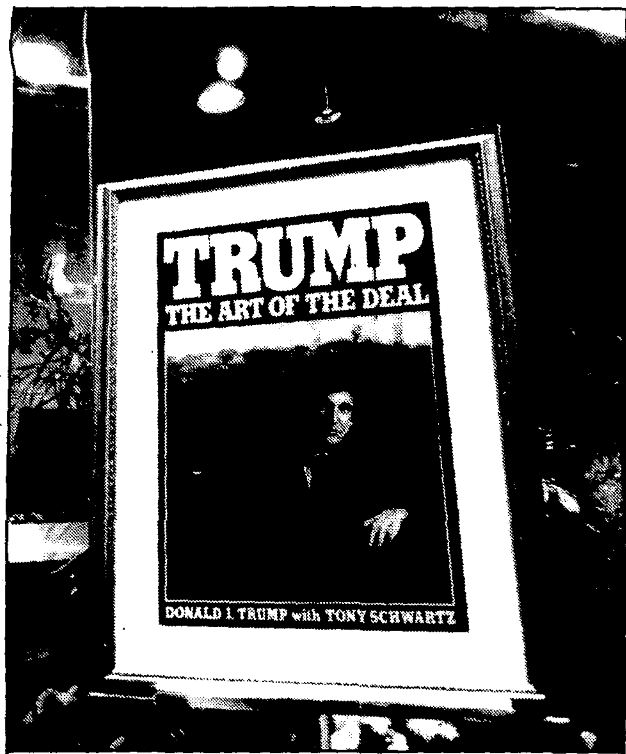
INSIDE STORY



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Donald Trump: losing the Midas touch?

Keep your eyes on the Trump card

By Daniel Lazare

NEW YORK

For Donald Trump-watchers these days—and who among us isn't?—the important, epoch-defining question may not be whether Ivana Trump takes him to the cleaners in her divorce settlement but whether his creditors beat her to it.

Although the news hasn't yet reached the tabloids, the man with the Midas touch is running into financial turbulence over and above the millions being demanded by his wife. On Wall Street his bonds are tumbling, while, in Atlantic City he's about to open a huge new casino, the Trump Taj Mahal, at a time when gambling receipts are flat. In midtown Manhattan there are signs that the Trump-owned Plaza Hotel may be turning into a white elephant, while other overpriced Trump properties may be in trouble for similar reasons.

James Grant, a respected Wall Street financial analyst and longtime Trumpologist, has staked out the Trump Parc condominium around the corner from the Plaza. He reports that fewer than 10 percent of the windows are lit on any given evening. It could be that the owners are rich Asians and Europeans who are out of town nine nights out of 10, as the Trump organization insists. Or, as Manhattan real estate crumbles, it could simply be that the condos are unsold.

Mum's the word: No one knows, of course, except Trump himself. At the very least, though, the rough weather suggests that *The Art of the Deal*, his celebrated (and self-celebrating) bestseller, may need an update on the perils of over-borrowing. Financial leverage—i.e., using other people's money—is what propelled Trump into the economic ionosphere back when he was just a mildly rich kid from the boroughs. In the early '90s, leverage—this time in the form of excessive debt—could be what yanks him down to Earth faster than you can say "Drexel Burnham."

America's premier bad-boy developer is still the same brash, rambunctious, overgrown adolescent he always was. Only instead of inspiring confidence on Wall Street, he now makes lenders nervous. With others busily cutting back, Trump's free-spending ways mark him as a man out of joint. He's in imminent danger of tripping over his own ego and tumbling headfirst down the stairway of history.

At least we can all hope. Politically, just as Trump symbolized the rise of the American private sector, he could also symbolize its comeuppance. In 1986, he scored a propaganda coup for right-wing government-bashers by taking over renovation of the Wollman skating rink in Central Park from the city and completing the project under budget and within schedule.

