Retail sales chains primed for disaster

by Anthony K. Wikrent

The problems with Campeau Canadian Corp., the retail store empire built on junk bond financing, are just a foretaste of what is to come for the entire retail trade and its suppliers, an ongoing analysis by *EIR* shows.

EIR has compiled a list of over 50 companies with financing structures based on junk bonds and junk loans. Of these, 12 companies are in the retail trade, and account for well over one-tenth of the nation's total retail sales. The list includes the nation's two largest grocery chains, Safeway and Kroger, the two largest convenience store chains, 7-Eleven and Circle K, and the company that operates the largest department store in the world, R.H. Macy and Corp. Campeau's Corp.'s two department store chains in the United States—Allied Stores and Federated Deptartment Stores—are also on the list.

Taken together, in 1987 the 12 companies on our list accounted for 12.8% of total retail sales, and five companies on the list accounted for 16.3% of all retail food sales. *EIR* is also studying the financial posture of Sears Roebuck to determine if it should be added to the list, which would boost the list's share of total U.S. retail sales to nearly 20%.

The essential problem is that these companies are being crushed under a gigantic load of debt. In many instances, the company's interest expenses exceed its operating income. This was the case for Campeau's Allied chain, where the cost of servicing the debt in 1988 exceeded operating income of $192.5 million, by $58.8 million. Almost all the companies on our list have interest expenses that are 70-80% of operating income, if not more.

These unstable financing structures are the result of what the financial wizards call "highly leveraged transactions" (HLTs), more popularly known as leveraged buy-outs. A major component of HLTs are the notorious junk bonds—low-grade, high-risk bonds yielding high interest rates to the investor. The entire junk bond market for which began to blow out on Sept. 13, when it became known that Campeau would be unable to meet a $401 million loan repayment to First Boston Corp. on Sept. 15. The loan repayment was for the unpaid portion of a $1.15 billion bridge loan First Boston had provided in July 1988, for Campeau's leveraged takeover of Federated Department Stores. Campeau's difficulties underline the fact that the largest component of HLTs are not the junk bonds, but short- and medium-term loans, provided by money center banks and investment houses, such as Manufacturers Hanover, CS First Boston, and Citibank.

Finance runs wild

Until the Campeau default sparked the junk bond collapse, banks and investment houses were willing to extend financing for HLTs, no matter how shaky the junk deal appeared, because they were guaranteed an up-front fee for simply arranging the financing. In fact, Morgan Stanley is now in court, attempting to collect fees from John B. Coleman and Co. for merely *intending* to arrange a financing package. In the case of Campeau, CS First Boston may have taken a major hit in the bonds it holds, which are now selling for one-quarter of their face value, but collected over $200 million in fees as Campeau's adviser and underwriter. As the *Wall Street Journal* put it modestly, Campeau Canadian Corp. was "First Boston's most lucrative client of the decade."

But financing is only a service to a company, and should not become the basis of its entire operations. Once a company is forced to carry the levels of debt that are routine in HLTs, the orientation of the management is shaped by the need to meet the demands of the company's creditors, rather than its clients. In a book being privately circulated on Capitol Hill, entitled *The Japan That Can Say No—The New U.S./Japan Relations Card,* Akio Morita, the highly respected founder of Japan's premier consumer electronics firm, Sony, warns that the function of money "should not be to enrich banks and securities companies, but to smooth the path of production."

A former vice president of Allied Department Stores, Herbert Wittkin, says the same thing. "The important part of a business is *products* and *service*," Wittkin stresses. "But what's happened is, the support side of the business has taken over. The banks have made debt fashionable. They have made a workable, sensible, attractive approach out of lunacy!"

Other companies in trouble have not been bought out, but have taken on large debts to make themselves less attractive as takeover targets, such as the nation's second largest supermarket chain, Kroger. In 1988, the largest HLT specialist firm, Kohlberg, Kravis and Roberts, moved in on Kroger. KKR had already pirated off with the nation's largest chain, Safeway, in August 1986 by means of a $5.336 billion HLT. Safeway's debt had rocketed upward overnight, and the chain lost more money in the last 17 weeks of 1986 than it had made in the first 35 weeks of that year, before KKR had taken control. Kroger's management, understandably, had no desire to have their company suffer Safeway's fate, and in October 1988 it fought back by quadrupling the company's long-term debt, from $986.8 million, to $4.725 billion,

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smashing Kroger's net worth from $1.134 billion to *negative* $2.679 billion. Now Kroger is selling off parts of its operations in an attempt to buy down its unmanageable debt.

