2006 Buyout Wave Is Default Blowout of 2007

by Paul Gallagher

The fourth-quarter explosion of so-called "leveraged buyouts" worldwide, accelerated wildly in the final weeks of the year, marked on Dec. 18 by the announcement of $87 billion "worth" of such buyouts, the fourth day in three months in which at least $75 billion in leveraged takeovers was made public. The Dec. 18 buyout splurge involved $57 billion in new debt loaded upon the takeover target companies, two of the biggest of which were immediately downgraded from investment-grade to junk-debt status in the process. And the $87 billion does not include the $30 billion merger, also announced Dec. 18, of Statoil and Hydro, two oil companies substantially controlled by the Norwegian government.

With the 2006 "debt-leveraged takeover" bubble reaching $4 trillion in "market value," which is, in fact, largely just new borrowings from commercial and investment banks and hedge funds, this bubble is threatening many nations with corporate debt blowouts in 2007. Fully $500 billion or more of this "market value" in takeovers was done during December alone.

Apart from the looting of many target firms already involved, the leveraged takeover boom looks to many financial regulators like a corporate twin-bubble of the U.S.-centered housing/consumer-debt bubble now bursting. Estimates of household debt in the OECD countries are at roughly 90% of total GDP, compared to just 29% in 1990. But estimates of corporate debt in those nations by the end of 2006 will be close to 80% of GDP, compared to 55% in 1995; and it is the corporate debt which is exploding in volume now. The 80% level is well above that of 1988, at the collapse of the 1980s takeover boom, which was much smaller in volume than the current boom.) The Reserve Bank of Australia's just-retired chief Ian McFarlane, for example, is publicly warning that the whole Australian economy is "becoming leveraged," and could be producing a corporate debt-jump like that of Australian household debt, which has leaped from under 50%, to 150% of disposable income in the past decade.

The wild acceleration of takeovers has lifted the record totals to 33,000 mergers and buyouts "worth" $3.9 trillion in 2006. Over $1 trillion will be in pure predatory takeovers by "buyout firms"—private equity and hedge-fund locusts—as opposed to mergers between two companies in an economic sector. But even in the cases of mergers or buyouts of one operating company by another, the takeover costs are usually being paid in cash—not stock, as in the 1999-2000 merger boom—and the cash is coming from terrific amounts of new debt, borrowed from banks, hedge funds, etc., on the basis of "leverage," another name for the promise of looting and destruction of the companies and their workforces. "Lenders are increasingly willing to arrange aggressive financing packages for corporate clients," is how the *Financial Times* characterized the debt-default bonfire being stoked up.

Moreover, private equity-fund predators were reported, as of mid-December, to have $200 billion more to put into mergers in the final two weeks of the year; with bank lending multiples typically of three or four to one, that could push the year's total to over $4 trillion, 20% above the previous record in 2000.

Effective action by governments to intervene and stop this destruction has been proposed and urged by Lyndon LaRouche. And in South Korea, the same principle has informed a crucial November decision of the Supreme Court, which found many leveraged buyouts illegal under clearly defined conditions (see box). The Republic of Korea Supreme Court decision indicates a precise model and *political* method for national legislatures—including in the United States, the epicenter of the buyout-bubble madness—to intervene to reverse it before the corporate debt bubble explodes in "leveraged defaults," blowing out the credit markets.

A Second Warning from Ratings Agency

The economics research department of the Standard and Poor's debt-rating agency put out a warning report on Dec. 14, about a coming wave of "leveraged debt defaults" threatening the international credit markets. This means rapid-fire, and potentially massive defaults on the debts loaded onto merger and takeover "target" companies by hedge funds, private equity funds, and banks. It's known as "leveraged" debt because it's issued on the assumption of looting the target. "Predators are extracting special dividends from prey to recoup their investment quickly, leaving these companies saddled with debt," said the report highlighted in a Dec. 15 London *Daily Telegraph* article by Ambrose Evans-Pritchard. The lending banks themselves, in turn, take risk fees which may be a couple percent of the total new debt; and the consulting banks, still more fees, which may be 0.5% of the total valuation of the takeover. Goldman Sachs led the world in this regard by making $2.1 billion in consulting fees on nearly 500 takeovers in 2006.

