Ritröð Samkeppniseftirlitsins

Are we entering a lost decade?

More effective competition is the cure against stagnation

Rit nr. 3/2013

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The state of the economy, i.e. a state of low profitability and productivity, calls for a special alertness. There is a real danger that this state will lead to increased entry barriers for both foreign and domestic parties, in order to protect the incumbent companies. Such a policy leads to diminished competition, lower productivity and a lower standard of living.

2

The pension funds have considerably increased their holdings in companies after the financial crisis. It is foreseeable that this trend will continue. The Competition Authority has worries about how opaque the ownership of companies is, i.e. about the opaqueness of the ownership of pension funds, banks and individuals through funds. It is a special cause for worry when institutional investors mutually own two or more competitors in the same markets.

3

The bank debts of the bigger companies have decreased considerably by the amortisation of debt, by court judgements in cases concerning loans in foreign currencies, and by paybacks. In spite of this the companies earn low profits and there are indications that their financial restructuring is not finished. Stagnation reigns in the economy and investment barely catches up with depreciation. This resembles the situation in Japan after the crisis in 1990, the so-called “lost decade“.

Contents

This study by the Competition Authority is based on data from 120 of the biggest companies in Iceland

The research data

- Financial statements of 120 of the biggest companies in Iceland from 2007-2012.
- Web survey on the financial status and the viewpoints of the leaders and managers of the 120 companies, sent to them in January 2012 and in June 2013.
- Opinions and viewpoints stated by the 120 companies in letters or in meetings in the period 2010-2013.
- Data and viewpoints the ICA asked for from the banks and the six largest pension funds in the summer of 2013.
- Public economic data.
- 100% response rate and 100% delivery of financial statements.

The 120 companies

- The operating income of the 120 companies in 2012 was in total about 1200 bn ISK, equivalent to 10 bn USD. This amounts to about 40% of the operating income of all Icelandic companies, with energy companies excluded.
- The companies operate in 14 sectors:

Fisheries	*Food production*
Production	*Contractors*
Retail	*Wholesale*
Hotels and restaurants	*Pharmaceuticals*
Gasoline retailers	*Transport*
Telecommunications	*Insurance*
Specialist services	*Automobiles*

The methodology of this research is described (in Icelandic) in Ch. 4 in report no. 2/2011, „Samkeppnin eftir hrun“ („The competition after the collapse“).
ICA refers to the Icelandic Competition Authority.

The ICA has tried to speed up the economic recovery

How can we work our way out of the problem? Examples of publications

2008:
Publication 2/2008 – Öflug uppbygging – opnun markaðar (Vigorous rebuilding – the opening up of markets).
Opinion 3/2008 – Ákvarðanir banka og stjórnvalda um framtíð fyrirtækja á samkeppnismörkuðum (The decisions of banks and the authorities concerning the future of companies operating on the markets).

2009:
Publication 2/2009 – Bankar og endurskipulagning fyrirtækja – stefnumörkun (Banks and the restructuring of firms – a policy).

2010 – 2013:
35 interventions in cases of bank takeovers of indebted companies.

2011:
Publication 2/2011 – Samkeppnin eftir hrun (The competition after the collapse).

2012:
Publication 3/2012 – Resurrection of companies – Profit generators or zombie firms? (Endurreisn fyrirtækja 2012 – Aflaklær eða uppvakningar?).

2013:
Publication 1/2013 – Financial services at a crossroad.
Publication 2/2013 – Is the lost decade ahead 2013.

Vigorous rebuilding – the opening up of markets (The report "Öflug uppbygging – opnun markaðar")

- Report published in November 2008.
- Analysis of 15 markets with emphasis on entry barriers for new or smaller companies.
- Possible remedies that would eliminate or lower these barriers were pinpointed.
- This report has been the guiding light of the operations of the Competition Authority after the banking collapse.

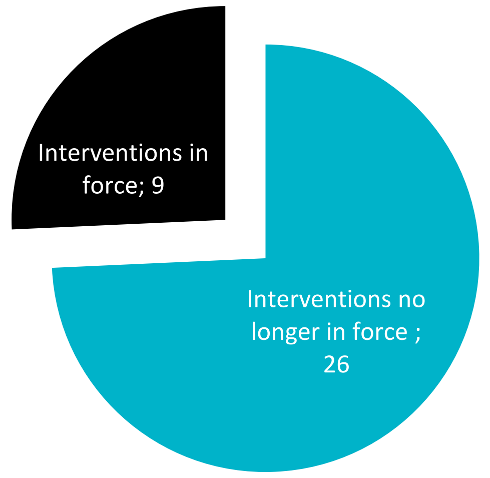
The Competition Authority has intervened in bank‘s takeovers of companies

The main contents of the settlements

- The bank were to sell the companies within a specified time limit.
- Rules set to ensure that the overtaken companies operate as independent competitors in the market.
- The banks were obligated to require a normal rate of return from the overtaken companies.
- The banks were forbidden to require the overtaken companies to do business with other companies in which the banks had business interests.
- Transparency in the future operations of the overtaken companies was sought for.
- The implementation of the settlements should be constantly monitored by the banks.

The interventions obligated the banks to sell the companies within a specific time limit

35 interventions 2010-2013



- Most of the interventions were made in 2010 and 2011.
- Banks seek other ways than takeovers to restructure companies.

1) Among the interventions that are still in force are interventions because of companies owned by The Enterprise Investment Fund (Framtakssjóður Íslands).

