



INSIGHT

Managing In a Stagnant Economy

In a sluggish economy, cutting costs and hoping for an economic upturn isn't enough; a business must remain dynamic.

Don't expect economic growth in 2003 to solve all business woes. It appears that the economy will remain sluggish for some time. As many of our clients have found, managing a business during a sustained economic slowdown can be extremely challenging. Simply cutting costs and riding out the downturn is unlikely to yield the desired results.

SURVIVAL FIRST

In order to survive during sustained periods of slack demand, most firms must cut costs and maintain liquidity. Capital investment is typically the first to go, quickly followed by costs that are not absolutely necessary for day-to-day operations, such as advertising, R&D spending, and certain administrative functions.

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Lowering its breakeven cost structure may allow a business to buy time; but it is rarely a prescription for improving one's competitive position. If the company is to thrive as the economy turns, its owners and managers must think more broadly and be willing to take steps to improve the strategic position.

UNDERSTAND HOW THE BUSINESS MAKES MONEY

It may seem odd, but one area of weakness that we repeatedly see among middle market businesses is the lack of a clear understanding of just how and where money is made and how much profit is necessary to justify the capital invested in an enterprise. In a robust

SUCCESSFUL BUSINESSES ADAPT AND EVOLVE

Successful management of a business has always been about operating in a constantly evolving competitive environment. Business owners must not only be vigilant in managing internal challenges such as customer and vendor relationships, but also must make decisions in the face of external forces such as the economy and competitive threats. External forces cannot be controlled, but businesses can adapt and evolve to exploit these changes.

During the last economic expansion, decision-making mistakes were covered up by a buoyant economy. Over the last three years, however, there has been no margin for error as the economy has become stagnant and uncertainty has increased. While good management cannot fully make up for being in a down economy or in a failing industry, it can make the difference between survival and extinction.

In our last issue of Insight, we looked at risk from the perspective of outside providers of various forms of capital. This issue investigates three challenges in operating businesses: operating in times of lackluster demand, taking advantage of historically low interest rates, and developing a framework for evaluating business strategy in an ever changing competitive environment. ♦

market, business owners and managers deal with shortages of employees, managers, and capital. Success is principally predicated upon removing those constraints. When demand slows, the natural tendency is to scale

back the business in essentially the reverse order of its growth. This is a mistake.

Managers must critically examine where profits are derived. It is a rare occasion when some form of the 80/20 rule is not at work. That is, 80% of the profits are earned from 20% of the customers or from 20% of the products. In a slow economy, there is an extreme reluctance to scale back customers or trim product offerings for fear of having to spread overheads over even less volume.

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However, long-term success often requires difficult choices. The approach should be to resize the business to the core customers who best fit its strengths and capabilities.

RECOGNIZE SUNK COSTS

As businesses grow, decisions are made to pursue certain markets and customers, to invest in certain assets and to hire new employees. Now, with dampened demand, many businesses find themselves saddled with excess capacity and/or assets that no longer earn adequate returns. Many owners/managers find this particularly difficult to acknowledge. As hard as it may be, business managers must force themselves to think of each asset, strategy, product, and customer as if there were no previous commitment to it. Past expenditures are sunk costs. That is, the original rationale for a capital investment and its cost is no longer relevant. It must be rejustified regularly.

Capital is a scarce resource, especially during a sustained downturn. Most small and medium sized firms do not have the luxury of tying up capital in substandard or non-performing assets. In many cases, companies would be better served by culling substandard operations, products or assets, converting the assets into cash, and using the proceeds to reduce leverage. Failing products or businesses

sap strength, time and energy. Continuing to nurture operations that are unlikely to earn sufficient returns puts the business in a position of weakness from which it is very difficult to recover. In fact, the inability to focus on successful operations is one of the primary reasons for failure. Put plainly, you can't afford to keep whipping a dead horse.