In 1987, he told *People* magazine that he put his name on buildings not because his ego demanded it but because "if somebody tells you you'll do $100 million dollars more business because you call a building Trump Parc than if you call it Tower on the Park or some other name, you'd have to be a moron not to do it." Not long after, he took a half-joking leap at the presidency, jetting off to New Hampshire to tell cheering audiences that the U.S. Navy should charge the Saudis and the Japanese for protecting oil tankers in the Persian Gulf.

Following the junk-bond disaster, the savings and loan debacle, the real-estate cave-in and who-knows-what-else may be waiting in the wings, this kind of private-sector chest-thumping is a thing of the past, as even Donald Trump is beginning to realize.

Only the best will do: Meanwhile, examples of the no-longer-so-deft Trump touch abound. On acquiring the Plaza in 1988, for instance, he and Ivana Trump (whom he placed in charge of day-to-day operations) set about taking it from the class of world-famous luxury hotels and elevating it into something truly nonpareil.

No expense was spared. Suites were decked with Italian silk tablecloths and 19th-century Biedermeier chests, valued at $40,000 apiece, while ordinary rooms were outfitted with pricey Italian Frette linens. The results, however, were less than economical by newly straitened Wall Street standards. *Crain's New York Business*, a local weekly, calculated recently that the Plaza will have to boost its room rates by an average of $100 over last year—to $350 a night—to turn a profit. This would come at a time when other luxury hotels, due to stagnant tourism and the recessionary local economy, are lowering theirs. A few years ago, Trump might have been able to pull it off. Now it seems doubtful.

Then there's the Trump Taj Mahal, the vast new casino he's opening in Atlantic City in April. In proper Trump fashion, it will be lavish and grand, complete with nine seven-foot carved elephants, $20 million worth of ersatz Indian architectural ornamentation, 3,000 slot machines and twice as much floor space as any other gambling emporium in town.

But while local town boosters are excited, creditors are uneasy. One reason is that casino revenues in New Jersey's Las-Vegas-by-the-sea rose just 2.6 percent last year, which, when inflation is taken into account, actually translates into a small decline. Another reason is that a sister casino, the Trump Castle casino, will be among the Taj Mahal's 11 competitors. Whatever bite the Taj Mahal manages to take out of the shrinking pie that is Atlantic City, it will almost certainly be at the expense of its corporate sibling.

This is a business strategy guaranteed to appeal to neither casino's creditors, which is why one Wall Street bond house, Salomon Brothers, advised its clients to dump Trump Castle bonds in January, while Taj Mahal bonds are selling at less than 75 percent of face value. The golden boy, it turns out, is tarnishing.

James Grant, whose *Grant's Interest Rate Observer* is one of the most widely followed newsletters on Wall Street, suggests that similar problems may soon plague other Trump properties. For instance, despite Manhattan's pressing apartment glut ("The Great Real-Estate Scare of 1990" is what *New York* magazine recently called it), Trump is steaming full speed ahead with construction of a 55-story apartment tower on Manhattan's Upper East Side, scheduled to open next year.

The Trump name may have cachet, but the question remains as to whether rich Japanese businessmen will shell out $350,000 for a studio when prices at the toniest Park Avenue addresses are dropping like stones. Grant reports that Trump is also trying to sell the Trump Princess, the 282-foot yacht he purchased in 1987 from the sultan of Brunei for $30 million and then spent $10 million refitting.

The asking price is $115 million. In the credulous '80s, Trump might have gotten away with nearly a threefold increase within less than a three-year period, but in the skeptical '90s it looks unlikely.

In fact, spinning off one Trump princess might be very much like spinning off another. Just as the yacht is likely to bring in less than Trump might have hoped, the divorce—provided Ivana Trump's lawyers can bust the limits of the couple's $25 million post-nuptial agreement—may wind up costing him more. In either instance, the damage to the bottom line is likely to be more serious than anticipated. If it's not going too far out on a speculative limb to say so, marital strains at this point may reflect underlying financial strains, which is why Trump's empire may be coming apart in more ways than one.

