

The Perfect Storm

Firm Vulnerability During Recessions

Professor Chris Higson

Themes

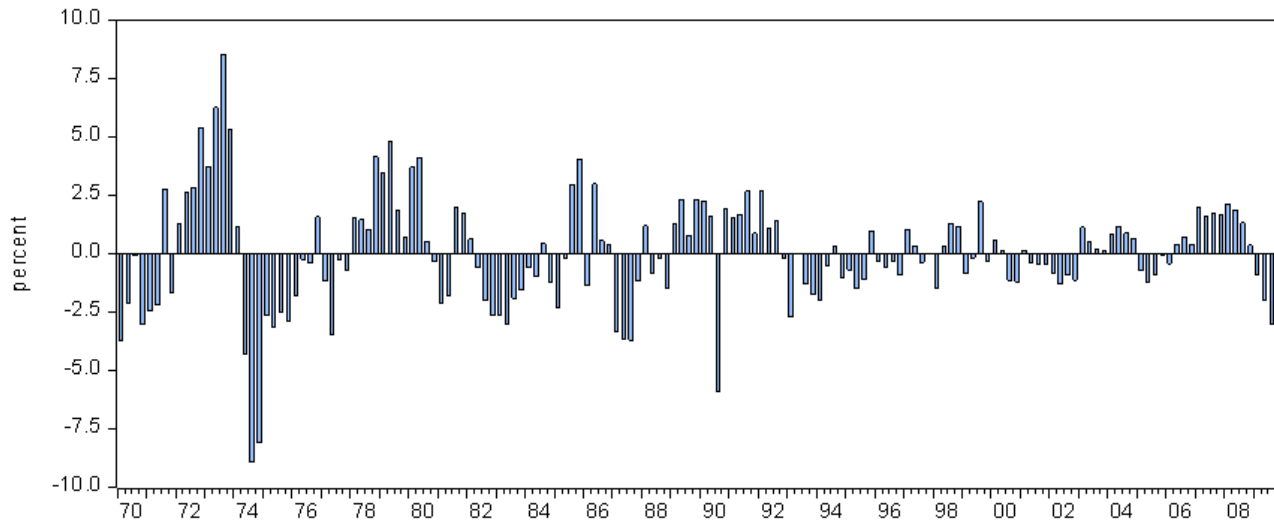
- ▶ Greece is expecting a deep recession (4% in 2010 and 2.6% in 2011?)
- ▶ What does recession mean for business?
- ▶ How should companies respond, to survive, and even thrive? What are the mistakes to avoid?
- ▶ What should government do? Tax policy? Reindustrialization?
- ▶ Economic stability, the EU and the euro.

