IG
Partners

Leveraging Expertise for Competitive Advantage

"The time to buy is at the point of maximum pessimism"

---Sir John Templeton

March 1, 2009

Dear IGP Clients and Friends

We thought it an appropriate time to weigh in on the economy, what it means for you and what potential actions make sense for you to implement in the coming months.

First: Recessions are a recurring feature of the U.S. economy

The United States has suffered through at least one major recession each decade over the entire 20th century (1900-1999). And this is the second recession in the 21st century which is nine years old: so neither the pattern nor the timing seem to be changing.

Second: Hysteria makes money for the media – accuracy does not

Remember that American news is a "profit making" service in the media world and telling the public that this recession isn't much different from previous recessions doesn't make headlines or money. Therefore, "chicken little the sky must be falling" has become the mantra of the evening news shows. And while we think academia is a pristine environment, professors must "publish or perish" and in today's world they must garner grant money to keep their departments and themselves professionally alive. Once again, academia is playing to the media's hysteria for its own purposes. We find the symbiotic relationship between academia and its largest funding source, the federal government, interesting since congressmen continually quote from academic papers which they funded.

Third: Analyze layoff percentages not layoff numbers

While we agree the layoff numbers are staggering, layoffs as a percentage of each company's total employees have been under 10% except in the financial services, auto and retail sectors. Let's face some hard facts, we have had almost 20 years without a general recession (we look at the dot.com bust as a "sector-based" recession) and many companies were overstaffed. Any senior executive knows that a company has at least 5% "dead wood", employees that should have been fired but their supervisors could not make the difficult decision and an additional 5% of the employee pool are "underperformers". This makes up the 10% layoffs that are occurring. And why are these layoffs occurring simultaneously? Companies don't want the bad publicity from a 10% layoff which can affect share price, corporate stature and customer confidence. So even though companies know that they need to "clean house" they defer the decision. A recession offers the perfect cover for a layoff and since recessions occur on average only once a decade, everyone eliminates employees at essentially the same time.

Fourth: The credit crisis is compounded by action from Washington

Let me preface this paragraph by saying we have a very dim view of politicians on either side of the aisle. So no matter which party is in power stupidity repeats itself. Obviously when banks are having operating problems, such as the sub-prime meltdown credit dries up. The problem was that the sub-prime debt was so large that it had to be syndicated among numerous banks. That means it was like the school-house flu, one person gets it and passes it on to the rest of the family. By the way, as late as 2005, Alan Greenspan was touting the virtues of the sub-prime mortgage.

> *"Innovation has brought about a multitude of new products, such as subprime loans and niche credit programs for immigrants. With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers. These improvements have led to rapid growth in subprime mortgage lending...fostering constructive innovation that is both responsive to market demand and beneficial to consumers"*
>
> *--Alan Greenspan (April 8, 2005)*

However, not all banks "drank the Kool-Aid" so to speak. Bank of America and Wells Fargo had no sub-prime mortgages on their balance sheets. (their current sub-prime debt results from buying institutions like Countrywide and Merrill Lynch at the behest of the Feds). The problem that exists today is politicians on the evening news asking why there is no available credit. They fail to mention that they having berated federal banking auditors for missing the boat on sub-prime mortgages and flushing all of these auditors out of Washington with the edict to let the bankers around the U.S. know what's what and who's in charge. Numerous banks in the Bay Area have had unannounced audits where the Feds have intimidated senior bank officers about their previous decisions on credit risk. And you were wondering why there is no credit? Remember we are speaking about politicians which mean speaking out of both sides of their mouth comes naturally.

Fifth: This is the worst recession since the great depression

Well, that statement makes a tremendous headline, scares the heck out of everyone but is totally false. Both the recessions of 1973-75 and 1981-82 were similar in severity to this one. Actually the 1973 recession was very similar to this recession in that it also had a financial sector meltdown. Americans have short memories. We remember the dot.com bust (1999-2000) and barely remember the bio-tech meltdown (1989-1990). However, both these recessions were "sector-based" and had minimal effect on the general economy. In fact, the dot.com bust actually helped many mainstream businesses buy enormous amounts of telecom equipment at bargain basement pricing, thus creating the Internet-based society we now enjoy. This recession is an old-fashioned broad-based recession with almost all sectors feeling the downturn. However, the good news is that each of these old-fashioned recessions (73 & 81) lasted between 16-17 months. This means we will likely see a recovery staring in the second half of 2009.

