

Back to the future

Today's managers have no experience of running a business in difficult times. Now with a recession looming, it is time to learn from the past and plan for what could be a very bumpy ride into the future, says Paul Hodges.

Downturns are not much fun. In recent years, we have been lucky enough to avoid the type of serious recessions that took place regularly in the 1970s and early 1980s. But this may have bred its own complacency, leading to the idea that these kinds of problems belong to the past. Equally, many managers in today's industry are in their 30s and early 40s with little experience of running a business in difficult times. This requires a different, more cautious, mind-set from one that is always looking for new opportunities. Instead of expecting blue sky and sunshine, one is constantly scanning the environment for clouds and the first signs of a storm. And although the consensus view of 2008 is optimistic, the clouds are gathering. The current credit crisis seems to be getting worse and there are problems developing in key end-markets for chemicals such as housing, cars and retail.

This year could prove to be the year when things gets nasty, and now is the time to make contingency plans.

The risks of an economic slowdown have been rising in recent months. And

unless there is a sudden improvement, global GDP could easily be lower than consensus. If this were to happen, chemical volumes and pricing would come under pressure, creating downward pressure on margins.

Tracking changes in end-user markets is difficult for chemical producers because so few companies sell directly to consumers. Monitoring developments in industrial production is therefore of critical importance, as 85% of chemical demand comes from this sector. And new figures from the Organisation for Economic Cooperation and Development (OECD) present a worrying picture.

The OECD produces leading indicators each month in order to capture turning points in the global economy. Its latest outlook (Figure 1) shows actual global industrial production, compared with changes in the OECD's indicator. It is based on data from the leading industrial countries (CLI) and the six main non-OECD countries: China, India, Russia, Brazil, South Africa and Indonesia. Recent monthly data have been showing a marked

deceleration. Now, the OECD is reporting that a global 'slowdown in growth lies ahead'.

In terms of individual countries, a downturn now seems to be under way in the US, Germany and the UK. Japan, France, Canada and Italy are also slowing down. In non-OECD countries China, Brazil and Russia, things are improving, whereas in India, demand is weakening.

This sense of a turning point, after the excellent performance in recent years, is confirmed by figures from the US housing and automotive industry.

Every new housing start generates an average \$16 000 of chemical demand. December's data reveal that builders broke ground on only 1m units, the lowest rate since 1991. Building permits, a leading indicator of future housing starts, fell 25% in 2007, the biggest decline since 1980.

A similar picture emerges from US car sales in 2007. Chemical sales to the industry were worth \$32.6bn in 2006. Sales by the big four (GM, Toyota, Chrysler, Ford) were down 5% overall versus 2006, at only 11.1m units. Toyota managed a 2.7% increase, but GM was down 6%. Ford suffered a 12% decline and Chrysler was down 3% even after offering major cash-backs to clear inventory.

The current consensus that 2008 will be a relatively good year for the chemical industry may still be right, but it is difficult to ignore the ominous signs from the US housing and automotives sectors. Financial markets are also getting nervous. And when things go wrong, the decline is often quite sudden, leaving little time to think.

In 1979, global chemical markets rode a similar wave of optimism and strong profitability. Crude prices averaged \$31.61/bbl versus \$14.55/bbl in

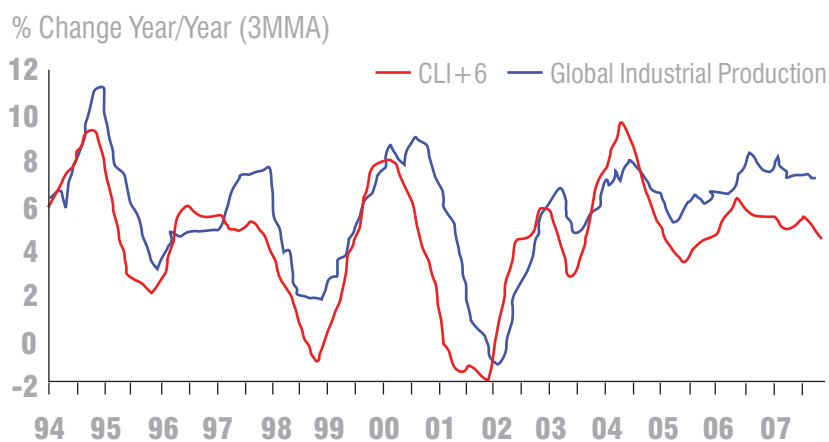


Figure 1: Global industrial production compared with OECD indicator

American Chemical Council

1978. In today's money, adjusted for inflation, this meant they had doubled to around \$94/bbl. Downstream markets seemed to have absorbed the increase, and demand appeared strong.

