EIR Economics

'Leveraged Debt' Crisis Menaces Banks, Pensions, Auto Plants

by Paul Gallagher

October was filled with a steady drumbeat of warnings—in muted form from various regulatory agencies, and openly in the financial press—about rapidly increasing "leveraged debt takeovers" by hedge funds and private equity funds, and the potential for "leveraged defaults"—that is, financial blowouts—resulting from the failure of these funds and their takeover targets. Fund tracking firms reported that huge flows of new capital were pouring into hedge funds—heading for $160 billion in 2006, four times as much as in 2005—despite the meltdown of a number of very big hedge funds like Vega and Amaranth partners, and hundreds of smaller ones. In turn, much of this flood of foolish investment (hedge funds now control $1.35 trillion internationally, and private equity funds somewhat more) is going into highly risky takeovers of firms with intent to loot cash out of them one way or another. And this takeover activity involves heavy borrowing from banks by the funds, putting both them and their pension fund clients on the line in this frenzy of merger and takeover activity. In Amaranth's failure, for example, at least seven public and private pension funds lost roughly $500 million.

Now this hedge fund gambling-takeover wave is about to wash over the remains of the auto industry in the United States, which Congress has refused to act to revive during two years of debt crisis, widespread plant shutdowns, and industrial shrinkage. "$50 billion worth of [U.S.-based auto] parts companies up for sale," pronounced the *Wall Street Journal* on Oct. 26, in a report from industry sources forecasting a whole series of hedge fund takeovers of big auto suppliers to be finalized "within weeks." Most of the parts companies involved are bankrupt; yet, the hedge fund predators are borrowing many billions from bank syndicates to take these half-ruined targets over—and complete their ruin. In a shocker, the sinking Ford Motor Co. was reported on Oct. 24 to be planning to mortgage out some of its 32 remaining U.S. plants as security to "lenders"—financial institutions, or perhaps hedge funds—to bolster cash reserves in the face of massive losses.

Economist Lyndon LaRouche warned Oct. 26 that the hedge funds are going to go down, and they are going to take the banking system down with them. The hedge funds have placed mountains of money in crazy speculation, LaRouche said, tying up all liquidity in this giant balloon. When they default on their exposures, then the banks that foolishly bankrolled them, are going to be stuck with the losses. He emphasized, "Get the banks out of this insanity. We have to save the U.S. economy—and the banks, so that they can perform their proper function. The banks are setting up their depositors for wipe-out when they are caught in defaults by these hedge funds; they're setting up the pension funds to be wiped out." LaRouche demanded action to simply stop bank lending to leveraged takeovers of companies by hedge funds and private equity funds. He charged the Fed and other institutions are simply *stalling* until after the elections, trying to put off the crisis with money-pumping. Their stalling brings on the crash.

As for the plants Ford is about to put in hock to "lenders," and the auto-supply plants hedge funds are getting control of—these are the very plants which LaRouche has, for two years now, demanded that Congress "assume" and save by extending credit and a new national mission, producing the bill of materials for needed new economic infrastructure projects.

Unheard-Of 'Lending Multiples'

A report by Standard and Poors agency (S&P) released Oct. 25 said that the ballooning "leveraged debt" and "collat-

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"Leverage": a wrecked auto plant in Baltimore, closed last year. The hundreds-of-billions wave of debt capital into hedge funds' super-risky takeovers, is "justified" only by promises of this kind of dramatic future looting, cost cutting, shutdowns, and shrinkage of the firms being taken over. It often doesn't work, and produces very dangerous "leveraged defaults." Lyndon LaRouche says, "Get the banks out of this trap."

eralized loan obligations" (CDO) market pits of the world are in danger of blowing up a large amount of debt; and that if and when they do, banks in Europe and the United States will be left holding up to 40% of the bag of losses. Pension funds will hold a lot more.

The threat results directly from large volumes of bank lending going to burgeoning hedge funds and private equity funds which are buying more and more risky debt; and banks advising pension funds to pour capital into these hedge funds as well. S&P and others say the funds are throwing this wave of capital into extremely leveraged debt (debt "justified" only by promises of dramatic future looting, cost cutting, and industrial shrinkage through takeovers, mergers, etc.), then thinking they can "dump the risk" by selling that debt, as securities and financial derivatives contracts, to each other and to banks on the CDO markets. As the *Financial Times* expressed it, "the heat of investor demand is forging lending multiples and structures that would have seemed impossible just a couple of years ago," and the *average* debt "multiple" of such "capital investments" has grown to $6 borrowed for each $1 invested. "Investors [hedge funds] are simply looking at the promised rates of return . . . and going for the highest one" with a lot of borrowed funds.

Let the wave of fund investments slow down due to major hedge fund losses, defaults by the firms being taken over, and withdrawals by investors, warns S&P, and *highly leveraged losses* will sweep over the banks and other lenders.

Hedge funds are now moving toward dominating the field of corporate takeovers, with the ten largest hedges, at $171 billion combined, now having as much capital as the ten largest private equity funds, and growing much faster.

A study published last month by New York University Business School professors April Klein and Emanuel Zur, shows hedge funds' growing dominance over the corporate managements which they target for takeover or "influence"—what is quaintly termed "activism" in hedge fund circles. The professors tracked 155 "13D" filings by hedge funds—in which they state their intention to influence the management of a firm whose stock and/or debt they're buying. "In 60% of the cases, the hedge fund gets the firm to acquiesce to its demands," they reported. "They have 75% success in getting the firm to buy back its own stock, replace the current CEO, or initiate a cash dividend." Half the firms agree to be taken over, or to drop a takeover bid of their own. The NYU study also showed that average dividend payouts double over the year following the hedge funds' "targetting" of a company; stock prices go up on average by 10.3%; capital investment and R&D spending fall very significantly in 60% of the cases. Debt rises by an average of 14%, another study showed.

