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Buyouts leave N.C. firms with big debts

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As RJR Nabisco Inc. prepares to take on billions of dollars in debt in a staggering buyout, North Carolina will be saddled with yet another company living under the shadow of borrowed money.

Over the last four years, many companies with large operations in North Carolina have been taken private to avoid takeovers by outside investors. By doing so, they heaped debt onto their balance sheets, a move that could severely hurt their operations if the economy sours, financial experts say.

"For the last eight years, we have had record prosperity, so we don't know how these [highly leveraged] firms will fare in a recession," said Tony R. Wingler, an associate professor of finance at the University of North Carolina at Greensboro.

In a leveraged buyout, such as that proposed for Atlanta-based RJR Nabisco, a company uses its assets as collateral to borrow money for the buyout. To pay off that loan, companies typically trim their operations by selling factories and laying off workers.

Moreover, the debt incurred by companies in a buyout forces them to become highly efficient — and disciplined — so they can meet loan payments.

No longer does a company's management report to thousands of shareholders who demand increasingly higher returns on their investment every three months. Instead, it is accountable to an often more demanding creditor — a bank that wields enough power to foreclose on a company if it

misses a payment.

"The difference has to do with flexibility," said Campbell R. Harvey, an assistant professor of finance at the Fuqua School of Business at Duke University. "If you have equity in your firm and the economy turns recessionary, then you have the discretion to lower or cancel a dividend paid to shareholders.

"But when you switch your stock for junk bonds [and debt], then you have less flexibility because you have an obligation to make payments," he said. "You face the possibility of more radical restructuring so that you can make payments." So-called "junk" bonds, which typically are used in financing leveraged buyouts, carry high risks and high interest rates.

Indeed, when Burlington Industries Inc. in Greensboro went private last year, the textile firm laid off 1,200 workers and sold several plants to other investors including some foreign firms to pay off its debts.

Likewise, J.P. Stevens & Co. was carved up earlier this year when three companies bought parts of the textile giant. While no workers have been laid off, analysts have said Stevens' investors face an uphill battle in paying debts incurred in the buyout. RJR Nabisco, which employs 14,000 people in Winston-Salem, faces similar prospects, regardless of who buys the company. A management team led by RJR President F. Ross Johnson on Thursday submitted an offer of nearly \$21 billion, edging a \$20.6 billion bid by the powerful New York investment firm of Kohlberg Kravis

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Roberts & Co.

Analysts have said a winner in the battle for RJR most likely will pile up \$15 billion in debt, five times more than what Burlington Industries incurred in its buyout.

"Anytime you use debt and things continue to go well, leverage will enhance a company," said C. Edwin Riley, an investment expert and vice president at Charlotte-based NCNB Corp. "But a slowdown or decline in the economy could hurt employees . . . Most leveraged buyouts require cost-cutting and that could mean a reduction in employees."

Cone Mills Inc., a Greensboro textile firm, felt such a pinch over the last two weeks when it announced it would close two factories, idling more than 800 workers. Like other textile firms, Cone Mills is highly vulnerable to swings in foreign imports, a factor the company cited for closing the two Triad area plants.

But Cone Mills also operates under a heavy amount of debt that it took on four years when it went private to avoid a takeover. Such debt, experts said, may have helped perpetuate the plant closings because executives were under fire to keep up with loan payments.

"Cone Mills really did well until this recent turn of events" with the large number of imports hurting its sales, said Dr. Wingle of UNCG. "Now they are closing mills that have been open for 70 to 80 years."

In a recession, RJR might fare differently than other manufac-

turers, in part because its customers continue — and even step up — their smoking in an economic downturn. Also, despite a continuing decline in U.S. cigarette sales, sales are soaring overseas — another safeguard against laying off workers, experts said.

"In RJR's case, there's an extreme amount of cash flow; so much that they don't know what to do with the money," said Mr. Riley of NCNB.

Nevertheless, Mr. Riley and others believe that as a private company, RJR would come under stricter control of its costs.

"There is increased risk," when a company takes on more debt," said Ivan A. Marcotte, an NCNB corporate economist. "But there is an upside to that as well to the extent that [the debt] makes management much more driven and focused."