Chapter | 5

Capital and Credit in Job Creation

❖ How does Texas ensure ready access to capital and credit?

Introduction

Former U.S. President James A. Garfield once remarked, "Whoever controls the volume of money in any country is absolute master of all industry and commerce." This is still true today. Capital and credit, defined as a promise of future payment given in exchange for the loan of money today, is the lifeblood of a capitalistic economy. Capital brings together the factors of production (land, labor, energy and materials) and is needed to effectively deploy these components in turning out goods and services. Thus, the investment of capital is generally the first step toward job creation.

As a result of an increasingly global U.S. economy, money saved by the citizens of one country is no longer always invested and put to work in that same country. This so-called footloose capital is essentially investment funds that are not geographically bound. Money can be readily placed and moved almost instantaneously to any location in the world without limitations.

In an increasingly digital global economy, practically all capital is footloose — it can be used and moved anywhere in the world for both speculative and traditional production-oriented investments. Global competition for this capital is fierce. And capital is critical whether that money is used for student loans, car loans, small business investment or multinational corporate merger underwriting. Credit availability and access to capital are the lubricant that greases the wheels of commerce. Nothing can bring an economy to a grinding halt faster than an ill-functioning credit market.

Looking at investment money flowing to Texas entrepreneurs, as well as a case study on global giant PepsiCo Inc., may help illustrate the role of capital in today's modern world.

What's Happening

Cautious bankers and investors in Texas are keeping one eye on the thawing of frozen lending in regional business and another eye on national and international economic indicators. Jimmy Rasmussen, president of HomeTown Bank in Galveston and chairman of the Independent Bankers Association of Texas, and other bankers say they'll feel better about making more loans once they see improvements in the data for national consumer confidence and business spending, as well as increases in local employment. Texas bankers are also waiting to see which new regulations federal banking authorities implement.

After a very difficult 2008 and a slow start in early 2009, the volume of U.S. Small Business Administration (SBA) business loans to Texas companies exploded in the last three months of 2009. SBA offices across Texas started 2010 with optimism. "There was almost a complete freeze in credit," said Herbert Austin, district director for the SBA's Dallas-Fort Worth office. "October to December 2008

was very hard for everybody, even the SBA and even in Texas. Then the economy started to change slowly."

Bankers across Texas have been describing a slow thaw to business lending, and that movement of money is vital to the state's economy. Forty-one local banks in the Dallas-Fort Worth area that had left the SBA program returned in late 2009 and restarted their business lending in North Texas. Multiple factors combined to help spur the banks to return to lending. First, the SBA temporarily waived its loan guarantee fees to banks and increased the loan amount that it would guarantee, which helped bankers make a financial case for new business loans. Second, bankers saw some business sales activities rebound from the depths of 2008, which helped them make the emotional case for new lending. Third, and perhaps most important, national banks and international investors slowly started buying business loans again on the secondary financial markets.

As a result, the Dallas-Fort Worth SBA regional office saw small business loans increase by 57% in the last three months of 2009, compared to the same time period in 2008. At the same time, the Lubbock SBA regional office saw business loan growth of 167%.

"We saw a lot more demand, and the supply came back," Austin said. "The climate for new business is very good in Texas. The lending community here is terrific. We have bankers who get together for lunch meetings just to discuss SBA loans. That doesn't happen in many other places."

But credit problems still loom on the horizon. The amount of commercial real estate loans on the balance sheets of Texas banks is twice the national average, according to Federal Deposit Insurance Corporation (FDIC) data. The ability to refinance existing commercial real estate loans, especially on properties that may have depreciated in value, has become more difficult. Federal regulators have stated they are worried that the value of commercial real estate may decline, even in Texas, which could undermine bank stability. Meanwhile, Texas consumers are putting more of their money into savings. "We've had our best year for deposits," Rasmussen said. "There's a lot of money being parked in this state."

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There is also a lot of uncertainty in the capital markets. The most devastating credit crisis since the Great Depression began unwinding in the fourth quarter of 2008 and has focused attention squarely on the importance of global capital and credit availability. A credit crunch (also known as a credit squeeze or credit crisis) is a reduction in the general availability of loans (or credit) or a sudden tightening of the conditions required to obtain loans from banks and other lenders. At the core of a credit crunch is uncertainty or a freeze in lending for fear that recipients, both businesses and consumers, may be unable to repay their loans. Adding to this uncertainty are highly leveraged assets of uncertain value on the books of many banks.

