Testimony of David Marchick

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"Manufacturing and the Credit Crisis."

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Committee on Banking

Subcommittee on Economic Policy

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Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify today on the impact of the financial crisis on manufacturing. A healthy manufacturing base is essential for our long term economic position, and no sector has been hit harder in this downturn than the industrial and manufacturing sector. I am also pleased to testify along side Leo Gerard, President of the United Steel Workers (USW), with whom we have worked very closely on a variety of investments and issues.

Carlyle and Manufacturing

The Carlyle Group is one of the world's largest private equity firms, with $85.5 billion under management and current investments in around 260 companies around the world. Our core business is investing in small, medium and large companies, improving their performance, and providing attractive returns to our investors, the largest group of which are public pension funds in the United States.

Over Carlyle's 22 year history, we have been a significant investor in the U.S. manufacturing sector because of our confidence in the creativity, vibrancy and dynamism of our nation's industrial base and because American workers are the most productive in the world. More specifically, we have been a significant investor in the aerospace, automotive & transportation, consumer, chemicals, building products, metals and technology sectors. Today, we have more than $9 billion of equity invested in more than two dozen companies that manufacture products in the United States ranging from aircraft components to semiconductors to auto parts. We are also proud to be a significant investor in Ohio, where two of our companies, Veyance Technologies and John Maneely Company, employ thousands of workers manufacturing conveyer belts for coal mines, tracks for armored tanks and steel pipe and tube for the construction and energy industries. Approximately 80% of the employees at John Maneely and two-thirds of the employees at Veyance are members of industrial unions, primarily the USW.

Carlyle's strategy is to invest in companies with leadership positions in their product areas, back management teams with vision and operational discipline, and invest in growth. We often will acquire non-core divisions of companies from large multinationals and, with a singular focus on their product areas, improve and expand the companies. And, contrary to popular belief, we often hold our investments for many years before we are satisfied that our work with management has achieved the desired results.

For example, we acquired Veyance from Goodyear, Allison Transmission from General Motors and Hertz from Ford. Allison, for example, is the global leader in automatic transmission for Class V and larger trucks, with a heavy manufacturing presence in Indiana. When we and Onex, another private equity firm, acquired Allison from GM in 2007, truck transmissions were far from General Motor's top priority. We and Onex are working closely with Allison's management to enhance research and development, including with respect to hybrid transmissions, expand products offerings, and increase exports from Indiana to Asia. We are also proud that, through close collaboration with the United Auto Workers (UAW), Allison's management has been able to reduce labor grievances from 2,400 at the time of the acquisition to less than 60 today.

In the last twelve months, we sold two industrial companies, both of which exemplify the work we pursue on a daily basis.

Carlyle acquired a Kentucky-based company called Kuhlman Electric in October 1999. Kuhlman designs, manufactures and markets a broad range of transformers for electric utility distribution systems that serve commercial, industrial and residential customers. We acquired Kuhlman when the industry was strong and the company's sales and revenue were on the rise. Shortly after the acquisition, Kuhlman was hit by one of the worst-ever downturns in the utility industry caused by, among other things, the California energy crisis and the dislocation in the markets related to Enron. Revenue dropped for four consecutive years, including 17% in 2002 alone. Employment and sales volumes also declined. By December 2003, Carlyle had written down the value of this investment to zero. But rather than throw in the towel, we and Kuhlman's management and workers redoubled our efforts to make this company a success. Because the value of the investment was written down to zero, Carlyle did not seek additional investment from its investors. Instead, partners at Carlyle invested their own money to keep Kuhlman afloat, enabling the company to retool and restructure. By 2007, sales had increased and employment was up 25% from the time we acquired Kuhlman. In August 2008, after a nine-year ownership period, global power company ABB acquired Kuhlman.

