JUNK BOND REVOLUTION

A TOOL FOR CORPORATE RAIDERS

by STEPHEN VELIK

With the rapid growth in the number and magnitude of junk bond financed acquisitions in the United States, many commentators claim that junk bond financing is leading to a fundamental restructuring of American corporate industry.

Large public corporations that until 10 years ago seemed impervious to hostile ownership changes now appear vulnerable to junk bond financed takeovers by entrepreneurs a fraction their size. The recent wave of multi-billion-dollar leveraged buy-outs, it is argued, has been made possible by the junk bond market. It is also claimed that the advent of junk bond financing has led to an enormous increase in outstanding US corporate debt and even threatens to "destroy the fabric of American industry".

What is generally agreed is that the junk bond market has provided an important and untapped source of finance for the rapid expansion of small and medium-sized American companies.

While there is no universally accepted definition of junk bonds, they are generally recognised to be non-investment grade corporate bonds. Such bonds are issued by companies that do not qualify for an investment grade (prime) rating by either Standard & Poors or Moodies, the major American corporate rating agencies. Some 94 per cent of the approximately 11,000 US public companies fall within this category.

Junk bonds are high yielding compared to investment grade bonds. The difference in yields typically ranges between 2 and 5 per cent, depending on the quality and size of the issue and the current state of the market.

Junk bonds are normally non-convertible and have maturities in the 10-to-15-year range. They are often unsecured and may be subordinated to the senior (secured) debt of the company in the event of a liquidation. Given the high gearing ratios which may apply, junk bonds have the appearance of debt but may turn out to be closer to preferred equity.

When junk bonds are used to finance takeover bids, the managers of the issue often obtain commitments from investors by way of a promise to purchase the bonds, contingent upon receipt of acceptances by the bidder of a pre-determined percentage of outstanding stock (shares). The issued bonds are then secured by the acquired company's stock (as opposed to the issuing company's assets).

Small high growth companies and medium-sized companies seeking internal expansion or highly leveraged acquisitions as well as leveraged buy-out companies are major borrowers on the junk bond market. All borrowers have a limited ability and/or desire to take on board large amounts of secured debt.

Borrowers are attracted to junk bonds because traditional non-bank providers of corporate debt (pension funds, insurance companies and venture capitalists) are unable to match junk bond underwriters' abilities to raise large sums of money on relatively short notice (in extreme cases billion-dollar issues may be raised in a matter of days).

Equally, the provision of debt by banks tends to be bound by restrictive

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covenants such as negative pledge ratios and gearing ratios or not be available at all. Junk bonds are generally a more flexible (though not necessarily cheaper) source of funding.

These factors and the pre-commitment process described above, make junk bond issues a particularly attractive method of financing highly leveraged takeover bids where speed and secrecy are of the essence.

Investors in junk bonds are primarily American financial institutions, particularly savings and loan companies (similar to a savings bank or building society) and high yield mutual bond funds. Pension funds, insurance companies, commercial banks and investment banking firms also hold large portfolios of junk bonds. (They are thus indirect providers of corporate debt in addition to their traditional debt provision activities).

The institutions are attracted by the high yields on non-investment-grade bonds compared to their investment-grade counterparts, even allowing for the increased default risk. Additionally, viable secondary markets in the bonds made by investment banks ensure that the securities are reasonably liquid.

A less publicised attraction of the market to fund managers is the absence of a public exchange for the dissemination of daily bond prices. Hence, temporary downturns in the market are less likely to be communicated to ultimate investors with a consequent lessening of transient pressures on fund managers.

Junk bond issuers may also be major investors. This phenomenon may be attributable to the intrinsic attractiveness of junk bonds as an investment, issuer loyalty and/or the market power of the dominant junk bond underwriters.

Prior to the advent of the junk bond market in the late 1970s, only the top tier of US corporations (those with investment-grade ratings) could obtain domestic bond financing. Those companies outside the top tier, whether because of lack of size or inferior or unsustained financial performance, had to rely primarily on bank loans to finance expansion or refinance debt. By the same token, the bonds of former investment grade companies, fallen from grace because of adverse performance, "fallen angels", traded at a severe discount to investment-grade bonds. The prevailing market view at the time was that the ability of bond issuers to meet their debt payments should be completely beyond doubt.

The size of the discounted bond market expanded greatly with the failures of Penn Central Railroad and a host of real estate investment trusts in the United States.

The idea that yields on non-investment-grade bonds more than compensated for the associated default risks only gained credence in the early 1970s. (Subsequent academic studies have confirmed this view. For instance, in the period 1974-1985 the average default rate on junk bonds was merely 1.53 per cent as against .09 per cent for investment-grade public bonds. Over the same period, the compound annual rate of return on junk bonds has been approximately 3 per cent over that for their investment-grade counterparts. It has also been estimated that theoretical junk bond portfolios have significantly outperformed investment-grade bond portfolios, even allowing for defaults.)

