface prosperity that encouraged complacency about the economy's underlying ills.

Several important bankers and economists have tried to puncture this complacency. One of the latest is Carolyn Kay Brancato, chief economist at the New York law firm of Weil, Gotshal & Manges. In a report written for the House Committee on Energy and Commerce, Brancato warns that the rapid increase in leveraged buyouts (LBOs) threatens to create an intolerable debt burden on individual firms and on the economy as a whole. An avalanche of loan defaults by LBO-financed firms has lent Brancato's report added weight.

Corporations as commodities: LBOs have been occurring for more than three decades. In a typical LBO, the management of a publicly held firm, with the help of an investment banking firm, raises the money to buy its own firm from the public. To raise the money, they use the company itself as collateral. The firm then becomes private. The purpose of many LBOs has been simply to wrest control of a company from a stockholder or group of stockholders. That's still a prime motive in LBOs, especially as managers try to fend off corporate raiders. But in the last decade a couple of new wrinkles were added.

In a 1982 LBO involving the Gibson greeting card company, former Treasury Secretary William Simon showed that investment bankers and managers can make a killing with LBOs. Simon's Wesray Capital, acting with Gibson's management, bought the firm from RCA for $80 million. When Wesray and Gibson's management took the firm public again a year and a half later, its value had climbed to $290 million—the result of a bull stock market and an initially undervalued company. In stock and fees, Simon alone made $66 million on an investment of $330,000.

Simon showed that managers and investment bankers could make big money buying firms and then selling them back to the public. As investment bankers rushed to follow Simon's example, corporations became commodities. "In the eyes of financial institutions," Frederic Dannen wrote in the banking publication *Institutional Investor*, "a large cross section of corporate America [became] a collection of properties to be bought and sold and flipped like high-rises, office buildings and shopping malls."

The investment firm of Drexel Burnham Lambert added the other ingredient to the LBO boom. Before the '80s, investors who wanted to take a firm private had to satisfy finicky commercial bank officials. But Drexel Burnham showed that investors could circumvent commercial banks by raising money through riskier high-interest bonds called "junk bonds." In 1982 Brancato reports, only 3 percent of LBOs were financed through junk bonds; in 1988, 43 percent were.

Investment bankers had a special incentive to encourage the use of junk bonds. They received much higher fees from peddling the riskier paper. In 1988, for instance, investment bankers received fees of $914.8 million from 158 junk bond deals, while receiving $489.2 million for selling 789 investment-grade bonds. LBOs and junk bonds created an entirely new group of Wall Street super-millionaires, such as Drexel Burnham's Michael Milken and the three founding partners of Kravis, Kohlberg and Roberts (KKR), all of whom are now worth more than $300 million.

Leveraged buyouts encourage short-term thinking at the expense of the long term.

The example of these investment bankers has whipped up enthusiasm for LBOs. From 1981 through 1984, the total value of LBOs was $11.1 billion. From 1984 to the end of 1988, it was $181.9 billion, climaxed by KKR's $25.3 billion buyout of RJR-Nabisco in October 1988.

Defaulting on loans: LBOs work by swapping debt for stock ownership—a practice rewarded by the tax system, which allows debtors to deduct interest payments. In the pre-1980 LBOs, these swaps did not necessarily create large debts, but in the '80s, as investment firms and management groups compete with each other and with corporate raiders to buy out stockholders, the price of LBOs has wildly escalated. In the spring of 1987, when raider Asher Edelman tried to buy Burlington Industries, its stock was selling for as low as $44.25 a share. By the time Morgan Stanley outbid Edelman, the stock sold for $78 a share.

As the price has risen, the debt carried by individual firms has risen accordingly. Even after Burlington, in an attempt to pay off its debt, sold off 11 of its most successful plants and subsidiaries, its debt was 96 percent of its sales. A minor slump in sales could plunge Burlington into default. At U.S. Gypsum, interest payments absorbed 23 percent of pre-tax earnings in 1987. The next year, after an LBO, interest payments took 90 percent of U.S. Gypsum's earnings.

As debt payments have risen, managers' and bankers' strategies have also changed. In the Gibson case, Simon relied on a shrewd assessment of Gibson's assets and an optimistic projection of the market. Now, investment bankers, like corporate raiders, assume that a company's parts are worth more than the whole. They pay debts by selling off firms' most profitable assets and drastically cutting costs. But as LBO prices have skyrocketed, the investment bankers have been increasingly proven wrong.

According to an August 21 *Washington Post* report, 26 major corporations operating under LBOs are threatening to default on their loans. Recently, several major LBO companies, including Fruehauf, the nation's largest producer of truck trailers, and Revco, formerly the nation's largest drug store chain, have gone bankrupt. According to a Sept. 11 *Business Week* cover story, there has been a record $4 billion in bond defaults and debt moratoriums so far this year.