This S&P report, "Risk Outlook for 2007," followed one it issued on Oct. 25, on the same danger (see *EIR,* Nov. 3, 2006). That earlier report said that if the ballooning "leveraged debt" and "collateralized loan obligations" (CDO) market pits of the world blow out, 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. Large volumes of bank lending, it said, are going to burgeoning hedge funds and private equity funds which are buying more and more risky debt; and banks are advising pension funds to pour capital

LaRouche, and Court: How To Stop LBOs

On Dec. 14, Lyndon LaRouche made an aggressive proposal to stop the "bonfire of buyouts" which is loading target firms with new debt, looting these targets and their workforces, and driving them toward default. LaRouche proposed that "*any* takeover that turns a viable firm into a junk-bond company is against the national interest. . . . Therefore, Congress should start to intervene to defend the national interest, and block the mergers, including *any merger in which it can't be shown that the target companies will gain in capacity, productivity, and production from the merger.* Congress has to draw that line, LaRouche said, and draw it now, in the face of the oncoming debt crash."

In November, the Republic of Korea Supreme Court made an extraordinary decision which reversed one apparently "successful" leveraged takeover, declared it illegal, and reinstated criminal prosecution against the CEO of the takeover company involved. The decision was made in the "leveraged" takeover of an engineering firm of the Shinhan Bank group. This takeover, using debt borrowed against the assets of the company targetted for takeover, and the subsequent "restructuring" of the target firm to lower operating costs, had allegedly led to an increase in profits, and no personal diversion of funds or assets was involved.

The Supreme Court ruled the takeover a breach of fiduciary duty by the takeover firm, because of its, and its CEO's, *prior intent* to indebt the target company without compensation or benefit, and to subject the target company to economic burden, risk of default and impaired credit, and risk of contraction. No post-takeover actions or results could be considered as disproving this criminal intent, the Court ruled: The elements of the crime were complete, under the law, *before the takeover took place,* and had not been compensated by any payments or economic benefits to the target firm which could be shown prior to the takeover. Thus, the Court ruled, the takeover was illegal—and by implication, the "leveraged takeover" *method* is illegal as practiced by the private equity pirates.

The decision impacts other takeover battles, and provides a principled method for legislatures, including the U.S. Congress, to stop the mad takeover wave—the method urgently proposed by LaRouche.

into these hedge funds as well. 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), thinking that 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.

The Dec. 14 S&P report and conference call warned that: "Leveraged loans have exploded. . . . As the interest coverage becomes thinner, defaults are certain to increase. . . . Prudent financial policies are being discarded. The average purchase-price for European LBOs in the three months to November hit a record high level of 9.4 times earnings." Most of this purchase money is being borrowed, and S&P points to disturbing signs, including "a trend toward deals that are not even rated for credit risk. . . . The big question is what happens [to this debt] in a downturn," now underway, the report warns.

The new round of ongoing attempted takeovers in the airline industry, for example—USAir taking over Delta, United and Continental merging, AirTran taking over Midwest—are new attacks on airlines already drastically shrunk and looted. Carriers that employed 420,000 workers in September 2001, employed 264,000 five years later, at more than a 25% cut in wages; their fleet of jets had shrunk by 12%.

On Dec. 13, Rep. James Oberstar (D-Minn.), who will chair the House Transportation and Infrastructure Committee, demanded that the Justice Department stop the USAir-Delta takeover; if not, he said, he'd start hearings to block such mergers.

Rapidly Worsening Financial Cancer

New York financial community sources report that, of the 30-40,000 corporate mergers and acquisitions (M&As) worldwide this year, only perhaps 1,000 have been "leveraged" takeovers (premised on placing large amounts of new debt upon the target firm in the takeover), but these account for more than half the market value and most of the debt. About half of these involve *hostile* leveraged takeovers and/or attempts, which bids often involve very large amounts of new debt, and "valuing" of the target company at 20-40% above its current market value. M&As in general are now the main driver for the stock market, led by the large amounts of money to be made in playing the leveraged takeovers. Investment banks and lending banks are making very large risk fees, up to 2.5% of the whole takeover loan. For hedge funds, the takeovers are more profitable than their derivatives-based strategies, which are getting harder to work.

