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NEWS LETTER

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Catching the next boom

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With the UK emerging seemingly from recession, now might be the time to lay down plans for catching the recurrent tide of renewed economic growth.

But if the slump did not get you, uncertain or lumpy recovery might. How best to apply diligence to markets of choice? What revised growth drivers will determine attractiveness? CSA has some thoughts for company management, investors and their funders to consider.

A PICTURE OF ECONOMIC IMBALANCE AND SLOW RECOVERY

Most pundits are forecasting growth of about 1 per cent in 2010, rising to 2 percent in 2011. One approach to measuring and quantifying growth, as measured by GDP, is the expenditure method, whereby GDP = government spending + private consumption + gross investment + (exports – imports).

Running through some of these key elements, it can be seen that the after-effects of the Government's fiscal pump priming will almost certainly weigh heavily on the economy for several years. A clear priority of future government will be the focus given towards broad public sector reform and cost reduction.

Estimates indicate cuts to real budget spend by departments will need to amount to over 2% per year to the year 2013/14. One key outturn may be the introduction of competing private company providers into the healthcare, welfare and education arenas creating long-term opportunities for private suppliers as a result of deregulation and policy change.

However, in practice we see public sector bureaucracy, slow decision making and long lead-times making the desired level of public-private partnership difficult to achieve. Additionally, programme amendments that focus on cost reduction often have a bearing on regional employment - an indigestible issue for most politicians.

We predict that the political issues at stake will remain sufficiently contentious and deep set as will inhibit effective public sector change, especially near term.

No more so than in the area of Defence. Already an area of substantial public/private sector cooperation, Defence faces particular uncertainty from intense political budgetary concern and critical refocus. Priority has been given to the strong desire to see military programmes, such as those in Afghanistan and elsewhere, reshaped to suit more clearly defined and controlled objectives. However, while the Government is under pressure to scale-back expenditures the practical dynamics of doing so are complex; programme lead-times are lengthy, involve political, technological and budgetary partnerships alongside other nation states - and difficult to untangle, other than extremely slowly.

BUSINESS INVESTMENT TENDS TO RESPOND TO GROWTH, NOT LEAD IT, AND WILL REMAIN CONSTRAINED

Business trading during the early stages of the downturn was hit by a headlong rush towards destocking. Companies can only operate on run down stock levels for so long and must now be looking to restock, aiding demand. However, business investment in capital goods tends to respond to growth and not generally lead it. The greater driver of growth, leverage, will continue to remain constrained for some time as the banks take time to redress balance sheets before recommencing lending once again. Constrained of market pull and in the absence of basic debt funding, we see corporate small and mid-market productivity remaining muted. Albeit one recognises that larger, investment-grade corporates may fair more favourably given certain ability to access capital markets via company bond issuance, for example.

One area where we do see business investment leading and not just responding to demand is in the converging fields of IT and telecommunications. Here, the penetration of broadband together with mobile applications convergence should continue to create growth markets that cater for both B2C and B2B user groups. CSA project work in this space has revealed strong user adoption, emergent technology and a favourable regulatory environment. Increasing e-commerce, social networks and voice traffic overlapped with data transfer creates areas of evolving demand. We see opportunities opening in the industry supply chain, as the major 'platform' operators cooperate increasingly with a host of independent service providers, able to address specific sub-sectors through flexible service and tariff arrangements custom designed to customer needs.

CONSUMER SPENDING: HAMSTRUNG BY PERSONAL INDEBTEDNESS, UNEMPLOYMENT AND TAXATION

The pattern of consumer retail demand will likely continue to reflect the ongoing high level of indebtedness endemic in the UK population. Unemployment, which generally lags a market's return to growth, will continue to rise in the short to medium term. Correspondingly, wage constraint will serve to limit disposable incomes and therefore suppress high street sales.

CSA experience of projects undertaken during the earlier stages of recession saw an evident flight of consumer spend towards the lower priced, value item. We witnessed female fragrance, soap and talc at the £50 stock keeping unit (SKU) end of the market give way to the under £15 item. Elsewhere, own-brand merchandise out-sold big shelf brands, with recession working particularly against 'big ticket' consumer durable goods from washing machines to cars.

Recent retail figures indicate a return to low, single-figure, levels of growth. A noticeable feature of this most recent trend has been to see the earlier recession driven boost given to the value-discounters come off the boil.

Top-ticket consumer products may, however, take longer to recover. We would anticipate increased labour market mobility and housing activity kick starting late cycle demand for articles like fitted kitchens/bathrooms, carpets and other household goods.