Commercial loan amounts from banks fell 18% nationally and 14% in Texas from 2008 to 2009, according to data from the Federal Deposit Insurance Corporation (FDIC). Such lending constrictions are common in an economic slowdown as bankers become more conservative in their lending practices and fewer companies ask for business expansion loans, said Scott Hein, banking professor at Texas Tech University in Lubbock.

But, Hein said, this scenario was exacerbated in 2009 and 2010 by federal banking regulators raising loan standards for banks.

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Texas bankers also have to pay about three times as much federal banking insurance and invest more equity into their banks, which means they have less money to make loans, said Bill Chittenden, finance professor at Texas State University in San Marcos.

On the consumer side, households further compound the uncertainty with diminished wealth due to declining home values and weakened stock portfolios and pension accounts while facing a volatile job market. Collectively, these forces can bring credit markets to a standstill and paralyze an economy. America finds itself in just such a perfect storm of credit-driven economic malaise.

Texas banks, so far, have weathered the current credit crisis relatively well. Some business historians point to the closing of the giant IndyMac Bank of California in July 2008 as one of the first signs of the recession. From July 2008 through January 2010, the FDIC closed 171 banks; 7 were in Texas. This figure pales in comparison to the 844 banks and savings and loans that closed as a result of the savings and loan crisis in the late 1980s. "Senior managers at Texas banks remember the 1980s. They lived through that era," said Hein.

Interestingly, the lion's share of capital chases global financial instruments in search of higher investment returns and is not used to invest in new production capacity. That leaves less capital for businesses seeking funding for startup or expansion. Simply put, highly speculative investments tend to offer higher returns in a shorter time than those with moderate risks. Market observers estimate that 70%–85% of capital chases financial instruments (i.e., speculation in various stocks, securities and commodities) in regulated markets where the returns over the long run tend to be high and investors believe they have a handle on short-term risks. Many of the current phenomena driving credit markets, including low levels of consumer confidence and bank balance sheets loaded with bad debt, have severely restricted the life forces that capital and credit bring to the economy.

As bankers gain confidence in the global and Texas economies, bank lending to businesses should heat up, said Victor Pierson, president of Moody National Bank in Galveston and recent chairman of the Texas Bankers Association. If the recovery falters, however, credit markets may once again begin to freeze. "What happens in the rest of the world affects us in Texas," Pierson said.

This uncertainty has affected both business lending and business investing in Texas, which affects businesses of all sizes, especially small companies seeking funding.

As a result, more small businesses and entrepreneurs are seeking alternative sources of capital. For example, loan activity by ACCION Texas, a micro-lending nonprofit based in San Antonio, increased by more than 10% in 2009 compared to 2008. In addition, 86% of ACCION Texas borrowers were women or minority business owners, even though the organization does not specifically target these minority populations. In 2009, ACCION Texas made $16 million in loans with an average loan size of $16,000 through its 12 offices across the Lone Star State.

"Since the banks aren't lending much, more entrepreneurs are coming to us more often," said Aurora Perkins, vice president of ACCION Texas. More laid-off workers and retirees go to the micro lender looking for loans to start their own businesses. "Small business is not going away. Small business is big business in Texas," she added.

As the world's economy continues to become more integrated and complex, an increase in bank lending may not necessarily lead to an increase in jobs in the immediate region. Capital investment can leak outside the primary geographic area in which the investment is made. These capital leakages can result in less domestic job creation than might otherwise be expected. This fact is a stark reminder that business exists to earn profits — however that is best achieved — and not to create more jobs.

The Data

The data can be represented through a story involving PepsiCo. This case study illustrates the power of global capital investment and the increasingly complex web of current business operations in which millions of global consumers and investors are being integrated into a global economy.

As vibrant new consumer markets emerge throughout the world, American companies are eager to establish beachheads in new markets (using both retained earnings and borrowed capital). To do this, many companies are locating production facilities in heretofore untapped foreign markets. To help U.S. companies gain access to these emerging markets, trade barriers and restrictions on financial transactions have been reduced or are being torn down. In March 1993, for example, PepsiCo put $10 million into a joint

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venture agreement with a Singaporean firm to open a bottling plant and distribution center in Vietnam. The joint venture also had to include entrepreneurs from Ho Chi Minh City as the price of admission to the Vietnamese market. Coca-Cola, Nike, Citibank, Harley-Davidson and Arthur Andersen soon followed Pepsi into joint ventures with the Vietnamese.