The Competition Authority has given clear messages

The messages aim to speed up the renewal and the rebuilding of the economy

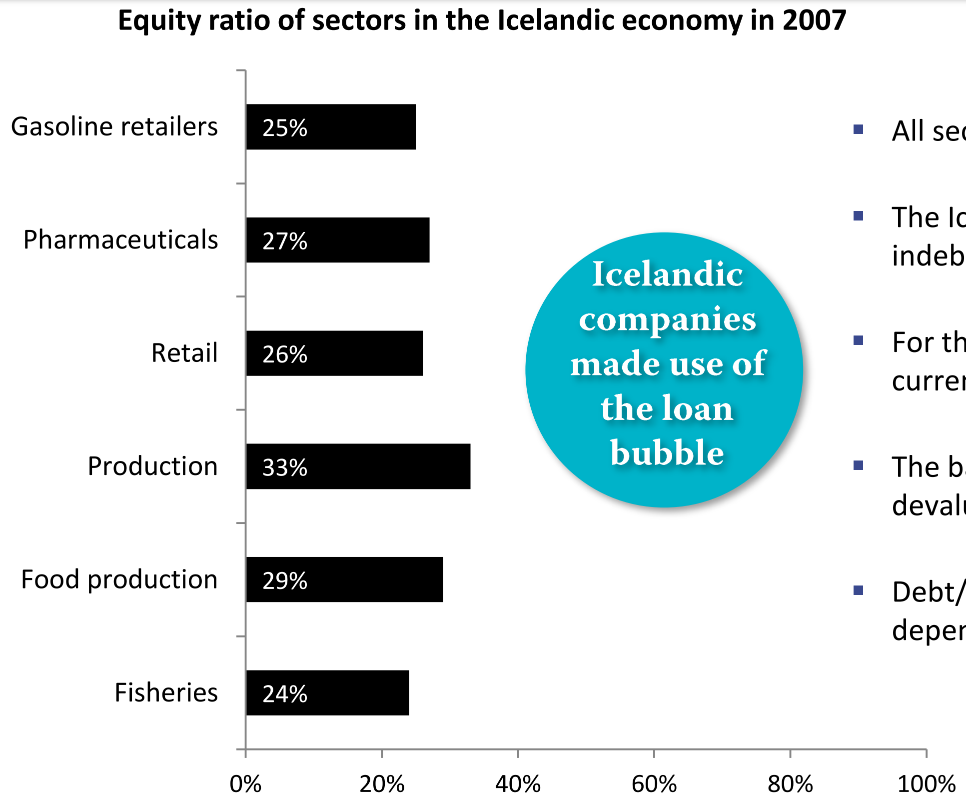
- Only those companies that are operational should be saved.
- The debts of the companies must be reduced – the enforcement of the competition act should not prevent this.
- The companies controlled by the banks must be operated with a normal profit motive.
- The companies controlled by the banks must be operated as independent competitors in the market.
- The companies must be relieved of the control of the banks as soon as possible .
- The interests of the society and the consumers are more important than the interests of individual companies.

Examples of overtaken companies

Contents

Before the banking collapse the economy was very heavily indebted and the companies were in a bad shape to face a financial crisis

The low equity ratio of companies shows how badly the companies were prepared for the collapse

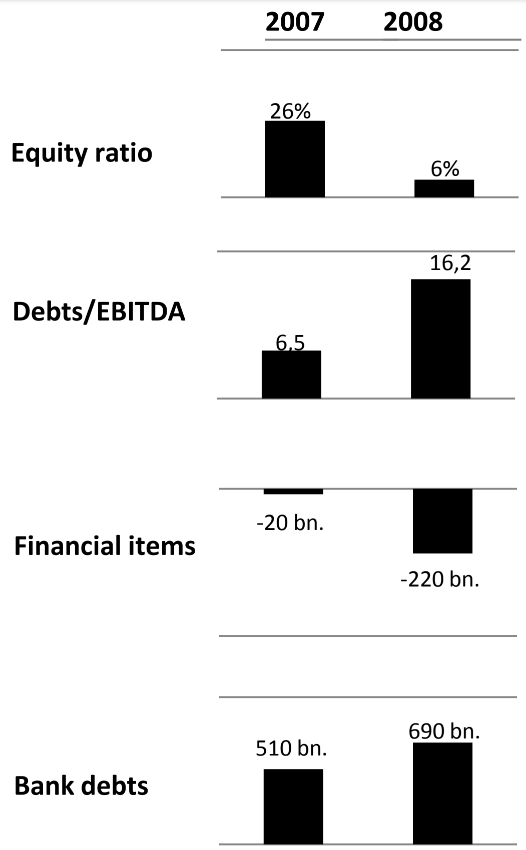


- All sectors had become very highly leveraged in 2007.
- The Icelandic companies were far and away more indebted than companies in neighbouring countries.
- For the most part, loans were denominated in foreign currencies.
- The balance sheets were therefore very sensitive to the devaluation of the Icelandic Krona (ISK).
- Debt/EBITDA multiplier was also very high or 4-7 depending on sectors.

1) The equity ratio is weighted average of each sector based on 2007 financial statements.

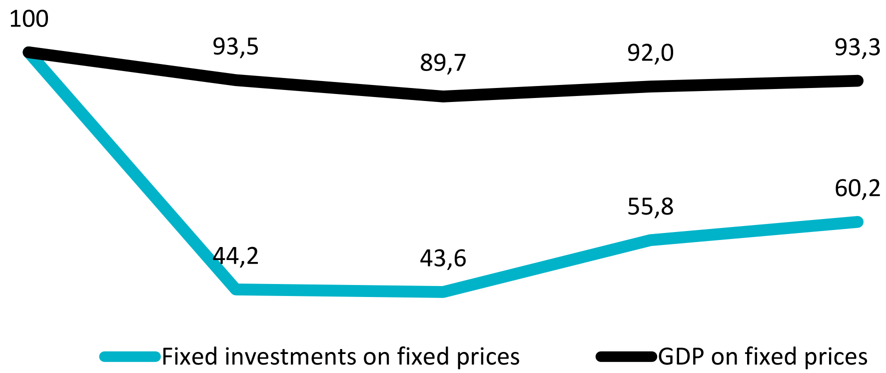
The financial crisis made the situation of companies extremely difficult

The economy hit a wall[1)]

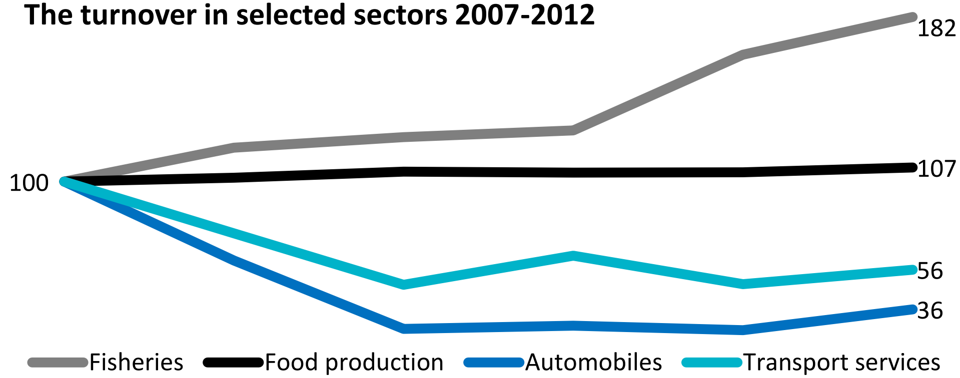


It will take the economy a long time to recover

GDP and fixed investment on fixed prices 2008-2012[2)]



The turnover in selected sectors 2007-2012

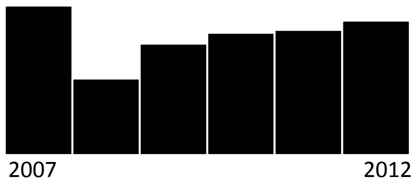


1) The percentages here are weighted averages.
2) According to data from Statistics Iceland.