ZERO BASED BUDGETING AND PLANNING

As operations are being re-engineered, the company's business plans should be redeveloped from the ground up. Just as historical expenditures are sunk costs, historical operating metrics are not the proper gauge of future performance. In concert with re-engineering business processes, budgets and plans should not be (as they often are) linear extensions of past history. No more revenues up 10-percent and costs down 5-percent from the prior year. Instead, each item of the business plan needs to be carefully considered and justified.

CONTINUE TO INNOVATE

Even though growth is slow (or non-existent), businesses must continue to evolve in order to position themselves to achieve

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Success in business, however, requires confronting the reality of the present position and dealing with it.

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above average performance when the economy turns. This evolution may take forms that were previously not contemplated or may be unconventional. For example, it may mean partnering with suppliers to leverage their capabilities and expertise, shifting production to a lower cost setting, and/or to exploring ways to add greater value to products and services targeted at specific market segments.

In this process, it is imperative to determine what the business does or can do better than anyone else in its market. There needs to be a well defined strategic vision—who are we, what do we do really well, and why? It may be that as the market has evolved, the strategic vision has slipped a little out of focus, and some readjustment is now called for. Researchers at McKinsey & Company found that during the 1990-91 US recession, successful companies spent relatively more on research and development than their peers. Businesses that eliminate spending on innovation are sowing the seeds of substandard performance.

It is much easier to wait for things to improve than to admit they have gone astray. Success in business, however, requires confronting the reality of the present position and dealing with it. As the business environment continues to evolve, the most effective way to cope with the change is to lead it. If this can be done effectively, the business will be in a much-improved position to compete as economic conditions improve. ❖

The Nature of Change

Successful companies that do not identify and respond to changes in their environment ultimately fail.

In a natural setting, the ecology of an ecosystem represents a delicate balance of interactions between different organisms and their environment. Small changes in habitat, food sources, or the introduction of new predators can alter the dynamics of the ecosystem impacting all of its participants. Some organisms adapt and thrive in the new environment, while others perish. It is the same in business, yet it seems to be an utterly perplexing phenomena and source of surprise when historically successful companies fail to respond effectively to changes in the environment and fall by the wayside. In the midst of a complex and often baffling economy, business leadership needs to determine if the business cycle is at work or the environment is changing.

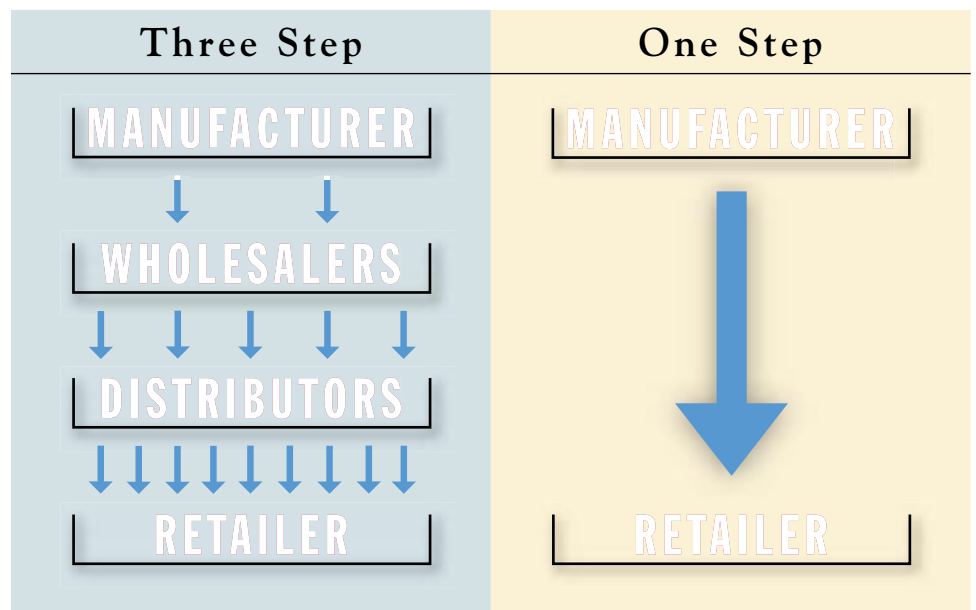
The business cycle moves like the tide - it goes out and, in time, comes back in. Business prospects rise and fall on the tide. Business leaders cut costs during the slow down and invest during the upside. Successful companies are often defined by a competitive proposition that rests on a unique and compelling blend of strategy, process, relationships and values. Over time, some change in the environment undercuts this winning formula, causing a shift in the competitive dynamic, which allows winners and losers to be determined anew.