Mountain of debt: LBOs still have their defenders. Harvard Business School's Michael Jensen argues that by raising debt levels, LBOs force managers to become more efficient and to cut unnecessary costs. Investment banking firm Clayton and Dubilier contends that by removing stockholder pressures, LBOs permit managers to focus on a company's long-term rather than short-term prospects. But these arguments are ludicrous. As Brancato notes, there have been successful LBOs where the company has emerged far stronger, but these have mostly involved smaller companies and have occurred before 1984. The current billion-dollar LBOs have few redeeming features.

Today's LBOs encourage short-term thinking and discourage long-term planning. Managers have to focus on keeping cash flow high enough to pay monthly interest payments. They can forgo dividends on stock but can't stop paying interest without defaulting on their loans. LBOs also have led companies to slash capital spending and to reduce expenditures for research and development. This winter, the U.S. National Science Foundation released a study of 200 companies that account for 90 percent of industrial R&D spending. The 24 that were involved in mergers or LBOs suffered a combined 5.3 percent decline in R&D spending between 1986 and 1987, while the other companies enjoyed a 5.4 percent increase.

Most dangerous of all, the LBOs have created a mountain of debt that could easily come tumbling down and turn a mild recession into a depression. In the '80s, the debts of non-financial corporations have skyrocketed, largely because of LBOs. In 1955, for instance, corporations used 13.5 percent of their internal funds for debt service; by 1988, they were using 65.1 percent. In 1983, the debt of non-financial corporations amounted to 32 percent of GNP; by 1988, it had climbed to 42 percent. The debt is also of poor quality, more short- than long-term, and more heavily weighted toward junk bonds.

Bringing down the banks: LBOs also threaten the stability of commercial banks. According to William Seidman, head of the U.S. Federal Deposit Insurance Corporation, LBO lending accounts for more than 50 percent of the loan activity of the 10 largest multinational banks.

Investment consultant Henry Kaufman, former executive director of Salomon Bros., warns that this structure could crumble during a recession. In congressional testimony last February Kaufman said: "What is important to bear in mind is that this decapitalization of so much of American industry has come into vogue under relatively benign economic conditions. The weakened financial structure of many corporations has not been tested during a business contraction. When it comes, there will not be the swollen sales, revenues and corporate income readily available to serve a bloated mass of debt that there is today."

Five years ago financial experts warned that loan defaults by a major Third World country could precipitate an international collapse. The danger remains. But now the threat of corporate defaults by LBOs has become an equally ominous threat to American, and by extension, international economic stability. □

IN SHORT

By Joel Bleifuss

The continuing threat

Following a U.S. Army initiative, the State Department, the Defense Department, the CIA and other federal agencies have spent the past year in a semantic imbroglio. The Army is trying to redefine "assassination" so that it will both satisfy all federal agencies and conform to Gerald Ford's 1976 presidential order banning assassination. This spring *Defense Week*, a publication of the military-industrial complex, reported that the Army's main lawyer, Maj. Gen. Hugh Overholt, released an eight-page internal report that searches for a way the U.S. can eliminate "terrorists" yet not violate federal law. Overholt writes: "The employment of military force against a terrorist or terrorist organization to protect U.S. citizens or the national security of the U.S. is a legitimate exercise of the international legal right of self-defense and does not constitute assassination." He argues that because terrorists "pose a continuing threat," any U.S. attack on such terrorists would actually be an act of "self-defense." Overholt's proposal is similar to that of former CIA General Counsel Stanley Sporkin's 1982 opinion that the "neutralization" of terrorists was not assassination but, rather, a "pre-emptive defensive action." ("In Short," July 5.) As Army spokesman Lt. Col. Richard Bridges explained to the *Washington Post*'s Norman Black: "There is nothing classified about this effort.... This is an attempt to define what is an assassination and what is prohibited and what is not.... If we're going after terrorists as a matter of self-defense, that is not assassination but the proper employment of military force." Of course, no one has bothered to define "terrorist," and it must be supposed that will be part of the charm of the new definition of "assassination."

Narco-terrorists

The Intelligence Newsletter, a Paris-based weekly, reports that it has learned from a congressional source that the National Security Council is "drafting a directive to broaden the war on drugs and to explicitly include assassination of foreign drug lords." Could assassination be one of the jobs for the CIA's recently created Counter Narcotics Center? CIA spokesman William Devine says the center's "mission is to more effectively use intelligence to help form the policy required to address the security problems raised by narcotics. It will lend analytical and operational support to the effort against international narcotics trafficking."