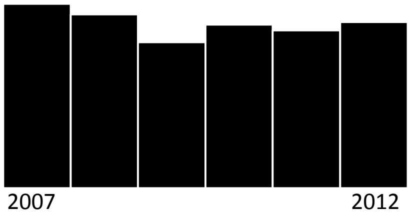
The financial statements of companies have taken extensive changes since the crisis

Profitability and turnover have contracted – very unequally amongst industries

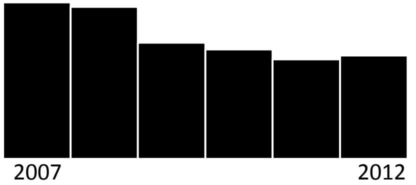
EBITDA (fixed prices)



Turnover (fixed prices)



Assets (fixed prices)



EBITDA contracted by half

The EBITDA of larger companies contracted by half between 2007 and 2008 but has been slowly recovering since then. It is now 10% lower than before the collapse.

This contraction varies however widely amongst the industries. The domestic sector is in trouble whilst the EBIDTA of export companies has increased.

Real turnover went down by 20%

The change in real turnover in the economy is very uneven and it is distributed throughout the sectors in a similar way as the changes in EBITDA.

There is however the difference that the change in turnover is comparatively much less than the change in profitabiliity.

Assets too highly valued

The book value of assets often badly reflects their ability to generate income.

Asset prices need to reflect better the yields of the assets.

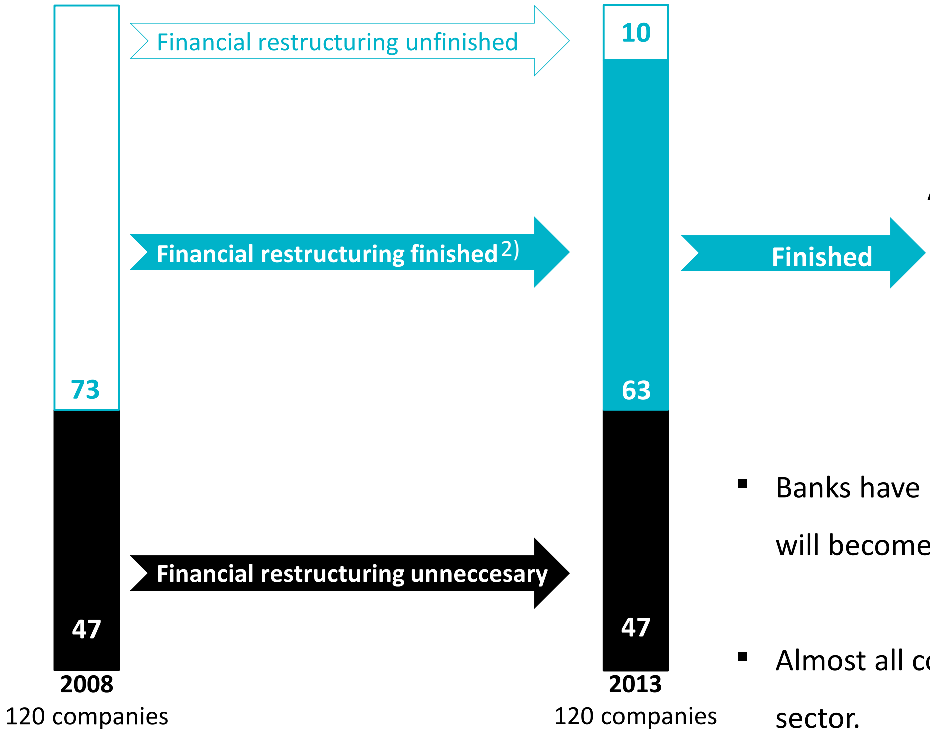
Most industries are run with a subnormal required rate of return.

The domestic sector refers to companies which have the domestic market as their only source of income.
EBITDA means profits before financial items and depreciation.

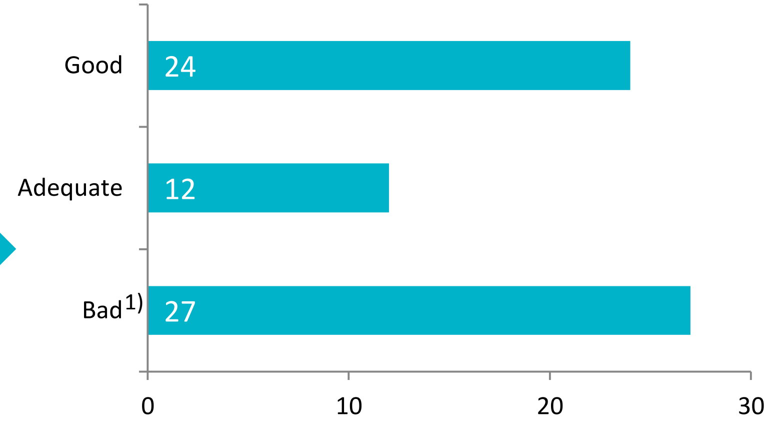
The first round of the restructuring of the bigger companies is now mostly over and their debts have been lowered considerably…

…but in spite of this … **…the finances of many restructured companies are in a bad state**

The progress of the financial restructuring in 2008 to 2013



The financial position of restructured companies

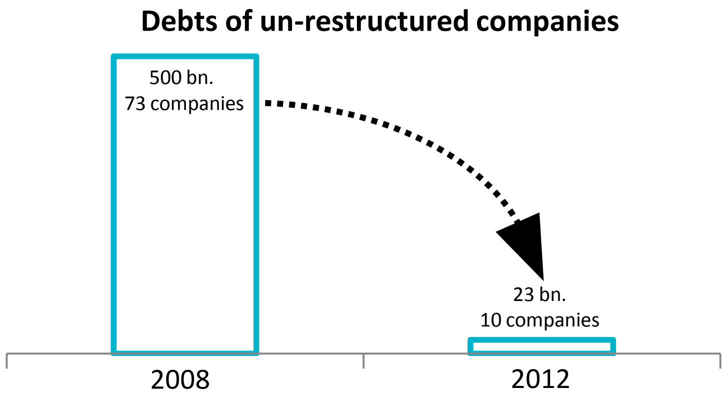


- Banks have restructured companies in the expectation that they will will become more valuable in the future.
- Almost all companies that are in a bad state operate in the domestic sector.

