THE DEBT SQUEEZE
CAN LEVERAGED COMPANIES COPE?

CORPORATE STRATEGIES: ▶DOW JONES ▶ROCHE

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The Iraq Crisis

THE FALLOUT

▶ THE GLOBAL COSTS

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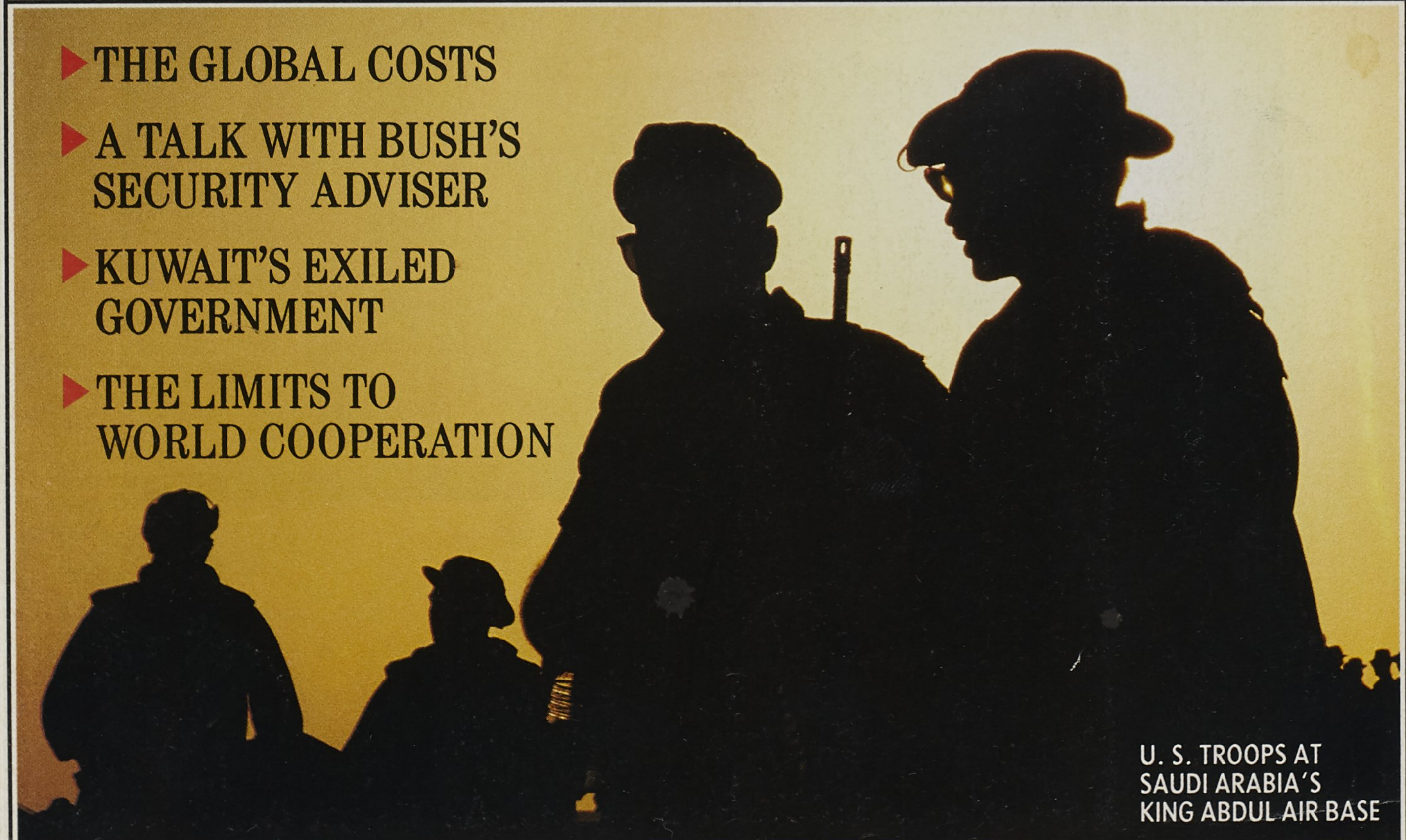