Although it may seem counter intuitive, the root of the decline for many firms actually lies in their past success. The strategies, processes, relationships, and values that underlie past achievement tend to be institutionalized. Once the code has been broken to reveal the formula for success, the culture and status quo invariably become deeply ingrained. As a result, the ability to adapt to a changing competitive landscape ends up being stifled.

One of the more visible examples of a competitive shift that has caught a number of previously successful firms flatfooted during the past decade, has been the move from two or three-step distribution (manufacturers – wholesalers – distributors – retailers) to one-step distribution (manufacturers – retailers). There is an impressive buzzword for the process of eliminating the middlemen in the supply chain – disintermediation – and the building products industry is a

Competitive Shift: Product Distribution

Lowe's and Home Depot reshaped the economics of product distribution. These retailers effectively bypassed most distributors by going directly to manufacturers. This caught their competition by surprise and propelled them to positions of industry leaders.



prime example. Lowe's and Home Depot reshaped the economics of product distribution in a number of ways. Having amassed enormous volume based buying power; these retailers effectively bypassed most distributors by buying directly from manufacturers. In turn, this set off a wave of consolidation among wholesalers and distributors that resulted in many of these firms shutting their doors. Regional building material manufacturers found their distribution channels disrupted and previously profitable business taken away by competitors that demonstrated

Time to Protect Against Rising Interest Rates

Now is the time to develop an interest rate strategy.

Interest rates don't invoke much impassioned debate these days. The prevailing view is that rates are low and stable and are likely to stay that way in the near term. So, what is there to do? After all, for many companies the most urgent issues are paring back debt and optimizing operations. Interest rate management is not much of a priority in the overall scheme of things. When you can borrow at an all-in rate of 3.5 to 4.5% (LIBOR plus 200–300 basis points), why worry? Debt has never been so cheap.

Nevertheless, complacency on this subject is not merited. Now is an opportune time for management to act on abnormally low interest rates to protect their businesses for the future.

HOW LOW IS LOW?

Under any reasonable scenario, we are at or very near the bottom of a historic interest rate trough. Rates are low both on an absolute and a real basis. As shown in the nearby chart, long-term interest rates, as depicted by 10-year Treasury securities, have dropped to their lowest levels in 40 years.

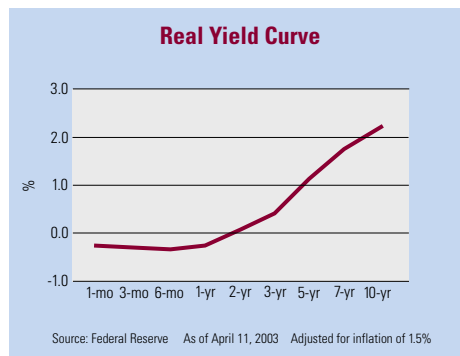
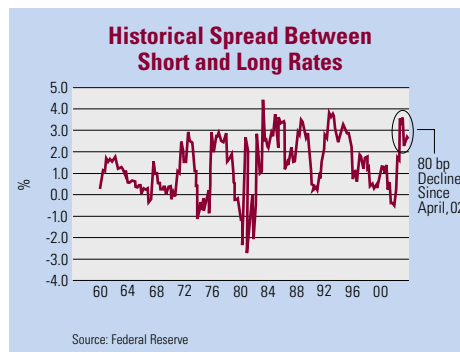
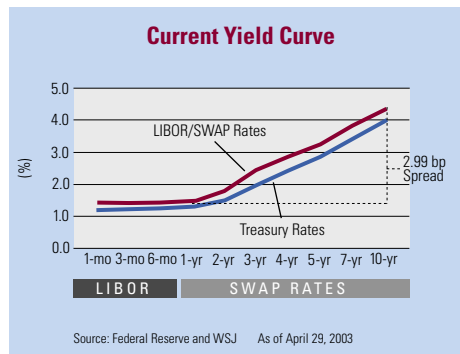
While long-term rates are exceptionally low by any standard, short-term rates are even lower, barely eclipsing the 1% level. The current yield curve indicates a spread of approximately 2.99% between 1-month LIBOR and the 10-year Swap Rate. The Swap Rate is the fixed rate that is exchanged for the floating LIBOR rate in a swap transaction.

