

2009 – Will it be Que Sera Sera for your Business?

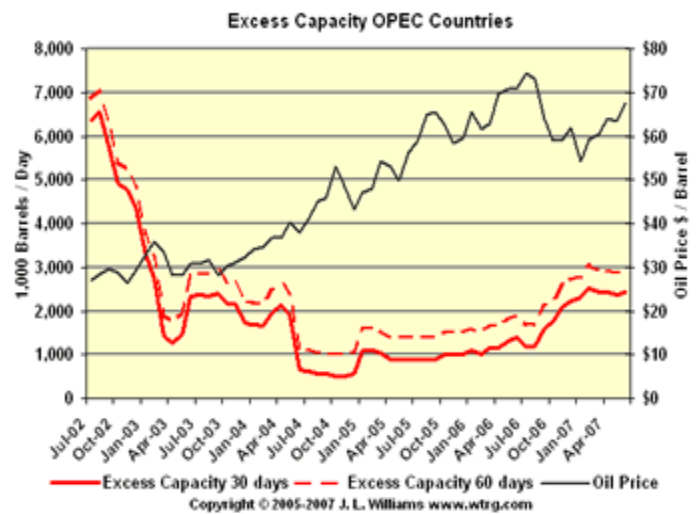
There will be a lot of people in India and in the rest of the world who will be rueing the fact that they did not predict the crisis of 2008. They could have actually anticipated this crisis way back and acted on signals that were there even in 2007. Their antennae were most probably picking up the signals but they were getting lost in the noise or they were not being interpreted or worse still, they did not act.

For example when the Scottish bank, Northern Rock, ran aground in May 2007, some people in the financial services industry realised that the sub-prime game was over. But for most people, it was simply some irrelevant news being beamed repeatedly on TV. Soon after that, news came around of warnings from wise men about the grave danger posed by derivatives.

The Oracle of Omaha's 'super danger' warning on derivatives is an example (*Goldwatcher, May 8 2007*) – “*Though at times he uses them to advantage Buffett has already branded financial derivatives weapons of financial mass destruction. Now he is warning they are potentially a 'super danger' that make the Federal Reserve's efforts to regulate the use of credit to purchase securities 'irrelevant, a joke and an anachronism.'* He warns *'there will be some very unpleasant things that happen in the financial markets' acknowledging 'we may not know exactly where the danger begins and at what point it becomes a super danger.'*”

But the common man and even informed businessmen, at best, treated these kinds of signals as 'good to know'. I realised that one needs to understand what else is happening to the World and whether, there is any pattern emerging that makes sense.

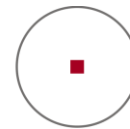
By July 07, we saw oil prices firming up. This sounded counter intuitive because oil prices were going down earlier given a build up of excess capacity in OPEC countries (see chart). That capacity did not go away and oil demand had risen only by 1.5% over the



previous 12 months. Then how did prices go up suddenly by July 2008? The argument of heightened war risks clearly could not explain it. Obviously, the guys who invested heavily in mortgage derivatives were moving into oil to offset impending losses due to sub-prime.

The testimony of Michael W. Masters of Masters Capital Management, LLC, who addressed the issue of “Commodities Speculation” before the Committee on Homeland Security and Governmental Affairs in end May 2008 is very revealing -

*“Today, Index Speculators are pouring billions of dollars into the commodities futures markets, speculating that commodity prices will increase. In the popular press the explanation given most often for rising oil prices is the increased demand for oil from China. According to the DOE, annual Chinese demand for petroleum has increased over the last five years from 1.88 billion barrels to 2.8 billion barrels, an increase of 920 million barrels. Over the same five-year period, Index speculators’ demand for petroleum futures has increased by 848 million barrel. **The increase in demand from index speculators was almost equal to the increase in demand from China.**”*



Index speculators had stockpiled, via the futures market, the equivalent of 1.1 billion barrels of petroleum, effectively adding eight times as much oil to their own stockpile as the United States has added to the Strategic Petroleum Reserve over the last five years. There were, therefore, signals available for those who cared to pick them up.

Even as early as September 2007, it was clear that the total outstanding derivatives were too huge to handle - of the order of \$485 trillion (8 times the global GDP) and they included oil. Unwinding that smoothly without a global financial crisis would be impossible. Warning bells sounded by us on November 21 2007 about the Indian capital market's imminent downward journey were picked up by very few ears. In the meanwhile, outstanding derivatives reached \$600 trillion at the start of 2008. The rest is history.