The buyout firms' strategy in leveraged takeovers now, is to try to borrow as much as possible of the takeover price, and use the extracted cash flow of the target company, or the sale of its assets, for repayment.

Some very recent examples:

• An example of the new leveraged-debt extreme is the current attempt on India's (Hong Kong-owned) Hutchinson Essar communications firm, by Blackstone Group and Reliance Group (this is one of several competing bids circling around this target company. The $15 billion takeover price will be borrowed in its entirety from Citigroup and UBS-AG, if this takeover goes through.

• Qantas Airways takeover by the pirates of Macquarie Bank, Ltd. and Texas Pacific Group involves $9 billion in new debt, 15 times Qantas' earnings. This is the most controversial of the takeovers of 2006; Qantas, a state company until 1995, essentially Australia's only carrier, and one of the world's best-run airlines, is suddenly pulled down like Persephone into the Hades of private-equity debt speculation. "This deal is all about debt," one banker told the Sydney *Herald.* "The deal will only work if the consortium [Airline Partners Australia, so-called] can extract a 20% internal rate of return for 5-10 years. Otherwise, watch out for default. Qantas' debt will rise from $3.7 billion to $12.5 billion; annual interest will rise from $158 million to $715 million; the Australian government warned Dec. 18 that Qantas' debt will be junk-rated, and the government will not bail it out in future."

• Express Scripts' hostile takeover of Caremark Rx—a merger of two of the biggest "pharmacy benefit managers" of the HMO jungle—involves $14 billion in new debt, which is nine times the annual earnings of the combined target company. Caremark Rx debt may be downgraded to junk.

• Apollo Management Group's takeover of Realogy Corp.—which owns Century 21 and Coldwell Banker real estate companies—involves $7 billion in new borrowings from JP Morgan Chase and Credit Suisse. Realogy's debt was immediately downgraded to junk on Dec. 19, and the cost of insuring its debt against default leaped up, from 0.6% to 3% of the debt.

• USAir's attempted takeover of Delta will leave Delta with an immense $23 billion in debt, as opposed to the $10 billion debt it would have otherwise. This $13 billion in new debt is more than 25 times earnings, when last Delta had any earnings, in 2003. According to Delta's reorganization bankruptcy filing Dec. 19, which opposes the takeover, it would lose 10,000 jobs, 180 aircraft, and a 10% shrinkage of the combined airline. And absurdly, $4-6 billion of the new debt is to be floated *simply to pay off unsecured Delta debt,* which is now frozen in bankruptcy.

• The Freeport McMoRan Mining takeover of Phelps Dodge loads $15 billion in debt on the combination of two corporations which had no net debt; and produces a combined junk-rated company from two companies whose bonds were each AA-rated.

tant Secretary of State for Nonproliferation; Lawrence Korb, former Assistant Secretary of Defense; Prof. Frank von Hippel of Princeton University; Daryl Kimball of the Arms Control Association; and John Isaacs of the Council for a Livable World.

Their concerns center around India's alleged unwillingness to curb its nuclear weapons program, India's lack of transparency in non-proliferation efforts, and its close ties with Iran. A new report by the Congressional Research Service, which examines policy issues for Congress, found that while India does not want Iran to have nuclear weapons, New Delhi's "views of the Iranian threat and appropriate responses [to that threat] differ significantly from U.S. views." In 2004, Washington imposed sanctions on two Indian scientists for nuclear-related transfers to Iran, and in 2005 and 2006, four Indian companies were sanctioned for chemical-related transfers to Iran, the report noted.

In India, the opposition to the bill is based on an entirely different perspective. India has remained a non-signatory of the Nuclear-Nonproliferation Treaty (NPT) since the Treaty entered into force in 1970, following U.S. ratification. Staying outside of the NPT-regime, India has tested its nuclear devices on three occasions—once in 1974 and twice in 1998. In other words, India has developed nuclear weapons, but it is not recognized as a nuclear weapons state by the five official Nuclear Weapons States (NWS)—United States, Russia, Britain, France, and China—which had all tested their nuclear devices prior to the existence of the NPT.