Companies that are in a bad state are the ones that have a negative equity value, i.e. the weighted EBITDA for the last two years multiplied by the estimated EBITDA multiplier for the sector minus interest bearing debt. A few companies that had negative equity value were transferred into the groups “adequate“ or “good“ because of other factors that had a positive influence. See further explanations in chapter 4 in report 2/2011. “Bad“ state here refers to “very bad“ state in older reports.
2) Few of the 120 companies have merged into other companies in the period and these companies are classified as “financial restructuring finished.“

The debts of those companies that still have to undergo the first round of restructuring are slight in comparison with 2008

Debts of companies that still have to undergo the first round of restructuring



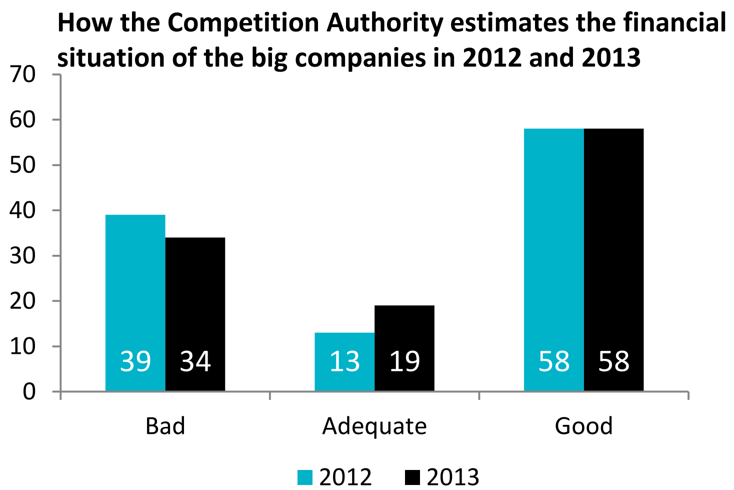
- 73 of 120 companies needed financial restructuring.
- Before the financial restructuring their debts amounted to about 700 bn. ISK.
- 10 of these companies still need restructuring and their debts amount to 23 bn. ISK.

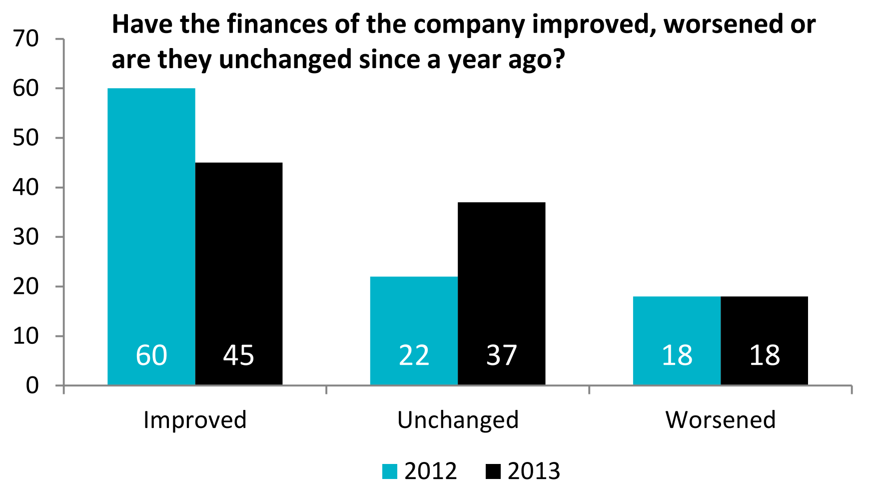
The survey of the ICA indicates that few companies are about to go through initial financial restructuring

- The survey uncovered that only 9 companies are in discussions with their claimants about financial restructuring.
- 31 companies consider themselves to have unfinished cases related to foreign currency loans – the effects on their finances are unclear.
- A judgement of the Supreme Court since June 2012 has not been reflected in the financial statements of companies, but it should be reflected in the statements for 2013.
  - It can be expected that the effects will not only be seen in the accounts of companies that are in a bad financial state.
- Companies are much less indebted now than after the collapse, because of Court judgements in foreign currency loans cases, amortisations and paybacks.

The recovery has slowed down, the managers think…

… which fits well with contracted economic growth





- Too many companies come out of financial restructuring too heavily indebted and many of them need still further assistance.
- The companies that are in a bad state are mostly financially restructured companies operating in the domestic sector.

- The managers had a much more positive view one year ago, this is a clue pointing towards a stagnation.
- The managers think the economy is improving, but there has been a slowdown of the economic recovery nevertheless since one year ago. The same companies express negative viewpoints as did so last year.

