

Mid-year update to our 2010 Economic Outlook

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The global situation:

Now is an exciting time to be a global news journalist. There is no one single underlying threat which is paralysing global confidence, more a series of cracks in the ice which taken collectively have an insidious, creeping impact on individual confidence. From the threat of war in Korea and Iran through piracy in Africa to the oil-stricken shores of America it is fair to say we are not making life easy for ourselves. Nature is playing its part with the frequency of earthquakes and tsunamis rising and the ash-laden skies of Europe, whilst only a short interruption, have exposed the greater concern that the last 500 years have been exceptionally quiet from a volcanic perspective and a return to the historical average level of activity will be much much harder for modern man to cope with.

That said, recent research indicates that even events as big as 9/11 only affected 0.3% of GDP for one quarter, but that research rests on a number of assumptions and struggles, ultimately, to iron out other factors – or even decide which ones are related. The reality is that a large chain of cause and effect can never be accurately assessed. Here is the most pressing example from that cauldron of insincerity, the EU.

Greece is the best proof business consultants could wish for that just because you want something to happen, and you say it's going to happen, doesn't mean it should or it will. It just means the problems will surface later. Now, no-one believes the EU's rescues package will work – and even if they do they cannot persuade their electorate why they should pay for Greeks to retire early. As a result, everyone is still very guarded with their cash. Banks worry about each others' exposure to sovereign debt (or BP) and want to keep as much of it tied up in safer loans. This drying up of capital, like the drying up of the land, slowly stifles activity. It also gives the advantage to the incumbent over the innovator, making markets less competitive.

Also, let's not overlook rising resentment. The 'Tea Party' movement is far from over and will spread through other countries as the middle classes finally get angry – at paying for fraudulent bankers, slovenly beneficiaries, bloated bureaucrats and corrupt politicians. While it won't presage civil war, it will make politics less predictable and less consistent. That of course is mainly a N Hemisphere problem (unless you see the Super City as a cunning plan to sweep Act out of the next Parliament by pinning all of the dissatisfaction on Mr Hide) - as very good quality of life makes the threshold for real dissatisfaction so much higher in NZ than the rest of the world.

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Domestic savings rates have risen dramatically (although from a negative starting point, they are now still not high) but this is not flowing through into available capital as most of it is merely reducing debt incurred in the noughties. It remains lower for Generations X and Y who still feel less than optimistic about the prospect of affordable home ownership.

Expect to see inflation make a steady comeback. Economists – and governments – are realising that ultra-low inflation is not the panacea it seemed to be. Higher inflation allows for real wage cuts by not increasing wages to match (far far easier than strikes as a result of actual numerical cuts) and allow governments to erode their debt.

And here in New Zealand:

The banks will continue to throttle the life out of many businesses. Cashflow constrictions in larger corporations will continue to wreak havoc with their suppliers and contractors, filtering down to all levels of the economy. Their suppliers and contractors should not look to the banks themselves for help – they are reluctant to lend to dirty businesses with real people who they have to actually talk to when they can lend to (some) governments for less effort and less risk.

Serious differences remain in close or similar markets with one steaming ahead where a similar application or customer group is dead in the water. Margins will be threadbare in markets served by 'zombie companies' - ones whose owners cannot sell on for the price they need, and who persist inefficiently with poor margins, often freehold owners of their properties as well.

Over-zealous purchasing – especially by larger organisations – is a rising threat to quality of business. Confident they have – and should exercise – all the power, purchasers will insist on price reductions which go beyond what allows for sustainable business by their supplier. Why is this so prevalent? Firstly businesses weakened by cashflow drought (or zombie companies) will often roll over and take it, even though like the drug user they are sweetening short-term pain at a potentially fatal long-term cost. Secondly purchasing, like everything else, has to improve results from one year to the next. With a lower turnover of products (less innovation, less change) and less stock management issues, the most obvious area to demonstrate value is being price-driven beyond the point of common-sense. There has to be something in it for everyone, otherwise a 'value chain' becomes the bonds of slavery.

There is a substantial problem in New Zealand with the allocation of capital. The lazy and cowardly enforcement of investment regulations is disastrous for this country. Let's be honest, a lot of people should have gone to jail for the related-party transactions which crippled many of the finance companies. Capital sits idle while companies thirst for cash to innovate, all because there is no trust in the management of other people's money. When even Kiwisaver providers are clearly pulling the wool over people's eyes, who can blame people for only believing in bricks and mortar?

