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How to Make Decisions in the World Market

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I intend to describe the international environment in which some of Litton Industries' operating decisions are being made. Hopefully, my remarks will shed some light on why the socioeconomic and political atmosphere encountered abroad may dictate operating decisions which seem wrong or even irrational when viewed from afar by the board of an American company. I also would like to suggest that the environment which business is encountering in Europe is beginning to occur in this country as well.

These circumstances are due, in part, to changing market conditions, demographic shifts, and new technologies, for Litton has had to modify its operations in Europe and to modernize its industrial facilities in order to grow. As I describe some of the problems that we have encountered and the tough decisions that we have made, keep in mind that Litton's 100 divisions are each operated independently and that its divisions abroad are headed by foreign nationals of the countries in which the divisions are located. The 100 divisions employ approximately 75,000 people worldwide, and sales this year are expected to reach a little over $4.2 billion.

Five European Nations

Sweden: Litton had a successful cash register business in Sweden. It was based on electromechanical technology, which became obsolete following the development of electronic technology based on microprocessors. We had two electromechanical plants in Sweden, one in Varburg on the west coast, and another in Stockholm. Both had excellent technology, a superb work force, and excellent management in electromechanical capabilities.

Sweden itself is highly socialistic, with a high tax structure that brings the accompanying social costs to approximately 60 to 70 percent, compared to about 25 to 35 percent in the U.S. These operating costs, together with the additional capital that would have been required to shift to electronics, forced us to give up a trained work force loyal to our company, to liquidate our assets, and to re-establish a capability with which we could make competitive products at a profit. Our decision was to come back to the U.S. Here is what happened when we tried to move gradually out of Sweden.

First, when a company announces its intention to leave Sweden, it has to do so publicly. In our case, we faced further complications because we needed to provide a spare parts inventory for seven years for all the electromechanical cash registers that we had sold throughout the world. A confrontation was inevitable.

Before a company in Sweden can announce a stop-work decision, it must request permission from the Work Council, a group made up of the very workers you are planning to lay off. Once you get through this, you seek the permission of various government agencies. This should not be confused with your decision to stop work. You must first seek permission to stop. Without that permission you do not stop. It took us two years to negotiate a phase-out plan, and only then did we begin to phase down.

The social responsibilities of a Swedish company to its workers are dependent, in part, on the worker's length of service. You must pay full salaries for up to three years. In our case, the government subsidized a takeover of the plant by the workers in order to keep it in operation. A shutdown would have been an admission of failure in their system, and the government could not have accepted responsibility for that publicly.

Italy: In Italy, Litton has several manufacturing plants. Our experience there has been different from that in Sweden because the environment in Italy is controlled by the governing power of the unions. A layoff, however, or an agreement to shut down, is equally difficult to achieve, and the social costs are similar.

Litton has suffered numerous strikes in Italy, sometimes three or four per day, with each lasting 15 to 20 minutes. You must be aware of this when a government VIP is scheduled to see your defense products. You ask the workers to please not strike so you can show the products. If they agree, a strike will not occur during the visit.

However, if you shut down a product line or lay off people, the unions will strike every plant you have in Italy. That means a total disruption of business throughout the country and a direct throwback to the common situs legislation which failed to pass in the U.S. a few years ago.

In spite of such difficulties—and interest rates which for a long time have run over 20 percent—our businesses there have been profitable and our sales have increased. We have achieved this, in part, by drawing a circle around Italy and telling our managers there that, "You are by yourselves. You will borrow money from Italian sources. We will not send money to you because the law restricts our ability to take it out. To operate, you must borrow from each other or from banks. If you fail to make a profit, we will take appropriate actions." We have adhered rigorously to this investment policy, though exceptions have been made to protect existing sunk costs.

France: In France, Litton had two machine tool operations which needed to be shut down because of a market collapse. It took two years before we could work our way through the roadblocks and have a meaningful conversation with the government about laying off workers or closing plants. After an agreement was attained, we had to go through what is called a "controlled bankruptcy," which made the plant closings a Litton failure, not a French national failure. During this situation, we experienced union strikes marked by violence, and we could not get into our plants to preserve inventories. Finally we resorted to night raids on our own facilities, carrying materials out of the buildings to satisfy customer commitments.