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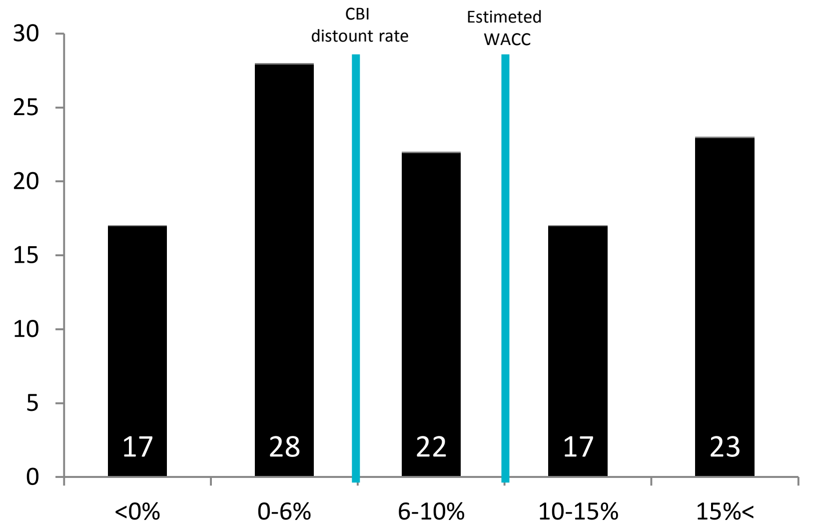
The operations of many companies are not sustainable if nothing changes

The return on capital in many companies bears a scant relation to their balance sheets

- The median value of the return on capital employed (ROCE) of the 120 companies was 7,9% árið 2012, the arithmetic average was 6,5% and weighted average 8,9%.
- The ROCE of about 3/5 of the companies is less than 10%, but 10% rate of return is equal to the estimated weighted cost of capital (WACC) of big companies in Iceland.
- More than one third of the 120 companies has a lower rate of return than the discount rate of the Central Bank of Iceland.
- It is to be expected therefore that the equity of these companies will decrease unless their profitability increases.
- This is similar to the situation in the „lost decade" in Japan.

Number of companies on each ROCE interval



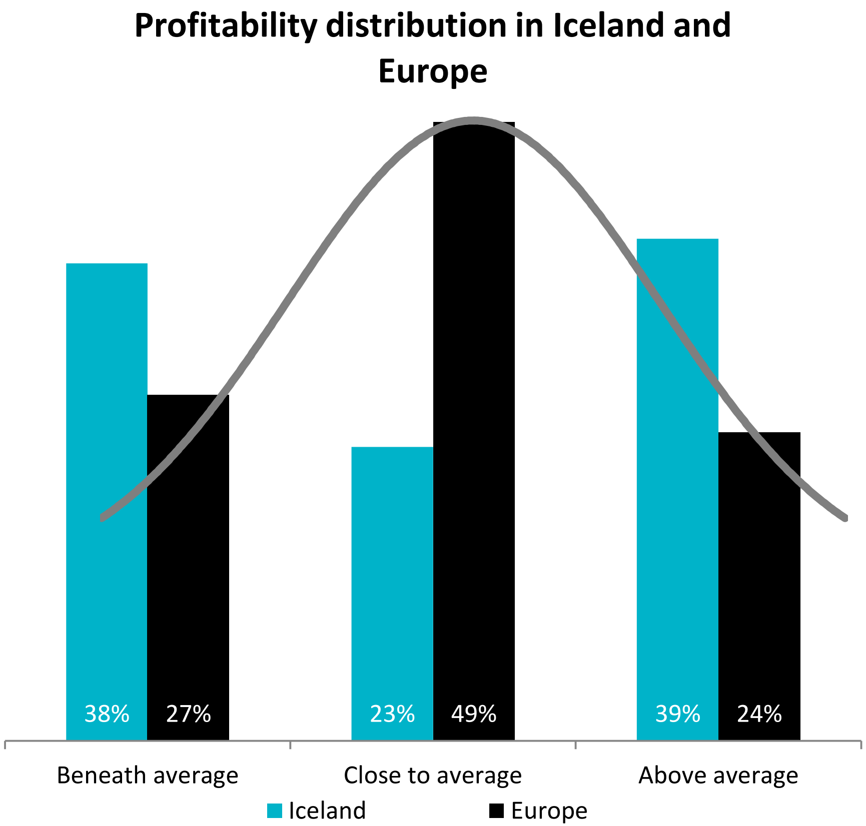
When the banks have finished their financial restructuring of the companies, expectations of increased profitability are built into their capital structure.

If the profitability of the firms does not improve, their equity will decrease. Many of them will therefore need financial restructuring again.

Return on capital employed refers to operating profit before interest rate payments and taxes against total capital minus short term debt: $ROCE = \frac{EBIT}{Capital\ employed}$
Estimated weighted average cost of capital is calculated from the formula: $WACC = (1-t) \times w_d r_d + w_s r_s$ This cost is estimated with reference to analysis of Icelandic companies in 2013 publications from various analysts. Clearly this cost is difficult to estimate with precision, considering the state of the financial market in Iceland.
CBI discount rate refers to the discount rate of the Central bank of Iceland.

The return on capital of Icelandic companies is either very good or very bad

An abnormal distribution of profitability



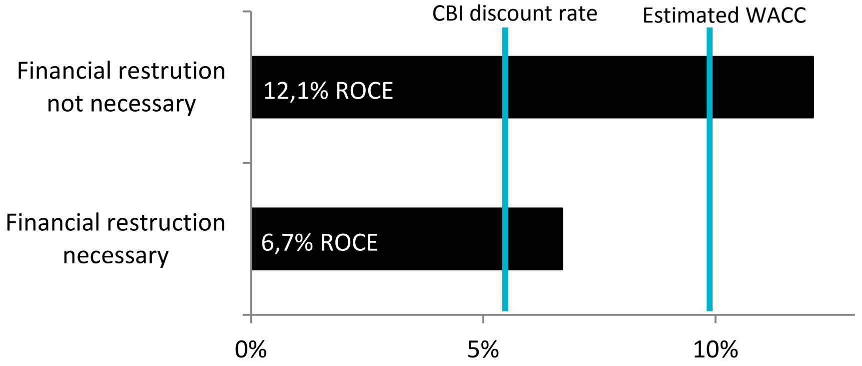
- There is a great variability in the capital asset profitability of the Icelandic companies.
- The balance sheets of the companies reflect badly how the assets generate earnings.
- The balance sheets of the Icelandic companies have not been adjusted to changes in circumstances since the collapse.
- It is abnormal how many companies are either much more profitable or much less profitable than the median company.

The profitability measure used here is return on capital employed (i.e. ROCE) and close to average is defined as +/- 2% from median value.
The European sample is listed companies according to Aswath Damodaran's database, the Icelandic sample are the same 120 companies that are covered in this report.