Over time, the differential between short (3-month) and long-term (10-year) Treasury rates has averaged 1.40%. The current wide spread between short and long-term rates provides a powerful incentive to float at the short end of the yield curve and enjoy the interest rate differential. And it begs the question, why move up the yield curve by 200 or more basis points to fix rates now?

FORCES AFFECTING RATES

Interest rates over the long haul reflect investors' expectations for inflation and risk. In the short term, however, supply and demand have a significant effect on the level and configuration of rates. At present, a strong argument can be made that demand for high quality debt securities has deflated rates abnormally, especially at the short end.

There are a variety of macroeconomic forces that have notably affected the current level of rates. First, the collapse of the growth stock bubble reshaped investment patterns and spurred an exodus from mispriced equity markets towards less risky alternatives. As equity gains faded, investors shifted gears and made their way into safer havens like high rated corporate bonds and



government securities. The demand for high quality debt instruments helped bring interest rates down sharply. A second factor that has contributed to low rates has been exceptionally weak credit demand, particularly among bank borrowers. As commercial credit demand slacked off, many banks replaced loans with bonds. This added demand for debt securities has further depressed inter-

est rates, especially at the shorter end of the curve, as investors are simply in a holding pattern, waiting to see how things shake out.

Borrowers are now benefiting from circumstances in which the pricing in U.S. debt markets has come down to the point that real interest rates, after inflation, are negative. In essence, investors have accepted negative returns as the cost of a safe haven until they decide where to park their money long-term. The argument is that it is preferable to accept a small real loss in buying power in order to avoid much higher losses in other markets.

LOW RATES AREN'T FOREVER

Negative investment returns are not sustainable over time. The current rate environment seems to be a confluence, or "perfect storm", of global and domestic conditions. With high rates of unemployment locally, soldiers in Iraq, and an unpredictable North Korean regime, there is certainly reason for worry, but it always seems darkest right before dawn. As geo-political stability is restored and investors gain confidence in the domestic economy, there is no direction for rates to go but up, especially at the short end of the curve. It won't take much change of investor perspectives to affect the level and structure of interest rates.

WHO SHOULD CARE?

There are several types of businesses that should pay particular attention to the impact of higher interest rates. First, any business in which customer demand is adversely affected by rising interest rates is a good candidate to investigate hedging strategies. The need is most acute among firms that have debt as a major component of their long-term (greater than 3-4 years) capital structure.

We recommend consulting the specialists at your bank to develop specific technical hedging strategies. Nevertheless, we can offer a couple of suggestions.

Separate interest rate risk from credit structure.

Interest rate swaps, caps, and options are generally better alternatives to fixed rate loans. Keeping borrowing arrangements on a floating rate basis provides greater flexibility to make adjustments to credit terms as conditions warrant. It is unlikely that it will be necessary or advisable to adjust the mix of fixed and floating rate debt and the credit or capital structure at the same time, and you should avoid paying penalties to unwind interest rate commitments in order to adjust credit structure. While banks typically view the credit risk of a fixed rate loan the same as a floating rate loan, they view a derivative contract (swap, cap, option) as added credit

Interest Rates *continued from p.3*

exposure. When negotiating your hedging strategy, you will want to retain the ability to keep the “hedge” in place if and when you decide to change lenders for the underlying borrowing. This may require a pledge of specific collateral, either at the time the hedge is implemented or at the time of change.