Recession

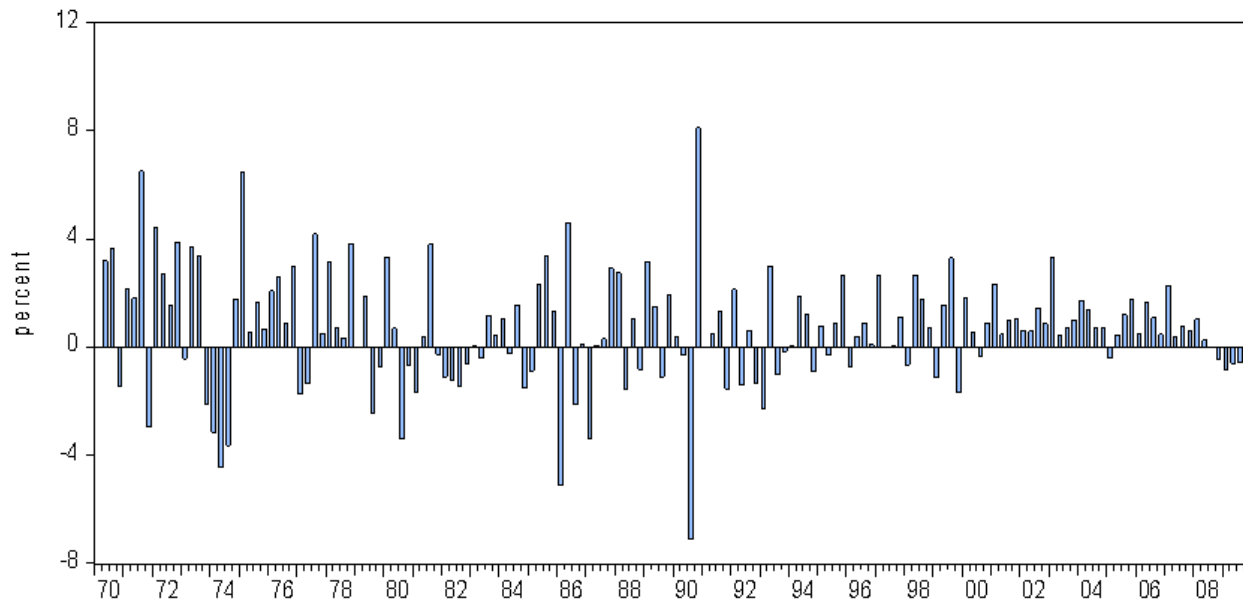
- ▶ Various ways of describing recession
 - ▶ Two quarters of negative GDP growth
 - ▶ The 'output gap', difference between actual GDP, quarter-by-quarter, and its trend.
- ▶ Recessions are often self-inflicted wounds. Economy allowed to overheat, has to be sharply corrected.
- ▶ Or caused by external shocks. So we can never believe we have conquered recession.
- ▶ Compounded by fear and self-interest
 - ▶ Individuals abruptly suspend consumption, asset purchases.
 - ▶ Firms respond by hoarding cash, sacking employees, cutting discretionary expenditure and capital programmes
- ▶ Individually rational responses are mutually destructive in aggregate, and deepen recession.