Another example is AxleTech, a medium-sized, Michigan-based manufacturer of heavy axles. We acquired Axletech in September 2005 and sold the company in December 2008. In the more than three years we owned Axletech, the company expanded product offerings and designed stronger, more durable suspension systems and components for light, medium and heavy tactical and combat vehicles, including the MRAPs that our soldiers use in Iraq. During our ownership period, revenue and employment more than doubled, and the number of UAW-affiliated employees increased by almost 50%. Although small, Axletech may be one of the only UAW-affiliated companies that has created, and not lost, jobs in the last five years.

These are two success stories. And, according to a recent study by economist Robert Shapiro, they are typical of the performance of manufacturing firms when private equity firms take stakes in them. Sales and capital expenditures, on average, grow faster than the national average. Unfortunately, the financial crisis has had a devastating impact on parts of the manufacturing sector, and some of our companies have been negatively affected.

The State of the U.S. Manufacturing Sector

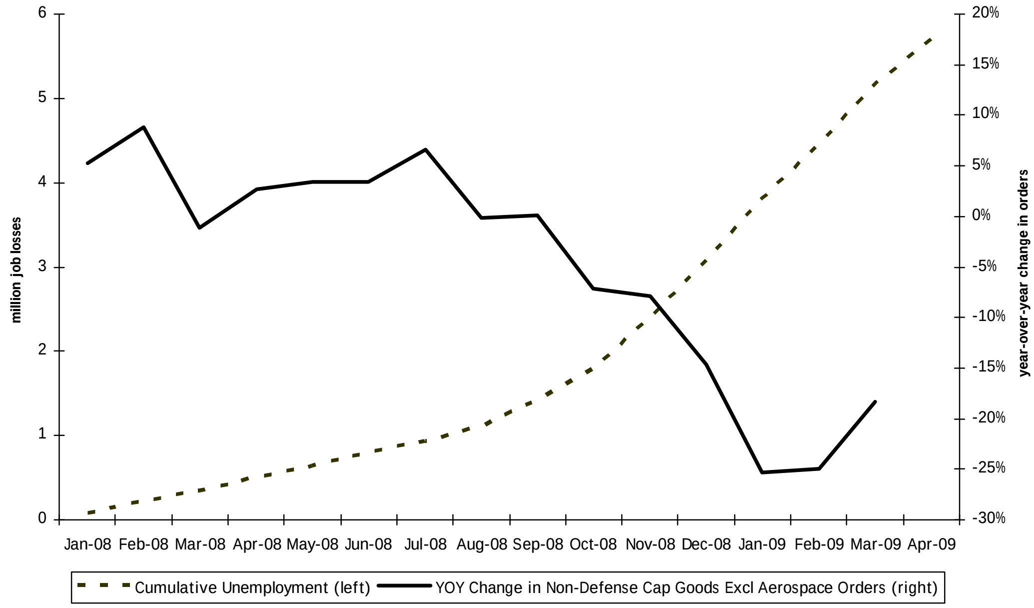
Manufacturing is the bedrock of our nation's gross domestic product, producing approximately $1.40 of additional economic activity for every $1 of direct spending in the sector – more than all other U.S. industries. The manufacturing sector has driven productivity growth in the United States, and manufacturing workers make on average

41% more in wages than the rest of the workforce. Unfortunately, the manufacturing sector, particularly in the Midwest, has been the hardest hit by the financial and economic crisis.

Credit is the lifeblood of the manufacturing economy, and when the credit crisis hit, the industrial sector was immediately affected. Allison provides a good example. Free and available credit is critical throughout the manufacturing and distribution chain in the industrial truck sector. When Allison sells a transmission to an Original Equipment Manufacturer (OEM), the OEM typically buys Allison's products for inventory using credit. When the OEM sells a bus or truck to a dealer or distributor, and when a dealer or distributor sells a truck or bus to an end user, those transactions also require the use of credit.