This assumed future control, looting, indebting, or downsizing of a takeover target, is the "leverage" in the "leveraged debt" taken on by the hedge funds for takeovers. The J.R. Paulson hedge fund offers clear recent examples, having forced companies like Mirant Energy and Algoma Steel (Canada) to cancel outright, planned new industrial facilities, and to cough up hundreds of millions in payouts to shareholders instead.

But apply this principle of takeover leverage to firms *already bankrupt or in severe distress,* and the result is super-high risk debt, because the attempt to further loot the firm will often fail, causing default or liquidation. The fund investors blithely assume they will have securitized and sold their debt before it goes—exactly what the speculators in the sinking U.S. housing bubble had been assuming about their multiple mortgages.

Auto Parts Firms Being Eaten

According to the *Wall Street Journal*'s sources for its Oct. 26 article, Wilbur Ross will soon finalize takeover of eight auto suppliers including Lear Corp. and Collins and Aikman.

The bank borrowing for Ross's predations is syndicated through UBS bank and the AMVESCAP private equity fund he recently merged his operations with. In the same short time, one of three hedge funds—Appaloosa Management, Cerberus Capital Partners, or Ripplewood Holdings LLC—will take over Delphi Corporation, the *Journal* reported. The United Auto Workers may "get to choose" by seeing which hedge fund, perhaps if offered more workforce concessions, may promise to keep more plants staying open than in Delphi CEO Steve Miller's and Felix Rohatyn's original outsourcing plan. Hedge fund Pardus Capital Mgmt now controls 14% of Visteon.

All these funds are borrowing billions from banks, debt which they intend to resell to each other or to other banks. Just one example: Appaloosa Partners has lined up $2.1 billion in loans, and intends to borrow a total of $3.8 billion—syndicated to many banks by JP Morgan Chase and Bank of America—to buy Delphi, a company with no earnings for the last three years.

The *Journal* adds that this predators' takeover will change the relation of suppliers to automakers, putting the suppliers "on top" in parts pricing questions, and leading to their [the funds'] increasing control over Ford, GM, and Chrysler themselves.

Vulture capitalist Wilbur Ross, whose funds are in the midst of this auto takeover push, showed how the process worked two years ago, in steel, when he bought up three bankrupt steel makers and then quickly sold them off to Mittal Steel. In short order, four of the seven major steel complexes Mittal bought from Ross have since closed or are in process of shutting down, in Cleveland, East Chicago, Indiana, Baltimore, and Wierton, West Virginia.

In fact, of Ford's disastrous $5.8 billion loss just reported for the third quarter, more than three-quarters was due to the "cost of cuts"—shrinkage, plant closings, and buying out workers. Highlighting present and future problems, Ford's worldwide revenues collapsed to $32.6 billion during the third quarter of 2006, from a level of $40.9 billion during the same period one year earlier, a 20% drop. Ford is already implementing a 21% production cut for the fourth quarter, as it works to buy out, and eliminate, 30,000 of its remaining 82,000 production worker workforce.

LaRouche observed on Oct. 24, "Stockholder greed, including that of the Ford family, has wrecked their own interests." He added, "Bill Ford had a partial realization of this, and organized a trip to Washington, one year after I raised a proposal [LaRouche's "retooling for infrastructure" legislation] showing what should be done. Nothing came of it." LaRouche said the real problem is the Senate: "The Congress—particularly the Senate—in their infinite lack of wisdom, listened to another agenda, the agenda of free trade." The plants that Ford is now talking about mortgaging are the same ones that could have been saved through LaRouche's proposal for retooling.

China Maps Out Next Five Years in Space

by Marsha Freeman

The most closely watched space program in the world today is that being carried out by the People's Republic of China. For decades, China's activities were largely an internal project, with little information available outside the country, leaving ample room for speculation. In 2000, China published and circulated in English, a White Paper, "China's Space Activities," English, which outlined its plans. The most stunning goal was for human spaceflight: Early in the 21st Century, China was planning to become the third nation in the world to send a man into space.

Since that first manned flight, in October 2003, the world space community's attention has been rivetted on China's emerging space capabilities.

Many space enthusiasts in the West are impatient with the seeming slow pace of China's manned flights, with two-year intervals between missions. But China is not in a space "race." Its approach is not to duplicate the U.S. and Soviet experience, by taking frequent incremental steps; it is to "leapfrog" with fewer, larger steps, taking advantage of the dramatic developments in technology since the first manned missions of the 1960s.

Over the past five years, China has applied its policy of "opening up to the outside world" in the space arena, concluding cooperation agreements and memoranda with more than 30 countries, international organizations, and space agencies. It is confident enough in the capabilities it has independently developed in space to now play an international leadership role, especially in Asia, and to share technology with other nations.

On Oct. 12, the State Council of the P.R.C. released a ten-page report titled, *China's Space Activities in 2006,* "in order to give people around the world a better understanding of the development of China's space industry over the past five years, and its plans for the near future." The paper outlines an ambitious, broad, space technology development program.

Judging from its performance over the past five years, reviewed in the paper, the next five years will see China progress in space science, satellite technology, launch vehicles, deep-space exploration, and manned space flight.

Economic Development Strategy

The major area of support in China's space program is not its high-profile manned space projects, but the space applica-