Should we plan for crises?

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The crisis is behind us and, more than ever, the critical issue is growth and the corresponding decisions about investments and allocation of resources. Should we therefore ignore the volatility that is inherent to market economies, and is even stronger when they experience major shocks, such as the rapid rise of emerging economies and energy and commodity pressures?

There have been 14 crises since 1950, i.e. one every four years. Six of these crises (including the last one) have been major, i.e. one every ten years (see table 1).

And yet, major groups continue to gamble every day on a crisis-free world. Apart from a few exceptions, they do not include the impact of a possible crisis in their medium-term strategies, except in variants that remain unlikely and are quickly forgotten. In any case, crises have no impact on the big decisions and on action plans. Forecasting agencies do not include crises in their "central" five-year scenarios either, to avoid creating negative expectations.

A crisis is understandably difficult to incorporate into a line of reasoning and into action. When is it expected to happen? 2014, 2015 or 2016? How big will it be? Given this uncertainty, how can we incorporate it meaningfully into a financial plan to be communicated to investors? And how should it be factored into the medium-term budgetary programmes and action plans of each of the operational entities within a group?

The strategies that are currently being developed coming out of the crisis are therefore based, by default – in terms of calculations and the main decisions taken – on an absurd assumption: this time, the future will be different from the past: there will not be another crisis; we are finally in an economic world in which volatility has disappeared; and in any case, volatility would in no way alter the strategies pursued.

This is certainly a dangerous convention.

Errors

There are three common errors.

The first is to project revenues and margins from the low point of the cycle to the future peak, without taking into account the reversal that is bound to happen sooner or later. Revenues, margins and cash flows are inflated as a result.

The second is to forecast an average trend, independent of cycles, in which revenues are smoothed. Costs and margins remain fixed as a proportion of these revenues. With this kind of approach, margins and cash flows are also inflated, although revenue growth is more realistic. Indeed, cyclical growth involves far higher costs than a steady progression since it entails industrial over or under-capacity, over or under-staffing, restructuring costs and depressed margins, etc.

The third error is to bracket a crisis-free central scenario between a "high" and "low" scenario reflecting the impact of a crisis. The low scenario is *always* assigned a low probability and, consequently, the enormous energy spent on the complex modelling of different scenarios has no impact on the ensuing thinking and strategic decisions.

These errors have a minor impact on non-cyclical businesses such as current consumer goods, utilities, etc. They are significant in businesses that are naturally cyclical such as agricultural produce, mining, chemicals, paper, steel, building materials, capital goods, microelectronics, air and sea transport, engineering, IT services, some financial services, media and hospitality, i.e. a major proportion of economic activity.

Impact

Let us forget these conventions and errors for a moment and examine the impact that incorporating a certain and significant crisis in four to six years would have on the strategic choices and action plans of a major group.

The majority of businesses would, to various degrees, seem more volatile, with lower growth and cash flows. Returns on the majority of investments under consideration would be downgraded and this view would necessarily lead to greater selectivity.

Worldwide growth, which is currently forecast at around 3.8%[1] per annum (in volume terms), would be more like 2.8%, with highly differentiated impacts across sectors and geographic regions (see table 2). Growth in cyclical industries would be reduced by 1.5 to 7 percentage points, i.e. it would be almost halved in the majority of cases (see table 4).

The average profitability of businesses would be downgraded by 1 to 2 percentage points and that of cyclical businesses by 1 to 5 percentage points (see tables 3 and 4). Furthermore, the profitability of these businesses during the two or three good years of the cycle (which are considered to be representative and often justify investments) would differ by 3 to 6 percentage points (see table 3) from the average, with crises included.

Consequences

Beyond the obvious average impact, the practical repercussions of factoring in crises in this way would be three-fold:

- Necessarily greater discrimination in operational and strategic investments, with stronger choices in resource allocation;
- A review of positioning and business models within an industry;
- Priority given to time management and to the speed and timing of initiatives, as opposed to simply pursuing market positions.

1. Greater discrimination between sectors and geographic regions, requiring stronger choices

Between investments: a number of investments presumed to be profitable in light of the short-term recovery actually constitute a dilution of resources from a medium-term perspective that incorporates regular crises.

Between geographic regions: factoring in another crisis towards 2015 would halve European growth from around 2% today to 1%, but would only reduce growth in emerging Asia from 7.5%-8% to 7%. The issue of growth in emerging countries would be amplified. Low growth continues to provide some leeway to justify investment in mature sectors in Europe or the United States, but, equally, a lack of growth raises far more daunting questions for groups whose businesses mirror average economic growth (see table 2).

