Bursting bubble or cycle turnaround: a necessary choice

by
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The theme of growth, or rather its slowdown, is more than ever the focus of all discussions. Are we on the brink of a true recession in the United States? Will the crisis extend beyond the banking system? Can recession reach Europe? Will the essential foundations of companies prove to be as good as claimed? Will the economies of emerging countries be an anti-recession guarantee?

So what's the deal? Are we in the presence of a speculative bubble that is bursting? Or is it just a one-off economic glitch? Are we experiencing a much deeper trend reversal? The appropriate conduct is not the same for each case. It is necessary to take a closer look.

1. Bubble or cycle: a necessary choice

1.1 Getting it right

The bubble, as its name suggests, is a boom phenomenon on a specific market. On the market in question, prices rise rapidly. Assets strongly increase and exceed current levels. One fine day, a series of triggering events occurs, leading to an unexpected collapse. The thunderbolt then spreads to industries having contact points with the initial market. Investors generally overreact and sanction assets not necessarily connected with the initial bubble. These are speculative phenomena. The game consists of making the most of unduly sanctioned assets, by focusing on turnaround.

The logic of cycles, however, does not have much to do with excesses committed in specific industries. Schematically speaking, the investment cycle and the consumption cycle are out of phase. During the upward phase and in the enthusiasm of anticipated favourable economic situations, all industrial players invest in capacity. Most players, fearing that they may be outdistanced when the situation seems favourable, invest at the same time. New capacity becomes operational within the time gap needed for it to be commissioned. When all this capacity becomes functional, the cycle has started its turnaround. There is pressure on prices. The situation deteriorates.

These activities are particularly difficult to manage. Bubbles only make them more complex. But winning solutions do not depend on the current economic situation.

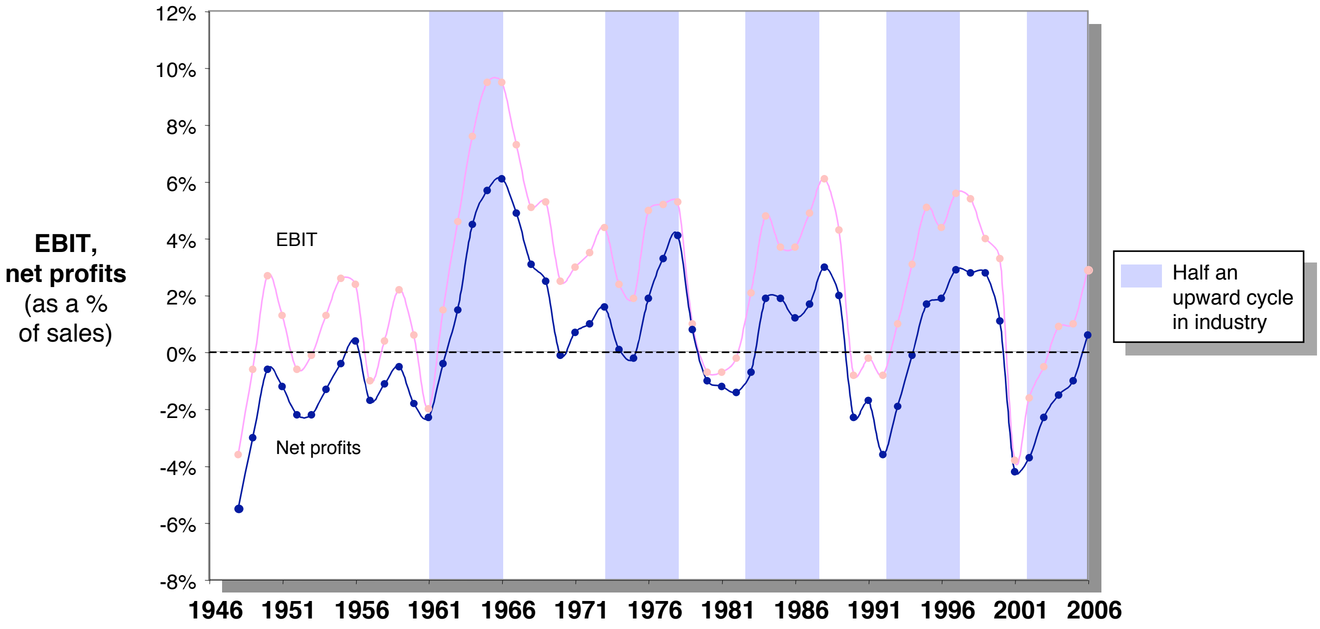
1.2 Cycles: the basic logic

In cyclical activities, the principle is simple, but fulfilment is complex as it is counter-intuitive. Managers are tempted to follow the call of the market, i.e. push volumes up during the upward phase. Yet, to the contrary, schematically, it is necessary to dedicate the upward phase to rationalization of operations to have the most solid cash flow possible at the peak of the cycle in order to acquire capacity at the lowest price during the downward phase and consolidate the market in one's favour.