When the credit crisis hit, it negatively affected each stage in the manufacturing and sales process. The sector literally fell off a cliff. When one part of the manufacturing sector is hit, it flows through other parts of the economy, creating a vicious cycle. Ultimately, this results in lost sales, lower demand and higher unemployment. The chart below shows what seems to be a clear correlation between the drop in manufacturing orders and increase in unemployment. Importantly, the uptick in the bottom right of the chart does not indicate a return to growth but rather a reduction of the rate of contraction, a decline of well over 15% in year-over-year orders.

Correlation between U.S. Manufacturing Activity and Job Losses

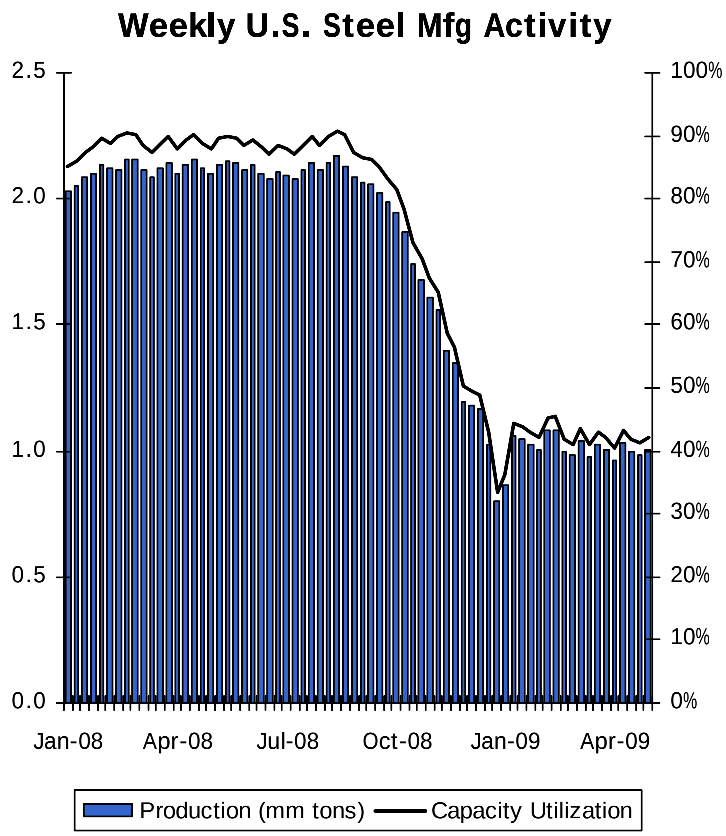


Source: Department of Labor, Department of Census.

Widely available data shows the staggering hit the manufacturing sector has experienced. The downturn in some parts of the manufacturing economy has been depression-like, not recession-like. A few examples:

- Steel production dropped by more than 50% between August 2008 and January 2009. Today, the steel sector is operating at slightly more than 40% of capacity. Only 8 of the 28 blast furnaces in the United States are in production.
- A staggering data point: Through the beginning of May, the U.S. steel industry is producing at a rate last seen in 1939.
- After falling 34% between 2005 and 2007, private residential construction dropped by another 33% in 2008 – and is now at a run-rate 44% below that level. This has decimated manufacturers of building products.

- Suppliers to the Big 3 have seen drops in revenues in excess of 50%, and the impact of this decline in demand has created ripple effects throughout their supply chains.



Source: American Iron & Steel Institute.

The combination of dramatic drops in demand with lack of availability of credit has placed small, medium and large manufacturing companies under severe stress. In these circumstances, managers stop focusing on profits and instead focus on liquidity and survival. Restructuring under Chapter 11 is an undesirable option today because of the lack of debtor-in-possession (DIP) financing. In normal times, companies use Chapter 11 to reduce debt, restructure operations and lower costs. DIP lenders gain a preferred, senior status when lending into a Chapter 11 process. Today, however, DIP financing is scarce. As a result, filing under Chapter 11 could easily result in Chapter 7 liquidation.