Between businesses: viewed from a realistic perspective that includes the certainty of regular crises, a number of *cyclical sectors* in mature markets appear for what they are: fundamentally and irremediably destroyers of value. Historical analysis reveals this: heavy chemicals, air transport, etc, have not generated net positive cash flows in Europe or the United States over the long term in the past. There is no reason that they should do so in the future.

Uncompetitive, low-profit businesses in mature markets would appear even less attractive (they are much more heavily affected by the cycle than other businesses), offering little justification for reinvestment.

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[1] IMF World Economic Outlook

The *value of high cash flow generating businesses or "cash cows"* would increase. Remember that in a world without crises, they are of no value[2]. In reality, however, they alone enable companies to keep investing, make acquisitions and gain market share during crises or even quite simply to survive and sustain the overall group, when external financing is restricted due to depressed financial markets and cautious banks. Too high a proportion of "cash cows" in a business portfolio kills growth. Too low a proportion makes the group vulnerable to crises. What is the right balance?

2. A review of positioning and business models within the value chain of an industry.

Between stages of the value chain within an industry: what is the point of volatile businesses that do not have any value to the leadership (highly cyclical, no economies of scale)? Shouldn't they be routinely sub-contracted? Should we integrate "vertically" more upstream or downstream in order to smooth cycles, or "horizontally" combine several counter-cyclical streams (different commodities and/or outlets) to smooth overall growth?

IBM became strongly integrated in service activities at the expense of home PC and server sales after the crisis of the early 1990s. Its competitors DEC and Compaq did not survive upstream specialisation.

Between business models: in a highly cyclical sector, is it better to own assets and manage them intelligently according to the cycle (investments, disposals, etc), or simply use them without ownership? Or is it better to concentrate on operations that manage the business cycle itself (marketing, trading, transport, stockbuilding, services, etc) as opposed to "productive" operations?

Niche players generally operate proficiently and flexibly in some or other of these areas and reap high returns from them. The major groups are usually involved in the most capital-intensive section of operations, without wanting – or necessarily being able – to manage it actively. They bear the brunt of the cycle.

Between functions and skills: which functions, teams, skills, know-how and systems are really central to the company's business model, setting it apart and making it competitive, and are worth investing in over time without adjustment to the cycle? Which of them, by contrast, are commodities that are available on the market, the volatility of which should therefore be outsourced?

Major manufacturers of capital goods in Germany (machine tools, production lines, process automation, etc) have now outsourced the majority of their production in order to focus on product engineering, assembly and quality control. This strategy enables them not only to absorb slowdowns in activity more effectively but also to become more nimble and flexible in periods of strong growth.

3. A greater emphasis on the speed and timing of initiatives as opposed to simply pursuing market positions

The strategy followed by Vivendi in 2000 was the right one in terms of vision and pursuing market positions. However it was ill-fitting in terms of the timing (acquisition at the peak of the cycle) and means (payment in cash rather than in shares) of execution.

Taking into account the reality of economic cycles profoundly alters certain perspectives and priorities. In fact, a value-creating sequence of initiatives is rarely progressive.

The successful launch of Ryanair took place in the crisis period of 2001 to 2003 in which all the conventional carriers were struggling and customers were looking for new solutions to suit the economic environment. Ryanair invested heavily and gained market share, rising from less than 10 million passengers carried to nearly 25 million (annual growth of 50%). Since 2004, the "conventional" airlines have stabilised their annual decline in passenger volumes.

Viewed from a perspective of regular crises, the speed and timing of execution become critical to optimising certain initiatives: acquisition price of targets, sale price of businesses or

[2] Profitable, high-growth businesses are the ones that generate high TSRs.

assets, procurement of commodities or equipment at the peak or bottom of the cycle, moving the start of capacity investment back or forward so that new capacity enters the market at the beginning of the recovery and not at the peak or trough of the cycle, gains in market share when it is cheapest and competitors are weakest, etc.

With strategy unchanged, but using a standard "reactive" sequence of initiatives, value is destroyed (see table 5)

The focus of most major groups on the market positions targeted rather on the speed and timing of attainment must be challenged. Time spent by management on managing the cycle is just as critical as that spent on operations alone.

Question

Are economic cycles predictable?

Yes, insofar as they are bound to happen sooner or later; imprecisely in terms of their origin, timing and magnitude for those that stem from overall economic activity or from demand within a sector; much more accurately in terms of the timing and impact of cycles that originate from the supply side (there is usually a good level of awareness of new capacity building in the majority of industries and its impact on the balance of supply and demand in terms of volume and costs is usually fairly well estimated).