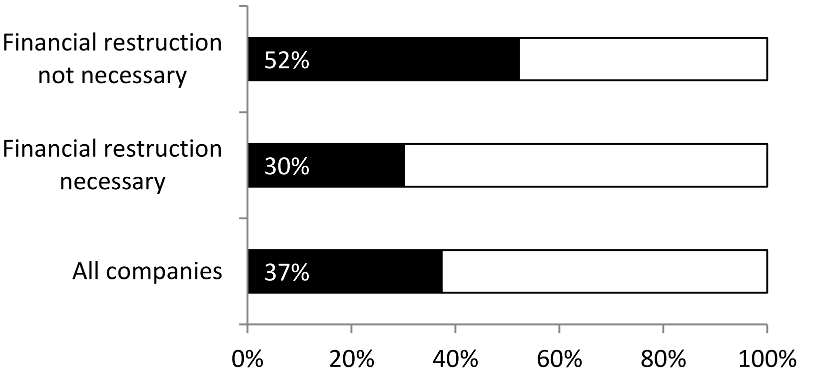
The restructured companies are in a much worse situation than those that did not need restructuring

The profitability of those companies which the bank have had to interfere in is less than normal

Weighted average of the ROCE of companies by whether they needed restructuring



Percentage of companies with ROCE higher than 10%



- The ROCE of 2/3 of the restructured companies is less than the weighted average cost of capital (WACC) and almost half of them have a rate of return which is lower than the discount rate of the Central Bank of Iceland.
- Just over half the companies that did not need restructuring earn a higher rate of return than the WACC.
- Companies come heavily indebted out of restructuring, and expectations about economic growth and better performance are built into the capital structure of the companies.
- 70% of restructured companies have unsustainable profitability.

The export sector flourishes, the domestic sector has a harsh time

In the work of the Iceland Growth Forum the economy was divided into four sectors

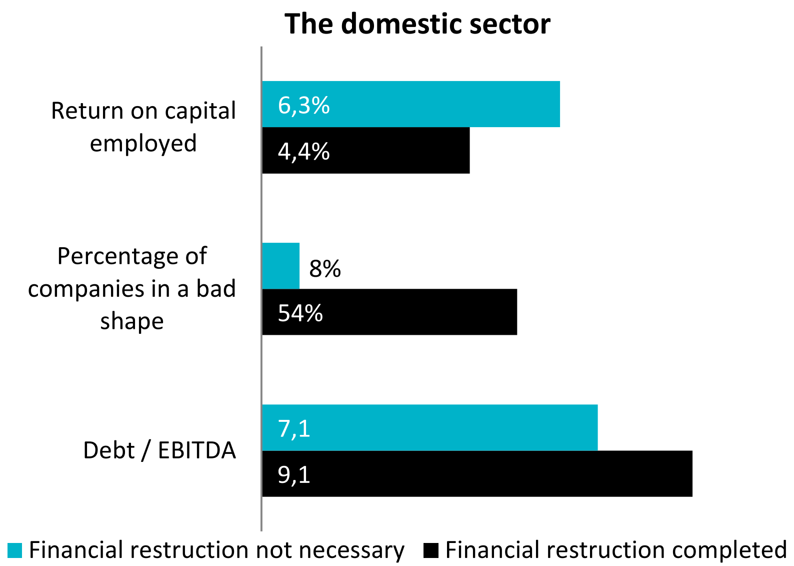
	Production	Labour force
The domestic sector	34%	40%
The public sector	22%	30%
The resource sector	30%	15%
The International sector	14%	15%
GDP	100%	100%

	Resource sector	Domestic sector
Debts/EBITDA	5	9
Equity ratio	37%	25%
Return on capital employed (ROCE)	12,2%	4,6%
Percentage of companies in a good state	82%	45%
Percentage of companies in a bad state	14%	34%

- The domestic sector includes all companies that earn all their income in the domestic market. The domestic sector is the largest sector in the economy.
- Fisheries, industrial companies related to the fisheries, and tourist companies are included in the natural resource sector.
- The economy is divided into two parts. Natural resource sector which is doing well, and domestic services sector which is doing badly.
- Return on capital in the domestic sector is in many cases not sustainable – and the weighted average return in the sector is lower than the discount rates of the Central Bank.

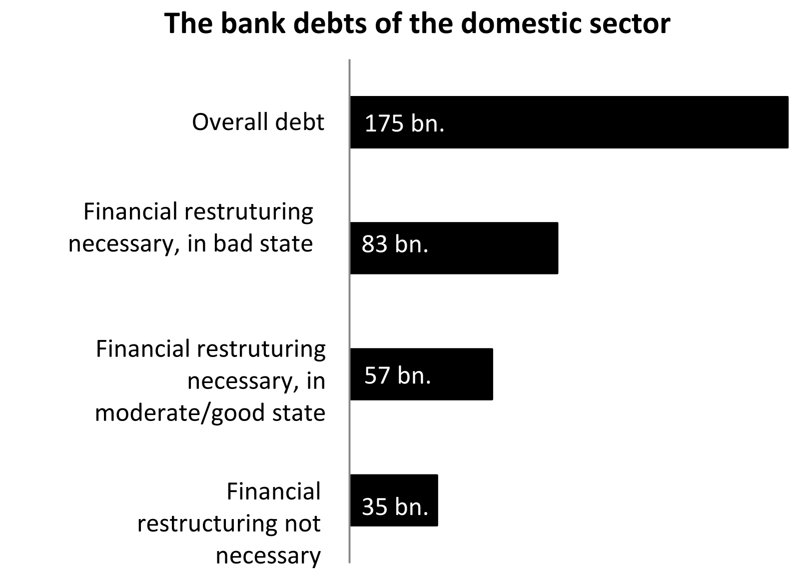
Restructured companies in the domestic sector will probably need further restructuring and write-offs

The operations of many companies are unsustainable



- These companies have extensive operations. The turnover of restructured companies was 460 bn. ISK (50 companies) and companies that did not need restructuring 250 bn. ISK (36 companies).

The domestic sector will probably need more write–offs



- The unfairness of well run companies having to accept that badly run competitors have their debts written off is often pointed out. However, this fairness problem seems to be less than often perceived, as the restructured companies are in general in a worse shape than those companies that never needed help.

Return on capital employed and debt / EBITDA ratio are weighted averages.

The cash flow statements of these 120 companies shows clearly how little has been invested

The cash flow statement of the 120 companies from 2009 to 2012

Cash flow from operations 340 bn. ISK	
Investing activities 170 bn. ISK	Financing activities -170 bn. ISK

- The cash flow is equally divided between investments on the one hand and repayments to financial stakeholders on the other hand.
- The funds generated by the operations of the companies are used to pay out to financial stakeholders, this is similar to the “ lost decade“ in Japan.
- Before the financial crisis the situation was dramatically different: more money was put into the companies in the form of loans and equity capital.
- Investment was higher in 2007 than through the whole period 2009-2012.