U. S. TROOPS AT SAUDI ARABIA'S KING ABDUL AIR BASE

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SEPTEMBER 10, 1990

■ **COVER STORY**

GLOBAL FALLOUT

THE IRAQ MESS WILL CLOBBER WORLD ECONOMIES

As the Persian Gulf crisis entered its fourth week, a peace lull hit. President Bush and Iraqi leader Saddam Hussein muted their bellicose rhetoric to let U. N. Secretary-General Javier Pérez de Cuéllar try his hand at mediation. The news sent panicked oil traders diving for cover. Prices fell $4 a barrel, enough to bring even bottomed-out stock and bond markets up for air. But if war is off for now—or permanently—the cost to the world economy of Saddam's invasion of Kuwait is already far higher than many Americans, Europeans, and Japanese initially thought.

After nearly seven years of safe, uninterrupted growth, the global economy is taking a serious hit. Most governments, businesses, and consumers confidently expected oil prices to remain at $18 a barrel. Now, the daunting prospect of crude stuck at $27 or $30 a barrel and long-term interest rates pushing 10% is dashing hopes that the booming '90s belong to Europe and Asia (table). Now, the question is: What boom?

Also fading fast are hopes that Europe and Japan are ready to shoulder more of the burden of global political leadership that comes along with economic superpower status. With Bonn and Tokyo offering limited aid to America's costly military effort in the gulf (page 20), the U. S. is picking up the tab. Japan has been "too slow to act," admits Kazuo Aichi, head of the Liberal Democratic Party's International Bureau. If the world economy stalls, some even wonder whether the Japanese and Germans will be willing to stimulate to get things going again.

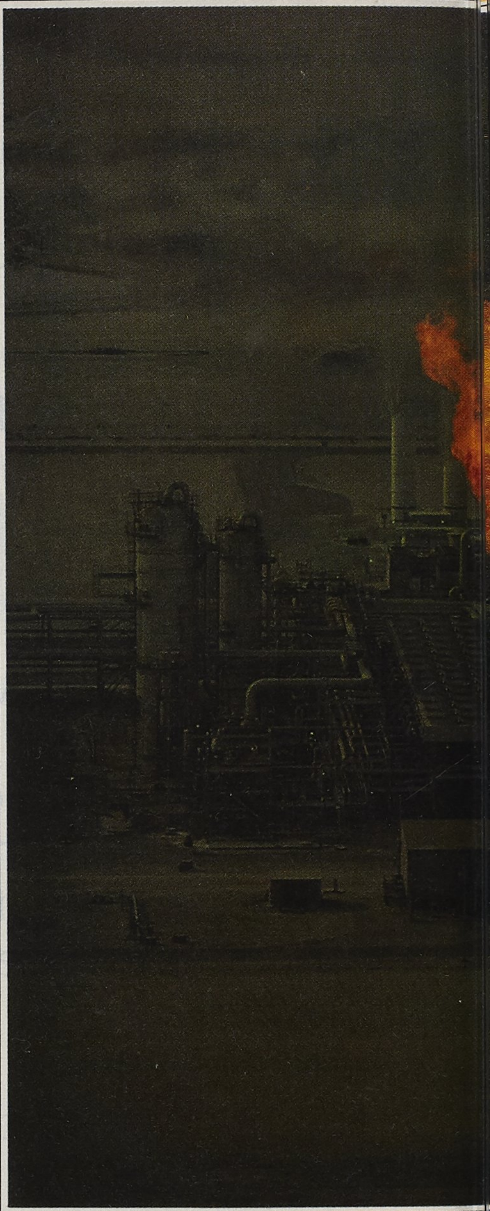
Amid the leadership debate, the question of how much the gulf crisis will hurt consumer sentiment is being watched carefully. With OPEC hiking output, oil prices could retreat to $25 or less later this year—something some cartel members vow to resist. But General Electric Co. Chief Economist Walter Joelson worries that even $25 oil could "condemn us to stagnation."

