THE NETWORK OF LEADERS CRITICALEYE

2009 and the Decisions You Should Take

Discussion Group

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Chair

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*This article is based on the proceedings of a recent meeting of members of the Criticaleye community. They gathered to discuss **2009 and the decisions leaders should take** – a subject proposed by one member of the group. To encourage open debate, the meeting was held under the Chatham House Rule. To instigate or to be part of future discussions in this area, to initiate a connection with other interested members or to request research from our affiliate and academic partners, please contact your Relationship Manager.*

This Discussion Group occurred on 13 January, 2009. Please note, some of the outtakes will have evolved since the event.

Key take-aways

- Q1 will determine many of the decisions that will be made in the next year
- Remove costs wherever possible and look to where further cutbacks may be made if the economic climate demands it
- Globalism provides an interesting perspective, particularly when it comes to the scaling of growth
- To assess value ask, 'What are we?' and 'What does the customer want?'
- There is much cautious investigation being undertaken when it comes to potential opportunities for investment and M&A
- Consumer perceptions of saving/debt are changing – there is an interest in spending less and investing
- Structural changes for the future – is there real evidence of change and innovation? Are people walking the talk?
- Leadership – getting employees focused and aligned with the strategy, constant and honest communications and transparency
- Current economic climate is a rich environment to learn from
- There is concern for coming up with similar reactions – we should be innovative in a time like this.

Introduction

This Discussion Group was designed to tap into people's thinking on the direction of the economy by industry, function and region for the next six to 12 months and hoped to answer not only what decisions business leaders *should* take, but what they *must* take today.

The discussion launched with a special dialogue from Trevor Williams, Chief Economist, Lloyds TSB Corporate Markets, who offered his thoughts on the downturn and predictions for the year to come:

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The downturn

The beginning of 2009 is very inauspicious – recent figures from the British Retail Consortium paint a bleak picture for the prospects of manufacturing. In general, there are two things occurring:

1. Very short-term sharp slowdown
2. Long-term structural change

The consumer spending-driven, decade-long growth undertaken by the UK is now at an end. This was driven by extremely low interest rates, openness in international markets and an increase in the flow of goods from emerging markets, which drove down inflation. That period is at an end in the sense that the deflationary effects of the inclusion of these large markets in the world economy has now turned from being as deflationary as it was, to being less deflationary and that has translated into higher inflation.

The deceleration is not only linked to the bursting of the credit market bubble, but to the strong growth in the global economy, which had used up enough spare resources to begin leading somewhat higher inflation. This raised interest rates and exposed the fact that there had been a lot of leverage based on a supposition of continued low volatility and low interest rates which was never sustainable, creating the crisis in the credit markets.

The interplay of those two things will create a severe contraction this year. There will likely be a drop of UK GDP between two and three per cent unfortunately. That is likely to be closer to 2 ½ - 3 per cent than 2-2 ½ per cent going by current trends.

It is somewhat surprising that the adjustment in the initial phase is taking place from the corporate sector rather than in the household sector. Although consumer spending growth was slow, it hasn't slowed at the same rate that investing spending growth has slowed. Why? It comes back to the fact that there was a dramatic rise in commodity prices in the middle of last year, which squeezed household incomes leading to lower spending. But it has also squeezed corporate profitability. In other words, companies saw massive increases in costs, but couldn't pass them on because demand was soft so profits began to be severely hit, which meant a big cutback on investment. There is also the overlay of the credit crisis, meaning it's harder to get credit, alongside the rise in cost of credit relative to base rates – so corporations have been hit with a 'double whammy'. These large organisations are even more cautious now and cutting back even more sharply, despite the fact that historically, corporate profit share of GDP is high.

Corporate profitability

Corporate profitability has been struggling over the last few years and the cash position of UK companies as a whole, as a share of GDP, is actually one of the highest of all time. The stock ratio in the run-up to this recession was quite lean, so we're seeing a very severe reaction in output to lack of credit, weakening demand, inability to raise prices to protect margins, and a great desire to hold on to cash given that it's harder to get it from banks.

We are looking at a sharp slowdown and redundancies are beginning to rise. The second leg will come when the redundancies begin to hit consumer spending more severely. Q4 will see a drop in GDP of around 1.5 per cent and Q1 we're looking at closer to one, maybe a bit lower, but we're going to start the year with the sharpest contraction in output since 1980. Unfortunately, it is no longer the case that the contraction will be on the scale of 1990.

There are however, big differences between the current crisis and that of 1980. We are starting with much higher levels of employment and lower levels of unemployment – although unemployment will rise by about a million – this will go from the Q3 figure of last year of 963, 000 to close to two million.

