Growing through crises

by
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The western economy has undergone 14 crises since 1950, i.e. an average of one crisis every four years (see tables 1 and 2). This did not stop it growing 7.5% per annum over a half century (including inflation).

Six were *structural* crises caused by the slowdown in certain industries and their replacement by others as economic growth factors, value transfers (petrol crises in the seventies) or by a slowdown in growth in certain countries after a period of strong growth (the post-war years in Europe, growth in Japan, etc.)[1]. Eight were *cyclical* crises caused by transitory adjustments of the economy, financial crises, geopolitical tensions or inappropriate governmental policies[2].

It is therefore difficult to achieve long-term growth without being prepared to resist transitory slowdown or even use them to one's advantage.

One thing is certain, one or two years after crisis, markets will be better or different! Will a company's position in its market be strengthened or weakened?

Crises are an inevitable and useful long-term growth factor. Leaders win market share and make all the difference in the long term against their competitors through the decisions taken during crises.

Two types of crisis

Whatever event triggers them off, there are only two types of crisis for a company:

- Cyclical slowdowns of varying intensity, which, over and above fluctuating financial results, can provide opportunities to lose or win market share; in cyclical industries (where the cycle of demand amplifies that of the economy in general and where supply does not evolve in a linear fashion), these slowdowns are expressed by significant transitory overcapacities and potentially high losses;
- Major changes in growth, activity model, distribution of value, technology or competition within an industry; apparently cyclical slowdown is in fact expressed by in-depth change in professions.

A crisis can sometimes conceal another. The solutions to be found for these two types of crisis are profoundly different. Misinterpretation on the nature of the crisis can jeopardize leadership and even independence of the company in the medium term.

Cyclical slowdowns

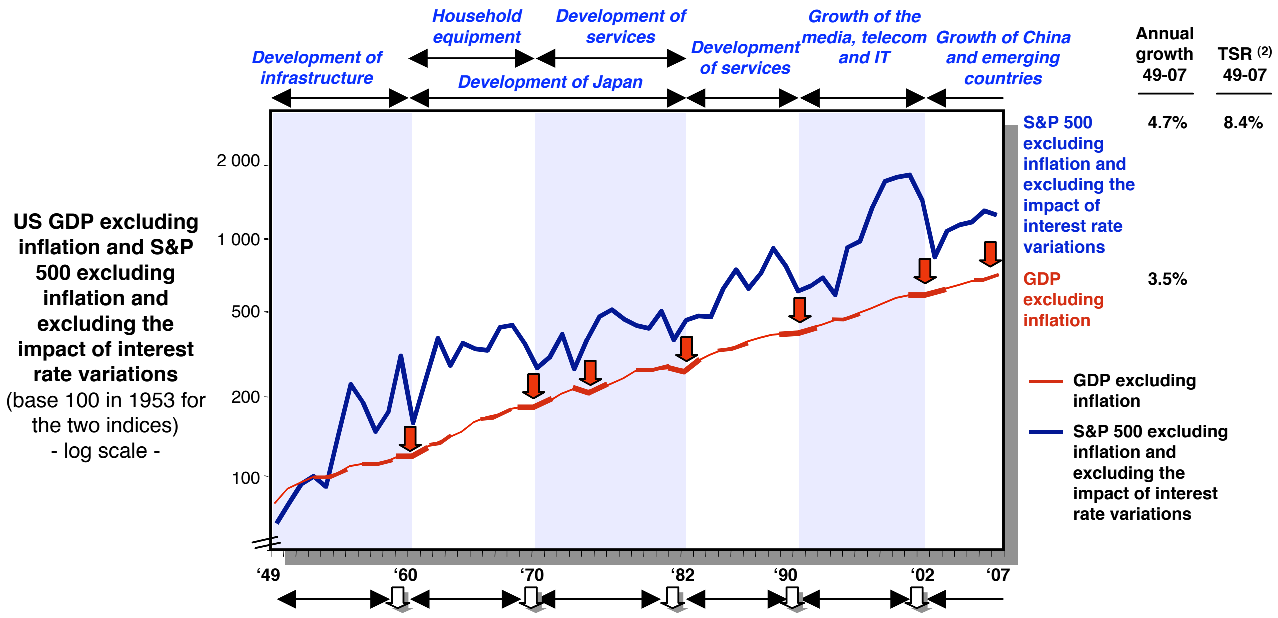
The value of cyclical slowdowns is to favour the concentration of industries. Marginal competitors can lose twice over:

- Through a drop in their results during the crisis (much stronger proportionally than for leaders (see table 3);
- During recovery, through their loss of market share, considering their difficulty to reinvest sufficiently and fast enough and therefore due to the fact that they do not fully benefit from the peak of the following cycle. They approach each new trough in the cycle in more and more deteriorated positions and are eventually taken over or disappear (see table 4).