Or worse. In the U. S., an already weak economy now has to bear the $1.5 billion-a-month cost of the gulf military buildup, and a recession seems inescapable. With the Conference Board's consumer confidence index in August taking its steepest plunge since 1983, some seers, such as Christopher P. Varvares of the St. Louis-based forecaster Laurence H. Meyer & Associates, believe the U. S. economy could shrink at a sharp, 2.1% annual rate in the fourth quarter.

ON THE BRINK. Abroad, slowing corporate profits are giving forecasters the willies. Europe is turning out to be the biggest surprise. Gripped by 1992 mania, many dazzled Europeans had chosen to overlook strains developing in their economies even before Saddam's troops entered Kuwait. But now, Western Europe is facing growing signs of overcapacity in autos, steel, chemicals, and paper. High interest rates engineered by West Germany's Bundesbank to keep inflation at bay are biting. And most of Eastern Europe is already in recession as countries shift from communism to capitalism. All of a sudden, "the vision of the European growth decade has been dealt a blow," says Giles Keating of Crédit Suisse-First Boston Ltd.

Britain will benefit from rising prices for North Sea crude exports, but that won't keep its economy from the brink of recession. Costlier oil and 15% interest rates make a volatile mix, says Richard Freeman, chief economist for Imperial Chemical Industries PLC. "The impact on confidence will hit business investment" when "the world economy is almost stagnant, and you're imposing an inflationary shock," he says.

In Italy and France, where stock markets have plunged 15% since the Iraqi invasion, pessimism is mounting. Turin-based Fiat, the giant auto maker, plans to lay off 35,000 of its 117,000 workers over the next four months to reduce its stocks of unsold cars. And Italian chemi-



cal maker Enimont is furloughing 2,000.

The French manufacturing slowdown already under way during the first half is likely to worsen as the year draws to a close. French carmaker Peugeot, for example, believes higher oil prices will prompt consumers to shift to cheaper small cars, reducing profits. Steep interest rates are also keeping the franc high and pummeling the competitiveness of many exporters. Luxury-goods maker LVMH Moët Hennessy Louis Vuitton, for one, has seen its shares fall 25% since Aug. 1 amid expectations of narrowing profits on sales of champagne, cognac, and luggage to its big markets in the U.S. and Japan. To offset oil's impact, Prime Minister Michel Rocard is considering cutting taxes by an additional $1 billion on top of a $385 million reduction already in the works.

West Germany's strong economy is best off, even though it must contend with the immensely costly challenge of rebuilding East Germany. Retail sales are holding up, and inflation of 4.5%, up from the current 2.5%, "will have only a slight effect," says Jörg Hinze of Hamburg's Institute for Economic Research.

But oil prices and the strong Deutschemark are cutting sharply into the profits of chemical makers Bayer and BASF, and the partly state-owned airline Lufthansa is running an operating loss. Fearing for jobs, the Socialist candidate for Chancellor, Oskar Lafontaine, wants to limit the rights of ethnic Germans in the Soviet Union and other former East bloc states to return to their fatherland.

SHRINKING MARGINS. Japan still believes it can avoid much damage, and Japanese companies are bent on raising capital spending even with interest rates at a nine-year high. But the Bank of Japan's tight-money stand will leave many debt-laden companies, including auto maker Isuzu and electronics maker NEC, with shrinking margins. And many big banks fret about shaky real estate loans and falling stock prices.

Despite the pain of tight money, no one is suggesting that the Bank of Japan—or the Bundesbank, for that matter—suddenly turn on the monetary taps. As central bankers learned from past oil-price jumps, to do so could court even worse inflation and a recession later. Even the Federal Reserve is reluctant to cut interest rates until the gulf and the markets simmer down. The longer that takes, and the longer oil and money remain tight, the more pain the world's economies will endure.

