How will groups exit the recession?

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1. Let's not blame everything on US finance. A financial crisis had to erupt at some time between 2008 and 2012.

   The current crisis is not merely the bursting of a financial bubble, although the bubble triggered it and made it worse. The crisis is the harsh landing from growth which, in the mature countries, had been artificial since 2002. Several large industries which had been driving the western economy for many years - carmaking, construction, and finance (as an industry) have reached the end of their cycle. Other industries will have to take over from these growth engines, or the latter will have to recover. This will take time.

2. The absence of real growth in Europe and the US has been brutally revealed. Western countries were thought to be growing at 2% or 3% per year (2002-2007). In fact, over a complete economic cycle (2002-2010), they will probably register annual growth of 1% to 1.5% - at best.

   The western economies are therefore clearly registering much less growth than emerging Asian ones (see Table 1). Assuming that China grows at 6% to 8% annually in 2009-2010, it would register an average of 9 to 10% annual growth during the 2002-2010 period.

   We can stimulate the automotive sector as much as we want (or are able to) in Europe and the US, but growth of this sector in the West is over. The potential market in Asia, however, will be huge for the next 20 years. Who will benefit from it? General Motors or SAIC[1]?

3. There is and will continue to be a major contradiction, in terms of trying to "create value", for the large western groups which have 80% of their activity in core western markets that are growing at 1% to 1.5% per year. A company can really only create value - significantly and over the long term - if it is growing much faster than the economy, and without diluting profitability.

   Competition for real sources of long term growth (markets in emerging countries and high-growth niche markets in western countries) will be ferocious.

   In just ten years, the large western groups have allowed serious competitors to emerge in China and India. The upstarts will not only make competition on their local markets very difficult, but will also seek to conquer western markets using the economies of scale which their own huge domestic markets have enabled.

4. In this respect, the current crisis changes nothing for the sectors and regions of the world which are growing strongly for the next ten years, and those which are mature.

   Growing strongly are raw materials, services, and all sectors driven by the strong, sustained growth in emerging Asian markets. We will soon see upstream tensions in sectors, rising oil prices, growth in capital goods, China developing a mass presence in consumer goods and domestic appliances, etc.

   But other sectors are also growing - namely, those linked to digital technology and the internet, the ageing of the population, energy and energy optimisation, and various niche areas in technology, services and consumption in the West.

   In order to benefit from these growth areas, groups must therefore re-position themselves.

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[1] Shanghai Automotive Industry Corporation

The question is, do they want to? Many large groups think that they must limit their strategies to their core businesses and that geographical or business diversification is risky. And it is. But the current crisis shows the extent to which a company's performance, in terms of both its business and its share price, is linked not only to its competitiveness but also to its choice of business and location.

Despite the recent collapse of financial markets, leaders in the internet sector, energy and related services, capital goods production, extraction of certain commodities, and high-growth sectors in emerging countries registered 10%-40% annual growth on the stock market from 2002 to 2008.

Shareholders are being deceived when they are told that value will be created, whilst groups continue to invest exclusively in businesses and regions which can no longer create it (with no more growth, weak market share value, capture of value by large clients, disappearance of entry barriers, competition from low-cost countries, etc.) This is true whatever the market share and however good the operational performance.

Many large groups which do not manage to move into other businesses or regions will disappear like the large western textile groups did before them. All their unique know-how will go with them.

5. The current crisis reminds us that cycles are an integral part of the market economy. Some discovery! This is the 14th recession since 1945, and certainly one of the most severe. The global economy has nonetheless grown at an annual average of 4% (excluding inflation).

   It is a classic illustration of the two major challenges for any company over a long period: survival (i.e. cash flow generation) and the creation of value (i.e. growth).

   Companies which get through recessions will have solid competitive positions, generating cash flow internally. "Cash cows" allow groups to survive recessions. But they do not create value. Only high-growth activities, those that grow much faster than the economy as a whole, can do that.

   Conversely, high-growth, pure players without sufficient internal cash sources, that finance themselves solely through the markets, are vulnerable to major crises (Alcatel and Marconi in 2001-2003, Lehman Brothers in 2008).

   The combination of cash generation and growth is the hallmark of the large groups which are both resilient and creators of value in the long term.

6. The next two years will force a large-scale restructuring of business portfolios in line with these two challenges.

   With regard to restructuring costs and investments to maximise sources of cash, if groups want to make meaningful improvements on the scale of the severity of the crisis, then they must fundamentally question certain activities and carry out in-depth re-focusing.

   Restructure activities to focus on a few sources of major growth: you cannot do everything at once.

   The two challenges overlap. There should be clear identification of the businesses and regions in which groups must continue to invest in order to position themselves for the upturn, those which should be managed for cash, and those which should be abandoned more rapidly than previously planned.

