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How Change Happens

By DAVID BROOKS

Forty years ago, corporate America was bloated, sluggish and losing ground to competitors in Japan and beyond. [I agree.] But then something astonishing happened. Financiers, private equity [LBO – David does not make this critical distinction.] firms and bare-knuckled corporate executives initiated a series of reforms and transformations. [I agree.]

The process was brutal and involved streamlining and layoffs. [I agree – and remember the word “layoffs.”] But, at the end of it, American businesses emerged leaner, [fewer jobs?] quicker and more efficient.

Now we are apparently going to have a presidential election about whether this reform movement was a good thing. [No, that’s not the point. This “reform movement” was a good thing. And, private equity firms who do LBOs play a valuable role in the economy – corporate discipline, creative destruction, improving productivity and efficiency. All of this is good for the long-term health of our capitalist economy. But, its goal is not to create jobs.] Last week, the Obama administration unveiled an attack ad against Mitt Romney’s old private equity [LBO] firm, Bain Capital, portraying it as a vampire that sucks the blood from American companies. Then Vice President Joseph Biden Jr. gave one of those cable-TV-type speeches, lambasting Wall Street and saying we had to be a country that makes things again. [I agree. Some of this is exaggeration, distortion, and oversimplification. But, voters seemingly have little patience for or the capacity to deal with complexity – the type of complexity that I’m trying to illuminate here.]

The Obama attack ad accused Bain Capital of looting a steel company called GST in the 1990s and then throwing its workers out on the street. The ad itself barely survived a minute of scrutiny. As Kimberly Strassel noted in The Wall Street Journal, the depiction is wildly misleading.

The company was in terminal decline before Bain entered the picture, seeing its work force fall from 4,500 to less than 1,000. [If it was truly “terminal,” no investment company would have knowingly bought it.] It faced closure when Romney and Bain, for some reason, saw hope for it in 1993. Bain acquired it, induced banks to loan it money and poured \$100 million into modernization [and presumably to pay fees and dividends to Bain Capital and its investors and to increase their potential returns] according to Strassel. Bain held onto the company for eight years, hardly the pattern of a looter. Finally, after all the effort, the company, like many other old-line steel companies, filed for bankruptcy protection in 2001, two years after Romney had left Bain.

This is the story of a failed rescue, not vampire capitalism. [Maybe. But, first it is important to know whether or not Bain Capital and it’s investors lost all of their investment, too. In many cases, LBO investors receive fees -- dividends, as they did in this case, according to the WSJ article – and other cash distributions early in the process which would mitigate their subsequent losses or even produce positive returns. Mr. Brooks and Ms. Strassel don’t tell us that.]

But the larger argument is about private equity [LBOs] itself, and about the changes private equity [LBO] firms and other financiers have instigated across society. Over the past several decades, these firms have scoured America looking for underperforming companies. Then they acquire them and try to force them to get better.

As Reihan Salam noted in a fair-minded review of the literature in National Review, in any industry there is an astonishing difference in the productivity levels of leading companies and the lagging companies. [This is the major point –LBOs are about increasing productivity, not about job creation. Increasing productivity is a good thing and is critical to our long-term economic vitality. But, productivity increases are in tension with job creation.] Private equity [LBO] firms like Bain acquire bad companies and often replace management, compel executives to own more stock in their own company and reform company operations [All good things, too. But, almost always, they also induce the company to borrow large amounts of money. This is done to increase returns to investors. It makes the company more risky, not less so. Usually, it is a kin to sub-prime borrowing.]

Most of the time they succeed. [I agree. Otherwise, sophisticated investors would no longer invest in “leveraged buyout” funds and lenders would not lend to them.] Research from around the world clearly confirms that companies that have been acquired by private equity [LBO] firms are more productive [that key word again] than comparable firms.

This process involves a great deal of churn and creative destruction. [“Creative destruction” is another concept which is useful, but is in tension with job creation, and Gov. Romney never talks about it.] It does not, on net, lead to fewer jobs. [This is still debatable. What isn’t debatable is the LBO investors’ objective. It’s return on investment through productivity improvements, not “creating jobs”.] A giant study by economists from the University of Chicago, Harvard, the University of Maryland and the Census Bureau found that when private equity [LBO] firms acquire a company, jobs are lost in old operations. Jobs are created in new, promising operations. The overall effect on employment is modest. [“Modest” is not a resounding endorsement for Gov. Romney’s claim that he “knows how to create jobs.”]

Nor is it true that private equity [LBO] firms generally pile up companies with debt [False – leveraged buyout firms almost always increase the debt burden of their companies], loot them and then send them to the graveyard [True – looting and burial are not their intentions.] This does happen occasionally (the tax code encourages debt [but, the primary reason LBO firms cause their companies to borrow is to pay fees and dividends and increase investment returns]), but banks would not be lending money to private equity-owned [LBO-owned] companies, decade after decade, if those companies weren’t generally prosperous and credit worthy [True].

Private equity [LBO] firms are not lovable, but they forced a renaissance that revived American capitalism. [An overstatement perhaps. But, they have played a positive role overall. So have corporate raiders, demanding shareholders, very highly paid CEOs, and many others.] The large questions today are: Will the U.S. continue this process of rigorous creative destruction? [This is a very valid and even necessary function of capitalism, but, again, Gov. Romney is not talking

about “CREATIVE DESTRUCTION.” He’s talking about “job creation.”] More immediately, will the nation take the transformation of the private sector and extend it to the public sector?

While American companies operate in radically different ways than they did 40 years ago, the sheltered, government-dominated sectors of the economy — especially education, health care and the welfare state — operate in astonishingly similar ways. [I agree – all governments could and should increase their productivity and efficiency. But, it is a real trick to “create jobs” at the same time.]

The implicit argument of the Republican campaign is that Mitt Romney has the experience to extend this transformation into government. [This may be a good thing in the long-term. But, it will cause job losses in the short to intermediate term – the opposite of what Gov. Romney is promising.]

The Obama campaign seems to be drifting willy-nilly into the opposite camp, arguing that the pressures brought to bear by the capital markets over the past few decades were not a good thing [Not exactly. Some developments in the capital markets were good – some, like excessive leverage, de-regulation, and speculation – were not.], offering no comparably sized agenda to reform the public sector. [Neither candidate is offering big ideas – perhaps we voters won’t let them.]

In a country that desperately wants change, I have no idea why a party would not compete to be the party of change and transformation. For a candidate like Obama, who successfully ran an unconventional campaign that embodied and promised change, I have no idea why he would want to run a campaign this time that regurgitates the exact same ads and repeats the exact same arguments as so many Democratic campaigns from the ancient past. [Perhaps obstructionism is one reason. As in most things, Pres. Obama seeks balance. Read carefully the comments on this subject that he made in his recent press conference, if you haven’t already (see Attachment 1).]