The Greek Business Cycle

The output gap

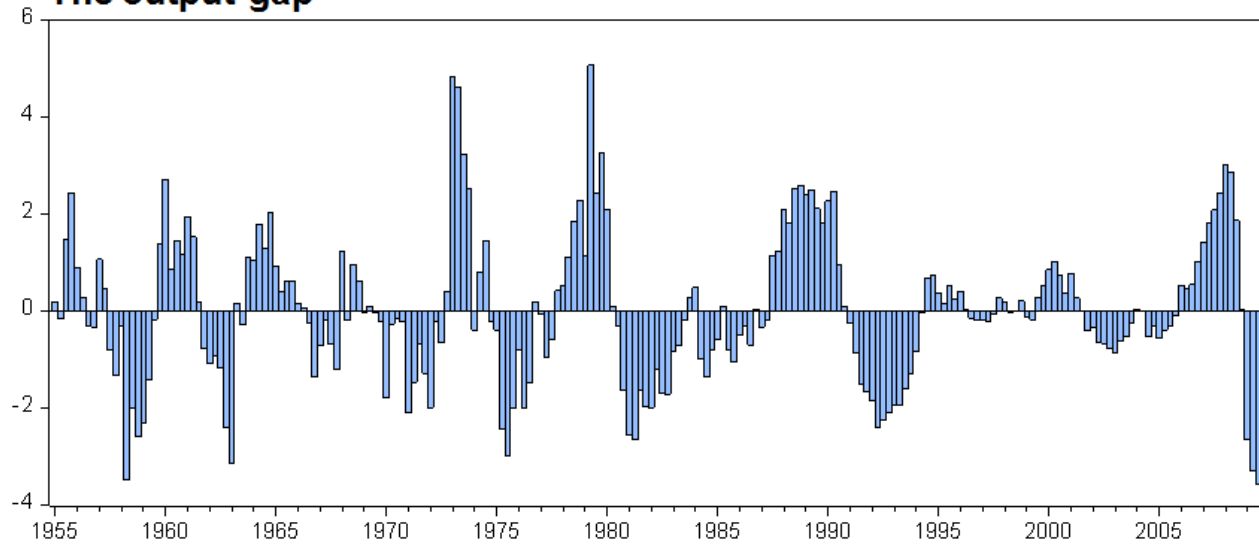


Quarter change in GDP

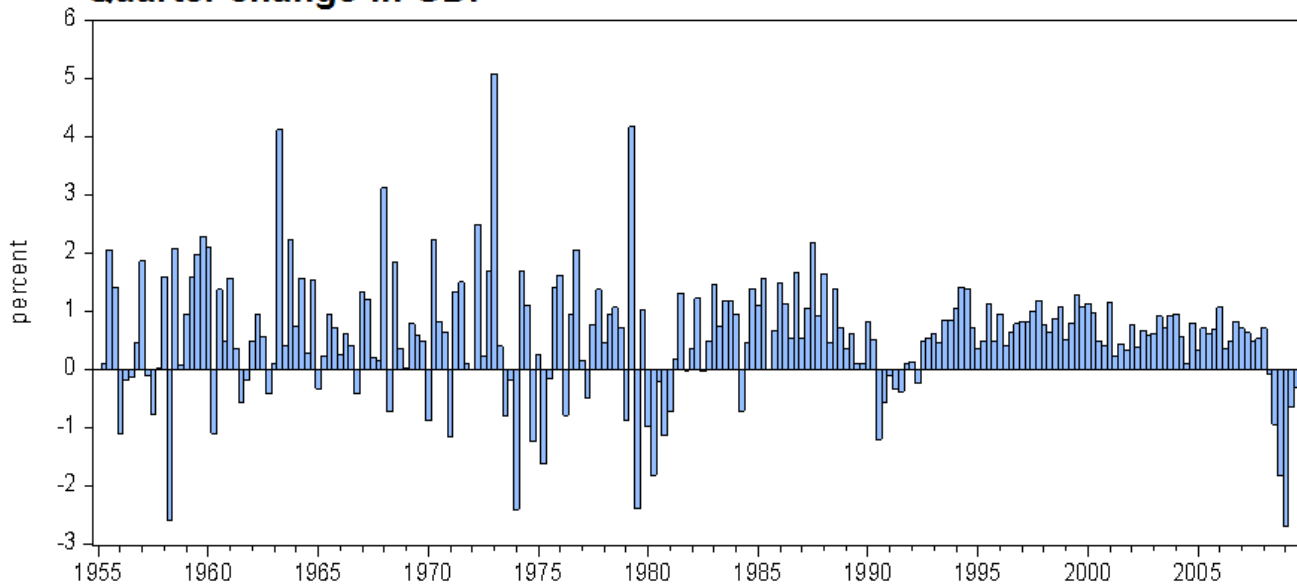


The UK Business Cycle

The output gap



Quarter change in GDP



Vulnerability depends on cash flow

Sales

Cash costs

Profit, EBITDA

Debt service

Tax

Net credit given

Inventory

Fixed assets

Other

Investment in net assets

Free Cash Flow

Net borrowing

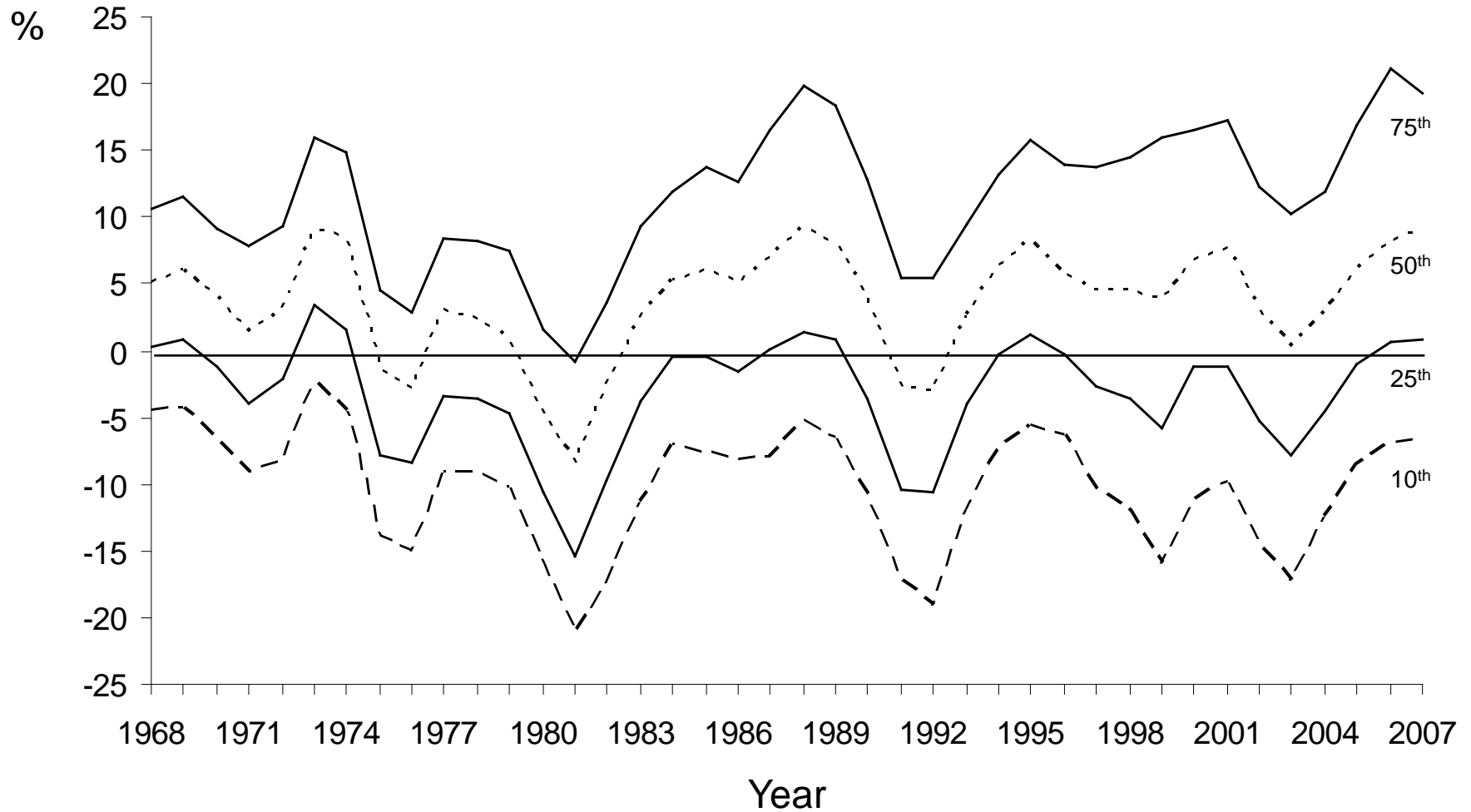
Equity

Financing

Normal times and times of disorder

- In a world of *orderly* or *planned* growth or contraction the elements of cash flow scale up or down together nicely.
 - You reduce inputs and shed staff to plan, so costs scale
 - Tax is proportionate to profit
 - Inventory and net credit adjust with sales
 - Sell fixed assets in active secondary markets
 - ... if need be, sell the whole firm in the takeover market
- Firms in managed decline often have positive cash flow - cash from offloading unneeded assets more than offsets reduced or negative profits.
- It is the *disorder* of a recessionary economy that is the problem.

Two-year real sales growth, percentiles