By William Glasgall in New York, with Blanca Riemer and Stewart Toy in Paris, Richard A. Melcher in London, Igor Reichlin in Bonn, and Ted Holden in Tokyo

■ BURNOUT: PREDICTIONS OF FAST '90S GROWTH WERE BASED ON $18 OIL

■ UNEQUAL BURDEN: THE U.S. IS PICKING UP THE MILITARY BILLS

(TOP TO BOTTOM) PHOTOGRAPHS BY AZZI/WOODFIN CAMP; BOUVET/GAMMA-LIAISON; ILLUSTRATION BY LAUREL DAUNIS/BW

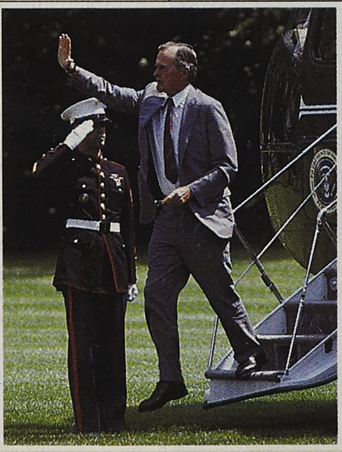
U.S. FORCES IN SAUDI ARABIA: $43 MILLION A DAY

Commentary/by Amy Borrus and Douglas Harbrecht

COOPERATION IS GREAT—BUT WHO'S GOING TO PAY THE TAB?

If there's a silver lining in the dark cloud over the Middle East, it's the burst of international cooperation not seen since World War II. In a matter of weeks, the U. N. Security Council has emerged as a diplomatic powerhouse. It put teeth into the international sanctions against Iraq, most notably by authorizing the use of force to make the embargo stick. President Bush's rhetorical claims of "Iraq against the world" rang true as U. S. forces were joined by warships from Britain, France, and the Soviet Union; troops from Egypt, Syria, and Morocco; and medical supplies and materiel from Germany and Japan.

But don't start celebrating a new era of international solidarity. Compared with the challenge of resolving other regional disputes, the unique circumstances of Saddam Hussein's aggression make isolating Iraq look easy. And amid all the global cooperation, the countries involved are just beginning to grapple with the divisive issue of who will pay for collective security.



BUSH: RISING TO THE OCCASION

Clearly, economic interdependence and the end of the cold war are pushing nations toward mutual action. With the easing of the Soviet threat, Western leaders are focused on containing regional conflicts as well as such relatively new problems as drug trafficking, global warming, and nuclear proliferation. "Instead of one huge problem, now you have five or six equally dangerous problems," says one State Dept. official. "Solving them takes many actors working together."

Still, the growth of such international organizations as the Conference on Security & Cooperation in Europe and the Asia-Pacific Economic Cooperation Council doesn't mean that conflicts will always be hashed out over the dinner table rather than on the battlefield. India and Pakistan may yet come to blows again over Kashmir. Southeast Asia remains mired in Cambodia's civil war, despite the sweeping U. N. plan for peace. And from Monrovia to Cape Town, Africa is riddled with fighting and internal unrest.

The current crisis in the Mideast is far from typical. Saddam's actions have threatened to throw the world's economy into another major oil-induced recession. And his crude propaganda efforts can't conceal that his annexation of Kuwait is a clear violation of international law. "There have been few cases of aggression as naked as Iraq's," says former State Dept. policy planner Francis Fukuyama. "In other regional conflicts, the rights and wrongs may not be so clearly drawn."

Collective security works best when there's someone to take charge. In this case, George Bush has risen to the occasion, masterfully galvanizing support for the isolation of Iraq. Events of the last few weeks have made it clear that the U. S. is the world's only true superpower.

The problem is that military might takes money—and Uncle Sam has a $200 billion-plus deficit. With Operation Desert Shield barely a month old, Democrats have tempered their support for the President by complaining that the allies, particularly Japan and Germany, aren't contributing their fair share. While the U. S. is spending $43 million a day for forces in Saudi Arabia, Bonn and Tokyo have so far offered only modest donations.