As capital flowed from the West to finance joint ventures and new businesses in foreign enterprises, job growth followed these investments. What was decried by some as an exodus of American jobs to offshore locations was not necessarily a zero-sum game. Jobs created at the Ho Chi Minh facilities were created as a result of trade restrictions being lifted and PepsiCo's partnership with indigenous entrepreneurs. It made more sense to bottle colas in Vietnam for local delivery rather than bottle them in the United States for shipment to Vietnam. Had the trade restrictions remained, the jobs created in Vietnam wouldn't have necessarily been created in the United States.

While such investments resulted in little direct job creation in the United States, profits from sales in Vietnam and other new Southeast Asian markets, Russia and Eastern Europe fueled part of Pepsi's expansion of its domestic food and beverage industry operations. For example, Pepsi used retained earnings from expanded profits to acquire parts of Seagram Company Ltd. of Montreal to venture into the alcoholic beverage industry. Then Pepsi bought 100% of the shares in Quaker Oats and Frito Lay to diversify its holdings. Pepsi grew and eventually spun off Pizza Hut, Taco Bell and KFC operations (YUM Brands, Inc.), with exclusive beverage vendor arrangements to compete with Coca-Cola's exclusivity arrangement with McDonalds. Pepsi also went into the orange juice business with Tropicana to compete with Coca-Cola's Minute Maid brand.

The story doesn't end there. To avoid being squeezed out of the potentially lucrative Southeast Asian food and beverage market, French investors gained

a controlling interest in a brewery that controlled 40% of the region's beer market. French investors then sold their interests in the brewery at a huge profit to a British investment fund with holdings in the United States. The Vietnamese-based company that maintained machinery in the Pepsi and Coca-Cola bottling plants and the region's top brewery was forced by necessity to develop innovative ways for increasing the output of bottling and canning equipment to keep pace with rapidly increasing demand across Southeast Asia. Those Vietnamese innovations are now used in America's beverage industry to improve efficiency and boost profitability. Wage increases for American workers in the domestic beverage manufacturing industry followed on the heels of Vietnamese-originated productivity gains.

As Miller Brewing Company lost market shares to competitors, such as Anheuser-Busch, jobs at its bottling plants and distribution centers were threatened. Those jobs became safer when a controlling interest in Miller Beer was acquired by South African Brewing (SAB) from Philip Morris. American jobs could have been lost at bottling plants and distribution centers because Miller was losing its market share to Anheuser-Busch and Coors. SAB saved those jobs by winning back Miller's market share as a result of importing and bottling foreign beers to meet the increasingly cosmopolitan demands of American beer drinkers.

Back at Pepsi, experience gained through competition for foreign markets led the company to partner with its former subsidiary Taco Bell to launch new drink flavors developed in Mexico into the American market. Pepsi also established its Aquafina brand to compete with Perrier for the emerging bottled water market first cultivated by the Swiss multinational corporation Nestlé. Pepsi entered a joint venture with Starbucks to launch the Frappuccino brand to capture a share of the growing market in the United States for flavored coffees in bottles, which was first popularized in Europe.

So What?

The Pepsi illustration drives home the point that workforce development and economic development are not identical. If workforce dollars are invested in economic development, the results must be measured differently. The immediate outcome of investments will be wealth creation, but to whom the wealth ultimately accumulates remains a question of the production process. Job growth will be derivative. And job growth will occur at different junctions along the supply chain leading to fulfillment of final demands by consumers. Jobs created initially by an investment will not necessarily be in the same region where the investors are located, nor will jobs necessarily be created in the same region where the economic development entity that helped broker the investment decision resides. This fundamental understanding must drive how success is defined, how performance is measured and which performance standards are set.

The levers of control over footloose capital and credit markets aren't within reach of most state and local government officials. Call this a manifestation of the economic tsunami we refer to as globalization. In this environment, it is vital that due diligence behind local investments includes an understanding of the company production processes, local staffing patterns and domestic supply chains to assess the degree to which expected direct and indirect job creation will be realized and which factors might limit local job growth.

Public workforce and economic development dollars pale in comparison to the investments by financial institutions. Corporations use their retained earnings to fuel some business creation and expansion along with derivative job growth. Nonetheless, the investment of capital or the extension of credit is critical to new business formation, expansion and domestic job growth.