Sixth: So where are the VC's in all of this financial mess?

The VC model is essentially broken beyond repair (see Richard Brenner's article in the San Jose Business Journal (2/6/09). The existing model assumes 8 failures, 1 breakeven and 1 wild success out of every 10 portfolio investments. This results in a 20% compounded rate of return over the life of the fund. So what's the problem? First, the 1 wild success was assumed to be an IPO in a spectacular growth market.

Since the passage of Sarbarnes-Oxley the U.S. IPO market has evaporated and will never return to its prior vibrancy. Without outlandish multiples from irrational IPO market share pricing VCs can't make up for their 80% failure rates. While there is a reasonable merger and acquisition market the VCs have not positioned their portfolio companies to take advantage of this type of exit. Most VCs see an M&A exit as a failure to go IPO. (An interesting, but little known, statistic is that less than 1% of all VC-funded companies actually exited through an IPO) In fact the industry return on investment since 2000 has not been 20% as predicted but -0.7%. (see Forbes 1/12/09 Venture to Nowhere). But, remember the VCs raised over $28 billion in 2008 and $35.5 billion in 2007 and must put that money to work as quickly as possible to achieve their internal rate of returns. They can't hold back on investing forever.

There are currently over 700 venture capital funds. Industry pundits are in general agreement that the number will shrink in the next two years by 200-300 firms. This market correction will make fundraising more difficult but it is assumed to assist in increasing returns since many believe there is too much money seeking too few good opportunities making valuations more difficult.

Seventh: Our housing market is in a complete mess

Well, yes and no. For over 50 years the home ownership in the U.S. was very stable at 65 million households. Starting in 2002, with the development of the sub-prime mortgage the number of home owners rose steadily to 69 million households in 2008. So why should it be a surprise the housing foreclosure number that the media and Washington toss about most often is 4 million homes (69 million versus the historical 65 million households). We were discussing the issue the other day when the parts manager at our local auto dealer told us this story. One of his employees was having his house foreclosed and wanted to know what to do. He had "purchased" his $400,000 home with no money down using an extremely low mortgage interest teaser rate for two years on his mortgage. Now for those of us who own homes, we have been told the PIT (Principal/Interest/Tax) is approximate $1,000 per month for every $100,000 of mortgage. So with a $400,000 mortgage his monthly PIT would be approximately $4,000. The problem, in addition to the value of his house dropping below the value of the mortgage, was that this employee only made $4,000 per month gross before taxes. Once the "teaser rate" finished he couldn't cover his mortgage payment. Another interesting number is that 80% of the sub-prime mortgages were made to speculators and those houses were not "owner occupied". So gang, we don't have a mortgage problem we have a "renter's crisis". If you put nothing down and can't afford a normal mortgage interest rate you haven't purchased your home you have just taken another form of rent. By the way all of the politicians in Washington were fully aware of these issues and authorized, even pushed, Fannie Mae and Freddie Mac to support this insanity. Reason why? New home owners re-elect their congressman (Democrat or Republican). In typical Washingtonian response, nobody knew anything about this growing mess, but just read the Congressional Record and an entirely different story unfolds.

Eighth: US. productivity must be in the toilet

Actually, just the opposite. Productivity in the fourth quarter of 2008 rose just over 3%. Domestic companies have reduced personnel faster than the reduction in product demand. Stated in more negative terms we have laid off more employees than the decrease in sales. While this is awful news for those out of work, it does mean rehiring will pick up faster once the economy turns around. Hopefully, these preventive actions will shorten the pain of unemployment for those caught in a situation not of their own making or control. And let's not forget that U.S. workers continue to be the world's most productive: which why we are seeing selected reversals of offshoring.

So what do we do now ?

1) Deal with the under performers

Reduce your workforce in a sensible manner. The benefits of a market driven reduction is that you don't have to write PIPs (Performance Improvement Programs) for those being laid-off or wait months to complete a review and assessment process. Be observant about state laws concerning plant shutdown. Historically, layoffs over 50 employees required prior notification, now many states have or are in the process of reducing that number. Check first to properly address these issues. Remember, no one likes firing an employee, especially if they also hired them, but the best rule is to be loyal to your best and most productive employees.