The constitutions imposed on Germany and Japan by victorious allies after World War II severely limit their military capability. But Bush has been turning up the heat on the allies. Responding to repeated phone calls from the President to Prime Minister Toshiki Kaifu, the Japanese government on Aug. 29 announced that it will give an unspecified amount of aid to Turkey, Jordan, and Egypt. Tokyo also offered two cargo ships and two airlifters to ferry food and medicine to the troops.

NOTHING LESS. While the steps are welcome, the Administration hopes they're just the first installment. "We're not just looking for money," says a State Dept. official. "We want to see the Rising Sun flag in the Persian Gulf." Congress will accept nothing less. "Japan should at the very least make a major financial contribution to the cost of the operation," says Senate Intelligence Committee Chairman David L. Boren (D-Okla.). "American young people are putting their lives on the line."

The intensifying debate over "burden sharing" only heightens the point that even a custom-made villain like Saddam can't keep the allies rowing together indefinitely. With U. N. Secretary-General Javier Pérez de Cuéllar in the Mideast, the immediate outlook in the gulf is for diplomatic wrangling, not fighting.

But even if Pérez de Cuéllar succeeds in negotiating Iraqi troops out of Kuwait—a long shot—the question of who pays for this and future operations will remain. It's nice to think that the U. N. can be the world's sheriff. But peace still comes at a price that too few seem willing to pay.

(TOP TO BOTTOM) PHOTOGRAPHS BY BOUVET/GAMMA-LIAISON; TRIPPETT/SIPA

■ **COVER STORY**

'EVEN SADDAM HUSSEIN CAN LEARN LESSONS'

A talk with National Security Adviser Brent Scowcroft

During the long days of the Persian Gulf Crisis, no aide has been closer to President Bush than National Security Adviser Brent Scowcroft. The 65-year-old retired Air Force general, who served President Ford in a similar capacity, has rarely been far from Bush, whether fishing or teeing off on the golf course. Taking a short break in his makeshift office at a Kennebunkport (Me.) inn on Aug. 26, Scowcroft spoke with BUSINESS WEEK *White House Correspondent Douglas Harbrecht about the Administration's strategy for facing down Iraqi leader Saddam Hussein.*

Q The American public seems to think that when the President talks about our way of life being threatened by Saddam Hussein, he's saying he'll put American troops into combat to keep oil prices down. Are our policy goals in this crisis sustainable?

A It's not simply to keep oil prices at a particular level. That is a gross distortion. We have two objectives. The first is to show that naked aggression, posing a threat not only to Kuwait but to all the other countries in the gulf, won't be tolerated. And we intend to prevent Iraq, either by physical control or by threats, from controlling the oil of the Middle East, with the consequent influence on the world economy.

Q Can you foresee any scenario where there isn't going to be a major U.S. troop presence in the Middle East for years to come?

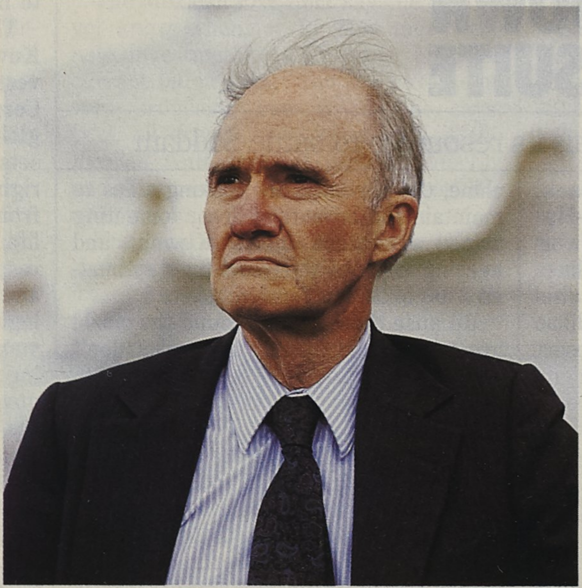
A Yes, if there is an [Iraqi] withdrawal. The fact that there has been this demonstration, not only by the U.S. but by the world community, of quick reaction to aggression means that expectations and attitudes throughout the region will change. It won't necessarily mean that peace and nonaggression have to be maintained by military force.