[1] GDP growth lower than 1%, and even recession, over one year.
[2] GDP growth lower than 0.5% over one or two quarters.

- Table 1 -

Evolution of US GDP and S&P 500
- 1949-2007 -

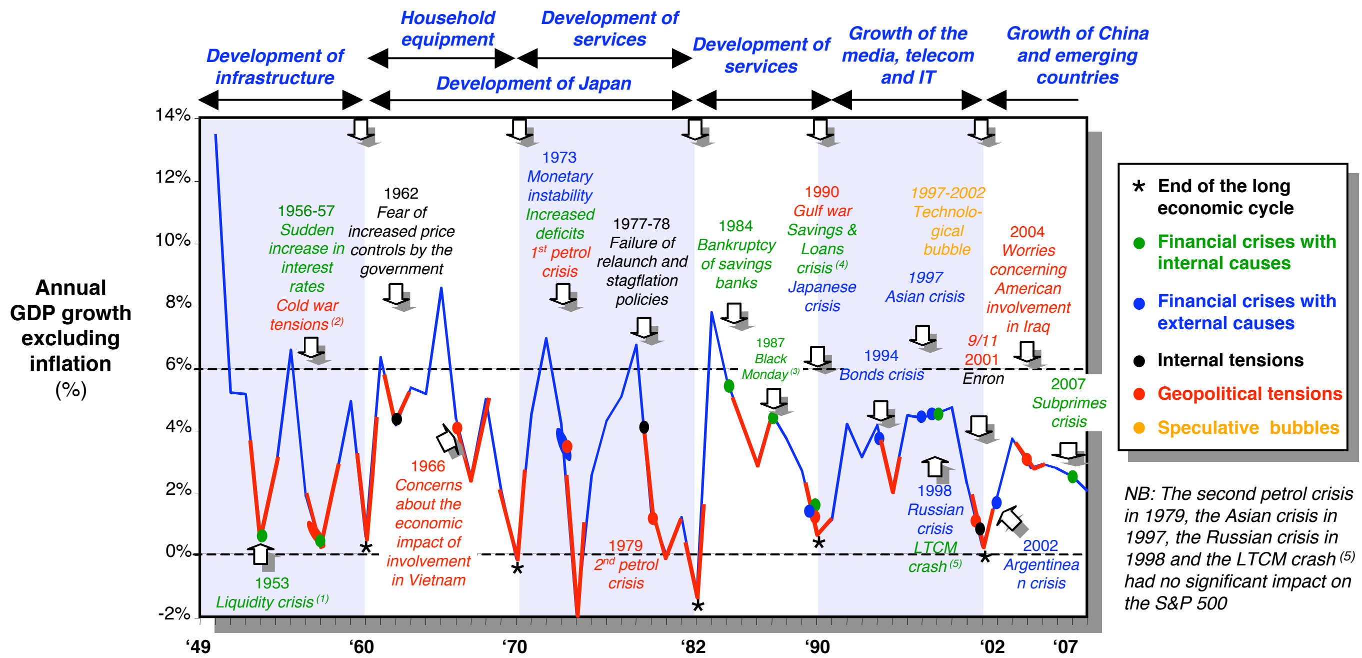


S&P 500 annual growth excluding inflation and excluding the impact of interest rate variations (%)	14.4%	- 29.5%	11.2%	- 9.4%	6.3% (1)	-22.0%	23.0%	-14.0%	14.6%	-29.8%	7.5%
Annual GDP growth rate exluding inflation (%)	4.2%	0.6%	4.8%	- 0.1%	3.1%	-1.4%	4.4%	0.7%	3.4%	0.2%	2.8%

(1) Impact of the first petrol crisis in 1973; (2) TSR: Total Shareholder Return: profitability of shareholder's investment (dividends, distribution of free shares, buy-back of shares, capital gain, etc.)
Sources: BEA, analyses and estimates Estin & Co