A Case Study – Woolworth

		cash flow		
2008 actuals		sales	-10%	-20%
Income	Sales	2969	2672	2375
	Cash costs - direct	-2246	-2021	-1796
	Cash costs - SG&A	-644	-644	-644
	PROFIT (EBITDA)	80	7	-65
	Tax	-11	-1	9
	Interest, after tax	-15	-15	-15
Net Assets	<i>Debtors</i>	347	35	69
	<i>Creditors</i>	-400	-400	-400
	<i>Inventory</i>	391	39	78
	<i>Fixed assets</i>	299	0	0
	<i>Other</i>	-184	-18	-37
Capital	<i>Net borrowing</i>	137	-125	-125
	<i>Equity</i>	316		
			-478	-485

Hit to sales

- ▶ In the deep recession of the early 1980s, 90% of quoted firms had a fall in sales, a quarter had falls of 20% or more. Firms' revenues are anyhow getting more volatile.
- ▶ Your 'recession elasticity of demand' is largely destiny; it depends on what you sell.
 - ▶ Building, Autos, Restaurants...*high elasticity*
 - ▶ Food, Discount retail, Telecoms...*low elasticity*
- ▶ Do competitive advantages help resilience?
 - ▶ Ownership of strategic tangible and intangible assets that competitors cannot copy
 - ▶ Market with high barriers to entry
 - ▶ Customers face high switching costs

Maybe the opposite!