It was also pretty clear that these punters had also attacked other commodities besides oil. Prices of commodities across categories rose over the next 10 months till July 2008. From 2003 to 2008, investment in the index funds tied to commodities has grown by 20 times to \$260 billion from \$13 billion! The fact that growth in commodity demand was not even close to that should have sent strong signals of an imminent disaster for everybody to pick up. Commodity prices had sky rocketed not because Indians were eating more food (a 'convenient' explanation from Condoleezza Rice) and metals were not rising because of demand frenzy from the developing countries or any other consuming market.

The commodity prices would have to spiral down like they went up as soon as the trigger went off. But what could those triggers be? Again it was not difficult to anticipate in early July 2008 that the sinking global economic situation would shrink the demand for oil and soon thereafter, the speculative bubble will burst.

At Avalon, we had anticipated the sub-\$100 oil price and I spoken about it on July 11, 2008 when Goldman Sachs was looking at \$200 per

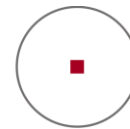
barrel. This was communicated to many friends and clients at that time. There was no magic involved in that - just interpretation of signals and anticipation. Surely the signals were there for all to see and interpret. But most people were happy trying the game of baseless prediction or getting swayed by other people's predictions.

**Most things can be
ANTICIPATED. There is
no need to PREDICT.**

It is time that, you started anticipating what 2009 will be like for you by interpreting signals that are there for anyone to pick up today and as we move on during the New Year. That will be far better, and more accurate than any general prediction from someone who knows nothing about you, your company and your industry.

Prediction has always been a combination of art and science even at the best of times. Now, with volatility as we are experiencing today, predicting is getting tougher and less reliable. At Avalon, we project the future scenario by combining 'anticipation by reading signals' with some 'hardnosed market research techniques'. That has helped us to get a peek into the future right consistently.

However, one of our anticipations in 2008 was delayed by 2 months. We had anticipated that the Government of India would undo by end September, the damage and pain inflicted on Indian businesses in mid 2008 (by withdrawing Rs 2 lakh crores and raising interest rates - a completely misguided strategy to fight the mirage of 'uncontrolled inflation' - 12.8% measured by WPI when the actual CPI had only risen from 6.2% to 8%!). This was a patently irrational thing to do when the whole world was conjuring ways to support their economies with more liquidity and lower interest rates while they too faced commodity price led inflation. This was clear to all by August 2008 but the Government of India was either still in denial or frozen with fear. Only in



late November, did they return the mopped up liquidity to the economy, which had been hurt so badly by then that much more was required to be done. A self-goal is the most polite description possible.

Fast forward to 2009 - What are the global signals and Indian signals for Indian businesses to pick up?

Signals from the US, UK and Europe

2009 will be worse than 2008 for the Western world. There is low consumer sentiment because of inability to spend and no confidence leading to lack of appetite to spend. Since consumer spend is 65-75% of the GDP of Western countries, there are certain things that we can expect there in 2009, viz.

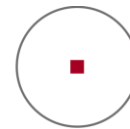
- Negative GDP growth in the US, UK, parts of Europe like Germany, Spain, etc. to marginal growth in some parts of Europe leading to:
 - More job losses
 - Postponement of high ticket purchases
 - Cut in discretionary spending by individuals and companies
 - Severe cut in marketing spend by companies
 - Serious efforts to saving / self preservation by companies
- A Bretton Woods-type initiative with more countries participating will happen to save the global financial system from collapse
- Credit crunch and liquidity problems continuing despite bail-outs
- Sectors like automotive, plastics, textiles, chemicals, travel and tourism, etc. slipping
- Sectors like healthcare, food staples doing relatively better
- More people will resort to e-commerce to fish for savings / discounts
- More business failure and consolidation than in 2008
- Service industries suffering in general
- Protectionism versus free trade debate will swing a bit towards the former

- Obama knows his politics and will attempt to create many new jobs in the US by offering incentives to invest in job creating ventures and to plug loopholes in the tax regime that put those who offshore jobs on the same plane as those who keep jobs in the US

Demand from Western nations will drop since for them, 2009 will be worse than 2008