- Table 2 -

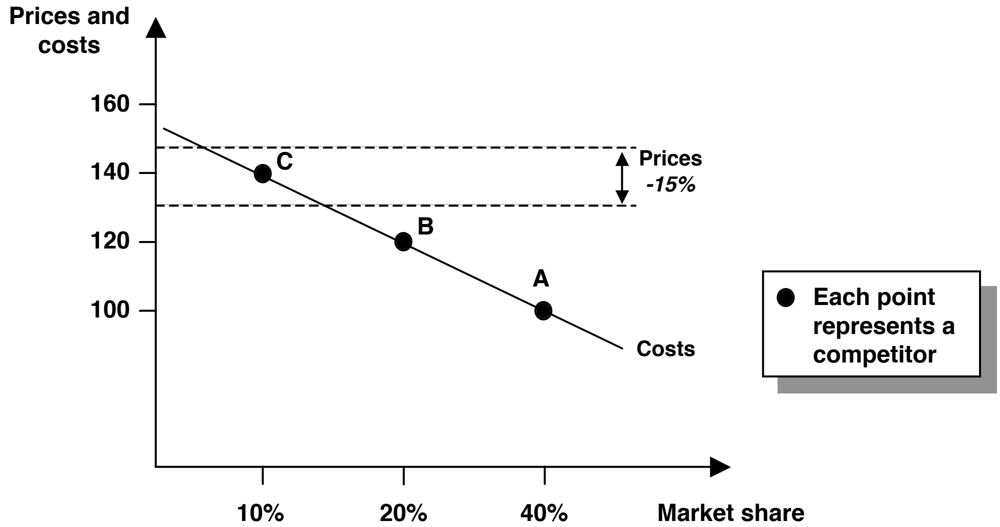
Annual GDP growth excluding inflation
- United States - 1949-2007



(1) Increase in the key rate from 1.75% to 2% to limit the increase in prices and non-injection of the new liquidity by the Fed in the fall of 1953 generating insufficient liquidities on the market; (2) Worries concerning events in Hungary (1956-57) and Sputnik (October 1957); (3) Consumer price rises leading to an increase in the key rate (6% to 7.25%); stock market decrease reinforced by the automatic futures sales system which does not integrate the possibility of a stock market crisis; (4) Crisis of American savings and loans banks in the wake of excessively risky investment; (5) Long Term Capital Management: American hedge fund, the partner of several major world banks, bankrupt after risky positions taken just before the crash consecutive to the Asian and Russian crises in 1997 and 1998
Sources: BEA, Bloomberg, Shiller, analyses, research and estimates Estin & Co

- Table 3 -

In an industry with strong scale effects, the impact of an economic slowdown is very different for the leader and its competitors



- **In the same industry subjected to a cyclical slowdown and 15% price cuts, the leader sees its result drop by 40%, whereas the n°2 sees its result drop by 70% and the 3rd makes a loss**
- **Within a group, activities where competitive positions are marginal often show the greatest variations in terms of results (relative) during crises**

The strategies of leaders that grow and win market shares through crises are based on a mix of six levers:

- Maintaining all commercial, R&D, etc. investments to defend market share during the crisis and increase it when the economy picks up (in industries where this market share has value);
- In growing industries, scheduling and launching new production capacities *during* the trough to be operational *as soon as* recovery kicks in and not two or three years too late; the example of Samsung which focused on RAM memory for 25 years to its advantage is a fine example (see table 5);
- Optimized management of gross margin and discretionary costs (prices, sales costs, service, quality, costs to adapt products to certain customers, …), with a *focus* on the most profitable customers or those representing the highest medium term growth potential for the company; it is often forgotten that "markets" do not exist in reality - only customers, who are very different from each other in terms of profitability and growth potential, count;
- Maximum reduction of all other non-directly productive costs in the short or medium term, in particular overheads. However, in most professions, and for well managed companies, these overheads defined in the strict sense of the word (excluding R&D, commercial costs, etc.) often only represent between 3 and 6% of sales. To deal with a slowdown or market reversal, it is evident that *this lever alone is not enough* (20% reduction on 5% of sales only produces 1% extra EBITDA);
- Accentuated focus on core portfolio or growth activities and increased withdrawal from marginal activities, with - in particular - more differentiated allocation of resources (allocation of CAPEX, etc.) and restructuring and transfer of losses or insufficient profitability. It is better to continue to invest heavily in critical fields, even