As a result of strong marketing of the risk return advantages of fallen angels by a small number of financial intermediaries (most notably Drexel Burnham Lambert), some of the more aggressive institutional investors took up holdings in the bonds. They were attracted not only by current yields but also the possibility of large capital gains should the issuing companies' performances improve.

In the late 1970s, investment banks, encouraged by their success in trading fallen angels, brought the first junk bond issues to the US market. The issuers tended to be fledgling companies with high growth potential and which had relied on limited and restrictive bank borrowings. During this period, there was also a significant increase in interest and inflation rate volatility leading to larger spreads within fixed-income security yield rates.

As a result, the risk/return characteristics of junk bonds became increasingly attractive. Growing numbers of institutional investors, such as savings and loan companies and mutual and pension funds, became purchasers of junk bonds. Increasingly also, financial intermediaries were being drawn into the market by the attractive underwriting commissions obtainable, compared to those for other fixed interest securities. Commissions for the latter had been whittled down by increasing competition in the US financial markets.

In 1981, junk bonds began being used to finance leveraged buy-outs (LBOs). As the name suggests, LBOs are highly leveraged acquisitions generally undertaken by the existing management of the subject company. In LBO situations, the debt-to-equity ratios of the acquired (generally non-investment-grade) company may blow out to as much as nine to one and cash flow coverage by reduced to only 1.5 to two times debt repayments.

In the early 1980s, LBOs were generally regarded as an unproven and therefore risky method of acquisition. Discouraged by US Federal Reserve bank lending policies, banks were reluctant to lend large sums of non-senior debt without fairly severe restrictions. Junk bond underwriters, on the other hand, were aggressively seeking new business in a potentially high growth, high profit market.

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Moreover, the underwriters' ability to place large volumes of junk bonds on short notice made junk bonds a natural source of LBO finance.

Two outstanding recent examples of LBO financing are the Kohlberg Kravis Robert & Co's buy-out of Beatrice for $6.2 billion and Safeway Stores for $5.3 billion. These involved debt issues of $2.5 billion and $1 billion respectively which were subordinated to senior debt. In all, some $31 billion (as at June 30, 1986) in junk bonds have been issued to finance LBOs.

From 1983, junk bonds became an important financing tool for the wave of large highly leveraged hostile takeover bids in the US. As with the LBOs, aggressive junk bond financiers were keen to underwrite the large sums of non-senior debt associated with such bids. And, as indicated above, the ability to place junk bonds with speed and secrecy made them a natural ally of many of the better known corporate raiders.

Recent examples of hostile junk bond financed takeovers and takeover bids are set out in Table 1.

The junk bond market has shown impressive growth over recent years and most particularly since 1982. Table 2 shows that the outstanding volume of junk bonds has grown from $18.5 billion in 1982 to $59.1 billion three years later. Its share of the total corporate bond market has also increased markedly. Table 3 indicates strong growth in new junk bond issues on a year by year basis. The 1985 figure of nearly $20 billion in junk bond issues shows the importance of the market as a source of corporate debt.

It is fair to say that with the growth of the market, highly leveraged acquisitions and hostile takeover bids for large corporations have been greatly facilitated. As a result, control of some of America's larger public corporations has passed to management and private entrepreneurs. Moreover, because of the accessibility of large sums of junk bond finance to so-called "corporate raiders" (such as T Boon Pickens, Carl Icahn, Irwin Jacobs and Ronald Perelman) the latter are now able to make hostile takeover bids of public companies many times their size.

However, the recent trends should be placed in perspective. According to most estimates (there is great variance between the various published figures) only a minority of junk bond finance is used for merger and acquision activity and only a small fraction of merger and acquision activity is junk bond financed. For instance, the US Federal Reserve Board calculated that only some 9 per cent of merger and acquisition activity was junk bond financed in 1984 and of all junk bond financing for the same period, only 41 per cent related to merger and acquisition activities. Morgan Stanley have calculated estimates of 4.5 per cent and 31 per cent for the corresponding figures in 1985. (However, in a more recent study Salomons calculated that some two-thirds to three-quarters of junk bond debt is used to finance such activity.)

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Notwithstanding the media attention devoted to junk bond financed "mega" buy-outs, LBOs of small- and medium-sized companies are financed principally by banks, institutions and venture capitalists. Indeed, banks provide some 60 per cent to 70 per cent of all LBO finance in the United States.

Finally, Tables 2 and 3 indicate that as regards the total corporate bond market, junk bonds play a significant rather than a dominant role. The growth in the share of junk bonds as a percentage of new corporate bond issues clearly seems to be tapering off.

The junk bond market has been recently affected by a number of potentially constraining factors. Primary amongst these has been the Dennis Levine insider trading scandal. As a consequence of the scandal, Drexel Burnham Lambert, the leading underwriter of junk bonds, is to be the subject of a federal investigation. Junk bond prices have softened (recovering subsequently) and it is believed that a number of prosposed junk bond financed takeover bids have been dropped.