Experience of different sectors

The sectors that will be worst hit are those which have traditionally been exposed in the UK because of its very open, international nature, and those that have strong competition in global markets as well. These are sectors that have been able to produce in low-cost regions that impact greatly on the cost of expenditure. These sectors will include motor manufacturing, textiles, clothing, and other mass-produced commoditised goods such as TVs and other media equipment. Those to be less badly hit are engineering and alloyed industries – because the UK has moved away from mass-commoditised markets and into higher valued markets like chemicals.

Those that will hold up well will include infrastructure, transport services and to some extent transport manufacturing. The increased growth in the last decade has meant that the transport system is under strain – in order for the economy to grow in the future, there must be investment in infrastructure. Oil imports are rising, and nuclear energy needs to be renewed. Planning of energy capacity is needed in the next seven years with the decommissioning of the oil plants not far off.

Consumer sectors, such as retailing and distribution will be worst hit. Growth has been led by consumer spending for the last decade and government spending. Government spending is going to tail off once this period of the slowdown is over, because it will have to put the public finances in sounder footing in the medium term. Goverement spending must be kept below the rate of spending in the rest of the economy. There is going to be a big squeeze in public spending once this period of slowdown and contraction is over.

Weak exchange rate is here to stay

The UK economy therefore, has to shift away from government-led growth and towards capital investment and corporate-led growth. This implies that the current account deficit will shrink through slow growth in competitor countries and a weaker exchange rate. The weaker exchange rate is here to stay. It's part of the adjustment process. In the period of strong growth, the UK became overly indebted. The consumer section is hugely indebted – they will not increase indebtedness as a share of their income any more, and that implies that spending will slow down in line with income as people try to reduce their overall debt.

The increasing indebtedness has been through mortgage debt – which is around £1.2 trillion, the overall indebtedness of the UK is about 150 per cent of consumer income, and this is the highest it has ever been. This will stay unchanged over the next few years; the structural shift must be there for that – so that the corporate sector can take up the slack. We're going to have a combination of a weaker annual average GDP growth – because we simply can't sustain the 2.6 per cent annual average growth.

Question and answer session

To what extent do you anticipate these predictions changing based on the corporate reporting season?

Trevor: The reporting season is absolutely crucial and Q1 will indicate the direction we're headed. My predictions are based on the case that the policy prescriptions can't do anything about Q4 or Q1 – we're going to have a sharp contraction in the last and current quarter. The future will depend on the reaction of the banks and the companies facing them. The indications are, if you look at the stock market and at the earnings expectations that are implied, [analysts do seem to think] that profitability is going to hold up. This is partly down to a reaction to cut-backs in anticipation of a slowdown. Is this good or bad news? It's good in that companies are making sure they survive the downturn and that expectations have already been reduced for the year ahead, but we don't know what the real balance sheet position is and we won't know until these figures are released towards the end of Q1. March-April is a critical period where I would be thinking about whether or not one needs to be changing projections for the year.

We're looking at a sharp contraction in growth, but a sharp recovery as well. We're having a synchronised downturn in the global economy and this implies a synchronised pick-up. So, when it does come, it will be powerful. The policy levers that are being pulled are also extremely powerful: the lowest interest rates in the UK, historically low interest rates in the US, severely low interest rates everywhere else, increased fiscal spending, and guarantees for bank lending – these levers will have an effect but they're going to take time.

What is your view of the health of the middle England businesses, the SMEs?

Those SMEs that face consumer demand will undoubtedly encounter difficulties, such as those in retail and distribution. Those in the middle market and at the cheaper end of the market, ie, facing consumer demand – but whose goods are at the low-value end, are more likely to survive because people will be moving towards low value as they look to save money. Therefore, the middle and upper ends are likely to be more impacted, the middle taking the worst. The industries in the SME sector facing corporate demands will also be severely hit. Those in transport and transport services will be less badly hit; those in agriculture actually face quite a good backdrop, insofar as food demand doesn't contract as much in a downturn as other sectors.

SMEs that face external demand and competition will also find it somewhat easier as the weaker currency will give them something of a competitive edge in terms of the domestic market (and export markets if they're exporters). Pharmaceuticals and companies that produce parts that go into other machines will have to react to lower demand. But, if they can cut costs, they have a better chance of survival because they'll immediately take an advantage if they take the falling exchange rate into their profit margins.

There are different aspects to consider when comparing this recession to those of the 1990s and 1970s, such as the lower rates of inflation and reduced oil pricing. What opportunities do you see there?

There are more people demanding goods in the world than there has ever been. The sharp fall in exchange rate is another key difference – it's the sharpest it has ever fallen – even in comparison to September 1992. Two years afterwards the UK experienced an export boom so we are on the verge of what could be a sharp surge in export if the world economies pick up in a couple of years and we still have a low exchange rate. Commodity prices *are* quite a bit lower now. So there are ingredients in place for a recovery. Sectors primed for a pick-up, that survive this downturn, are going to be in a good position in 2010-11 just ahead of the Olympics.