An additional reason to favor a swap over a fixed rate loan is that its value increases or decreases as interest rates move up or down. If it is necessary to unwind the swap at some

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future date and rates have moved up, the increase in the swap’s value accrues to the company rather than to the bank.

Hedge interest rates for a period that makes sense for your capital structure and business.

The funding for long-life assets, such as plant and equipment, should be hedged for a corresponding term. The emphasis should be to protect against rate changes in the three through ten-year period in order to take advantage of low short-term floating rates. Even if rates rise, it will take some time to erase the savings.

Monitor rates for signals of when to move from floating to fixed rates. Just like the equity markets, it is impossible to precisely time interest rates. But, you can maintain a sense of what interest rates are doing by looking at the actual level of and the spread between LIBOR and Swap Rates on a weekly or daily (if a decision is imminent) basis. Either your bank will provide regular quotes, or you can monitor rates in the Federal Reserve’s daily posting of Statistical Release H.15 at www.federalreserve.gov/releases/h15/Update/.

Lower interest rates have saved the bacon of more than a few leveraged businesses by lightening the interest burden. It would be tragic to have rising rates negate these benefits. There is an open window to take advantage of the current interest rate environment. We can’t know how long it will last, but you can be certain that if you don’t have a defined hedging strategy, the opportunity will be lost. ❖

Nature of Change *continued from p.2*

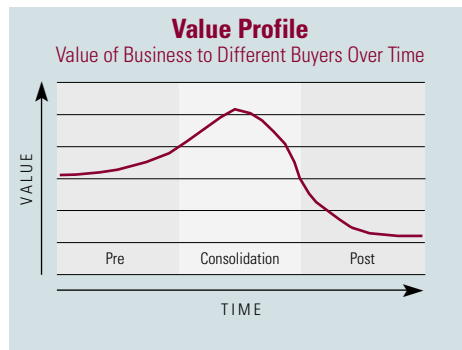
an ability to directly service a national retail footprint. This led to consolidation of manufacturers in an effort to achieve economies of scale in production and distribution. In essence, the whole competitive landscape realigned.

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Owners frequently find it difficult to appreciate the fact that the value of their business may rise and fall, independent of its own financial performance. The restructuring of the building products supply chain emphasizes the fact that as industries evolve and businesses adapt, significant strategic value is gained and lost by individual businesses. Our experience is that the greatest value is at stake once the new reality is widely understood and the race is on to reconfigure into a position of competitive strength. It is in these times that the optimum value of a business may be its ability to allow another business to achieve its strategic objective. The chart below illustrates how the value of a business



to different potential buyers can change over time as a result of these external forces. Business owners should recognize that their personal timeline and investment horizon might not coincide with maximization of the business’ value in a dynamic market.

We have observed far too often that when the economy is retrenching, some business leaders pull in their horns and live on the hope that conditions will “return to normal.” They count on the strategies, processes, relationships and values that brought past success to help them return to glory when the market “straightens itself out.” The fact is that “normal” is in a constant state of flux and what was thought to be normal may never be experienced again.

It’s hard enough to run the internal aspects of a business. It is harder yet to analyze and adapt to the external forces that

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impact business success. It is incumbent upon management to pay particular attention to the major external forces and competitive developments that have or will influence their industry, suppliers and customers. Only after management comes to grips with the changes and obstacles that it faces, can it develop a program of change. To the individual company, this evolutionary process can result in periods of tumultuous change in order to avoid joining the industry’s endangered species list. We believe that this evolutionary change, much like in a natural ecosystem, is the only way to sustained prosperity. ❖

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to ZacharyScott.com.

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