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Domestic Credit by Steve Parsons

The RJR bond downgrade

The nail in the junk bond and LBO coffin—and maybe the doom of the entire corporate debt structure.

After weeks of financial battering that culminated in the Jan. 15 Campeau bankruptcy filing, just about the last vestige of hope for the shellshocked wheelers and dealers of junk bonds and LBOs were the so-called "blue chip" takeover companies, epitomized by RJR Nabisco.

But whatever lingering fantasies were left were dashed on Jan. 26 with the unexpected downgrading of RJR debt and the renewed junk market collapse that ensued.

The $25 billion RJR deal had been regarded as the Rolls Royce of all the leveraged buyout companies, immune to the pitfalls that had engulfed so many others. Engineered in 1988 by takeover king Kohlberg Kravis Roberts, RJR's huge debt burden was considered to be manageable, and its bonds were given the highest ratings of any junk—the cream of the crap, so to speak.

KKR immediately began stripping key asssets from RJR Nabisco in order to pay down debt. Such familiar names as Chun King, Del Monte, and Baby Ruth candy were just some of the familiar brand name segments that were pawned to bring in $5.5 billion or so in six months.

On Sept. 17, just days after the initial Campeau collapse signaled the imminent demise of the junk bond and LBO bubbles, a *New York Times* analysis characterized RJR's post-buyout financial parameters as "stellar," citing increased operating earnings, a spate of new products, and sweeping internal cost-cutting measures.

Reality hit in January, with a vengeance. RJR planned to issue $1.25 billion in senior notes to retire bank debt, and was confident it would cross the junk bond line and receive a higher-quality, investment-grade rating. But Moody's and Standard & Poor's not only rated the issue as junk; it downgraded nearly $18 billion of RJR's existing debt.

The impact was devastating. RJR bonds were dumped wholesale, losing up to 10 points on Friday, Jan. 26 and up to 10¾ the following Monday. That's about $200 for every $1,000 in face value, in just two trading sessions. And the entire junk market plunged one to three points across the board.

This was a "major confidence killer," moaned Frank Colombo of Dillon Read, "this was not expected." Acknowleged Morgan Stanley's Peter Karches, "The whole junk market is in bad shape."

The incredible extent of RJR Nabisco's financial insolvency, and the desperate maneuvers taken by LBO firms in the junk bond market, were laid out by *New York Times* columnist Floyd Norris. First, it was revealed that one of the means by which RJR was able to both sell its junk bonds and keep their "value" up, was to promise that it would raise interest rates on at least $6 billion of its junk, to whatever levels necessary—i.e., unlimited rates—so that bondholders could sell the bonds at face value in 1991. It was undoubtedly only with this open-ended proviso that it could sell the garbage in the first place and keep up its value.

That means that investors who bought RJR junk bonds that were selling on Jan. 29 at only $58 per $100 of face value, would be paid about 77% interest rates by next year in order to bring the return up to $100! It was precisely this "innovative" financing that finished off Hillsborough Holdings, another KKR buyout firm that declared bankruptcy last year.

But that's not all. Apart from this insanity, these bonds not only pay no interest until 1995 and 1999, but the interest and principal is compounded, and is supposed to be paid for—in new bonds! And with the junk market nosediving, and the promise to raise interest rates to meet face value, new bonds can only be issued at rates over 20%. On $6 billion, each percentage point of interest is $60 million, 20 points is $1.2 billion—and it's all compounded!

RJR's only—but totally futile—hope is that bondholders will convert their debt into equity shares in the company. Share prices are now down to about $5 or $6, or 20% of what it takes to entice the bondholders to exchange.

Junk bonds are now defaulting at a 38% annual rate, according to a recent study by the nonprofit Bond Investors Association. This has enormous implications for all corporate debt paper. Junk bond volume, including non-rated issues, is actually $300 billion, not just the $226 billion rated by Moody's, says the BIA report. This means that an astounding 30% of all corporate bond issues are junk, up from just 6.5% in 1981. And such a high default rate for junk means that 13% of all corporate debt will go into default this year.

But this assumes that the economy has had its soft landing. Even a "mild recession" would dry up short-term funding for junk bond issuers, says Moody's. Which, of course, would send the default rate zooming, and torpedo the bond market.

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