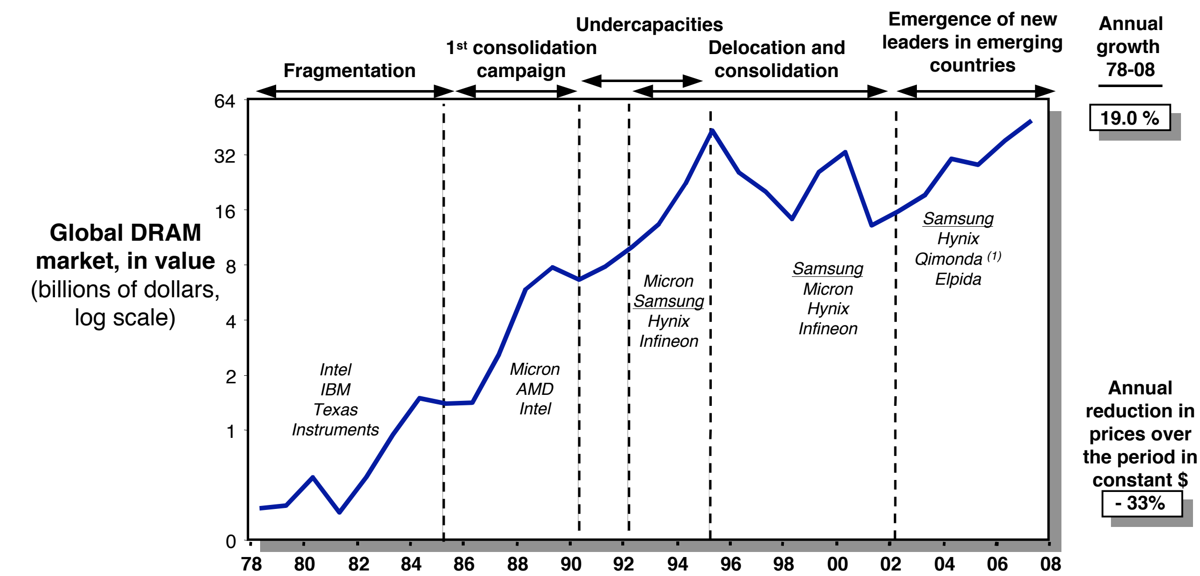
if it is necessary to disengage from other areas, rather than cut expenditure and investments. A strong strategic vision is obviously indispensable to select this restructuring and allocations and avoid the destructive application of "- 20% across the board";

- Effective takeover of marginal competitors who are depleted by the crisis, when this takeover is worth it.

The issue for each company is to determine the right mix of these levers for its professions, cost and investment structures, value of market share, scale and length of the crisis and of the competitive game.

- Table 4 -

Market dynamic and concentration of players in RAM memories - 1978-2008



Market's annual growth rate (in volume)	**109% / year**	**61% / year**	**78% / year**	**75% / year**	**150% / year**
Market share of the three world leaders	**< 15%**	**25-35%**	**30-35%**	**66%**	**62%**
Market share of Asian manu-facturers outside Japan	**< 5%**	**< 10%**		**60%**	**80%**
Players disappearing from the market	***n.a.***	***IBM Texas Instruments***		***AMD***	***Micron***

(1) Infineon set up a spin off of the DRAM division, called Qimonda
Source: Infineon, Micron, DataQuest, Semiconductors Industry Association; analyses Estin & Co

Overcapacity cycles

In several capitalistic professions or sectors with a high proportion of fixed costs, cyclical crises are expressed by violent overcapacity cycles and potentially by losses for all players, including leaders, especially when:

- Demand changes with cycles, amplifying economic trends (consumer goods, information systems, air transport, etc.);
- New production capacities have a large unit size with respect to the market; the arrival of new capacities with poor timing, temporarily creates significantly excessive supply;
- Marginal costs are very low with respect to total costs and overcapacities can incur price reductions of 50% or more.

In these professions, the aforementioned adjustment strategies are necessary but insufficient. The only decisive variable to maintain margins is the price level. This entirely depends on *capacity management*, as no sales force or price optimization system, as sophisticated as it may be, can hold out against major overcapacities.