Possible explanations of low investment levels

- The profitablity in many sector is far below normal standards.
- Investments were high in the period before the financial crisis.
- The heavily indebted companies have difficult times in investing in profitable projects.
- Uncertainty in the economy and foreign exchange restrictions.

Very little investments

- Investments in the past few years have been similar in amount to the depreciation of fixed capital.
- Little investments in the fisheries in spite of high profitability.

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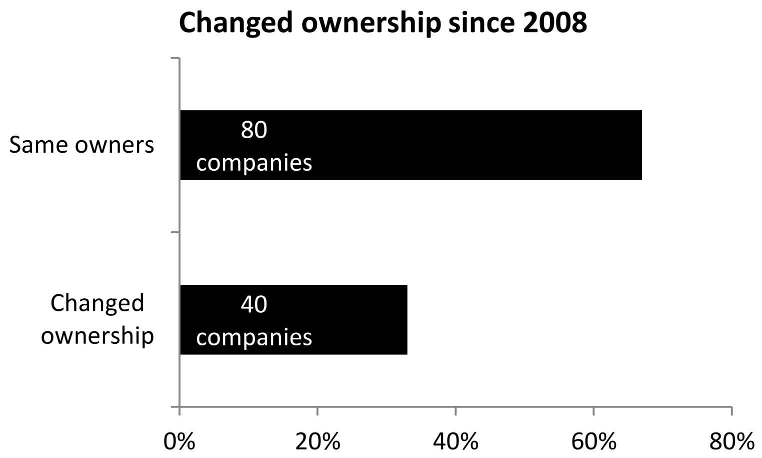
There has not been much structural change in the companies since the collapse

Controlling interest has changed hands in one third of the 120 companies



- Four of the 120 companies have been merged with other companies after the financial crisis.
- Nine companies have become bankrupt or gone through composition but their operations sold to new owners.

- In rare cases small units have been removed from bigger companies and sold, such as 10-11 from Hagar and Bluebird from Icelandair.
- Nevertheless, 11 of the 20 companies that had the highest turnover have changed ownership.
- Since the banking collapse the change in ownership equals that the ownership of 7% of the companies has changed hands every year.
- This rate of ownership change cannot be regarded as unnaturally high in an economy that is in equilibrium.
- It may be concluded that the banking collapse did not result in increased rate of change in ownership - rather the opposite – as ownership change was more common before the collapse.

Companies that have merged into other are classified as sold.

Pension funds own an increasing share in the companies but the banks have a decreasing share of direct ownership

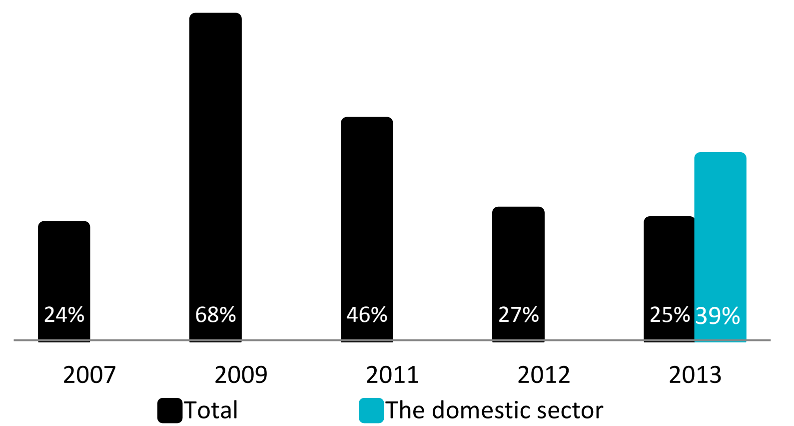
...but banks do nevertheless have all the power in a big part of the domestic sector through its indebtedness

Formal ownership

	2007	2009	2011	2013
Individuals	85%	65%	48%	56%
Banks	2%	11%	17%	9%
Resolution committees	0%	11%	12%	5%
Pension funds	2%	3%	9%	14%
Foreign owners	4%	3%	7%	6%
Other	7%	7%	7%	10%

- Formal ownership of banks and resolution committees has decreased by half between 2011 and 2013.
- The share of individuals and pension funds has increased between 2011 og 2013.

Banks in control in the bigger companies



- The banks have control over the bigger companies through direct ownership and through the indebtedness of the companies.

The ownership here is stated as the share of each category in the turnover of the 120 companies.

2/3 of the capital stock of pension funds is invested in listed companies

The Competition Authority got information from the 6 biggest pension funds about their direct and indirect share in the capital stock of Icelandic companies. These six pension funds own 160 m. ISK in the capital stock of companies and funds.

	Number of funds	Number of companies	Amount in bn. ISK
Listed companies		11	104
Innovation funds	4	30	3
Enterprise funds	10	20	42
Capital stock as a result of financial restructuring		9	11
Other unlisted		18	2
Total		88	160

- The capital of the pension funds is in high demand, because of how limited the capital funds are on the market, because how few investment opportunities there are, and because of the foreign exchange restrictions. The pension funds can be expected to participate in big corporate takeovers in the near future, and increase still further their stakes in the domestic market.
- The pension funds own about a third of the stock of the listed companies on the Nasdaq OMX Iceland.[1)]

1) According to an analysis issued by Arion bank on 9th of September 2013.

The opaque ownership of companies a cause for worry

...this leads to stagnation when owners do not fulfill their overseer functions

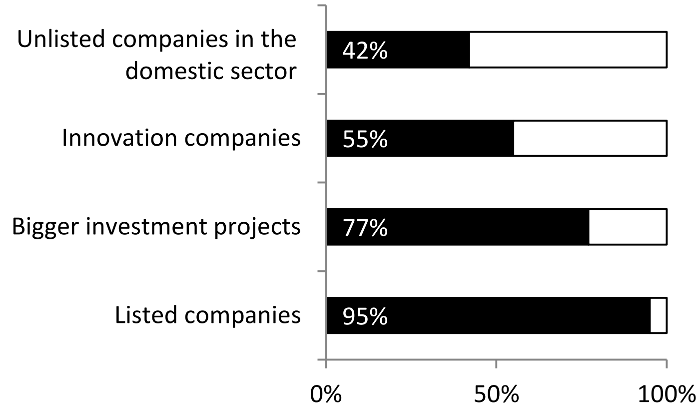
- To a great extent the ownership of companies is in the hands of institutional investors and banks.
- The pension funds will continue to be big participants on the equity market.
- When profitability is low there is little incentive to invest.