Cost flexibility

- ▶ High *operating leverage* - % of costs fixed in short-term - amplifies the impact of a shock to sales on profit.
- ▶ Firms have reduced operating leverage by:
 - ▶ shifting risk to employees by increasing variable pay and using temporary and part-time labour
 - ▶ writing more flexible supply contracts with suppliers
 - ▶ use of operating leases has had the opposite effect.
- ▶ Ultimately, your operating leverage is destiny too; it depends on the technology & the industry. Do you have lower fixed costs than competitors? Some industries are inherently cyclical.

Financial markets close in recessions

- ▶ Asset markets shut down in recession
 - ▶ You need to sell your assets, but no-one is buying
 - ▶ Though there are plenty of failing firms to acquire, there are few acquirers.
 - ▶ A US-style Chapter 11 system comes into its own, providing some shelter until the next acquirer comes along.
- ▶ Credit markets behave perversely in recessions
 - ▶ Larger firms use their market power to the detriment of smaller firms
 - ▶ Some supplier firms simply withdraw credit altogether and require cash on delivery
 - ▶ In a recession banks are reluctant to lend; may withdraw factoring facilities.

Survival of the fattest

- ▶ Dominant financial culture in recent years has been to strip the equity out of firms' balance sheets.
 - ▶ dispose of fixed assets; lease back the ones you need,
 - ▶ reducing working capital to the minimum,
 - ▶ pushing debt levels up to maximum,
 - ▶ distribute all this cash to the owners.
- ▶ In a recession you want the opposite; you want slack
 - ▶ strong balance sheet, plenty of cash, unused borrowing capacity
 - ▶ organisational slack, people who are not creating value in the organization, wastefulness
- ▶ After the Titanic, who is going to survive in the lifeboat?

‘Creative destruction’

- ▶ Joseph Schumpeter, early-20th century economist, talked about *creative destruction*. For him, recession unleashed innovation.
- ▶ Economic fundamentalists are relaxed
 - ▶ A firm may run out of cash but, if it has a positive net present value, investors will fund it through the downturn.
 - ▶ Government should not intervene. This just creates moral hazard and entrenches inefficiency.
 - ▶ In due course, the economy will emerge stronger as resources are transferred from inefficient firms to better uses
- ▶ It's not obvious the right firms will fail,
- ▶ But it's true that deep recession may bring long-needed structural change.

Vulnerability – do the ‘right’ firms fail?

Sales

Recession elasticity of demand

Cash costs

Operating leverage

Profit, EBITDA

Operating margin

Debt service

Financial leverage

Tax

Net credit given

Suppliers withdraw credit

Inventory

Fixed assets

Asset markets are closed

Other

Investment in net assets

Free Cash Flow

Net borrowing

Credit markets are closed

Equity

Equity has been stripped out

Financing

What can management do?

Financially

- ▶ Balance sheet strength matters. Maintain this in all ways.
- ▶ Diversify by business line and/or geography helps
- ▶ Support of government, investors
- ▶ The main problem with recession is surprise. With warning, you can manage an orderly contraction.
- ▶ Ultimately, as in a hurricane, your destiny depends on the architecture of your house and where it is.

Strategically

- ▶ The strong firm will take advantage of the errors of others
- ▶ The agile and innovative will come out ahead.
- ▶ Evidence that strategic reordering often follows economic trauma

What should government do?

- ▶ Tax policy
 - ▶ High corporate tax rates are counterproductive?
 - ▶ Companies aren't paying tax in recessions
 - ▶ There's a danger of emigration and relocation
 - ▶ Consumption taxes are better?
- ▶ Bank regulation
 - ▶ Need to ensure banks continue to supply credit.
- ▶ Cultural and structural change
 - ▶ Once in a lifetime opportunity
- ▶ Support entrepreneurship and industrialisation.

Has the Euro helped convergence?