Therefore cycles can and must be taken into account, even if they cannot be easily included in medium-term financial forecasts. *Strategy is not a budgetary exercise.*

Wager

What would you do if you strongly believed that another severe crisis would erupt towards 2015?

1) *Nothing*: your businesses are well positioned whatever happens, they are all competitive and growing, you will generate enough cash, you will control your shareholders, and you will be in a position to take over more vulnerable rivals;

2) *Everything*: you would halt a number of investments, sell a number of futureless and assetless businesses at the peak towards 2012-2013 in order to generate cash, you would invest more heavily in other businesses with strong potential regardless of the cycle, optimising the timing of such investments, you would bring forward or move back certain increases in capacity and other capital expenditure that has an impact on the cycle, or certain acquisitions with price tags that are set to fluctuate substantially.

   In fact, you would heavily restructure your business portfolio and your capacity before the next crisis so that – *this time* – you were in the best possible position to capitalise on the cycle and gain market share during and after the crisis.

Do you want to gamble on a crisis-free world?

If not, reconsider your strategy and your investments, downgrade them in light of the impact of a severe crisis in 2015, and reassess all of your current choices against this new vision. Revise your action plans and compress them into a smaller window of time, even if it means abandoning some. Assume that everything that you have not done by 2012-2013 can only be done in a sub-optimal fashion or not at all in the subsequent three to four years. Significantly expedite some programmes and explicitly defer others. Make clearer cut choices.

Whatever happens, this perspective will give you a better strategy and better results.

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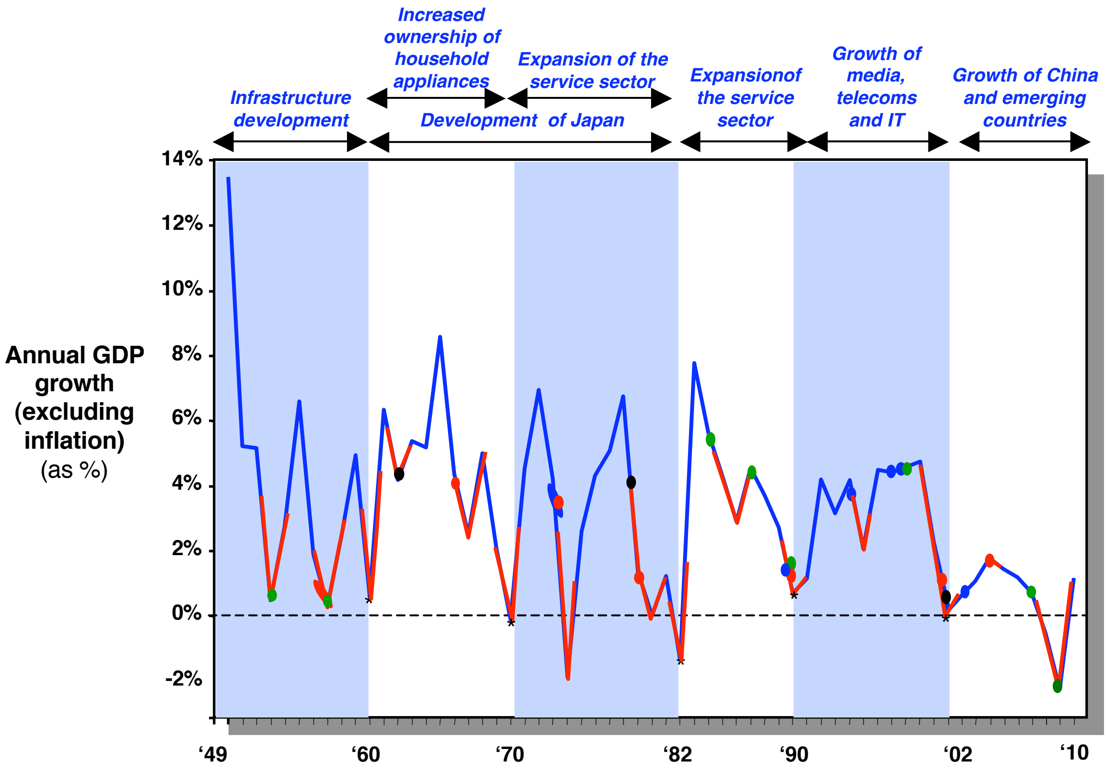
Estin & Co is an international strategy consultancy based in Paris, London, Geneva and Shanghai. The firm assists the boards of major European, North American and Asian groups in their growth strategies, and private equity funds in analysing and improving the value of their investments.

