The Economist

Surviving the slump

A special report on business in America | May 30th 2009 period. Much of it was financed by debt. In five years, American households extracted $2.3 trillion of equity from their homes. They blew 20% of this on consumption, 19% on sprucing up their homes and 44% on assets such as stocks.

The hangover from this party will be long and painful. Households' total outstanding borrowing fell in the fourth quarter of 2008, for the first time since the second world war. The personal-saving rate rose to 4.2% in the first quarter of 2009, from a nadir of minus 0.7% in 2005. "It is easy to see how consumer deleveraging could result in hundreds of billions of dollars-worth of forgone consumption in coming years," say Martin Baily, Susan Lund and Charles Atkins of the McKinsey Global Institute.

For most non-financial firms, however, there are a couple of bright spots in the gloom. Their balance-sheets are mostly healthier than the banks'. And for the strongest firms the downturn offers opportunities to snap up prime assets cheaply.

Consider Marriott. Although the hotel business tends to rise and fall in lockstep with the wider economy, not every hotelier is equally exposed. The Marriott name (or one of its sister brands) graces more than 3,000 hotels worldwide, but the company owns only half a dozen. The rest are franchised out or managed by Marriott for a fee. Since Marriott owns so few properties, it profits less during a boom. But it suffers less during a slump. It still collects franchise and management fees. Only its performance-related payments shrink.

Cleaning up in tough times

So while owners are struggling, Marriott is scouting for bargains. Mr Sorenson, the company's president, predicts that distressed hotels could soon be on sale for half-price. He will buy some, perhaps, and sell them when times improve. Like the Rothschilds of old, Marriott likes to buy to the sound of cannons and sell to the sound of violins.

Making money by saving money

Firms that help other firms save money are also in a strong position. For example, Accruent, a Californian information-technology firm, helps big organisations make more efficient use of their land and buildings. Its clients include Target (a retailer), Lockheed Martin (an aerospace firm) and Yale University. Organisations such as these may have hundreds of properties, tens of thousands of pages of leases and a labyrinth of obligations to landlords, janitors and the taxman.

In good times property management is seen as a fixed cost, says Mark Friedman, Accruent's chief executive. But now firms are looking for ways to trim their bills. Accruent helps them build more rationally, find cheaper leases and fend off landlords who try to overcharge for extras. The recession creates new problems: leases don't expire just because you lay people off. Accruent helps firms shuffle employees around to create an empty building that can then be sold or sublet.

So its services are in demand. But the sheer unpredictability of the economy still makes Mr Friedman nervous. Quite often, he opens the *Wall Street Journal* and finds that something bad has happened to a firm he thought he was about to do business with. "It feels like we're driving at 100mph in a fog," he says.

On the plus side, many of the efficiencies discovered through necessity during the downturn will outlast it. For example, firms are cutting business travel by videoconferencing. Mr Sorenson of Marriott plays down the threat, arguing that there is no substitute for meeting people face-to-face. Others are not so sure. Videoconferencing technology keeps improving. Some meetings are necessary, but others are a waste of time. Mr Kozyra of TI Automotive predicts that, when the good times return, "we'll go halfway back" to travelling, and maybe send two executives to meet customers instead of six. ■

Creative destruction

The struggle is ugly, but the survivors will be stronger

ON A quiet street in Romulus, a suburb of Detroit, is an empty house. Even if there were not a foreclosure sign outside, the rotting newspapers and broken toys on the lawn make it obvious that no one lives here. The owner lost his job and left last year, according to neighbours.

But the house itself is solid and spacious, with four bedrooms and an ample yard. Someone should buy it and fix it up, reckon the neighbours. So long as it is empty, it drags down the value of the surrounding properties, grumbles one, a retired car worker. "Homes round here used to sell for $120,000, but if you can get it for $25,000, that would be a good deal," he suggests.

The house was sold that same day by an auction firm, Real Estate Disposition Corporation (REDC). The bidding started at a mere $500, but soon grew heated. "We're approaching the bottom of the market! This is a great time to buy!" buzzed the auctioneer. As his sales patter rattled through the amplifiers, tuxedo-clad "spotters" dashed back and forth among the crowd spotting bidders and shouting out their bids.

The house in Romulus was one of dozens REDC auctioned on March 30th at a hotel in nearby Dearborn. It went for $32,000, to a local entrepreneur who plans to turn it into a home for the mentally ill. Perhaps not what the neighbours most wanted, but at least it will be occupied.

Such auctions are now common in America. They are a conspicuous sign of misery but they serve a purpose. If banks could not seize and sell homes with mortgages in default they would not lend in the first place. And though it may be heartbreaking for former owners to see their homes offloaded cheaply, low prices are good for first-time buyers.

The auction in Dearborn was packed with young couples who until recently could not afford to own a house. There were throngs of landlords, too, looking for bargains to buy, clean up and rent out. Someone has to do this. A mobile population needs rentable homes.