Big companies in big trouble

The two largest convenience store chains, 7-Eleven and Circle K, are also choking on debt. Southland Corp., the operator and franchisor of 7-Eleven and half-owner of Citgo Petroleum, is in particularly bad shape, even with annual sales approaching $8 billion. In December 1987 Southland was bought up by JT Acquisition Corp., a front for the Thompson family. Interest expenses have leaped from $75.2 million in 1986, to almost $200 million, while operating income has dropped from $319 million to around $200 million. The result: Whereas Southland posted a net income of $200.4 million in 1986, it posted a $149.7 million loss in 1987, and a $216.2 million loss in 1988.

And then there's the flagship of department stores, Macy's, whose Herald Square store in New York City is the largest in the world. The parent company, R.H. Macy and Co., which does business in New Jersey, Georgia, and California as well, acquired Macy's in a buy-out in July 1986, dumping over $2 billion in debt on the retailer. While operating income has increased over one-fifth, based on steadily rising sales, interest expenses have increased *fivefold*. The result: Net income of $189.3 million in 1985 and $205.6 million in 1986, has been replaced by a net loss of $13.8 million in 1987.

But the largest detonator could very well be the largest retailer: Sears Roebuck, with total revenues of $50.251 billion, of which $30.256 billion are from its 824 retail outlets and 2,303 catalogue offices, is now consuming over half its operating income for debt service. Officials at Sears refuse to comment, but a retail trade analyst said that Sears overstretched itself in its purchases of Dean Witter Reynolds and Coldwell Banker. Sears has already begun to spin off parts of its subsidiaries; in January it sold off its All State insurance group.

Trigger for deflationary collapse?

The financial wizards who have created this lunacy are heaving sighs of relief, since Olympia and York, the Canadian hot money real estate operation of the Reichmann brothers, came to Campeau's rescue on Sept. 18 with an emergency infusion of $250 million, calming the raging storm in the junk bond market. But retail analysts who are trying to calculate the toxicity of the fallout, are terrified that something much worse may have been set into motion. The Olympia and York bailout will only meet Campeau's immediate debt obligations, particularly to its suppliers, which does little to ensure that Allied and Federated will be able to order more merchandise, as little as a month from now.

"There is only one answer," according to Kurt Barnard, of the Barnard Retail Marketing Newsletter. "Allied and Federated will go into an intense promotional mode, take a huge markdown, and try to blow all the merchandise out the door as soon as it comes in, to raise the cash right away they need to guarantee their purchases of merchandise for Christmas. And this is a terrible concern for the other retailers." Thus, leveraged retailers already operating with razor thin profit margins may find themselves hurled into a price war that could sink them in red ink, and replicate the Campeau default dozens of times over.

But even without the "last straw" of such a price war, retailers are now facing a collapse in Americans' discretionary income. Recent statistics show that retail inventories are beginning to bloat, as consumers back off from assuming new debt obligations. Elliot Janeway authored major signal pieces in the *Washington Post* on Sept. 24, entitled "A Deflation Wave? Awash in Money, the Economy is Drowning in Debt," and in the *New York Times* Sept. 17, entitled "The Inventory Mess—Caution: A Price Deflation Is Under Way." Collapsing sales in Long Island, for example, is what has caused KKR's Seaman's Furniture, the nation's second largest furniture retailer, to run into debt difficulty. And the owner of a Boston area office furniture company told the *Boston Globe* on Sept. 23, "Activity is slow and slower, the worst that I've seen in my 17 years in the business."

Effect of blowing out one-fifth of retail

Because the effects of the economic collapse in physical production have been papered over by floating layer after layer of debt, we have now reached the point where the failure of one company in the retail sector will initiate a chain reaction of failures among other companies burdened with excessive debt, and working with operating income to debt service ratios considered disastrous 20 years ago.

Think of it this way: One-tenth to one-fifth of the nation's distribution chain to the consumer is about to be blasted into financial oblivion. This is the system that distributes the very basic necessities of sustaining human existence—clothing and food. If a 1929-30-style chain of collapse were to hit the retail sector, the disruption in distribution of food and clothing would begin to approximate that of a low-level nuclear war. And then there would the shock effect on unemployment, where an industry with a highly disproportionate share of the workforce, compared to physical production, would be shut down, laying off hundreds of thousands of workers. Just imagine every 7-Eleven across the country shutting its doors. The shock effect, both economically and psychologically, would make the 1930s Great Depression seem like a fairy tale of prosperity.

Sound outlandish? Consider this: The week when Olympia and York moved in with $250 million to bail out Campeau, it suddenly cut off negotiations to buy out a prime piece of real estate in Chicago for $1 billion. The seller was Sears, and it was trying to sell its corporate headquarters, Sears Tower.