- Table 1 -

Crises are an integral part of economic growth

US GDP (excluding inflation) - 1949-2010



Sources: BEA, Bloomberg, Shiller, Estin & Co analysis, research and calculations

- Table 2 -

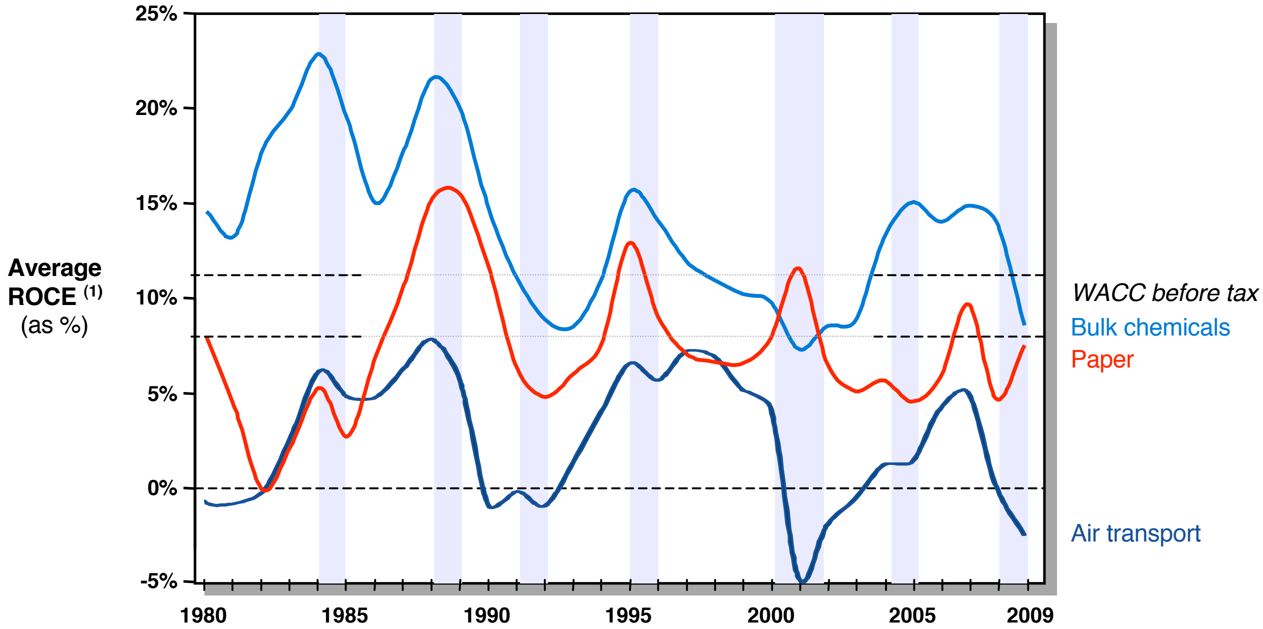
Factoring in a crisis in 2016 reduces global growth in volume terms by 0.5 to 1 percentage point depending on geographic region

	Average annual growth (in volume terms) 2010-2016		
	Using IMF forecasts: no crisis	Factoring in a significant crisis in 2016	Delta
North America	2.7%	1.8%	**-0.9%**
Europe (1)	2.0%	1.0%	**-1.0%**
Emerging Asia(2)	7.5%	6.9%	**-0.7%**
Japan/Oceania	2.1%	1.0%	**-1.0%**
Latin America	4.0%	3.1%	**-1.0%**
Other (3)	5.0%	4.1%	**-0.9%**
Middle East	4.7%	4.1%	**-0.6%**
Worldwide	**3.8%**	**2.8%**	**-1.0%**

Note: figures are weighted by the distribution of growth (in value terms) at the start of 2010
(1) Including Eastern Europe; (2) Including Russia, India and China; (3) Mainly Africa and Central Asia
Source: IMF World Economic Outlook Databases, Estin & Co analysis and calculations

- Table 3 -

Sharp variations in the profitability of cyclical industries
ROCE - 1980-2009



Note: Based on a sample of the main players among the sectors' top 100 groups worldwide by market capitalisation
(1) Weighted average ROCE of the players in question - ROCE=EBIT/CE
Sources: Bloomberg, Estin & Co analysis and calculations

- Table 4 -

Factoring in a crisis in 2016 reduces the growth of cyclical industries by 1 to 7 points and their average profitability by 1 to 5 points