Managers think that hidden ownership is a problem in the economy

Do you think that hidden ownership is a problem in the economy?

Discernible antipathy to the ownership of the pension funds in unlisted companies in competitive markets

Do you think pension funds should invest in...



- Managers generally think that unlisted companies operating on competitive markets are not suitable assets for the pension funds.
- Investment opportunities refer to public infrastructure and energy projects.

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Competition is the most important single factor to encourage increased productivity

Why do we strongly emphasise competition?

- Creates discipline in the operations of companies
- Leads to new ideas, innovation and technical improvements
- Is conducive to efficiency in the use of productive factors

Increased productivity

> „Increasing productivity is by far the most important ingredient in economic development…
>
> …we have learned without doubt that the most important condition necessary for rapid productivity growth is fair and intense competition in all sectors of an economy“
>
> William W. Lewis
> The power of productivity

This slide is from the Economic Growth Forum, see samradsvettvangur.is.

Companies can be sheltered from competition in many ways but such a shelter decreases productivity in the economy

Restraints to competition

	Description
1 Monopoly or collusion	Collusion or an abuse of a dominant position in the market lessens the incentives to utilise the factors of production in the most efficient way.
2 Access to infrastructure	Access to infrastructure can be necessary for new entrants to gain a foothold in the market, for example, access to transport and telecommunications infrastructure.
3 Switching costs	If the switching costs of consumers are high, new entrants can have trouble gaining new customers.
4 Regulations and permits	Difficulties in establishing new companies and getting permits to start operations can reduce the incentives to establish companies and prevent new entrants to enter the markets.
5 Imports hindrances and subsidies	Hindrances to import and subsidies can shelter domestic companies from competition from foreign companies abroad.

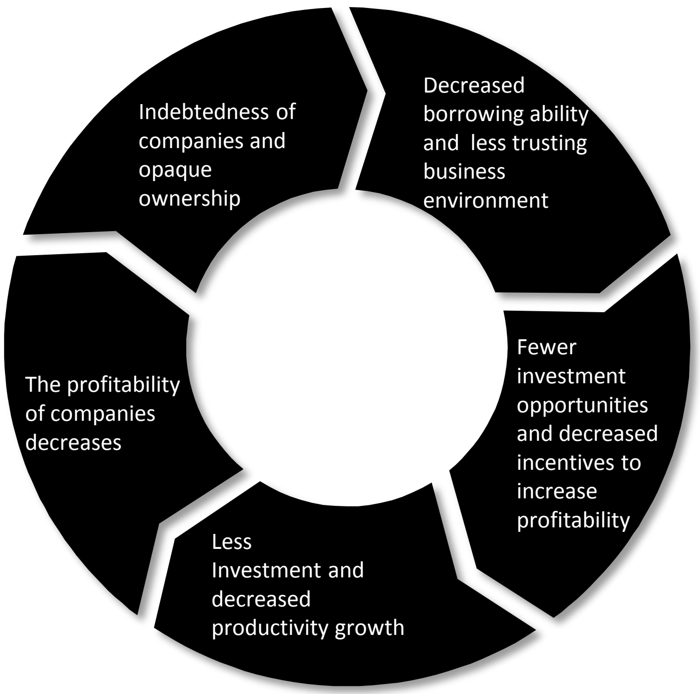
This slide is from the Economic Growth Forum, see samradsvettvangur.is.

Many indicators of stagnation and weak competition

Iceland

Japan 1)

Many similarities with „the lost decade“ in Japan



„The lost decade“ in Japan

The long lasting economic recession in Japan in the wake of a depression in the nineties is often called the „lost decade“. It is thought that the problem stemmed from the fact that the banks did not have a recourse to a necessary financial restructuring, but lengthened the loans and added to other financial assistance. The resulting companies have been called zombie firms to describe the fact that they were heavily indebted and inefficient.

1) Bear in mind that much has changed in Iceland after the financial crisis and in Japan in the nineties. The comparison made here is meant to emphasise that heavy indebtedness will in the long term lead to stagnation, less investment and have a negative effect on growth.

Low productivity, low profits of companies, decreased turnover and opaque ownership leads to increased danger of protectionism and government interventions

Two scenarios

Increased protectionism

- Barriers to entry into markets raised by government actions.
- The possibility of a competition from abroad decreased.
- Supply of goods and services limited by regulations.
- Collusion or abuse of a dominant position in the market facilitated.

Economic decline

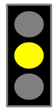
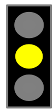
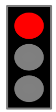
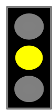
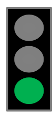
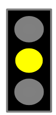
More open markets and vigorous competition

- Barriers to entry removed and markets thereby opened.
- More numerous market participants.
- Increased diversity and bigger markets.
- More active monitoring of collusion and abuse of a dominant position in the market.

Economic growth

The Competition Authority has emphasised the importance of increased productivity in the domestic sector

The policy of the Competition Authority has not in all cases been realised

Action	Results	Comment
Only sustainable companies should be rescued.		Clues indicate that more companies were helped than was sensible.
Debt burden should be lessened – the competition act should not prevent this.		The debt burden has decreased significantly but nevertheless the balance sheets of many companies are too large.
Companies under the contol of the banks should be run on a normal profitability basis.		A large proportion of financially restructured companies are not operated on a normal profitability basis.
Companies should be removed from the control of banks as soon as possible.		In the main, companies have been removed from the direct control of the banks, even though that process was slow in the beginning.
Companies controlled by the banks should be operated as independent competitors in the market.		The banks have in most cases endeavoured to adhere to the conditions of the ICA in this respect. The ownership of the banks has nevertheless negative effect on the competitiveness in the economy.
The interests of consumers and the society as a whole are more important than the interests of individual companies.		Companies have been financially restructured in spite of objections from their competitors. Many companies consider the end result unfair. Clues indicate that further financial restructuring is necessary for the common good.