Or so preliminary indications suggest. Anyone wanna buy a luxury condo, cheap? □

Double take

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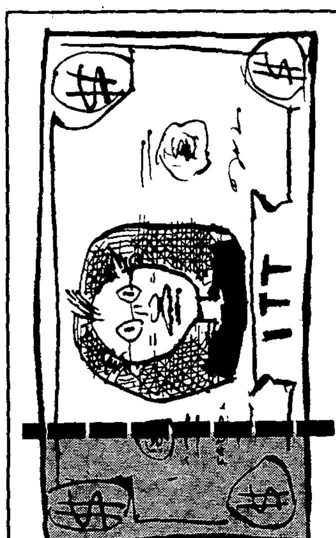


Creeping upward

Last week 183 subscribers contributed another $8,151 to our $150,000 fund appeal, bringing our total receipts, so far, to $23,903. In addition, 15 people agreed to become regular sustainers, for a total of 29 new sustainers. The pace is still too slow, so if you plan to send us a contribution, please do so now.

Drexel junk-bond downfall may be a warning tremor

By David Moberg

THE COLLAPSE OF DREXEL BURNHAM LAMbert, king of junk-bond finance, probably provoked as many cheers as tears. But the firm's downfall just before Valentine's Day, like its rise to wealth and power on the corporate takeover wave it financed, may send new ripples through the economy.

Junk-bond takeovers symbolized the U.S. economy of the '80s: huge fortunes quickly made from questionable deals that shuffled assets while undermining a firm's investment and research, as well as its cultivation of human resources needed for long-term growth. But Drexel's fall does not mean that the economic forces underlying its rise have radically changed.

From a charitable perspective, the $200 billion junk-bond market represented an initially plausible idea that, like most get-rich-quick finance schemes, quickly ran wildly out of control. Some, however, considered it a scam from start to finish. A few issues may have succeeded, but in the end the scheme cost the nation dearly.

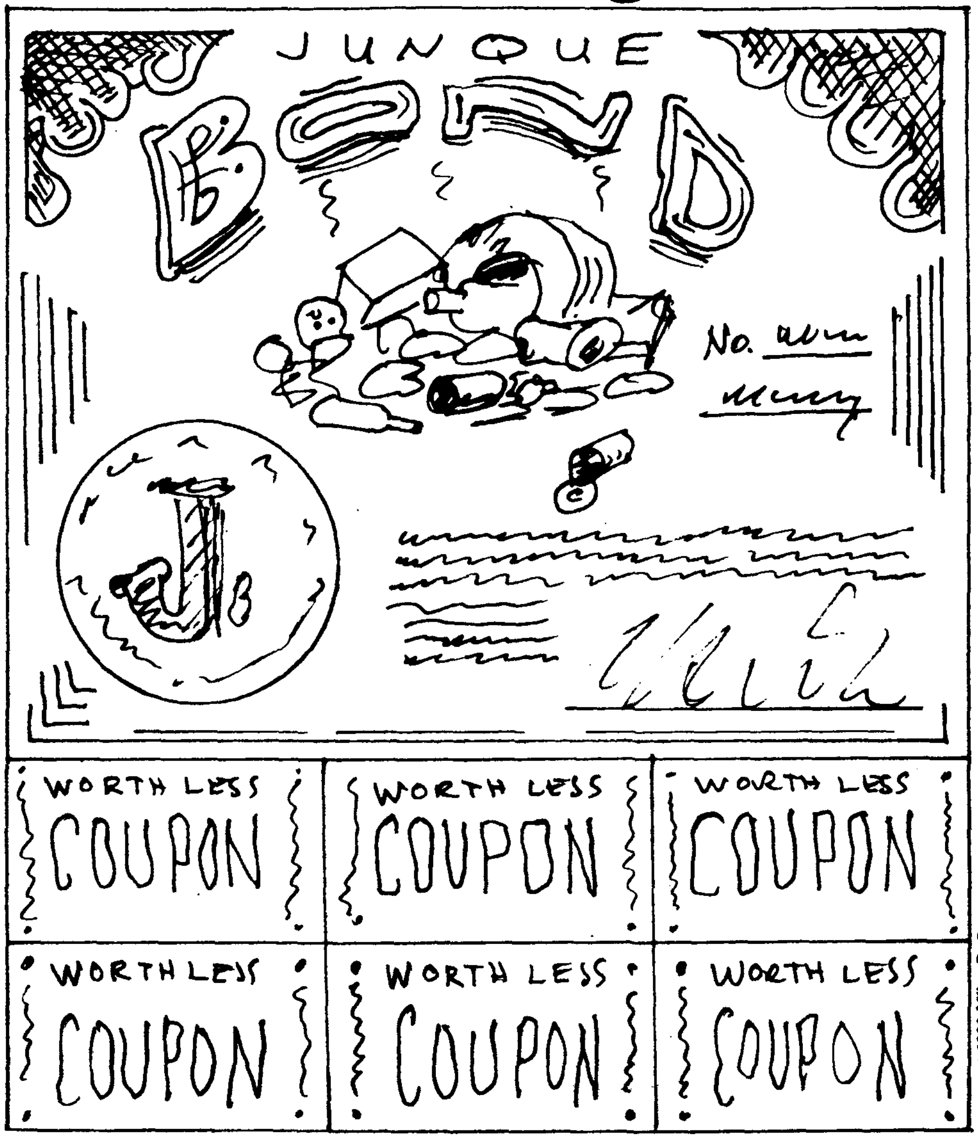
Junk bonds are high-interest, high-risk loans from investors hoping for bigger-than-average returns. The risk is that at some point the companies may not be able to pay the interest or repay the loan—in other words, that they will default on their debt. Consequently, bond-rating firms do not rate them as "investment-grade." The high interest reflects a premium paid to investors for taking the extra risk. Many small or new companies may necessarily resort to such debt because they do not have the size or track record to rate as investment-grade.