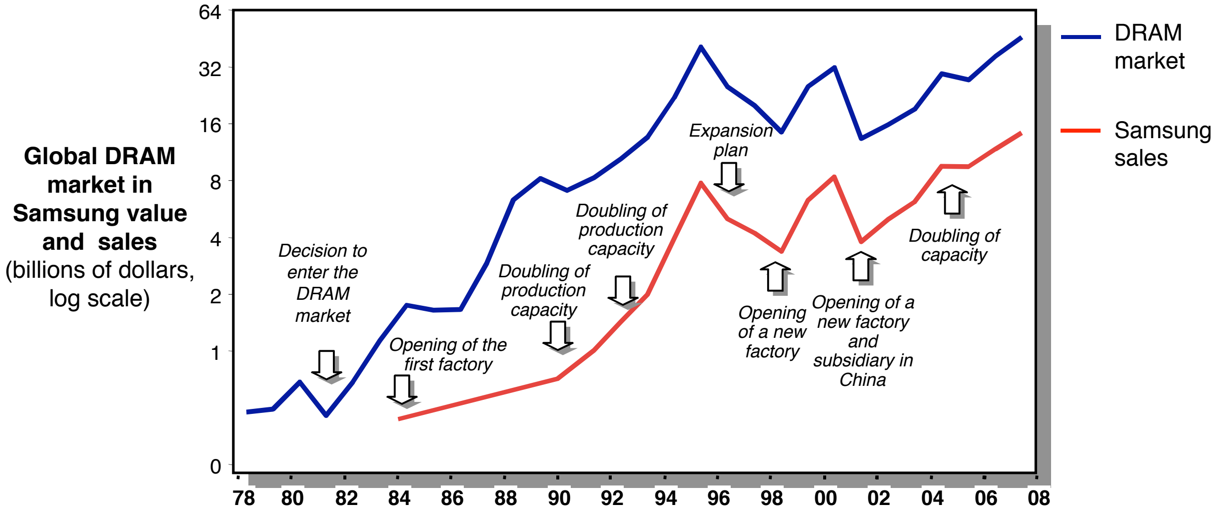
Only leaders have a strong enough position in their markets to ensure that capacity adjustments have an impact on industrial margins. The question for them is balancing strategic outlook with short-term financial outlook. Both can coincide or not, depending on the value of market share in the relevant profession.

If market share has value or industry is in a growth situation, it is difficult to decide between the transitory adjustment of capacities, maintaining market share and the necessary availability of new production capacities when the market recovers.

Should market share have little value (all major competitors have practically the same costs regardless of their market share), adjustments should be more drastic and rapid and focus on short-term financial gain.

- Table 5 -

Samsung has expanded regularly in the RAM memory market by investing in new production capacities in an optimized way with respect to industry cycles



Samsung market share			**10%**	**15%**	**20%**	**28%**	**28%**
Number of production lines	**1**	**2**	**4**	**5** (1)	**8**	**12**	**15**

(1) Doubling of capacity partly thanks to the modernization of existing lines Source: Samsung, DataQuest, Semiconductors Industry Association, analyses Estin & Co

Timing

Management is an art of execution. In crisis situations, timing is key. A company that implements the right levers over a three year period rather than in eighteen months makes a major mistake. It is subjected to disastrous falls in profits at the heart of the crisis and has to continue to cut costs and capacities even after recovery instead of winning market share.

Market share is more easily won during the recovery, when most competitors are still fighting to rebalance their financial results. Before, during the slowdown or market fall period, it is difficult (all competitors defend their sales to fill their capacities and cover their fixed costs); after, in the strong market growth period, it is also difficult (all competitors have had the time to build capacities and redevelop their product ranges and sales efforts).

Appropriate management of crises therefore requires *strong* and even autocratic *management*. How else can one make teams (and shareholders!) accept to stop capacity investment, start to adjust costs and not buy out competitors when growth is strong, cash flow high and all experts' forecasts look good? In contrast, it is the only way to force teams to start to reinvest in capacity or commercial costs at the trough of the cycle whereas markets are still stagnant and even in regression, when financial results are reduced and experts' forecasts gloomy.

The decisions that fundamentally create value for the company are not necessarily consensual.