Of perhaps more lasting importance, the scandal has added political fuel to the anti-takeover and anti-junk bond arguments being currently waged in Washington. The outcome may be legislative restrictions on highly leveraged hostile takeover bids. In this regard, a number of anti-junk bond bills were introduced in the last congressional session. While none were passed, further congressional activity is likely.

The Federal Reserve has also entered the junk bond political debate by announcing rules that place limits on the use of debt (including junk bonds) for hostile takeover bids. Under the rules, only 50 per cent of such bids may be debt financed. However, the scope of the rules' application is limited in that they only apply where the acquisition vehicle is a shell company rather than an operating company and where the debt securities are not guaranteed by the parent company.

Perhaps the most important potential limiting factor has been the recent increase in the default rate for junk bonds. In 1986 this rose to approximately 5 per cent, well above the average for 1974/1985 of 1.53 per cent. 1986 might be viewed as an extraordinary year. However, many observers believe that the quality of more recent junk bonds issues has deteriorated with only marginal interest cover being provided. A general economic and/or stock market downturn could lead to higher default rates over a prolonged period and a general reassessment by investors of the risk return advantages of junk bonds.

However, it appears that junk bonds have a long-term niche in the corporate finance market. The commercial incentives referred to above for borrowers and investors can be expected to remain though, as indicated above, legislative restrictions and default risk may be limiting factors on the overall size of the market.

There are currently no domestic corporate debt securities akin to American junk bonds in the Australian market. Those small number of Australian companies who have required junk bond financing have looked to the United States market.

For a junk bond market to be viable in Australia an environment similar to that which enabled the American bond market to develop must exist. Primarily, this means a significant mismatch between borrowing costs and default risks for second-tier companies. Historically, interest rate spreads between prime and second tier American companies have been larger than those between Australian companies, principally due to greater size and fragmentation of the American investment market and the generally lower interest rate levels in that country which could in turn support larger rate spreads. Interest rate spreads in Australia have lessened with financial deregulation and the consequent increased availability of bank debt.

It is not clear whether individual Australian investors have a substantive appetite for lower quality or long-term debt securities in the current inflationary environment.

The Australian market for debt securities must be of a sufficient size and depth to support a viable secondary market. Not only is that market small compared to the American market, but it is also dominated by financial institutions which prefer investment quality debt or alternatively equity investments with upside potential.

It is not clear whether individual Australian investors have a substantive appetite for lower quality or long term debt securities in the current inflationary environment. Apart from government/semi-government securities, the only significant debt securities purchased by Australian private investors are finance company debentures, and buyers of these securities are generally older individuals who are risk-averse.

Whilst the pre-conditions for a viable junk bond market are not presently met, it is arguable that a more conducive environment will exist in the medium to long term. This view is principally based on three factors.

Firstly, the number and size of potential borrowers and investors in the Australian market are likely to increase significantly over time, as domestic capital markets become increasingly large and internationalised. Secondly, Australia's future economic performance may be such as to induce a fall in domestic interest rates to international levels. Finally, Australian investing institutions may, over time, take less risk minimising and a longer term approach to corporate debt provision, following in the steps of their American counterparts. □

TABLE 1: HOSTILE JUNK BOND FINANCED TAKEOVERS AND TAKEOVER BIDS

Year	Vendor/Target	Purchaser/Bidder	Purchase price ($ million)
1985	Phillips Petroleum	Carl Icahn	8000*
1985	Trans World Airlines	Carl Icahn	400
1985	Revlon	Pantry Pride	1800
1986	Metro Media Television Stations	News Corporation	1500
1986	Metro Goldwyn Mayer/United Artists	Turner Broadcasting	1500
1986	Uniroyal Chemical Co	Triangle Industries	760*
1986	Union Carbide	GAF	3500*
1986	USX	Carl Icahn	8000*

* Unsuccessful or current bids

TABLE 2: OUTSTANDING DEBT OF US CORPORATIONS (US $ BILLION)

Year	Public junk bonds	Total corporate bonds
1985	59.1	653.7
1984	41.7	568.9
1983	28.2	518.0
1982	18.5	487.4
1981	17.4	458.6
1980	15.1	431.7
1979	9.4	370.8

Source: Morgan Stanley & Co; Federal Reserve Board

TABLE 3: YEARLY PUBLIC ISSUES OF CORPORATE DEBT (US $ BILLION)

Year	Total public bond issues by US corporations	Public issues of straight junk bonds
1983 (1st half)	114.3	15.8
1985	120.0	19.8
1984	73.6	15.8
1983	47.6	8.5
1982	44.3	3.2
1981	38.1	1.7
1980	41.6	2.1
1979	25.8	1.7
1978	19.8	2.1
1977	24.1	1.1

Source: Federal Reserve Bulletin; Drexel Burnham Lambert