What you should do

1. Stand firm on margin

There comes a point where you should refuse to lower your quote. It is not being greedy or stubborn, just reflecting that you have costs and must make a profit in order to justify the risk and the capital invested – just as your customer must. In taking a job on, you are normally denying yourself the ability to fulfil others – either because of limited stock, production resources or the sales ability to pursue additional prospects.

If you reduce your Gross margin, it can have crippling consequences. However, you should balance that with a recognition that what might technically be a Cost of Goods & Services (production wages) is actually an overhead for the purpose of this exercise given that you won't make them redundant on any day you have no work. A **good** understanding of the costs you incur – and need to meet – with your work is essential in order to be able to say confidently where the point is below which you will not go.

See this excerpt from our Comparative Graphs which quickly and powerfully show the consequences of changing one factor in an equation. For the full Tables, please see your BMC consultant. As you can see, operating at a 35% GP, discounting by 4% needs to result in a 13% increase in volume just to stay in the same place. Ouch!

Your GM is	15%	20%	25%	30%	35%	40%	45%	50%	55%
Reduce Price by:	<i>Percentage increase to former sales volume required</i>								
2%	15%	11%	9%	7%	6%	5%	5%	4%	4%
4%	36%	25%	19%	15%	13%	11%	10%	9%	8%
6%	67%	43%	32%	25%	21%	18%	15%	14%	12%

2. Do a good sales analysis

Do not persist with historical beliefs (especially those from long-serving sales staff) that X and Y are good customers. Analyse who spends what, how regularly, for what margin and how well they pay. Then decide who your good customers are and go and find more of them.

3. Move to higher margin markets

Every pricing decision is a combination of Price, Service and Quality. Sellers hope their offering's combination of price for a given level of quality and service is what customers were hoping for. Changing the trade-offs can be considered a paradigm shift by allowing you to provide better of one factor without reducing the other 2. Therefore, people are less price-sensitive when Service or Quality are more important to them. You must find those customer groups and orientate your offerings to meet their needs.

4. Consider the effect of inflation on your pricing

We have seen a lot of exchange rate fluctuation – and will see some consumer price inflation, and whilst labour costs are static materials costs have risen in many areas. Review your pricing, and work out how, when, how much and in what areas it should be changed. Be imaginative - consider overall rises balanced by either increased discounts for loyal customers maybe or prompt payment discounts.

5. Go for margin once you have got the job

Make efficiency your religion in 2010. Do not waste a scrap of material or a minute of time. Running at 90% efficiency makes most staff complacent. Use that 10% spare to make everything as tight as possible. Your example, your consistency, your explanation of how important every tiny action can be - is critical.

6. Revisit your sales strategy

If you found it hard to imagine where or how you could pursue points 1-5 you need to look at your market, your value chain and your whole environment. It has changed, and now you need to know it more intimately than ever before. Book a day with your staff and work out where you are going to go.

7. Risk Management

Look at what your business relies upon – people, materials, machinery, communications, systems – and identify the most likely to fail with the greatest consequences – and then try and reduce the chance, or the consequences. Often, you will learn a lot from doing this in other respects, too.

8. Cashflow

There are five months to get your cashflow sorted before the summer. In theory, each month should make 20% of the progress you need. This is not just a question of not spending – far from it, it is actually preparing yourself for a period of strenuous activity and less reliable consequences:

1. Plan raw material purchases – rigorously review usage.
2. Try and dispose of unwanted stock and assets now.
3. Review which customers you believe will pay late (or worse) and make a decision on how they will be handled in the run-up to the summer.
4. Plan the cashflows themselves.
5. Plan investment expenditure for the coming 12 months.
6. Make realistic, seasonally adjusted targets for the next 12 months.
7. Get into the habit now of rigorously forecasting forward workload. It is your Peace of Mind.

We hope the insight above has helped you gain a better idea of how the world is moving and how the distant shores of NZ are affected by the mighty currents in events afar. Take this opportunity to make some plans and set some goals for the second half of the year – which is now about to start. The BMC is experienced in tackling all of the issues above and can help as little or as much as is appropriate. Call 0508 843 262 for more details.