Major changes in the economic environment

Every ten years since 1950, western economies have undergone economic crises that are more structural than a simple adjustment.

Some industries or countries that have grown economically amidst the general picture are reaching maturity. The transitional period, before new industries or countries find significant growth relays, produces an air pocket (see tables 1 and 2).

The issue of these crises is not that of a simple adjustment and stronger focus on costs and investments. Nor does it concern the restructuring of production capacities, even though these two possibilities remain relevant. The real issue is a possible in-depth modification of the portfolio of activities and geographic locations.

Causes of long growth and value in fact change with the crisis. Professions or geographic location that created a company's growth for ten or twenty years reach maturity or are called into question. The value waves of the following ten years move to new geographic locations (now "emerging" countries) or new professions in terms of growth and profitability.

There is therefore no point in wishing to continue to fight exclusively within a portfolio of activities and geographic locations that grow structurally 2 or 3% per year and are subjected to intensive competition(1) when significant shards of the economy or major geographic areas are scheduled to grow 10% per year for the next ten years or more.

In these situations, restructuring costs (overheads, purchases, potential industrial restructuring, etc.) or capacities instead of *restructuring the activity portfolio* is a major aberration.

What is the nature of the current crisis?

A crisis often conceals another. The current situation involves two, quite different crises:

- The first results from the bursting of the financial services bubble. Significant artificial activity has developed based on loans to households that did not have the necessary borrowing capacity. This cyclical crisis has a major impact for financial service players. Its impact on the western economy will be felt to a lesser or greater degree;
- The second is totally independent of the first. It is a *growth crisis* caused by the major development of China and its general impact on resources and rare raw materials and at a more transitory effect, through bottlenecks created upstream of all branches (food products, steel, consumer goods, maritime transport, infrastructure, engineering, high value-added specialists, etc.) with supply that is unable to keep up with demand (but which will eventually do so).

There is no overcapacity crisis (except for financial services). This will soon occur however in certain areas, upstream from certain industrial branches and in certain transport segments when new developing capacities will have caught up (and exceeded!) demand. Nor is there a strong structural crisis yet. This will really occur when China experiences a first transitional stage in industries that have induced its growth.

The current growth crisis nevertheless has a major impact. It differentiates companies' performance according to their mix of activities in terms of sectors and geographies, as has rarely occurred hitherto.

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(1) Unless to profoundly redefine activity models, precisely re-segment markets or regularly find significant areas of innovation

Players present downstream of branches in western Europe and the United States (mass consumption, mass retailing, automobile, … excluding luxury or low cost segments) are experiencing weak growth and are subjected to strong pressure on margins. This situation will last, even after the recovery of the whole market, as it is structural.

Inversely, growth is strong upstream of branches (consumer goods, infrastructure, etc.) or, in emerging markets, downstream of branches (household equipment) and in the long term, regardless of the cyclical crises that are bound to occur[(2)].

A major issue for large western groups is to redefine their activity portfolio strongly and rapidly with respect to these new sources of long-term growth, while taking into account the fact that severe crises will intervene regularly (and even soon!) within these new sources of growth.

What should be our conclusion?

Long-term growth is impossible without providing good solutions to regular crises which are part of normal growth. It is important to correctly identify the type of crisis, the fundamental levers to be used for each crisis, the value of market share and the utility of certain consolidation strategies or the implementation timescale of certain decisions.

Some crises allow and require the reinforcement of professions and winning of market share in the ensuing recovery. The adjustment of costs and investments should therefore be extremely precise and differentiated. Other crises require acceptance of the defence of short-term financial results. Defending market share at all costs is meaningless. Some require profound modification of the portfolio of professions and geographic locations if growth is to be significantly pursued in the long term.

Each manager needs to have a specific vision of each crisis facing the company and of what will happen after this crisis, independently of the consensual vision of the market or experts which is not necessarily the best. Growth and medium-term leadership of the company depend on this vision – which should be stronger than that of competitors – and the decisions taken – which must be more consistent.

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Estin & Co is an international strategic consulting company based in Paris, London, Geneva and Shanghai. The company helps general management of major European and North American groups in their growth strategies as well as private equity funds in the analysis and valuation of their investments.

(2) In the hypothesis of long-term growth in emerging countries and the absence of protectionism by developing countries as established in the nineteen-thirties.