Q So Saddam must go?

A Not necessarily. Even Saddam Hussein can learn lessons. And if he becomes convinced that aggressive behavior will not be tolerated, then it may not be necessary to keep massive forces in the region. After all, we have had a naval squadron in the Persian Gulf for years and years. There is likely to be a presence, but it doesn't have to be massive.

Q The U.S. seems to be taking on a new role as global cop in the post-cold-war era. Can we afford it?

A There's no question the U.S. as a superpower has a certain leadership role to play. But I want to underscore the role of the world community. Hopefully, if there needs to be a world policeman, the U.N. Security Council can do the job. And if it can act decisively in cases of aggression, then the would-be aggressors may be deterred. There won't be the need to repeat the massive threat of force that we have in this circumstance.



GAMMA-LIAISON

■ **'There's no question the U.S. has a certain leadership role to play. But I want to underscore the role of the world community'**

Q Does the vote to give the embargo teeth foreshadow a new, stronger role for the U.N.? Or is this just a rare case where everyone's interest coincided?

A We may be seeing the emergence of a new world order. In 1945-46, the U.N. Security Council was given [broad] powers to enforce the rule of international law. It didn't work out because of the cold war. Now, we are seeing the kind of cooperation and action that was envisioned by the U.N. charter.

Q To make the blockade more effective, will we intercept airlifts to Iraq?

A Voluntary compliance with the sanctions has been very, very good. And an occasional aircraft flight in or out isn't going to make a big difference.

Q Even from Libya?

A Even from Libya. What we are doing is interdicting the basic commerce in and out of Iraq. We are talking about enormous quantities here, both of exports and imports. And if there is an occasional flight or overland delivery here, it's not going to make a big difference.

Q Have we asked the Soviets for active intervention in the gulf?

A We haven't asked. They have made some suggestions, and they have a naval presence. We welcome their participation.

Q How will this crisis redefine our relationships with our allies?

A I think it helps solidify the alliances. What we have here is close cooperation with all of [the Allies] in areas outside the perimeters of our major alliance systems—that is, NATO and the Japanese security system in the Far East. What we're seeing is everybody making the kind of contribution that they can best make. With the Germans and the Japanese, there are constitutional problems with using their military forces. Therefore, their contributions are of another kind. But there's plenty of need, and everybody can contribute.

CORPORATE FINANCE

ALL THAT LEVERAGE COMES HOME TO ROOST

As the economy stalls out, a host of big companies with big debts face trouble

A weakening economy, steeper interest rates, and burgeoning oil costs are a witches' brew for heavily indebted companies. Their weaknesses first appeared in last year's more benign climate when Resorts International, Integrated Resources, and Maxicare defaulted. Now, with the Iraq factor helping to hobble the economy, heavy leverage will force many more companies to travel the sorrowful road of defaults and restructurings.

Because new junk-bond issues are almost impossible to float and banks are increasingly skittish about loans, debt-laden companies head into the coming bad times with precious few options. Says Joseph C. Bencivenga, head of junk research for Salomon Brothers Inc.: "The situation for the highly leveraged ones has to get worse, since they have no access to capital anymore." Drexel Burnham Lambert Inc., which invented the 1980s leverage craze and rescued several failing participants, is a memory. Many Japanese banks, once eager for the U. S. buyout action, are staying home to deal with their own slumping stock and real estate markets.