- ▶ Classic argued benefits of a single currency:
 - ▶ Reduction of transaction costs, elimination of exchange rate risk and volatility
 - ▶ Gains from trade
 - ▶ Gains from international capital flow, reduced cost of capital,
 - ▶ Increased price transparency and competition, allocative efficiency
- ▶ EU sponsored research by Higson, Holly, Petrella (2010)
 - ▶ Evidence that a slow process of integration is under way in Europe
 - ▶ But its EU wide; not much evidence it's to do with the single currency.

Appendices

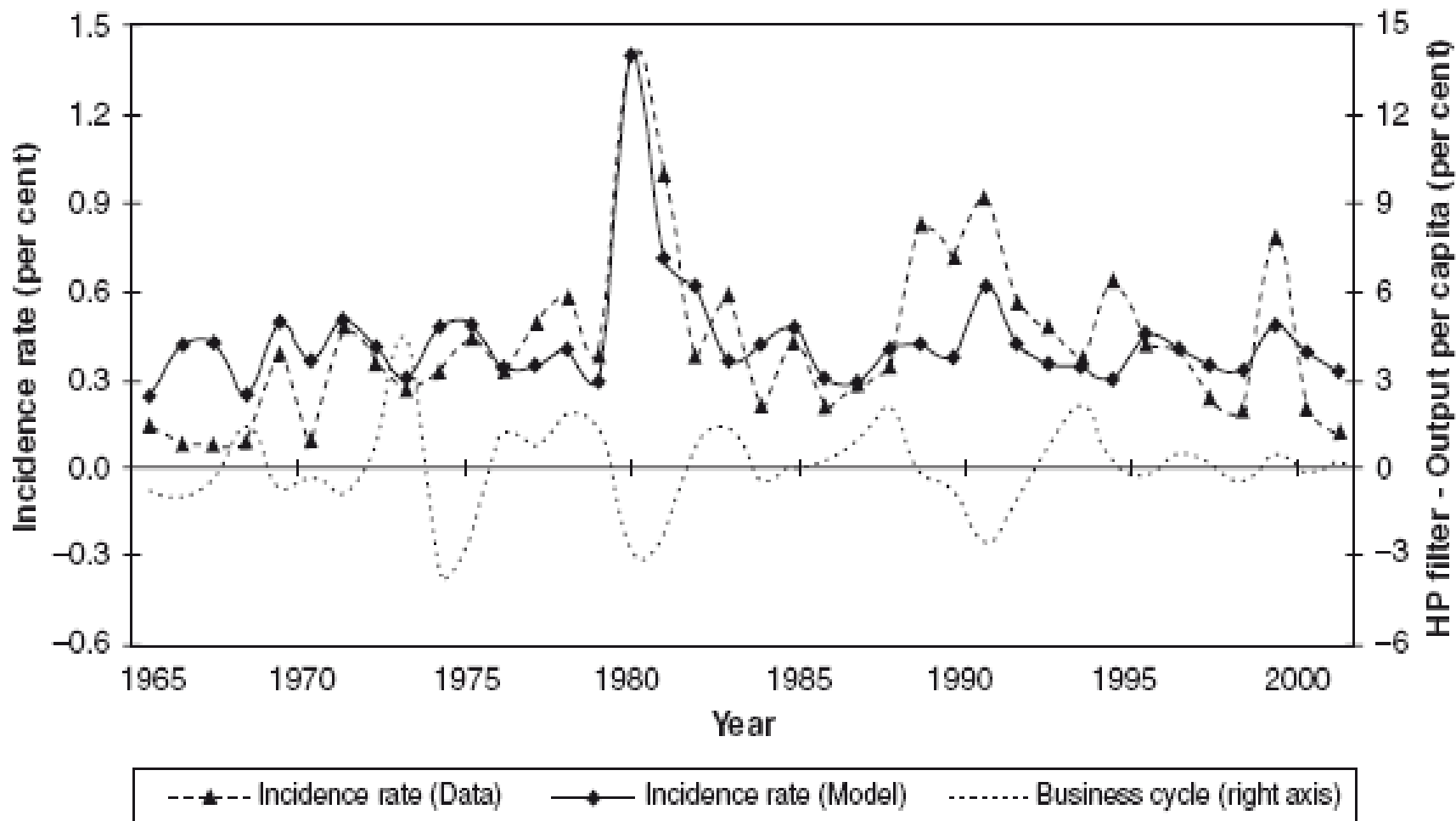


FIGURE 3. Business cycle and bankruptcy incidence (actual data and predictions).