Some think the housing market is about to recover. Optimists took heart when sales of single-family homes rose in February but March's weak figures undermined their hopes. Pessimists note that one home in nine is still empty. Between 2002 and 2007, at least 1m more homes were built than new households were formed. It will take a while for this surplus to be cleared. In much of the Midwest and north-east demand is unlikely to catch up with supply until 2012, by some estimates.

Bankruptcies are soaring. In the first quarter of this year, 20,251 companies filed for bankruptcy, a 52% jump from the same period last year, according to AACER, a firm that monitors such things. Including individuals as well as firms, AACER expects to see 1.5m bankruptcies this year, twice as many as in 2007.

Bankruptcy lawyers are busy. Douglas Bernstein of Plunkett Cooney, a Michigan law firm, says he could work 14 hours a day, 7 days a week and not keep up with the demand for his services. "Unfortunately, when the economy is bad, they don't add hours to the day," he grumbles in an e-mail from his office at 6am.

Companies that recycle the valuable parts of bankrupt companies are doing well, too. Distressed firms typically shed assets to raise cash so they can restructure and continue operating. If that does not work, they may go into liquidation. Everything must then be sold—the goods on the shelves, the shelves themselves, the leases on the shops, the websites, the trademarks, you name it. Firms such as Hilco, a privately held Illinois firm, can help, either by broking the sales or by buying assets themselves and selling them later. Richard Kaye, a vice-president of Hilco, says there has been a "significant uptick" in its bankruptcy business. In April, for example, the firm agreed to buy the remnants of Polaroid, a once-iconic instant-photo firm whose only significant asset now is its name.

Firms that prey on dead or dying firms are not popular. When someone calls you a "vulture", it is not a compliment. But vultures have their place. The easier it is for lenders to collect what they are owed, the easier firms will find it to borrow. An efficient bankruptcy process is an essential part of capitalism red in tooth and claw. The weak die. The strong feast on their carcasses. Little is wasted.

In January Circuit City, an electronics retailer, went into liquidation, shutting more than 500 stores and selling its entire inventory. Shoppers snapped up bargains at its closing-down sales. Other retailers pounced on some of its properties. And its rivals in the iPod-and-toaster-hawking trade are fighting to woo its former customers. "We think there's six to eight billion dollars of business up for grabs," says Brad Anderson, the outgoing boss of Best Buy, Circuit City's closest competitor.

An ideal bankruptcy system would transfer resources efficiently from less productive to more productive uses. How close does America come to this ideal? It is less ruthless than Britain, which is quick to force firms into liquidation, but less indulgent than France, which has a "huge bias" towards propping up zombie firms on the assumption that this will save jobs, says Michelle White, a bankruptcy expert at the University of California, San Diego. Overall, she thinks the American bankruptcy system does a "very valuable" job.

But Jack Williams of the American Bankruptcy Institute, a think-tank, adds a caveat. Firms are now finding it hard to use bankruptcy as a temporary shield to allow them to reorganise, because that usually requires a bridging loan of some kind, and at the moment no one is lending. That has given the system an unfortunate bias towards liquidation, he fears.

When times are hard, American firms find it easy to lay off workers. When times are good, however, they are quick to hire new hands. A ruthless labour market and a miserly welfare state have historically meant that Americans are more likely to have jobs (albeit often low-paid ones) than Europeans, and far less likely to be unemployed for a long time. In 2007 America's jobless rate was 4.6%, compared with an average of 7.9% for the OECD's European member countries. And whereas the average jobless American was out of work for less than four months, the average jobless European spent nearly 15 months involuntarily idle.

Recessionary recipe

During previous downturns, unemployment in America has risen more sharply than elsewhere but then fallen more quickly, too. This time round, it has certainly followed the painful first part of that script. Joblessness is already almost 9%, and the OECD predicts that it will hit 10.3% next year. The question is: will the labour market rebound as robustly as it has in the past? No one knows the answer. This recession has been particularly severe. More than 2% of American workers have been out of work for six months or more, which is close to a post-war record. And firms are cutting back on hours, too. The average working week fell by half an hour in 2008 to 33.2 hours, the shortest since records began in 1964.

Now for the creative part

Despite the gloom, there are several reasons for believing that American business retains its underlying dynamism. First, one can listen to what businesspeople say. They may be feeling wretched this year, but few doubt that things will get better. Bill Green, the boss of Accenture, a consultancy, predicts that America will come out of the recession "much earlier" than other parts of the world. He talks constantly to other chief executives around the world, he says, and their consensus is that America will begin to recover later this year or in early 2010. They give three reasons. The recession started earlier in America than elsewhere. The government's stimulus package is likely to work. And "they believe that we have a natural competitive streak—that people are going to want to get back in the game."