- Western countries will be much less prepared to participate in wars in distant lands
- Obama knows his economics too and will be willing to negotiate rather than fight avoidable wars
- The Dollar will weaken before end 2009 because the 'safe haven' concept at near zero returns will not make the US Treasury the best bet for investors. Some investments will seek more returns in India (if there is no war with Pakistan) and China.
- Russia is richer, stronger and has gas. The Russians will exercise much greater influence over their erstwhile satellite countries in 2009 than in the past decade, whilst USA and Europe just watch from the sidelines. From now expect USA to decline as a global economic power, not suddenly but slowly and steadily whilst the Russia quietly rises. 2013 may see 2 global policemen and not one like it is now.

One or more of these will impact your business in India. What are they? What is the potential impact? Is there something that you should do next week about it? What will you do to track the above events? If you are a garment exporter what should you anticipate this year? If you are an auto-component manufacturer what would you expect the prospects to be? If



you are an FMCG company do you need to bother?

What could the second level consequences be for your business?

It is little consolation that these trends will hurt China more than India because you should worry about the dragon turning its attention to the Indian markets for its own growth. Can China's geographic business options exclude India? Why else do you think that the Chinese political stance vis a vis India has softened since November? If in early 2009, they start dumping in India, goods that you produce, are you ready to handle to consequences? The legal process for anti-dumping is too slow. By the time, it works your business will already be hurt. What is your immediate game plan?

**Ignore second level
consequence of events
at your own peril**

**Signals relating to the Indian economy/
market**

The economy was coasting along very well despite a slowdown in export growth till the Government of India mistakenly decided to fight commodity-driven inflation instead of fighting the effects of the global melt-down that would be expected to visit our shores. Thanks to that, the year, 2008 witnessed a pretty rapid slippage from July completely offsetting the subsequent fillip provided by the declining commodity prices which lowered the WPI from 'alarming' levels. The drop in WPI inflation had nothing to do with Government intervention but the deceleration in the economic was certainly thanks to the Government's mid-year folly. Industry would, no doubt, have suffered from effects of the Global melt-down but the Government's wrong action, followed by inaction has more or less sealed the fate of the economy for FY09. The Government action to reduce money supply and raise interest rates ensured that Indian businesses were

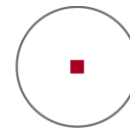
weakened instead of strengthened when they had to the weather the global turbulence. Businesses, where consumer demand itself depends upon the availability of finance, were virtually hollowed out.

It was reasonable to expect a rational reversal of these policies by the Government at least by end September but the Government was in denial till end November. In Marie Antoinette style, our Finance Minister prescribed that industry could eat cake if they could not afford bread (drop prices when margins and business volumes were already dropping because of high interest rates and non-availability of finance). The signals are now clear that the Government will come up with some serious packages in January 2009 to revive the mother sectors of the economy, viz. Construction (housing and infrastructure), Automotive and Textiles, on which a large number of industries and service businesses depend. While it is better late than never, the fate of FY 08-09 has been sealed by the delay. GDP for the year will be in the 6 range and not in the 7s which was possible earlier.

What signals can we now see in India, that are relevant to industry in 2009?

Things will be better in India than in the rest of the world. That is mainly because there is an underlying viability in the economy due to low cost structure, growing incomes, good agricultural output in this year and the banking system is not broken as in the West. Thank God, the global crisis happened in 2008 and not in 2011, because Indian banks had not yet fully adopted the bad habits of the western banks. They still have a decent lending portfolio and manageable bad debts.

- *Consumer confidence is low and uncertainty prevails...will need a strong trigger to reverse it like good corporate news (good performance and re-hiring surge)...will drag on till the June 09 quarter results are published in July*