But during Q1 1980, oil prices topped out. And suddenly it became clear that a large part of 1979's apparent demand had been based on inventory build down the chain. Purchasing managers had felt it was prudent to buy forward in a rising market. And sales forces had been so busy pushing through price increases that they hadn't had time to spot the problems that were developing.

Q2 1980 was a disaster. Demand fell, as inventories were reduced to more normal levels. It then fell again, as it became clear that the world economy had gone ex-growth. Producers started to cut prices to try to maintain operating rates on their plants and margins tumbled. For many companies, the losses incurred in 1980 wiped out the profits recorded the previous year.

So what can be done in case 2008 turns out to be another 1980? Many believe that buyers have once again been building inventories down the chain, in spite of 'lean and mean' policies in the chemical industry itself.

Companies must develop contingency plans in advance, plans that can be put into operation if there is a recession. These should be based on a robust understanding of where value is really created. Once things begin to go wrong, time is of the essence and it is all too easy to panic.

What might such plans contain? A good process, although obviously not the only one, is to start by deciding on a realistic savings target. Is the expectation that sales and profit might fall 10% in a downturn? Or might they fall 20%? Asking this high-level type of question helps to crystallise the key issues very quickly.



Contingency planning can then start on both the income and cost side of the business (Figure 2).

1. All the main functions can be asked to consider what can be done, and how quickly their proposals can be implemented. In most companies, there are three main areas to address – commercial, financial and technical. For purposes of speed, it is best to focus on just the key areas. And the 80:20 rule applies. This is not a full-scale budget exercise, and one wants the business to carry on running whilst it takes place. So a taskforce approach is best.
2. Each taskforce needs to consider what its own area can achieve. Clearly they may also come up with ideas that need to be delivered in conjunction with

another functional area. But clarity of ownership is critical. The key people need to be involved within each function, and they need to be given a clear brief and timescale within which to work.

3. They also need guidance on the 'toolkit' that they can use. Of course, cost reduction is the simplest programme to implement. And cost reduction is almost certain to figure in the final plan. But equally it may be possible to fast-track development of a new product or plant process, to generate new sales and profit. Or it may be possible to improve management of working capital, to reduce interest charges and avoid breaching bank covenants

4. Clear communications are also required. Most people will already be aware from their own personal lives that several parts of the western economy are looking rather shaky. But they may not be aware of the detailed linkages between a turn-down in the housing or automotive sector and their own business. These linkages need to be spelt

out when the initial remit is being developed, in order to generate the necessary urgency and sense of criticality.

Once the initial plans have been developed within each function, they should be compared across functions and a timetable set for potential implementation.

Crucially, the final plan needs to be tested for alignment with the original brief. Will it make up the 10% or 20% shortfall potentially lost as a result of a downturn? If not, then harder questions need to be asked, until robust answers are achieved.

Time spent now on preparing contingency plans, in case today's slow-down turns into a full-scale recession, may therefore prove to be a good investment.

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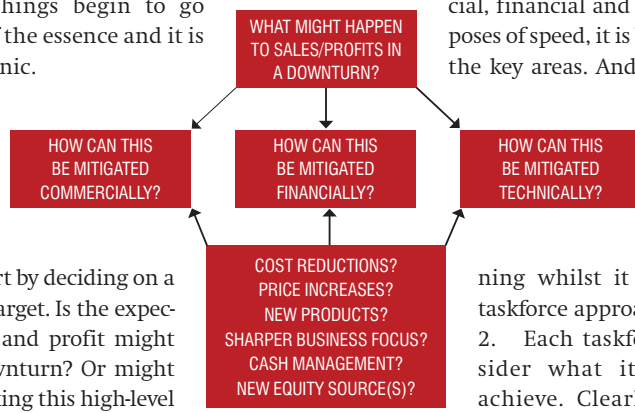


Figure 2: Planning ahead