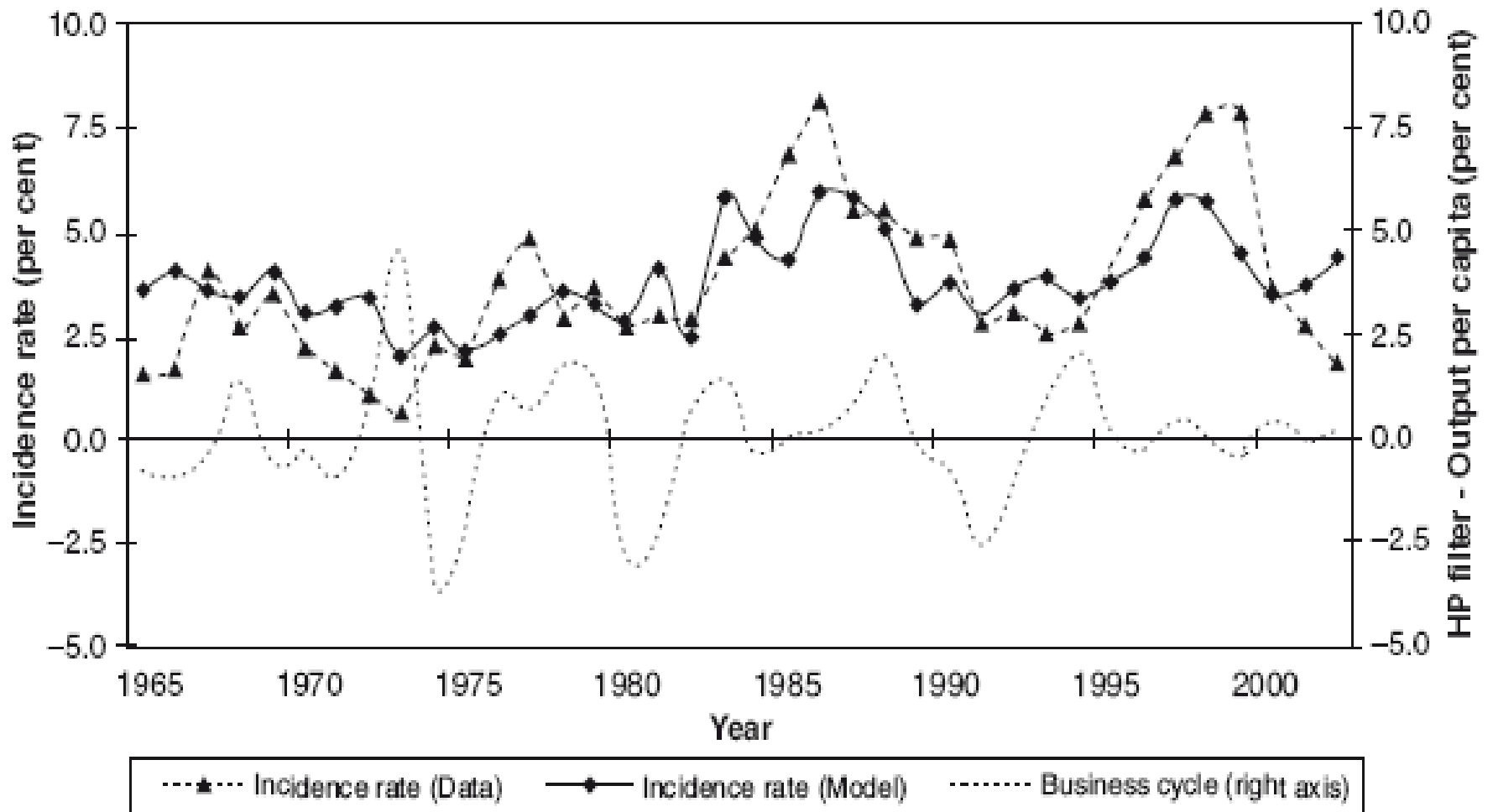


FIGURE 4. Business cycle and acquisition incidence (actual data and predictions).