- *Interest rates will be lowered and Liquidity will be improved* as is being done all over the world. India has no choice but businesses will not have adequate liquidity for most part of the year. Banks will return to consumer financing but will not go berserk as they did in 2006 and 2007.
- *Serious plans for starting infrastructure projects* will be effectively put in place by the Government ...will help cement, steel, and several other businesses besides creating employment
- *Direct and Indirect taxes may be reduced (even at the cost of deficit financing)* to put money in the hands of consumers
- *Real estate buying is being postponed, prices have dropped and big builders are illiquid....*interest rate reduction will soothe the mood but the real trigger will be the capital market (people need to feel rich to buy real estate or feel that prices will rise in order to speculate)....capital market recovery may be after mid 09 but market pundits feel that the bad news of 2009 have already been factored into the current share prices. The overall corporate results for the Dec 08 and March 09 quarters will not be encouraging.
- *Many companies were close to being illiquid by end 2008.* There will be closures and acquisitions especially in the SME category before mid 2009. This is an opportunity and a problem
- *Discretionary expenses are being postponed.....*restaurants, movie halls, big ticket purchases at malls are reporting significant drop but consumer demand is not dead
- *Reduced working days in many industries* (especially automotive and exports related), because of poor off-take...there are signals that banks will

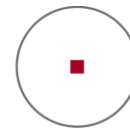
be persuaded to substantially up vehicle financing but exporters will continue to suffer. A good dose of liquidity injected by Banks in January-Feb will result in some improvements for the Commercial Vehicle industry, but good tidings will come only when the volume of goods to be transported rises along with the whole economy

- *Terrorist attacks have increased and there is no effective solution to curb them as yet...they will continue in 2009. But the Government of India is already launching a massive diplomatic campaign to across the globe to focus the flood lights on Pakistan and is taking steps to show the world that India is a safe place.* Hence investments and tourism, which have suffered badly due to recession and the attack on Mumbai on Nov 26, could be expected to return once the a new stable Government is in place that looks like it is in control of the economy and security
- *Political brinkmanship in Pakistan can keep war hysteria high* though the

Things will improve in India in the second half of 2009 if there is no war with Pakistan

year till either the military or the civilians take(s) effective control...war cannot be ruled out and if it happens, it will be ruinous for India and Pakistan

- *Period of lull at the wrong time* There will be a period of 3 months or so from March onwards when no major decisions that are required to be taken by the Government to help the economy/ industry survive the effects of the global recession will be taken because of the pre-election cool off



requirements. This is the period to be most carefully watched

- *Fractured mandate at the polls in 2009* will continue to make it difficult to take quick and bold decisions although being the first year in office, decisions are easier to make....expect to fend for yourself from March till the new Government settles down but by then benefits of the packages that may be announced in Jan-Feb 09 by the Government will start bearing results. The economy can start looking up from mid 2009
- *The Russia (and countries in its zone of influence) will become an alternative market for Indian exporters* and India will try to cosy up to them. OVL's expensive investment in Russia is just the start. Harried Indian exporters of goods from garments to tea, will try diversify their customer base to enter those markets. They have already started probing Japan and Asian countries.

What does all this add up to?

The second half of 2009 will be better than the first half and will be the start of an economic upswing for the Indian economy. However, 2009 will not be good for all. The winners will be those who change the way they work to adjust to the new reality, which is volatility. There are too many tactical things to list when it comes to the perspective of individual businesses but at a general level, there are 6 issues worth considering. Companies will need to

- be very flexible to deal with volatility
- be quite liquid
- be very innovative
- have very quick response time to deal with changes in the market environment
- have their ears close to the ground to pick up and interpret early signals
- get closer to their key customers and be part of the customer's solution

Whilst all Indian companies will agree that it is important for them to not just survive but to do well in 2009, very few of them can honestly claim that they are where they should be on any of these 6 issues. None of these can be achieved by minor tweaking of their present business system and configuration. Serious transformation work will be required to attain them.

Make sure that you are not easy prey for another hunter. It need not be '*Que sera, sera*' (what will be, will be).

About Avalon Consulting

Avalon Consulting is a premier management and strategy consulting firm. The firm was set up in 1989 and it specializes in providing solutions to business problems in the areas of Strategy Development and Implementation, Organisation Transformation and Innovation for clients in India and abroad. The firm has offices in Mumbai, Delhi and Chennai.

About the Author

Raj Nair is the founder and Chairman of Avalon Consulting. He has over three decades of experience in strategy consulting for a diverse set of verticals. Throughout his career, Raj has been known to be a thought leader and a pioneer in the use of innovation to create competitive advantage. He serves on the boards of several companies and industry organisations. Raj holds a B. Tech from Indian Institute of Technology, Mumbai and a PGDM from Indian Institute of Management, Ahmedabad. Raj can be reached at Raj.Nair@consultavalon.com