It's a harrowing prospect for those U. S. companies that must service mammoth interest payments to face a downturn alone (table). Since the late 1970s, corporate interest expenses have doubled, to 35¢ per dollar of pretax profits, for the average U. S. company. The most vulnerable, of course, are those with above-average debt ratios in cyclical industries. Consider USG Corp., whose wallboard business is threatened by the ailing homebuilding sector. A $105 million bond maturity comes due in December, and a $65 million bank loan is up next year. The company says it can pay the December bill but can't say yet how it will handle the 1991 crunch. Analysts say USG has to persuade the banks to postpone the payback date.

BART GOLDMAN

Companies that are the most directly affected by Iraq are big oil users such as airlines. Higher fuel costs and a recessionary drop in passengers is a volatile mix. Among the most vulnerable is Pan Am Corp. It posted a yearly profit only twice in the 1980s, showed more red ink for the first half of 1990, and, with its equity sinking, debt now stands at more than two times capital.

QUANTUM'S LEAP. Jet fuel, up 50% in price since the Kuwait invasion, has an especially big impact on Pan Am, whose planes are among the least fuel-efficient. According to Airline Economics Inc., a Washington (D. C.) consulting firm, only one other U. S. carrier, Northwest Airlines Inc., has higher fuel costs per fleet. Pan Am spokeswoman Pamela Hanlon says the planned sale of its East Coast shuttle—which it hopes will fetch as much as $300 million—will boost the airline by letting it focus more resources on its profitable Latin American routes, now providing one-quarter of its revenue.

Highly leveraged companies in industries that use oil as raw material are little better off. Quantum Chemical Corp., which depends on petrochemicals to make plastic, was limping even before the Mideast crisis: Earnings for the first half of 1990 had dropped by 90% from the comparable 1989 period, to $12.9 million. New York-based Quantum more than doubled its debt last year to discourage raiders, giving stockholders $1.2 billion via a $50-per-share special dividend. The company insists that its health will improve because demand has been picking up and it can pass along higher chemical feedstock costs. But that optimism is not warranted if demand plunges in a recession.

Even noncyclical companies that don't use much oil are looking at rough weather. Most of the toys made by Tonka Corp. retail for under $10, so a recession shouldn't devastate sales. Tonka assumed its debt load when it bought rival Kenner Parker Toys Inc. in 1987. Living with this is uncomfortable because of a strategic problem: Tonka gets more than half of its revenues from promotional toys tied to movies and television. That's gambling a lot on the whims of kids. Its last big success was in the mid-'80s, with knockoffs from the film *Ghostbusters.* So the Minnetonka (Minn.) company had a $19 million loss in the first six months of this year. It attributes part of that to more cautious ordering by retailers. A spokeswoman says the company expects sales to pick up and insists it can manage the debt. The danger is that Tonka won't make interest-rate coverage ratios on its $411 million in bank loans, which could trigger higher interest payments. This would leave it at the mercy of the banks, which tend to be more demanding during recessions.

Wall Street is uneasy. Salomon Brothers' recent report on the junk bonds of Gaylord Container, Harcourt Brace Jovanovich, and Kaiser Aluminum, among others, concluded that the companies would be hurt as a result of higher oil prices and recession. But the companies say they can make it through, arguing that the future isn't as bad as feared or that they will be nimble enough to prevail.

PALMS OUT. The heavy borrowing that plunked companies into these worrisome existences at least trained their executives in a vital survival skill: negotiating new financing. R. H. Macy & Co., the venerable department store chain, must pay off or refinance $952 million in debt between now and its fiscal 1993. The easy part will be the first $554 million, using new loans backed by credit card receivables, which are considered A-1 collateral.

The rest is more problematic because it depends on an ailing real estate market. Macy's is scrambling to raise $75 million by mortgaging warehouses, plus an additional $35 million selling a Los Angeles office building and the lease on a Chicago store. Other real estate deals may follow. Even if it can sell the property, New York-based Macy's is heading into a grim period for retailers, particularly in its Northeastern home turf. It can ill afford a repeat of last Christmas, when bloated inventories and a price war killed margins. The chain is scraping by, with cash flow covering its $730 million yearly interest payments a scant 1.2 times. Myron E. Ullman III, executive vice-president, insists Macy's has seen the worst and is turning around.