Michael Milken, the man who brought Drexel into the big time and then out of existence, argued that junk issues weren't as risky as most people thought; he claimed investors typically undervalued them. If an investor bought a diversified selection of junk bonds that were well-chosen—by Milken—he could more than offset the risk and make a return of 15 percent or more instead of the nine or 10 percent he could make on a top-rated bond.

Of greed and finance: Beyond boundless greed, other economic influences spurred the rise of junk bonds, among them high interest rates, declining profits and deregulation of financial markets.

In the early '80s, after the U.S. Federal Reserve tightened credit to dampen inflation, real interest rates rose to several times their historic rates and remained high throughout the decade. That meant the cost of borrowing capital exceeded the capital's declining net return, says Brookings Institution economist Margaret Mendenhall Blair. Companies often found themselves with more cash from their lucrative old investments than they could profitably invest in expansion or new ventures in the absense of rapid growth or technological advance, compared with returns from buying Treasury bonds or other debt, Blair argues.

Normally, high interest rates would discourage companies from borrowing money. But because interest payments are tax-deductible, Blair argues, the firms that choose to "disinvest"—shift wealth back to their stockholders—may favor debt. Businesses that hope to invest and grow, on the other hand, would likely favor equity financing or stocks.



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During the '80s, U.S. corporations withdrew about $600 million in equity and issued about $1 trillion in debt. The mechanisms varied: voluntary restructurings, management leveraged buyouts (LBOs) and takeovers. Although some new, growing businesses assumed huge new high-interest debt by issuing junk bonds—MCI and McCaw Telecommunications are the two most-cited junk-bond successes—Blair found that LBOs were favored by mature, slow-growth industries.

Now and later: One could argue that truly innovative management could develop products, manufacturing techniques or even organizational improvements to lower costs, improve quality or expand markets in order to raise profits. But U.S. firms were under tremendous pressure to "maximize present shareholder value"—that is, enrich stockholders now and forget the future.

In the winter 1989-90 *Brookings Review*, Shinichi Yamamoto, a scholar from the Japan Economic Research Center, concluded that the Japanese trade lead grew rapidly since the early '70s because U.S. manufacturers raised operating profits and increased dividends even when profits declined. By contrast, he says, Japanese manufacturers concentrate on long-term growth and "cut their operating profits, emphasizing increased sales at the cost of some loss in profits per unit."