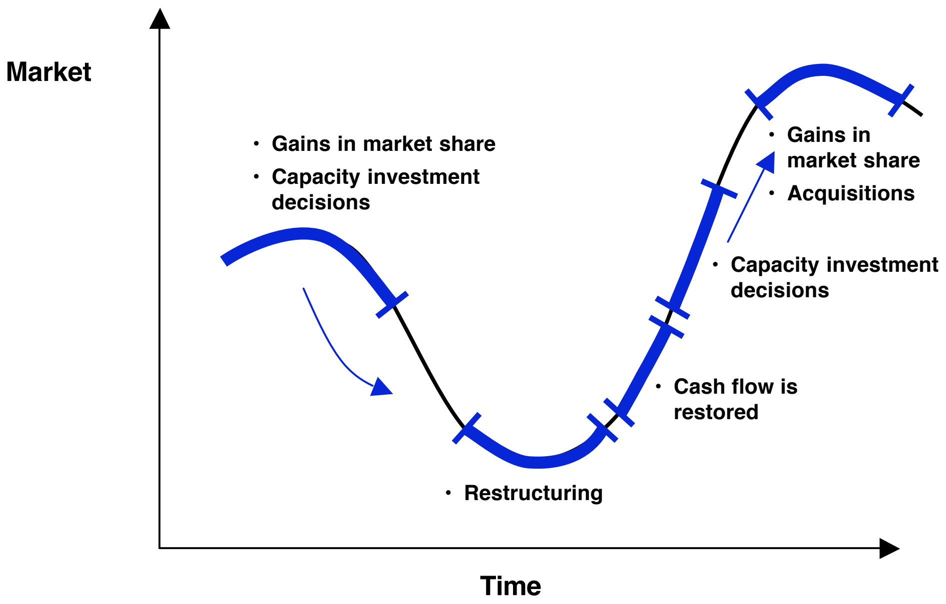
	Average annual revenue growth 2010-2016			Average ROCE 2010-2016		
	Growth without crisis	**Factoring in a crisis in 2016**	**Delta**	**ROCE without crisis [1]**	**Structural profitability with crisis**	**Delta**
Chemicals	11.5%	6.1%	**-5.4%**	14.1%	11.2%	**-2.9%**
Paper	0.7%	-0.6%	**-1.3%**	7.7%	6.8%	**-0.9%**
Building materials	12.8%	8.8%	**-4.0%**	12.0%	10.7%	**-1.3%**
Sea transport	16.2%	9.4%	**-6.8%**	18.0%	13.3%	**-4.7%**
Air transport	10.7%	5.5%	**-5.2%**	2.3%	0.6%	**-1.6%**

(1) Chemicals: 2004-2008; Paper: 2006-2007; Building materials: 2004-2008; Sea transport: 2004-2008; Air transport: 2004-2007
Source: IMF World Economic Outlook Databases, Estin & Co analysis and calculations

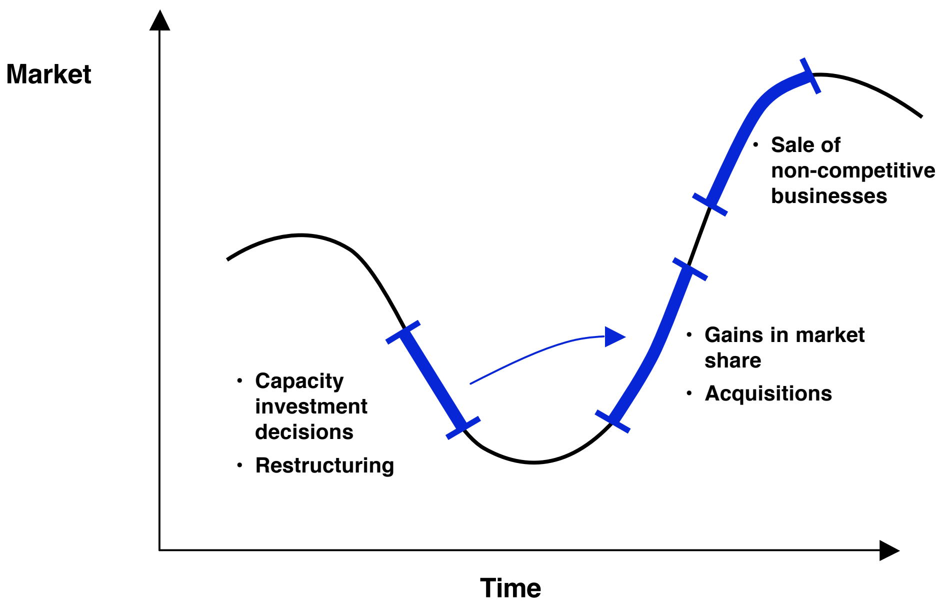
- Table 5 -

With strategy unchanged, but using a standard "reactive" sequence, value is destroyed

The standard "reactive" sequence



The "right" sequence



Note: the arrow shows the time when capacity investments appear on the market