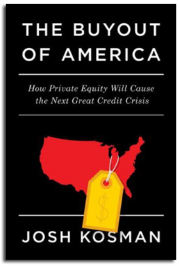
Excerpt

The Buyout of America: How Private Equity Will Cause the Next Great Credit Crisis



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Introduction

It is late 2011, months before President Barack Obama will run for reelection. The U.S. economy is gradually recovering from four years of hovering on the brink of disaster. Banks are lending money again, at least to strong companies, and employment is stabilizing.

President Obama has finally begun to breathe a bit more easily, when the secretary of the Treasury walks into his office one day.

"You better sit down," the secretary says. "I've got bad news. First Data, the largest merchant credit card processor, has defaulted on $22 billion in loans. Clear Channel Communications, which owns more than twelve hundred radio stations, is on the brink. The other credit tsunami that we knew was out there has begun."

The Treasury secretary is talking about private equity. It's not the private-equity firms themselves but the companies they own that are defaulting. During the boom years of 2001–7, private investors bought thousands of U.S. companies. They did it by having the acquired companies take on enormous loans using the same cheap credit that fueled the housing boom. That debt is now starting to come due.

"Considering what we have already been through, how bad can it be?" Obama asks.

"Well," says the Treasury secretary, "PE firms own companies that employ about 7.5 million Americans. Half of those companies, with 3.75 million workers, will collapse between 2012 and 2015. Assuming that those businesses file for bankruptcy and fire only 50 percent of their workers, that leaves 1.875 million out of jobs.

"To put that in perspective, Mr. President, NAFTA caused the displacement of fewer than 1 million workers, and only a slightly higher 2.6 million people lost jobs in 2008 when the recession took hold.

"A spike in unemployment will mean more people will lose their homes in foreclosure, and the resulting nosedive in consumer spending will threaten other businesses. The bankruptcies will also hit the banks that have financed LBOs and the hedge funds, pensions, and insurers who have bought many of those loans from them."

"Is this bigger than the subprime crisis?"

"It is similar in size to the subprime meltdown. In 2007, there were $1.3 trillion of outstanding subprime mortgages. As a result of leveraged buyouts, U.S. companies owe about $1 trillion.

"Sir, we are on the verge of the Next Great Credit Crisis."

Obama is no longer smiling.

The picture painted by the Treasury secretary in this imaginary scene, as dire as it is, is not total fantasy, nor is it a worse-case scenario. There are people in the financial world, including the head of restructuring at one of the biggest banks, who predict this outcome. Some knowledgeable observers say the carnage will start sooner. In December 2008, the Boston Consulting Group, which advises PE firms, predicted that almost 50 percent of PE-owned companies would probably default on their debt by the end of 2011. It also believed there would be significant restructuring at these companies leading to massive cost cuts and difficult layoffs.

A rain of defaults is already starting. From January 1 through November 17, 2008, eighty-six companies defaulted globally on their debt. That is four times the number in 2007, and 62 percent of those companies were recently involved in transactions with private-equity firms.

The tsunami of credit defaults described by the imaginary Treasury secretary is not inevitable. If the U.S. economy manages to recover from the credit crisis that began in the mortgage markets in 2007 before the big PE debts come due, more of the PE-owned companies will be able to refinance their debt. In that case, we won't see a full 50 percent of them go under. Although if history is any guide, many of them will collapse anyhow, regardless of any easing in the credit markets, thanks to the greed and grossly shortsighted management policies of their private-equity owners.

First a little primer on how private-equity firms operate. Private-equity firms buy businesses the way that homebuyers acquire houses. They make a down payment and finance the rest. The financings are structured like balloon mortgages, with big payments due at some point in the future. The critical difference, however, is that while homeowners pay the mortgages on their houses, PE firms have the businesses they buy take out the loans, making *them* responsible for repayment. They typically try to resell the company or take it public before the loans come due.

Played out within reasonable limits regarding the amount of the debt, the strength of the acquired company, and the continuation of some threshold level of investment to maintain that strength, it's a strategy that can offer big payoffs. But private-equity players are quintessential Wall Streeters whose grasp of the concept of reasonable limits is quite limited. For them, the whole purpose of doing business is to make money, so if a strategy works, each success is just an encouragement to raise the ante and be a bit more daring next time.