Atomic Scientists and the Military

The issue of future nuclear tests is important to the opponents of the bill in India, because they consider that such tests are necessary in order to upgrade India's nuclear weapons to match nuclear developments elsewhere, and provide security to the nation. The Hyde Act that President Bush signed, categorically demands that India ban all nuclear explosive tests in the future. It, however, does not address the fact that the United States itself is working on the design of a "Reliable Replacement Weapon" (RRW) to modernize its nuclear arsenal, and may indeed carry out a test in the future!

Moreover, in the "Definitions" section of the contested bill, it is clearly stated that the "Additional Protocol" is to be based on the Model Additional protocol of the IAEA applicable to non-nuclear-weapon states, which is highly intrusive, as pointed out by India's former Atomic Energy Commission (AEC) chairman, M.R. Srinivasan, in a recent article in the English news daily *The Hindu.*

He also pointed out that the Hyde Act makes it clear that the U.S. President has to satisfy himself that India is working actively on an early conclusion of the Fissile Material Control regime (FMCT); that India is supporting the United States in preventing the spread of enrichment and reprocessing technologies; and that India adheres to the Missile Test Control Regime (MTCR) and NSG guidelines (without actually being invited to be a member of these bodies). These actions which India is obliged to take are not consistent with what "a strategic partner" (which Washington wishes India to be) should be taking. Neither are they consistent with what India—described as a "responsible state with advanced technology"—should be mandated to take, Srinivasan affirmed.

What also concerns India's defense planners about the bill, is the way it has been formulated. The Hyde Act calls for achieving a moratorium on the production of fissile material for explosive purposes by India, Pakistan, and the People's Republic of China. It may be recalled that China has been producing fissile material for weapons purposes for a long time, while India was forbidden to do so by the NWS. Therefore, stopping production of fissile material at the same point in time would lead to a serious imbalance. The statement of policy goes on to say that the United States shall "seek to halt the increase of nuclear weapon arsenals in South Asia and to promote their reduction and eventual elimination."

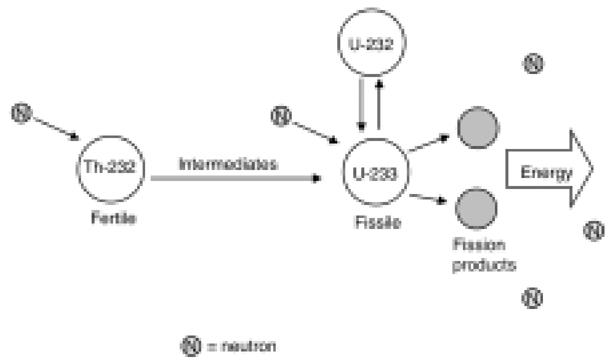
India's Thorium Program Is the Issue

Indian scientists have made their views known about the inadequacy of the Hyde Act, citing two specific areas. First, the bill says categorically that India cannot reprocess spent fuel from its reactors. It demands this because the United States claims that the "no reprocessing" clause would prevent India from getting plutonium, which could be used later for making nuclear weapons. However, there is more to the clause than meets the eye, Indian atomic scientists point out.

India decided on a three-stage nuclear program back in the 1950s, when India's nuclear power generation program was set up. In the first stage, natural uranium (U-238) was used in pressurized heavy water reactors (PHWRs). In the second stage, the plutonium extracted through reprocessing from the used fuel of the PHWRs was scheduled to be used to run fast-breeder reactors (FBRs). The plutonium was used in the FBRs in 70% mixed oxide (MOX)-fuel, to breed uranium-233 in a thorium-232 blanket around the core. In the final stage, the FBRs use thorium-232 and produce uranium-233 for use in the third-stage reactors. (See Ramtanu Maitra, "Thorium: Preferred Nuclear Fuel of the Future," *EIR,* Nov. 18, 2005.)

To a certain extent, India has completed the first stage, despite the fact that it has only built a dozen nuclear power plants so far. The second stage is only realized by a small experimental fast-breeder reactor (13 MW), at Kalpakkam. Meanwhile, the Indian authorities have cleared the Department of Atomic Energy's proposal to set up a 500 MW prototype of the next-generation fast-breeder nuclear power reactor at Kalpakkam, thereby setting the stage for the commercial exploitation of thorium as a fuel source.