Fundamentally, costs should be controlled during the growth phase. And growth controlled, in terms of market share gains or acquisitions, during the contraction of the cycle. These reflexes are not easily acquired. But the interesting thing about cycles is that history repeats itself.

1.3 The Air France-KLM example

The example of air transport is particularly clear. 10 to 12 year cycles have characterized the evolution of profits in the industry over the past 40 years.



Sources: International Civil Aviation Organization, analyses and estimatioı Estin & Co

Air France magnificently handled the last cycle by purchasing KLM, a healthy player, in the middle of the upward phase. Air France-KLM was therefore able to rationalize during the end of the upward phase thus arriving at the peak of the cycle with a rationalized position and solid cash flow.

1.4 Bubble or cycle: bubbles announce change

If bubbles theoretically have no reason to be linked to cycles of a specific industry, in practice, when they take on a certain scope, they have a psychological impact which acts as a turnaround factor. This is particularly the case of the banking markets, which have strong ties with other investment or consumption markets. In a way, we could say that the bubble is a cycle turnaround catalyst.

However, cyclical components are precisely analyzed in the long term. Levelling off periods can be early or late in a phase. But cycle phenomena are profound and need to be precisely analyzed.

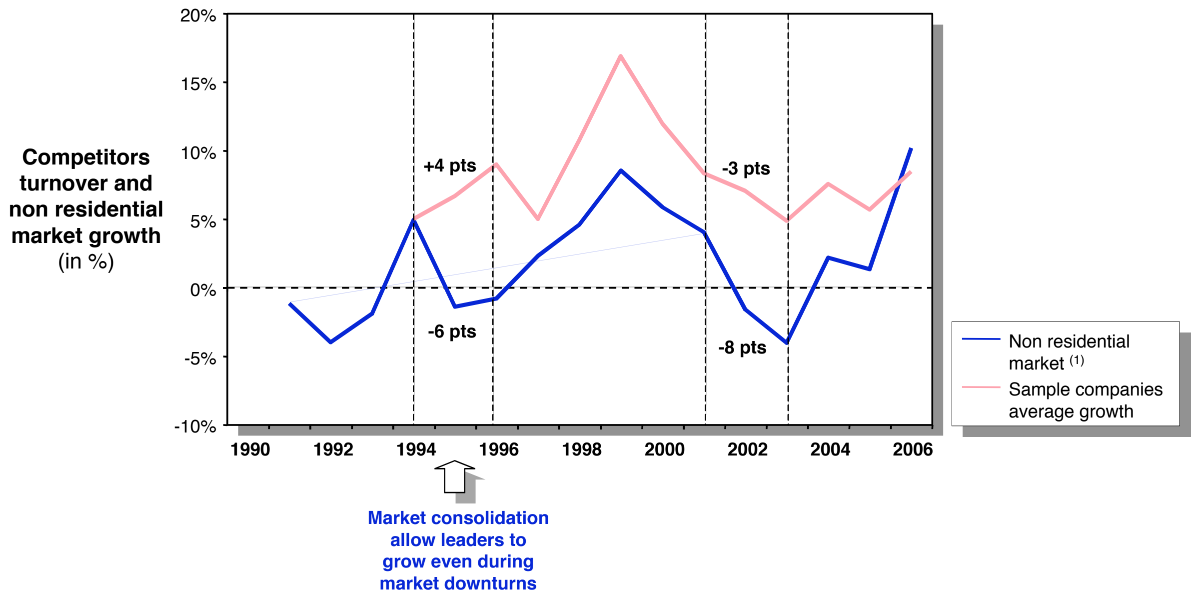
2. How to manage cycle slowdowns

2.1 All industries are cyclical

Certain industries are fundamentally cyclical. They are listed as such. This is the case of air transport. They are pure models. In contrast with these examples, there are many industries or market segments that have a cyclical component. This can be observed when these industries or segments are connected, within the supply channel, to an industrial with a strong cyclical component.

Building supplies for example are like this. The supplies in question can be aimed at various types of buildings with their own cyclical components: industrial buildings, service buildings, etc. Moreover, they have two main destinations: the construction market and the renovation market. The construction market has a clear cyclical component, linked to end markets. The renovation market, in contrast, has no specific cyclical component.

In the end, these types of market, although they do not show such striking trends as purely cyclical assets, do show a cyclical component.