7. Recessions create opportunities for bargain acquisitions.

   But is it better to consolidate your positions and gain more market share in mature markets or to take advantage of the opportunity to acquire development platforms in growth markets? With like-for-like profitability, the latter strategy is worth two to three times more than the former. This is what will differentiate groups during the upturn.

8. The growing divergence between the economies of mature countries and those of emerging countries (see Table 1) will necessarily produce another recession (2015-2016?) which may be just as harsh as the current one, with the same causes producing the same effects.

The sudden entry of 1.2 billion people (and more if considering India in the longer term) into the modern economy cannot happen without violent shocks (relocation of industries, tensions on commodities, pressure on prices and margins, emergence of new competitors, etc.).

In addition, the absence of structural growth in the mature countries leads governments to adopt policies in the areas of interest rates, debt, or intervention to artificially boost the economy. These efforts are not sustainable over the long term. Each recession is just the bursting of a bubble.

9. Which groups have the mix of activities and competitive positions that they need to survive and grow *through increasingly volatile economic cycles?*

   The question is how to combine:

   - *Strategy* (with a mix of activities, geography and competitive positions which are more resilient and quicker to adapt to the economy's value waves),
   - *The business model* (with more variable costs and a better position in the value chain),
   - *And the management of the operations* (with more anticipation and responsiveness).

10. We can be certain of just one thing at this stage: more volatility means more risks, more distance between competitors and fewer winners in the medium term. It will not be enough just to survive this recession. It is no longer enough just to take part.

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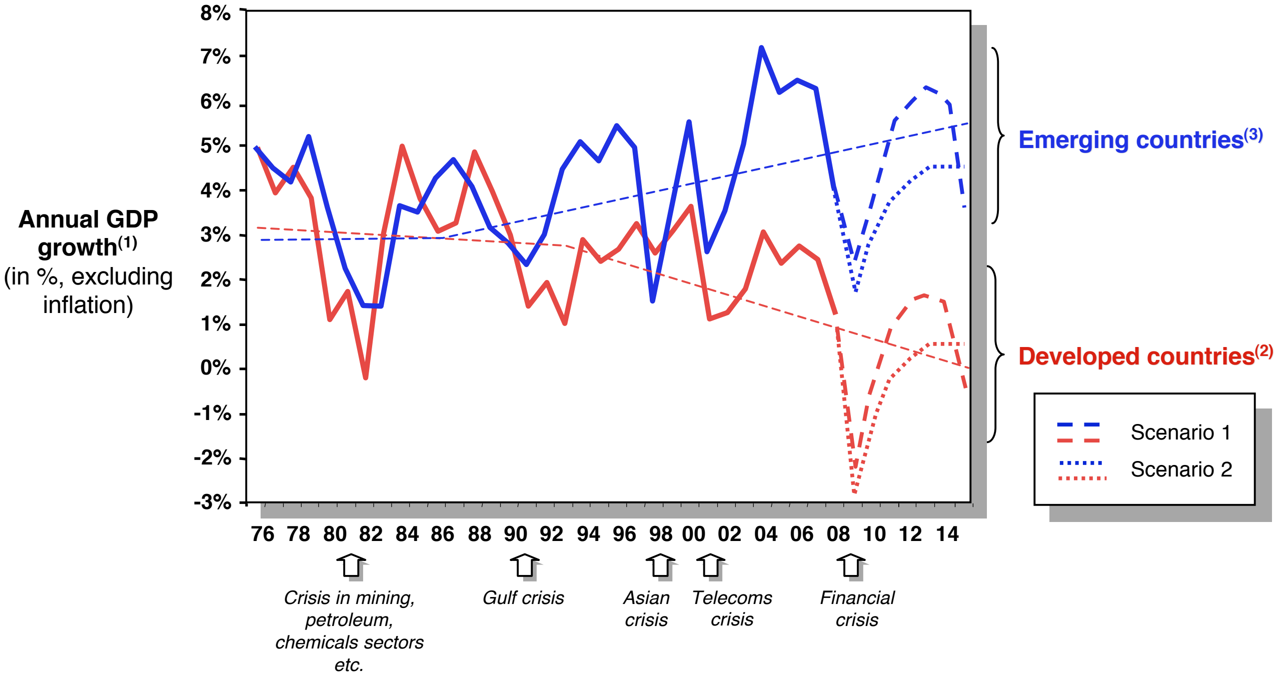
Estin & Co is an international strategy consulting firm with offices in Paris, London, Geneva, and Shanghai. The firm assists CEO's and senior executives at large European and North American companies develop and implement growth strategies, and works with private equity funds to assess and value their investments.

- Table 1 -

Growth of mature countries and emerging countries



(1) In constant US dollars (2000) and at constant exchange rates; (2) USA, Canada, Japan, Western Europe, Scandinavia, Australia / New Zealand; (3) Other countries

Source: World Bank, OECD, Estin & Co analysis and estimates