There has been a significant amount of discussion in recent weeks of the "glimmers of hope" in the economy. On the positive side of the ledger, it does appear that the free fall has stopped. Consumer confidence is inching forward. The ISM index, a commonly-used barometer of manufacturing activity, suggests that the rate of decline is slowing. And housing inventory in certain parts of the country has dropped. The Federal Reserve's extraordinary intervention in credit markets has freed credit up for the most credit worthy borrowers.

Although there have been some positive signs, the economy is still contracting. Whereas some parts of the economy may be at or near bottom, other parts of the economy are just beginning their downward cycle. The aerospace industry, for example, typically lags the rest of the economy both going into downward cycles and coming out of them. The foreclosure crisis shows no signs of abatement. The Wall Street Journal reported on May 6 that the downturn in home prices has left nearly 30% of U.S. homeowners owing more on a mortgage than their homes are worth. Until Americans across the country feel secure in their jobs and their homes, they won't begin spending again.

We would caution against reading one or two months of data and creating too much optimism. We hope that we will turn to growth again soon, but it is too early to tell, in our view. Credit markets remain severely compromised. Bank lending remains anemic, particularly to small- and medium-size companies. The non-bank credit system is moribund. Unemployment will likely increase as consumers continue to be very cautious in their spending patterns. Finally, even if we are at the bottom, it will take years to climb out of the hole.

Policy Options

I would encourage Congress to avoid a sense of complacency and continue to support aggressive policy efforts by the Administration and the Federal Reserve.

The Administration, Federal Reserve, FDIC and the Congress have been active, creative and aggressive in their policy responses to the crisis. Secretary Geithner and his team deserve credit for not only being designing strong policy responses, but also articulating a conceptual framework to attack the problems with the economy: increasing aggregate demand; restoring credit markets; and mitigating problems in the housing sector. Without these actions, it is hard to imagine the carnage in the U.S. economy. A strong policy response is essential for the resumption of market confidence. And strong policy actions to strengthen credit markets are essential for the resumption of growth in the manufacturing sector.

Congress should be commended for increasing spending on infrastructure projects as part of the stimulus package earlier this year. But now the real work begins: deploying the $311 billion in federal, state and local spending in a way that jump-starts the economy and creates jobs. The key to success of the stimulus is maximizing the economic activity generated by each tax dollar spent. The more money spent in the manufacturing sector, the greater the economic benefit. That’s why it’s so important to concentrate the expenditures on products with significant domestic value added, which will more quickly generate more jobs and economic benefits.

One other point on the stimulus: unless the credit markets are repaired, the benefits of the stimulus package could be blunted. Unfortunately, in some cases, suppliers that want to fill orders related to stimulus demand don't have access to working capital necessary to buy parts and equipment to fill those orders.

The Administration and Federal Reserve's efforts to jumpstart credit markets have been important and well designed. For example, the Term Asset-Backed Securities Loan Facility (TALF) seeks to bring liquidity to the securitization market, the once large but now largely closed source of funding for residential mortgages, commercial real estate, small businesses and large corporations. Year to date Asset Back Securities (ABS) financings are way down, and this financing source is critical for credit for consumers, businesses and manufacturers.

Treasury and the Federal Reserve should be applauded for expanding the asset classes eligible for TALF funding to include commercial real estate, auto fleets and dealer floor plans. At the same time, while it is critical that the Federal Reserve limit its risk exposure, potential beneficiaries, including auto dealers, may not be able to benefit from these securitizations because they may not be in a position to qualify for or support a AAA rating, especially because monoline insurance enhancement is no longer available in this market. Policymakers should consider expanding the credit criteria for securities that qualify for TALF support.