(1) Construction and renovation
Sources: Euroconstruct, Amadeus, Information Memorandum, Estin & Co analysis

In fact, it is rare for a production or service activity, whatever it is, not to have a cyclical component. Whenever end demand has a notion of equipment, fleet, renewal, technological or other replacement, this demand induces a cyclical component to some degree.

In contrast, the long period cycles are not observed in industries subjected to strong technological waves or rapid economic changes, as long period movements are concealed by replacement logics. But for most industries, companies have a cyclical component that cannot be ignored. This component has a powerful strategic leverage effect. The profitability of all players is affected. The clairvoyant competitor that understands and controls this process is more likely to take advantage of the situation to increase its competitive edge.

2.2 The game is won in the downward cycle

In a cyclical sector, the upward phase provides opportunities but the downward phase of the cycle is decisive as that is where the competitive game is won. Competitors get tired. Prices fall. Profitability decreases. Customers put on growing pressure and competitors with the most strained capacity give in. This is the phase in which it is necessary to make as many moves as possible.

The most interesting options come to light in the downward phase. It is necessary to be in a position to exploit them effectively.

When the market is buoyant, there are fewer options: all competitors develop, capacity is saturated, delivery and service times are longer and competitors feel comfortable. Major movements are difficult to imagine and usually very costly.

In contrast, when the cycle turns, capacity is released, there is pressure on prices. Competition is tougher. A number of competitors consider that the best attitude is to bear it out until better days arrive.

This is the most serious mistake. Not moving is the best way not to survive. Immobile competitors are the best targets. The downward phase is difficult. However, it is when all the decisions are taken. The agenda is a busy one.

2.3 There is much to be done

The agenda is busy in tactical and strategic terms.

In tactical terms it is busy, as in the downward phase, competition is tougher, use rates decrease and irrational behaviour appears. It is essential not to be drawn into value-destroying tactics. Here tactics to target sales efforts and optimize prices take on their full value.

The agenda is also full on the strategic level as the moment when major movements become timely and financially attractive is approaching. Monitoring and anticipation are key.

Finally, even if the cycle is difficult, there are always growth opportunities in certain regions. Now is the time to study them.

3. Areas to explore

3.1 Adjust capacity as early as possible

Capacity adjustment is probably the most complex decision. Adjustments should ideally be made before the cycle turnaround to avoid overcapacity.

Capacity reduction in the downward phase is extremely difficult. The company takes half-measures hoping that that the end of the downward cycle has arrived. Weary, demand and prices continue to fall.

The logical choice is to adjust capacity available for as long as possible at the beginning of the turnaround. It is better to take the risk of resorting to subcontracting than having to have to deal with chronic over-capacity for several years in a depressed market.

3.2 Price strategy: selective follow-up

Optimizing price strategies is fundamental during downward phases of the cycle. In the first place, the price momentum should be integrated into the sales policy. Pressure on prices is not the same in all market segments. The breakdown of available capacity and the competitive positions of players should be carefully monitored. Precise optimization of price strategies per segment has a high opportunity value. Management of the capacity to resist in a differentiated way to general pressure on prices is essential. It yields a high return on investment.

Secondly, the application of this strategy is difficult as it involves modifying traditional authorization channels. Price reduction decisions have a strong impact on margins. Decisions on taking market share, price-volume arbitration and revenue management in general should be monitored carefully. The problem of centralization vs. decentralization of decision arises, in particular concerning the latitude to be given to sales forces to minimize lost reactivity.

Another aspect to be explicitly covered is competitive targeting. A common error is to target marginal competitors in order to pick up their business as they have the reputation of having the least complete and least sophisticated offer on the market. Sales teams feel that they can at last win in terms of quality. Yet this is rarely the case. Marginal competitors are prepared to make major sacrifices in terms of prices, quality or service levels. They should not be challenged. The cycle will take charge of that.

It is necessary however to target several types of competitor: firstly those not comfortable with price reductions. They usually have extensive ranges. They have invested in over-quality. They have a generous service policy. These competitors are vulnerable. It is difficult for them to change their stance. Then it is necessary to target competitors with high financial objectives, structurally or culturally. Structurally when, for example, they have high debts to be repaid. Culturally when they belong to groups requiring high financial ratios. These competitors will have difficulty following the demands of their customers.

Finally, it is necessary to target non-focused competitors. The lack of focus is a fatal flaw in the cycle's downward phase. It is necessary to adapt the offer to meet customers' demands. Generalist leaders with a broad offer covering the whole market are an ideal target.