THE SLOWDOWN COULD HIT THESE COMPANIES HARD

Company	Long-term debt: Millions	Long-term debt: Percent of capital*	Comment
GAYLORD CONTAINER	$626	78%	Cardboard producer has sunk big bucks into expansion, making it vulnerable as prices sink
HARCOURT BRACE JOVANOVICH	$1,696	191%	Lower tax receipts could strain school budgets and further damage HBJ's core unit, its limping textbook division
KAISER ALUMINUM	$716	63%	Up against better-capitalized competitors, Kaiser would suffer from demand dip for aluminum products
MACY (R.H.)	$4,901	78%	Another bad Christmas would jolt the department-store chain, which is angling for mortgage financing
PAN AM	$733	184%	Surging fuel costs and declining business travel would send weak airline into nosedive
QUANTUM CHEMICAL	$2,433	110%	On top of expected flagging demand for plastic comes a price runup in its raw material, petrochemical feedstock
TONKA	$411	68%	Lagging toymaker faces problems on interest-rate coverage required by banks
USG	$2,265	242%	With homebuilding drooping, wallboard maker faces large debt maturities this year and 1991

*Can equal more than 100% when equity is negative

DATA: DONALDSON LUFKIN & JENRETTE CORP.; SALOMON BROTHERS INC.; STANDARD & POOR'S CORP.; BW

Leverage woes extend to the investment firms that arranged the deals. Here, though, the problems are annoying, not life-threatening. Shearson Lehman Brothers Inc. still holds a $500 million bridge loan for the 1989 buyout of Prime Computer Inc. because the Wall Street firm couldn't replace the issue by selling junk to others. In exchange for boosting its 19% equity stake in the Bedford (Mass.) computer maker, Shearson agreed to a lower interest rate that will save Prime about $40 million annually. That's good news for Prime, which just reported its first quarterly operating profit, $50 million, in 18 months. For Shearson, the refinancing makes the best of a bad thing. A spokesman says it's "a good resolution for both parties."

Nor are banks likely to be sunk by the leverage crunch, though they stand to suffer. While sour commercial real estate loans are their biggest headache, a wave of company defaults will pack a punch. Citicorp has the largest exposure to highly leveraged deals at $8.8 billion, or 3.9% of its loan portfolio. Some $964 million of that is already on the nonperforming list. In percentage terms, Bank of Boston Corp., with $4.8 billion lent to highly leveraged customers, is the leader, at 19%.

Not every highly leveraged company is in trouble. Those in consumer goods will be the least harmed by a slowdown. Even though their bonds have taken losses since the invasion of Kuwait, RJR Nabisco, Duracell, Kroger, and Supermarkets General still generate strong cash flow.

SAFETY FIRST. The leverage era is not dead: Even the much-delayed buyout of UAL Corp. could still happen. What do the deals of the 1990s look like? Safer and more modest. Most deals lately are far less dependent on debt and more on equity. Debt, which has the advantage of tax deductibility, works fine only as long as cash rolls in and lenders are willing to lend. Look at how Hicks, Muse, the Dallas investment firm, bought Neodata, a Boulder (Colo.) unit of Dun & Bradstreet that processes magazine subscriptions. The $85 million Neodata purchase includes $10 million in equity. "Two years ago, that would have been $5 million," says Hicks Muse Chairman Thomas O. Hicks.

Because the big debts assumed in the last decade were based on overly sanguine forecasts, it is tempting to say that the current gloom and doom is overdone, too. Perhaps. But even if oil prices ease, they likely won't drop to pre-Iraq levels. And that inflationary prospect won't allow the Federal Reserve Board to lower interest rates appreciably until the slump is well under way—no comfort to hugely indebted companies. For many of them, this is like a Greek tragedy: For all their great dreams, a fatal flaw could bring them low.

By Larry Light, with Jon Friedman and John Meehan in New York and bureau reports