Simplified Diagram of the Thorium Fuel Cycle



The neutron trigger to start the thorium cycle can come from the fissioning of conventional nuclear fuels (uranium or plutonium) or an accelerator. When neutrons hit the fertile thorium-232 it decays to the fissile U-233 plus fission fragments (lighter elements) and more neutrons. (Not shown is the short-lived intermediate stage of protactinium-233.)

One reason for India's commitment to switch over to thorium, is its large indigenous supply. With estimated thorium reserves of some 290,000 tons, it ranks second only to Australia. Further, the nation's pursuit of thorium helps to bring independence from overseas uranium sources. Since India is a non-signatory of the NPT, its leaders foresaw that its civil nuclear-energy-generation program would be constrained in the long term by the provisions laid down by the commercial uranium suppliers. The Nuclear Suppliers Group demand that purchasers sign the NPT and thereby allow enough oversight to ensure that the fuel (or the plutonium spawned from it) is not used for making nuclear weapons. A non-signatory of the NPT is prevented from receiving any nuclear-related technology or nuclear fuel.

India has already begun construction of the Advanced Heavy Water Reactor (AHWR) in 2005. The AHWR will use thorium, the "fuel of the future," to generate 300 MW of electricity—up from its original design output of 235 MW. The fuel for the AHWR will be a hybrid core, partly thorium-uranium 233 and partly thorium-plutonium.

In other words, if India cannot reprocess the spent fuel to secure plutonium for the sake of converting thorium into fuel, the thorium reactors will never take off. Separation of plutonium is essential for the eventual use of thorium as a nuclear fuel. India therefore expects that reprocessing will be an important activity of its nuclear energy program. This is what has put the Indian atomic scientists on a warpath against the Singh government's willingness to accept the bill.

Natural uranium contains about 99.3% of the isotope uranium-238 and 0.7% of the fissionable isotope uranium-235. Although uranium-235 is the rarer of the uranium isotopes, it is the one that most readily undergoes nuclear fission, and is thus the most useful for common nuclear applications. Therefore, to use uranium, the proportion of the uranium-235 isotope found in natural uranium must be increased. This process of increasing the fraction of uranium-235 in natural uranium is called enrichment. At the same time, one must note that while uranium-235 is present in natural uranium in small amounts, uranium-233 does not exist in nature. Therefore, thorium-232 must be converted to uranium-233 in order to generate nuclear power.

Not an Easy 123

The second concern of the Indian scientists is the scope of "full civilian nuclear energy cooperation" (Section 123 of the U.S. Atomic Energy Act) that was promised to India in July 2005. India had assumed that this term encompassed the fuel cycle, namely enrichment of uranium and reprocessing of spent fuel. In the discussions leading to the adoption of the Hyde Act, U.S. legislators argued that the U.S. Atomic Energy Act of 1954 specifically forbids export of these technologies, as well as heavy water production technology, to other countries. India has developed its own technologies in these three important areas.

According to an English news daily, *The Times of India,* India's top atomic scientists have spelled out some of the key points which are to be incorporated in the 123 agreement:

- India should not be asked to participate in international non-proliferation efforts with a policy congruent to that of the United States.
- There should be full-scale civilian nuclear cooperation, with an assurance of constant fuel supply.
- India should be free to carry out more nuclear weapons tests.

Although the Bush Administration has shown a great deal of interest in seeing that the nuclear agreement goes through, it is highly unlikely that it would bow to the Indian atomic scientists' demands. At a Dec. 16 powwow in Mumbai, organized by India's present AEC chairman, Anil Kakodkar, and attended by six former atomic czars, *The Times of India* reported a scientist saying: "We hope the voice of the former nuke chiefs will now resound in those areas where the 123 agreement will be negotiated."

This could spell danger for the bill, as well as for the Manmohan Singh government, which has made the bill the centerpiece of its foreign policy initiatives. These top scientists and administrators of the country's nuclear establishment told *The Times of India* that since July 2005, bureaucrats in the External Affairs Ministry were calling the shots, either in New Delhi or at the Indian Embassy in Washington. However, there is now an indication that for the first time, these informed critics of the deal cannot be kept out of the country's nuclear diplomacy.