Can you explain why you think currency won't recover?

It won't recover because we are replacing a big external deficit, with a big internal deficit. It's going to be ten per cent of GDP in the next couple of years and very difficult to bring down. The increase in lending which has gone on internally in the UK, and helped to raise the household debt burden to the level that we're currently seeing has been partly caused by an inflow of funds from overseas. That funding gap in other words, the lending that has occurred in the UK - £300 - £400 billion has been from overseas rather than domestic deposits. The funding gap in the UK is about £700 billion and that is going to be difficult to maintain unless the exchange rate is lower. So we're going to see two things:

1. The financing of our deficit will become more difficult meaning a cheaper currency

2. It will be more difficult to sell gilts – which means higher interest rates to attract those flows. However, slower growth is inevitable and with that will come a more competitive economy.

It's very difficult to see how the pound, which has been very strong in the last eight years, can remain strong. All of the factors suggest that we're in for a period of sustained currency weakness against all currencies – but particularly against the US dollar and Euro.

You talked about this being a synchronised downturn, which implies a synchronised recovery – and clearly the US economy plays a critical role – can you provide an overview of your perspectives on the American economy – specifically in light of Obama's proposed $800 trillion package and your thoughts on a timeline for the recovery of the US?

The overall view of the US is somewhat similar to the UK – as it is also a highly indebted economy (though not as much as the UK). Its advantages are that it's much more diverse; the dollar is the international reserve currency still and they have a better ability to bounce back from a weaker period than any other major industrialised economy. This will be exhibited by a quicker recovery – they went into recession first and will come out first.

The fiscal package is necessary to kick-start the domestic economy but also because the resolution of the credit crisis depends on the US spending money to buy up the securitised mortgages which have turned bad and caused the lack of confidence in credit markets worldwide and have drummed up the works of the financial market sector generally. Recovery in the credit markets and world economy will depend on the US generally. The spending they're doing will lead to that occurring. The dollar has become more competitive and actually, that's already beginning to combine with weaker growth to lead to a substantial reduction in their trade deficit which means they're more likely to recover more quickly.

As an overview, I think the US will contract by one to two per cent this year but grow between two and three next year. The stimulus package will be enough, I think, to kick-start their economy – there are already signs that the housing market is beginning to fall sharply. What's awaited now is the overhang in unsold properties to fall to sufficient levels to begin to pick up in new housing stock. This won't be until the end of this year to 2010 – but when it happens, there will be a fast pick-up high level of policy response, the low interest rates, and the lower cost of service in debt will begin to restore real incomes in the US. Those factors will lead to a recovery.

Global imbalances will be much reduced in the medium-term as a result of what we're seeing now. And although it's very unpleasant medicine, it's actually medicine which is necessary in order for the world economy to continue to grow in a sustained way in the medium-term. We simply had too many imbalances with the UK and US running too large account deficits. It needed a fall in the exchange rates and slower growth and that's what we're experiencing.

Is it true that a change in copper price is indicative of a forthcoming upturn?

Metals prices do start to rise first because they are required in the construction of basic goods. I do think yes, base metals necessary for the construction of capital goods – the goods that make goods – do indicate turning points in the economic cycle. But it's probably too soon to say that changing copper prices is sustained for long enough to indicate we are close to a turning point. But it is certainly something to watch very closely indeed.

Following Trevor's insightful commentary, the Criticaleye Members embarked on their own discussion considering his predictions and their own concerns.

Redundancies and cost cutting

The majority of companies represented in the group had made redundancies in the region of five to ten per cent. The automotive industry had cut hours and there was discussion of wage decreases. One FMCG company had announced the previous day that it wouldn't be raising salaries for the next six months. Another company had increased off-shoring, cutting UK work and increasing work in India. The downturn does, however, present an opportunity to nurture talent, and shed people who needed to be let go.

There is, as well, an opportunity to get 'more' out of people in this climate; the downturn can help to create a rallying cry. In one company, productivity was up by 40 per cent.

Most of those around the table reported cuts to marketing budgets, which can be dangerous as there is a threat in losing momentum. A balance must be found in proportion to the competition. Branding is important, but consistent, strong support and feedback from customers is as well.

Changing demands, changing models

Business models need to change to deal with reduced consumer demands. This is why Woolworth's failed, thought a Member, who added: "No matter how big a restaurant's overdraft is, it won't put people in it seats". For large corporations there is an issue around funding, but if a customer sees good value for money, they will buy.