One important area of future focus for Treasury and the Federal Reserve will be to ensure that the corporate loan market remains vibrant. Today, only six large publicly-traded companies are rated AAA, showing how difficult it is to achieve AAA rating. Small, medium and large manufacturing companies, for example, lack access to term loans, working capital facilities and the bond market. This means that they do not have financing to undertake capital improvements, to fund research and development projects or to fund new inventories. Moreover, given the staggering amount of new loans that were issued in the 2005 – 2007 that will come due in 2010 – 2014, it will be essential that credit markets can facilitate refinancing of this debt. Hopefully, credit markets will rebound in time, but if not, the Federal Reserve and Treasury will need to find ways to support the corporate loan market to avoid massive bankruptcies.

Allow me to flag three other areas of potential policy actions by the Treasury and Federal Reserve, which hopefully this Committee will support.

First, once the economy starts to grow, businesses will need to increase inventory. To do so, they will need access to working capital. Today, companies' access to working capital loan facilities is very limited. I would encourage this committee to explore ways to invigorate this part of the credit market, which will be essential for recovery. The program recently launched by the Administration to insure receivables to the auto makers provides a good starting point.

Second, I would encourage the Committee to explore ways for Federal Reserve and Treasury programs to facilitate franchisee financing. Small business is a powerful and important driver of economic expansion. The relationship between lending, small business jobs and economic output can be summed up by the following: For every million dollars of lending obtained by small businesses, 34.1 jobs are created and $3.6 million in annual total economic output is realized. We know this through our investment in Dunkin Brands, which last year created 762 new Dunkin Donut and 124 Baskin Robbins stores in the U.S, resulting in more than 20,000 new jobs. A new franchise creates construction jobs, demand for new equipment and material and employs dozens of workers. The loan market for franchisees, unfortunately, is very weak, and many franchisees are either not eligible for SBA loans or find the process too bureaucratic and slow. As a result of the credit crisis, many of the traditional lenders have pulled out of the market. Making capital available to small businesses and franchisees is critical to growing local economies.

Third, the number of bankruptcies will inevitably increase this year. The absence of an active debtor-in-possession financing market will cause companies that otherwise would be strong candidates for restructuring to instead liquidate. Without an active DIP-financing market, unemployment will continue to soar and companies that should be restructured will cease to exist. I would encourage the Committee to work with the Treasury and Federal Reserve to explore whether policy actions could help bring liquidity to the DIP financing market.

Finally, a few words on General Motors. It is hard to overestimate the importance of the auto sector to the U.S. economy. Virtually every manufacturer touches the auto sector in one way or another. Auto suppliers are already under distress, and the lack of orders and lack of credit has virtually eliminated any cushion. If not handled properly, a GM bankruptcy could be the "Lehman Brothers" of the manufacturing sector given the sensitivity of the automotive supply chain. It could affect suppliers outside the auto sector, including commercial vehicle, heavy equipment and even military suppliers. If GM is indeed required to file under Chapter 11 reorganization, it will be critical that the process be efficient, quick and transparent. It will be essential that GM honor its commitments to suppliers and business partners. A GM filing with any type of meaningful trade payment delays or impairments could push the next group of troubled suppliers into the abyss. And, as Leo Gerard has said, it is important that GM maintain as much manufacturing as possible in North America. I also want to compliment you, Mr. Chairman, on your work with Senator Stabenow on the "cash for clunkers" legislation, which I encourage the Senate to adopt.

Conclusion

Thank you once again for calling this hearing on the impact of the financial crisis on the manufacturing sector. Unfortunately, as mentioned above, the manufacturing sector has been hit harder than virtually any other sector, and no other sector is more important to the vitality and vibrancy of the U.S. economy. The Congress, Treasury and Federal Reserve's policy actions have been helpful and important in reducing the impact of the crisis, but additional and broader policy actions will be needed.

One of the hallmarks of the U.S. economy is its resilience. The U.S. economy is more flexible, more diverse and more dynamic than any other economy in the world. We are experiencing the most difficult economic circumstances of most of our lifetimes, but even in the darkest days, we should be comforted by the fact that we will rebound, retool and return to growth and prosperity.