In Texas, the recession stripped much of wealthy investors' personal wealth. As a result, business investing — particularly

Venture Capital Investment in Texas and the United States

Year	Texas Venture Capital Investment	U.S. Venture Capital Investment
1996	$519 million	$10.611 billion
1997	$823 million	$14.178 billion
1998	$1.119 billion	$19.807 billion
1999	$2.892 billion	$51.282 billion
2000	$5.740 billion	$100.473 billion
2001	$2.825 billion	$38.618 billion
2002	$1.195 billion	$20.977 billion
2003	$1.203 billion	$19.100 billion
2004	$1.146 billion	$21.968 billion
2005	$1.163 billion	$22.967 billion
2006	$1.373 billion	$26.315 billion
2007	$1.437 billion	$30.518 billion
2008	$1.288 billion	$27.992 billion
2009	$644 million	$17.680 billion

SOURCE: PricewaterhouseCoopers and National Venture Capital Association

Table 5.1

from angel investors, venture capital investors and private equity investors — dropped dramatically in 2008 and 2009. For example, according to data from PricewaterhouseCoopers and the National Venture Capital Association, venture capital investing in technology-oriented Texas companies fell from $1.437 billion in 2007 to $644 million in 2009 — a drop of 55% — while venture capital investing fell 42% nationally (see **Table 5.1**).

Walt Trybula has been experiencing the constraint of capital firsthand. Trybula is director of the Nanomaterials Application Center at Texas State University in San Marcos and is working with 13 scientific-product start-up companies across Texas. All of those companies are struggling as they enter 2010. "They need money to stay alive . . . but there isn't much available," Trybula said in early 2010. "People are looking for safe places to put their money, but business startups are risky."

Many of those 13 companies received some initial money from the Texas Emerging Technology Fund; however, they cannot find additional funding sources. The Emerging Technology Fund is a limited lifeline to promising start-up companies, a resource that makes Texas stand out compared to other states. Still, business funding is challenging in this new decade.

"The entrepreneurial spirit in Texas is alive and well, and I believe Austin is its center of gravity," said Randall Crowder, executive director of the Central Texas Angel Network in Austin. "The network of technologists, thought leaders and experienced business professionals easily rivals that of Silicon Valley on the West Coast or Route 128 in Boston. Unfortunately, what we don't have is a comprehensive investment ecosystem. In Texas we have a funding gap. We have to develop the same interconnectivity [as in Boston and Silicon Valley] between angel networks, venture capital shops and private equity firms."

Chapter 5 | Suggested Strategies

Think Globally, Plan Regionally

As in the Pepsi case study, jobs created through a specific investment may be scattered across the globe. To determine which new jobs will be created — and how many will be created locally — community leaders can study connections between the region's comparative advantage and the kinds of industries and occupations in an investment-target cluster's entire value chain. For example, investment capital from Austin invested in the research and development of innovative communications equipment may produce the following results:

- **Local jobs** in scientific, professional and technical design services and critical occupations within this industry
- **Distant jobs** in Asia's electronic products manufacturing industry
- **Jobs in logistics, warehousing and freight handling** at the ports of entry along the Houston Ship Channel; in Long Beach, California; or in Corpus Christi

The Emerging Technology Fund and the Texas Enterprise Fund have layers of legal requirements about using the money specifically for jobs in Texas and include clawback provisions to ensure that recipients meet job creation promises. But jobs created outside the region through the use of capital from investors inside the region should not necessarily be treated as losses or negative outcomes.

The newly created jobs beyond the region's boundaries were not sucked out of the region. Were it not for the investment, those jobs would not have been created at all. One cannot assume that the new jobs would have been located within the region had locals invested in business opportunities closer to home. This is an argument for wider regional collaboration in economic development projects that allow a business to select an optimal location within a broader geography. Optimal location should improve business performance, while residents of the larger region will benefit, either directly or indirectly, from subsequent growth.

In terms of understanding local capital investment or simply to appreciate the context for assisting local businesses weather the economic downturn, some fundamental questions should be asked of company representatives seeking financial assistance from economic developers and the public treasury. The answers to these questions will help local investors to better anticipate the likely returns to, and possible leakages of, capital, especially regarding local job creation:

- **Where do (will) you produce your product or service?** Where do (will) you produce subassemblies or intermediate products? For example, are there local suppliers involved in your supply chain? The location of the physical supply chain also dictates the employment multiplier or ripple effects of local investments.
- **How much product or service will you produce?** While financial incentives for high-volume production can drive more local job creation, there may be a threshold beyond which any additional investment might be used to move all or some portion of the supply chain outside the region.
- **How do (will) you produce your product** (e.g., tradeoffs between labor vs. automation)? If more automation will be used, what occupations will be most affected?
- **How do (will) you control your labor inputs** (e.g., will the company employ fewer payroll workers, use more temporary or contract workers or promote a higher percentage of production to out-of-area or offshore locations)?
- **Will there be any alterations in your product or service mix** (e.g., will additional capital be used to focus on higher value consulting or contracting for noncore support services as opposed to current operations)?