Meanwhile, a proportion will opt to take advantage of the Government's 'scrappage' scheme, temporarily alleviating the year on year reduction in car sales - small cars in particular, but overall the effect of scrappage may be only to borrow sales from sometime in the future.

Sterling remains about a fifth below its peak 2007 value against the US Dollar. As a predominantly low-exporting economy, the greater impact of the softer pound has been on imports such as durable goods, food products and commodities, which have risen in price. The lower pound has also dissuaded holidaymakers from travelling overseas, providing a boost to 'stay-at-home' tourism, which has benefited theme parks, heritage sites and the like.

In the restaurant and catering industry, the decline of consumer spending has negatively impacted sector growth for the first time in nearly 40 years. The bulk of the UK's restaurateurs have seen trade decline and insolvencies rise as consumers have chosen to eat at home or purchase cheaper take-away food. Interestingly, London restaurants have appeared to hold up better in the light of the rise seen in visiting tourist numbers, in line with sterling's weakness.

Another area where we remain positive, from our experience of recent project work, is the London sandwich/coffee shop retail space. Sandwich shops and their like have also benefited from the influx of tourist numbers to the capital. However, the sector has also been able to capitalise on a need for office workers to seek out-of-office refreshments. This sector-niche benefits also from that other great driver of the UK economy these past 25 years – the growing importance of the female professional working population to the economy; a consumer segment observed to be less firmly attached to the (lower margin) sandwich lunch, a trend many of the more upmarket sandwich chains have successfully spotted.

Ultimately, consumers spend what is in their pocket and here the omens are not particularly good. Notwithstanding public concern over employment, personal disposable incomes have been further stymied by a recent rise of 2.3p per litre in car fuel duty and an end to the Stamp Duty holiday on properties under £175,000. Additionally, VAT, a tax on consumerism, is on 1 January to be put back to 17.5% after a temporary 'market-boosting' spell at 15%. Lastly, a new 50% rate of income tax on high earners comes into force next April.

SLOW RECOVERY WILL RQUIRE PRUDENT BUSINESS JUDGEMENT AND DILIGENCE

All told, we think the macro-UK situation points towards a slow climb out of recession. Control of the public finances will be slow; liquidity will remain on short supply and business development correspondingly cautious. Additionally, as a predominantly low-exporting economy, the greater impact of the softer pound will be on imports, priming the potential for returning inflation.

Businesses coming out of recession do not have much wool on their backs and it is said often that as many companies get into financial difficulties rising from the ashes of recession as going into one. Dressing up for recovery may not be an all too easy re-awakening.

Consequently, we conclude by list some early questions that business management might do well to consider - or ask their advisors to investigate:

1. The recession will cease at different times in different sectors. Not knowing the likely order of recovery may mean opportunities are miscalculated in the upturn. Would formal 'pipeline' analysis, as determined by customer referencing, provide accurate information about the timing and phasing of product/customer/market demand?
2. Business collapses can traumatise some business owners and managers. Has the company still got the management, with the necessary motivation and strategic thinking, to take the business forward into a new dawn? Would management (HR) diligence or a strategic sense check about business direction help at the outset?
3. Can the old business plan be truly resurrected to take advantage of the upturn? Or is it a case that even an upturn cannot revive a tired formula? Would an external business plan review determine whether or not the revenue and margin projections are realistic (and work to support bank covenants, etc)?
4. Does the business really have the wherewithal and capacity after dormancy or mothballing to accommodate orders of more than a limited size? What un-utilised capacity per revenue stream can be accessed? What re-tooling /resourcing cost might be involved?
5. What will be the impact of returning business volumes, when industry pricing remains an issue? Will the company's competitors aim for a land grab, in which margins are trampled underfoot? Would competitive analyses help?
6. What has been the impact of recession on the industry supply chain or, more specifically, the suppliers and their materials that have to be depended upon? Would examination of the strategic positioning, strengths and weakness of these companies help?

MANAGING BUSINESS VALUE-ADD IN A RECOVERING MARKET

It is difficult to manage business value-add in a recovering market without linking a business's performance to revised and understood competitive yardsticks. Catching the next boom will require good business judgement and commercial diligence. However, new growth drivers will emerge in markets, which if mapped will provide businesses with fresh opportunity to go forward and compete successfully.

CSA fills the gap between general industry information and true sector understanding. Our analysis and opinion bring perspective on key points of business concern. As advisors, our strategy is to identify areas where we can add value to the business transaction process. We provide proactive solutions, while sensitising risks and issues of concern to corporate organisations, equity investors and bank lenders.

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