3.3 Toughening commercial segmentation

This point goes hand in hand with the previous point. Managing price changes firstly involves identifying customer demand per segment better and, secondly, integrating the competitive structure on each of these segments effectively. An average price policy can be disastrous in the downward cycle phase. In the upward phase, volume increases can mask market share movements between different segments. In the downward phase, an undifferentiated sales policy could generate major market share losses in segments where the price strategy is not adapted.

Objectives should be precisely defined per segment and should be differentiated according to each case: size of customers, region, price sensitivity, etc.

Segmentation errors are heavily punished as they prevent analysis of the reasons for evolutions observed and provision of appropriate solutions. Finely specifying segmentation becomes a strategic priority.

3.4 Adapting the offer

Adaptation and redefinition of the offer are essential. In the downward phase, customers' price sensitivity increases, but this increase is rarely identical throughout the spectre. This change of environment should be taken into account in all the segments covered.

In the upward phase, competitors invest to broaden their range, in terms of quality and service in order to set themselves apart. It is essential to review the offer in the downward phase and understand what is really important for customers in their business. These analyses often result in a "cleaning up" of sales policies, an operation to be steered through per segment.

Finally, it is also necessary to invent or redefine low-cost approaches. It is during the contraction phase that a share of traditional segments opts for low-cost. It is essential to anticipate this development in order to satisfy this share of demand with an adapted offer, if applicable, rather than lowering prices throughout the traditional segment.

On the contrary, demand for non low-cost segments must be properly identified, as these segments continue to focus on service rather than price. Here again, an across-the-board service reduction strategy is not the right answer.

3.5 Developing partnerships

Downward phases are ideal for targeted approaches. It is indispensable to clean up the cost base during the upward phase when the roll-out of cost-cutting programs is relatively less painful. Triggering off cost reduction programs during the downward phase is always more costly.

However, the downward phase is ideal for partnerships and business partnerships in particular. In the upward phase, the company finds no particular benefit in exploring business partnerships as the priority is capacity to supply demand. In contrast, in the contraction phase, it is necessary to increase the appeal of the offer with respect to competitors. Cross-selling policies need to be explored. The aim is to study customers' targets, other suppliers with whom a common approach can create value for the end customer: the palette is wide, from coordinating delivery to the common design of sub-sets.

Finally, outsourcing non-core functions can be analyzed throughout the value chain in production, distribution or support functions.

3.6 Seeking out growth where it is located

The cycle is rarely contracted in all industries and all geographical areas at the same time. The first option is to accelerate international development. The second addresses diversification options linked to the core business. Each option has products, services or zones where the company can develop with the result of attenuating the cyclical character of the main activity. Maintenance, after-sales service and supply of related equipment are examples of activities that can help to attenuate cycle effects on the core business.

3.7 Exploring new directions

The contraction of the cycle is also an ideal time to challenge existing models. Major launches have a greater chance of success during growth phases. Customers are more prepared to change their habits when the cycle is buoyant: try a new distribution channel, buy complete sets rather than assembling themselves, etc. Prior reparation, modelling and testing work can therefore be undertaken during the contraction phase.

3.8 Anticipating consolidation, but not immediately

Last and not least, it is necessary to anticipate consolidation of the market. Industrial profitability is under pressure. This phase will last 18 months, maybe longer. It is necessary to carefully observe merger movements. There is no hurry. It is necessary to avoid being involved in a heavy restructuring operation at the beginning of the turnaround. The virtue of waiting is fundamental

Beware of acquisition opportunities at the beginning of turnaround. They are rarely the most appealing. They only arrive later in a high pressure environment. A mediocre and premature acquisition will prevent involvement in a higher yield, more structuring operation. All the benefits of patient construction work during the upward cycle could be jeopardized.

Finally, size is no longer a curb. The latest operations in the banking or food processing industries show that clever joint ventures can steer through operations that the community described as unattainable for each of them.

The downward phase is one of unique opportunity. The company must have complete freedom to manoeuvre to take full advantage of them.

4. Conclusion: accelerating when markets slow down

Agendas were full during the period of euphoria. They will be even more so during the downward phase of the cycle. Even though we are entering turbulence, it is not the time to take a passive stance until the return of better days.

There are many projects. Firstly, margins will not automatically fall for all our competitors, far from it. Business optimization produces real yield optimization potential. Secondly, contraction phases are fruitful periods from a strategic viewpoint. It is during these phases that opportunities arise to fundamentally modify competitive balances. Specific attention must be paid to exploit them effectively. They will not be back before the next cycle contraction.

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Estin & Co is an international strategy consulting firm based in Paris, London, Geneva and Shanghai. The consultancy firm assists CEOs and senior executives in major European and North-American groups in defining their growth strategies, and provides support to private equity funds in analyzing and maximizing their investments

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