Drug war *uber alles*

Time magazine reports that drug czar William Bennett has considered decapitating convicted drug dealers. "There is no moral problem there," he said. "I used to teach ethics—trust me." It has yet to be discovered whether the domestic drug lords—what the administration calls the "drug kingpins"—will become targets for assassination. One thing is known—Bush is ready for war. What follows are the relevant highlights of last week's drug speech: "Turn on the evening news or pick up the morning paper and you'll see what some Americans know just by stepping out their front door: Our most serious problem today is cocaine, and in particular, crack.... We need more prisons, more jails, more courts, more prosecutors.... We will help any government that wants our help. When requested, we will for the first time make available the appropriate resources of America's armed forces.... And for drug kingpins, the death penalty.... Every school, college and university—and every workplace—must adopt tough but fair policies about drug use by students and employees. Those that will not adopt such policies will not get federal funds. Period.... The private sector has a role to play [by working with advertisers and media firms to generate] a million dollars worth of airtime every day for the next three years—a billion dollars total. Think of it, a billion dollars of television time, all to promote the anti-drug message. As president, one of my first missions is to keep the national focus on our offensive against drugs.... These are the most important elements in our strategy to fight drugs. They are all designed to reinforce one another, to mesh into a powerful whole, to mount an aggressive attack on the problem from every angle.... If we fight this war as a divided nation, then the war is lost. But if we face this evil as a nation united, this will be nothing but a handful of useless chemicals. Victory, victory over drugs is our cause, a just cause, and with your help, we are going to win."

Family portrait: An angry resident of the Bensonhurst section of Brooklyn confronts photographer David Vita. Vita was trying to take a picture of the man's wife and daughter who are heckling demonstrators protesting the murder of black youth Yusuf Hawkins. Moments later the man attacked.

Summer in Guatemala: the untold story

If somebody had decided to mark the 10th anniversary of the Nicaraguan revolution by blowing up the offices of *La Prensa*, denunciations of the Sandinistas' violent denial of free expression would have saturated the U.S. press. Instead, it was a television station in Guatemala that was attacked for broadcasting news of neighboring Nicaragua's revolutionary celebrations, and the mainstream media here remained silent.

Televisiete Channel-7 had ignored numerous threats not to report on the anniversary, and on July 19 the station covered the celebrations and broadcast an interview with Nicaraguan President Daniel Ortega. That night its transmission tower, located 16 miles outside Guatemala City, was blown up and Roberto Perez Paniagua, a 62-year-old nightwatchman, was shot dead. The Associated Press put the story on the wire, where it languished, its news value apparently considered of no consequence by the foreign editors of the major U.S. newspapers.

The studied neglect of violence in Guatemala has been standard procedure since the election in 1986 of President Vinicio Cerezo, a man regularly portrayed by the U.S. press and politicians as courageously leading his country along a path to democratization. This image was enhanced by the attempted coup of May 9, and, having survived the plot, Cerezo has also avoided any U.S. criticism of the human rights situation in Guatemala, which has reached a new level of horror since May. Americas Watch reports that the attempted coup resulted in a "strengthening of those sectors in the army least disposed to allow a modicum of respect for human rights."

For example, on May 24 a company of 100 soldiers terrorized the town of Santa Maria Caba. The military destroyed houses and crops and abducted four people, including five-year-old Pedro Santiago. Eight-year-old Manuel Cobo was shot and killed. According to the Council on Hemispheric Affairs, the number of disappearances and extrajudicial killings since May 9 surpasses last year's total and "will at this rate exceed by the end of the year the combined number of well-documented political killings in the past three years."

Cerezo dismissed the increased killings as "a wave of common violence and criminality" and, with the help of the U.S. government, cossets the military with improved means of destruction. On June 23 Cerezo agreed to buy two military transport planes from an Italian company at a cost of $42 million. A week later the United States sent the Guatemalan army 32 military trucks worth $650,000. And on July 19 the U.S. House of Representatives passed a Foreign Authorization Bill that includes a $9 million military aid package for 1990.

Guatemalan labor leader and opposition representative at the U.N. and the Organization of American States Frank LaRue says the attempted coup in May "was successful in forcing concessions out of Cerezo." But this is not unusual. An old joke in Guatemala is that the only "democracy" there is exercised through military coups. —Rich McKerrow

Workplace democracy

BOSTON–It took a tough 17 years of organizing for the Harvard Union of Clerical and Technical Workers (HUCTW) to win a contract. But it has been worth the wait: not only is the union's first contract good for the Harvard workers, it is an example of new approaches that organizers of the pink-collar workforce can adopt.

Going further than past power-sharing plans, the pact establishes worker-management councils that will have real power in addressing workplace issues.

Worker-management committees will be set up in all university departments. The committees will examine issues such as changes in work process, building renovations, affirma-