IGP Capabilities:

1. **IGP can help identify under performers with a formal review process**
2. **IGP can assist in the layoff process and develop procedures to meet legal requirements**
3. **IGP has a 4 day outplacement clinic**
4. **IGP can implement annual reviews, peer review, 360 reviews and PIP programs**
5. **IGP can work you through the legal HR issues such as plant closing laws**

2) Reduce costs sanely

It never fails to amaze us that VCs and sometimes management don't take industry differences into account when reducing costs. In manufacturing companies, generally 70% of overall cost is in materials. That means a 7% reduction in material costs equals a 25% reduction in the entire workforce. On the reverse side, a software company usually has 80% of its costs in manpower costs and less than 10% in materials. This means cost reductions have to start with personnel. It is amazing how many companies misidentify the best opportunities.

IGP Capabilities:

1. **IGP can work with suppliers to reduce costs**
2. **IGP can identify operations to eliminate unnecessary or hidden costs**
3. **IGP can assist in setting corporate benchmarks**
4. **IGP can analyze sales to determine profitability by customer or product**
5. **IGP can take on the delicate issues leaving management focused on mainstream issues**

3) Prepare for the rebound

We believe the U.S. will come out of this recession in Q3 of 2009. Now before everyone starts sending us disparaging emails about our prognostication let's discuss what that means in reality. First, economists couldn't even tell us we were in this recession until 12 months after it started. We are projecting a 1-2% increase in GNP in the second half of 2009 which is such a slight movement it won’t be noticed by most observers. It also means most economists won’t be able to confirm this rebound until Q2, 2010. However, it will mean credit will loosen up, VCs will be back funding new as well as existing companies and the overall pessimistic mood of the consuming public will start to turn hopeful if not optimistic. We believe the merger and acquisition markets will open up and companies will accelerate opportunistic acquisitions before the market overheats. Keep in mind that in the last 7 recessions the year following the recession the stock market has rebounded 31.5% on average. That means a Dow of between 9,000-10,000.

IGP Capabilities:

1. **IGP can reposition companies to maximize existing technological and sales potential**
2. **IGP can assist in building a revitalized and highly focused sales team**
3. **IGP can assist in “design for manufacturing” (DFM) products**
4. **IGP can address public relations, investor relations, marcom and branding issues**
5. **IGP can implement Intellectual Property Asset Management (IPAM) programs**

4) Be prepared to be first in line

A number of clients are speaking with us about raising funds or selling their business. Well now is the time to get in the front of the line. If it is fundraising, start updating your business plan, financial models and due diligence files. Ensure your PowerPoint slides tell an exciting business case, not just an interesting technology position. Start reviewing VC funds, strategic investors, PE firms, etc. to determine who will be a fit and want to invest in your business. Remember getting a meeting with a VC is not hard, but meeting with the wrong VCs can leave your business with the unwarranted reputation of be a “shop worn” story that isn’t fundable. Even in good times, it takes 6 months to close a financing round and you can easily add 3 months to that timing right now. What does that mean? Start your efforts immediately.

If you are looking for an M&A exit large companies generally want a 9-18 month period for potential acquisitions. Once again, it is time to shift into high gear and actively start your efforts.

IGP Capabilities:

1. **IGP can assist in developing new and exciting, achievable strategic visions**
2. **IGP can rebuild new and fundable business plans**
3. **IGP can produce effective bankable fund raising presentations**
4. **IGP has assisted numerous management team in their fund raising activities**
5. **IGP has lead over 30 M&A transactions as operating executives**
6. **IGP has lead 2 management teams in the sale of their businesses last year.**

IGP understands how difficult the current market conditions are to our clients. All of our managing directors have over 20 years of line experience and have been through numerous recessions. Let us assist you in developing and implementing proactive strategies to ensure meeting your long-term goals in spite of the current market conditions.

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Please contact your Innovative Growth Partner and feel free to discuss your views on the economy or discuss how we can assist your company through these difficult times.

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