One financial services company had taken a strategy of building confidence with partners in order to secure longer-term contracts. A Member from an international B2B IT services company said his firm was keeping a close eye on any changes in customer business models and then focusing sales resources on aggressively chasing new clients. Growth over the past five years was based on customer centricity. Now the focus should be on customers' strategies and executing to perfection.

Demands are different, particularly with IT, which has gone from offering 'sexy' product lines to a more back-to-basics approach.

Emerging markets

It's difficult to tell how the emerging markets will fare – the biggest slowdown has been in Central and Eastern Europe. From a consumer perspective, it appears they haven't been affected by the downturn as much as those in the UK, aside from the oil price increase, which has meant people struggle to get to work. A lot of the countries, such as Slovakia, have to decrease their gas consumption by 60 per cent this year because of the 'gas problem' which is creating much uncertainty. But Romania and others have strong (up to eight per cent) growth in GDP – so the effects vary from country to country.

Prior to the downturn, the costs of labour and raw materials were going up – is it now going down? Could this create an opportunity for more outsourcing?

The economies in Brazil, India, Russia and China (BRIC countries) are very different and depend very much on industry and location. The earthquake in China, for example, had a large impact on sales for one company before the credit crunch. Both India and China are part of the global economy and while labour and raw material prices are likely to go down during the recession, there are companies in these countries that will struggle in the near future as UK/US firms re-evaluate strategies, take up incentives from their governments and bring work 'back home'.

Media, communication and motivation

The UK media is sending out dire messages to the public – how are leaders responding to this from a corporate level? One Member thought that the marketing function work to influence the media, adding, "It's an ugly time but bringing the fundamentals of value propositions to the press is crucial".

Leaders must make deliberate attempts to live the company's values, 'show face' and generally work to improve communication. If not, staff members will read the papers and come to their own conclusions. It was also recommended that leaders be very honest, keep the vision for 2010 in close sight and hold more town hall-style meetings where the company's successes should be demonstrated to create hope.

Leadership

The downturn presents the opportunity for great and future leaders to make their mark. Unfortunately, there seems to be a critical shortage of leadership, particularly in financial services and the political arenas which is exacerbated by the constant stream of bad news. “It’s not that there aren’t good leaders out there,” said a Member, “it’s just that they’re not able to act in coordination with government”.

The only option is to focus on that which one can control – nurturing staff, engaging the customers and improving the product. Authentic leadership is more important now, than it ever was before.

Risk and sustainability

Most companies are curbing their appetite for risk. One Member’s organisation now has a risk assessment where every deal across the business is examined on a weekly basis and decisions have been made to pull out of contracts where the risk was felt to be too high.

There is a much more holistic approach to risk now that includes environmental, security etc. considerations. The environment is a large part of President Obama’s stimulus package including building environmental infrastructure, which creates jobs. Tesco is using the current economic climate to push through planning for green development.

Acceleration of globalisation

Leveraging international reach and gaining control over global suppliers is crucial, but this becomes difficult when there are third parties involved. Will this lead to a renaissance in UK manufacturing? Through the right conditions of currency value and exporting, UK businesses might actually end up more localised.

Trevor’s comments on the sectors that are set to do well are very useful for targeting business development resources to possibly ‘hit some’ growth. The combination of globalisation and weaker pound provides interesting opportunities – such as British companies being bought by foreign entities. For those who import a lot, there is a horrible ‘squeeze’ where one must be very tough on suppliers of raw materials.

Suppliers

There has been a strategy in recent years to pressurise and over-rely on single suppliers but this is suddenly catching up. One Member thought this could “back organisations into corners”. He wondered, “Do we take a more cooperative and less adversarial approach to suppliers? Should we consider the Japanese model where we’re all one big happy family? The current push against suppliers isn’t sustainable; it’s like cutting off your own nose despite your face…”

On the other hand, many companies are finding it difficult not to take advantage of the current situation. People aren't willing to build long-term, collaborative chains; they're breaking it down. People seem to be much more wary of partnerships and acquisitions with potential uncertainty. There is zero appetite for investment into new frontiers.

Conclusion

The current economic climate is pushing change in business ethics and culture. It requires a change in strategy of leaders – ruthless prioritisation was mentioned, taking the tough decisions, telling the difference between setting strategy and implementing strategy – these things are much more on top of the table today.

Criticaleye (www.criticaleye.net), as a community of senior executives, provides members with an experiential platform that allows them to innovate and develop by sharing business experiences and expertise with their peers from different industries/functions. These Discussion Groups are member instigated and provide immense value in the provision of specific strategically oriented debate.

If you, as a member, have any strategic issue or subject that could be addressed in a facilitated peer Discussion Group then please contact your Relationship Manager. For more information on Executive Membership please contact Tom Beedham, Executive Liaison Manager, on +44 (0)20 7350 5104 or tb@criticaleye.net