Second, one can look at America's admirable record of dealing with turmoil. A study by the Ewing Marion Kauffman Foundation, a think-tank that studies entrepreneurialism, found that America's high rate of economic "churning" boosts productivity and hence material well-being. Between 1977 and 2005 some 15% of all American jobs were destroyed each year as firms closed or cut back. Thanks to the expansion of successful firms and the entry of new ones, however, many more jobs were created than destroyed. Start-ups (ie, firms less than five years old) provided a third of the new jobs during this period.

Start-ups that went bust were on average 32% less productive than mature incumbents. Mature firms that went out of business were 27% less productive than mature survivors. Start-ups that survived, however, were 3% more productive than mature incumbents; five years later they were 5% more productive. This was true of all industries but especially retailing, in which stores the size of football fields have given way to even larger ones.

The credit crunch is making it harder for new firms to find capital. That matters: not all entrepreneurs start up in their garages with money from "family, friends and fools". In a survey for the Kauffman Foundation of 4,163 companies started in 2004, Alicia Robb and David Robinson concluded that 80-90% of start-up capital for a typical firm came from two sources. One was the entrepreneur's savings. The other was external debt: either a bank loan or a credit-card balance.

Most start-ups do not require huge amounts of capital. The average in the Kauffman sample was $78,000. Some need far less. Saudia Davis, for example, founded Greenhouse Eco-Cleaning, a green apartment-cleaning firm in New York, with $800 she earned from mopping floors herself. She now has between seven and ten cleaners working for her and would like to expand, but banks are not lending, she says. She is looking for an "angel" investor but this is tough when you have no intellectual property, so she may have to grow organically.

The recession itself sometimes generates start-up capital, in the form of severance payments. Adrienne and Kelly Lumpkin got their start with the help of a redundancy package Mr Lumpkin received from IBM in the early 1990s when Big Blue was in trouble. Alternate Access, their Raleigh, North Carolina-based firm, helps florists, doctors and other small enterprises do clever things with internet telephony. It offers call-centre services, for example, and sells software that helps employees see, on their computer screens, whether the person calling them is an important customer or a deadbeat.

Despite the recession, Americans started 530,000 businesses a month last year. And firms founded during tough times have to be tough. Although more firms typically start up in fat years, Paul Kedrosky of the Kauffman Foundation found that each bad year in America since the second world war produced just as many firms that have subsequently grown large enough to list their shares. He concludes that firms that begin in bad times are more likely to turn out to become economically important: think of Microsoft, Apple and Krispy Kreme doughnuts.

During good times, any idiot can get his ideas funded, says William Barnett, a professor at Stanford University's business school. During bad times, only the most impressive and persistent entrepreneurs can. Mr Barnett has discovered that firms which are set up shortly after a successful IPO (initial public offering of shares) by another firm that does roughly the same thing tend to do very badly. By contrast, firms founded shortly after news of the bankruptcies of firms doing roughly the same thing tend to do well. Google, for example, got started just after a clutch of other search-engine firms crashed.

During a crisis, says Mr Barnett, the market's signals are clearer. During a boom, people buy stuff without much thought. During bad times, they are much choosier. So only firms with genuinely superior products or services will thrive. ■

Red tape and scissors

Despite crazy rules, convoluted taxes and rampant lawyers, America is still a great place to do business

AMERICA is supposed to be the land of laissez-faire, but it doesn't seem that way to Erroll Tyler. He wants to run tours of Cambridge and Boston, cities that nestle on opposite banks of the Charles river. He would pick up punters in an amphibious vehicle, show them the sights and give them a pleasant cruise. But Boston will not let him. Officials say he needs a sightseeing licence. Alas, there is a moratorium on such licences. It was imposed for fear that Boston would get congested during the Big Dig, a construction project. But the Big Dig ended three years ago. Mr Tyler thinks the real reason he cannot get a licence is that someone is protecting a cartel of local tour operators. He is suing the city authorities.

Mr Tyler is not the only American who feels that red tape is garrotting his business. Senseless rules that benefit cartels are common. Oklahoma protects consumers from the perils of unlicensed interior decorators. Marylanders are barred from massaging animals without a vet's licence. Wisconsin until recently banned the sale of excessively cheap petrol (gasoline).

Not all rules are pointless. Under George Bush, the White House Office of Management and Budget reckoned the total yearly cost of federal regulations between 1997 and 2007 was $46 billion to $54 billion. The benefits, in terms of pollution averted, lives saved and so on, were far higher: $122 billion to $656 billion a year. But businessfolk still have plenty of gripes.

First there is the tax code. Overall, American taxes are light and the tax code is highly progressive. But corporate taxes are steep. Federal and state taxes on profits together average 39.3%, the second-highest rate in the rich world. And the system is repulsively complex. Federal, state and local rules accumulate each year in a vast and impenetrable heap. No one understands it.

Incomprehensible tax returns