Capital markets in the U.S., however, emphasize the short run. Even though U.S. gross savings declined only slightly in the '80s, net investment, especially in manufacturing, has been "decidedly weak," according to a study last fall by two New York Federal Reserve Bank economists. The money pumped out of businesses by the debt-driven restructuring drove up stock-market prices and contributed to the huge growth in wealth, income and conspicuous consumption for the upper 5 percent of the population, but it did not result in much constructive new investment.

The '80s economy: huge fortunes quickly made from questionable deals that merely shuffled assets.

Deregulation and changes in the financial markets contributed to the destructive effects of junk bonds. As blue-chip corporations relied more on their own debt issues, banks—which cannot invest in equities—began investing in riskier, equity-like junk bonds. This trend now worries the Federal Deposit Insurance Corporation because LBOs make up more than half the equity capital of the 10 biggest multinational banks.

Some deregulated savings and loans institutions, which turned to chancy oil and real-estate deals, also bought junk bonds. And although the Securities and Exchange Commission (SEC) regulates brokerage firms, it does not regulate the highflying parent-company subsidiaries that issued and invested heavily in junk bonds. But mutual funds and pension funds, which should have been more patient investors, were the biggest junk-bond buyers, together holding 60 percent of all junk bonds.

From early on there have been warnings that the junk-bond empire was a house of cards. Massachusetts Institute of Technology finance professor Paul Asquith studied junk-bond financed companies over the period 1978-87 and found that instead of the 2 percent per year default rate Drexel claimed, one-third to one-half would default within eight years.

Numerous studies have shown that historically the vast majority of mergers fail, that shareholders in the acquiring firms typically lose in the months to years after a takeover and that there are few if any efficiency gains.

By firing workers, slashing pay, selling off assets and cutting investment and research, some companies can muster short-term payoffs. But the debt-laden companies are far more vulnerable in the event of a recession.

How did Milken and Drexel get away with selling their junk-bond mania, despite the evidence against its continued success? Lawyer and economist Benjamin J. Stein argues in the February 19 issue of the financial weekly *Barron's* that "Drexel/Milkenism was largely a vast scam based upon myths about bond-valuing skills and bond value, kept going by a vast Ponzi [a swindle in which earlier investors are paid off by later investors, like a chain letter] controlling markets, prices, reputation and data about defaults."

According to Stein and others, Milken created an inner circle of favored investors who would bid up junk bonds and engage in a number of questionable transactions—such as borrowing more on one junk-bond issue than needed in order to use part of the money to buy the next junk issue. By clever manipulation, exuberant salesmanship and a promise that Drexel and its allies would always be ready to act as a market of last resort, Milken lured investors.

And the billions he made for himself and Drexel put pressure on everyone else to join the game, worsening the pressures for short-term stockholder gain.

The "scam" began to come apart when Drexel employee Dennis Levine admitted to insider trading and then fingered Ivan Boesky, who in turn set up Milken for 98 counts of securities fraud. Drexel pled guilty to charges, paid $650 million in fines and, under government pressure, ousted Milken last January.

But the empire fell apart as Drexel failed to back up junk bonds, and its allies began to founder. As part of the federal savings and loan bailout, the troubled financial institutions were directed to reduce junk-bond holdings. As the junk-bond market plummeted, Drexel's value—backed up mainly by the increasingly worthless securities it had issued—fell as well. Having raided the capital of its other subsidiaries, exhausted its ability to borrow and failed to find investors, Drexel threw in the towel.

There was no panic when Drexel went under, but the effects of the junk-bond takeover craze will linger with the burden of heavy debt and the internal wreckage of many companies that may default or simply be unprepared for the future. The underlying problems of high interest rates, low investment and the short-term emphasis on stockholder wealth will persist. Takeovers will slow down, but as the ripple effects of default spread, many observers believe interest rates will increase, raising the specter of an economic bust at the end of a junky boom. □