England: In England we had two typewriter plants which we wanted to consolidate into our Triumph Adler facilities in West Germany. Before we could do this, there was a prolonged period of negotiation with the workers and with many British government departments. The workers occupied and maintained the plants during this period, but kept the machines in beautiful condition. They were motivated to do so by their request for a government subsidy to continue the operation of the business. A subsidy was not granted, but if it had been it would have been adverse to our business interests, since we would have been forced to take the output of those British plants as part of our closing settlement.

West Germany: In West Germany our experience was somewhat different. There, we had a business which produced typewriters, business machines, and business systems. Employees numbered over 12,000, and sales ran about $600 million annually. Germany's social costs range between 65 to 70 percent and include unusual educational benefits for a worker and his family, holidays, sick leave, and various other policies favoring employees. Combine this overhead with the high tax rates and the recent problems with currency exchange and you have a frequent opportunity to face tough decisions.

Picture if you will a soft market situation that calls for a cut in labor to reduce the rate of production. A layoff of more than 49 people in one week is considered a *mass layoff*, and it requires the approval of the Council of Workers and then the government. Even after these approvals, a company often is reluctant to cut the work force because there is a great deal of pressure generated by these layoffs. So the alternative of a shorter work week is often preferred. However, a four-day work week requires an economic justification plan, which has to be submitted to the Council of Workers and then to the government. If you have convinced them that you are right, you can operate for four days, but you must continue to pay for five. Therein lies the test: At the end of three or four months, you have to go back to them, and they compare your business results with the plan. If your plan is wrong, you have to absorb the cost for the fifth work day. But even if your model is right, you have to carry the cash cost of the idle days until the government reimburses you.

I think the most ominous threat to American business and free enterprise coming out of Europe is "co-determination." The law of co-determination requires an equal number of members from labor and capital on the board of a publicly held company. In Germany, the board chairman is given two votes to break ties. At present he is on the side of capital, although a rotation with the labor representative was considered.

We frequently hear comments or see quotes attributed to senior government officials in Germany who say that co-determination works. Our experience and observation has been that it doesn't work at all. Extended discussions by boards without a resolution of the issues is typical of this system. I define it as an environment of appeasement, and you cannot manage a business when you are appeasing someone who does not have the same objective as you, which is to generate a return on investment.

I don't argue that a qualified member—in this case someone who is capable of making the kinds of judgments that a board member is required to make—should not come from the work force. None of us can argue with that. It is the essence of the system in which we live. It doesn't follow, however, that the union should be represented on a board, because the first objective of a union is not the first objective of the corporation.

The inclusion of union leaders on U.S. boards is just the beginning of what we commonly see in Germany today. It is a flagrant intrusion on the fundamentals of our free economy. Union officials are representatives of the work force. I cannot agree that capital should be any less than in full control of its investment—with capital goes risk, and capital carries that risk.

The Middle East

In Saudi Arabia, Litton Industries has a $1.64 billion fixed-price contract for an air-defense system that will take six years to complete. A fixed-price contract of this size poses some big challenges for us—it can "yo-yo" our balance sheet at a pretty good rate. While our experience thus far has been positive, we have worked very hard to give ourselves some protection, given our experience in other countries. Let me explain.

Because the contract is fixed-price and has, by Saudi insistence, no escalation clauses for inflation, we needed a way to protect our financial position. We have achieved this protection by making the contract forward priced and by using escalation rates which we have anticipated in both the Saudi Arabian and American economies. Further, we have negotiated an up-front payment of $300 million in cash. The interest we earn on that sum is ours, in lieu of an escalation clause in the contract. We negotiated a payment schedule into the base contract which calls for payments to be made at the beginning of each working year. The first payment of $280 million for the first year's work was received in July 1979. Added to the $300 million up-front payment, this makes a total of $580 million in cash that has been received thus far. This amount represents a considerable portion of the cash position on our year-end balance sheet. In the next few weeks, we expect another payment, which will carry us through the second year.

The terms of the contract call for payment in riyals for the work done in Saudi Arabia and for payment in dollars for the work done in the U.S.—thus avoiding currency exchange problems. If all goes as planned, Litton will remain in a net positive cash position.

We are continually called upon to explain the protective factors built into the program. Our bankers, investment managers, and other large investors have exhibited nervousness about any number of problems, real or imaginary, including the kingdom's ability to maintain security, the distance between Saudi Arabia and California, and the size of the program.

Interestingly, even though it is a monarchy, the Saudi system is not without its bureaucracy. This is the largest procurement contract ever issued to a private company in the history of the kingdom, and the Saudi's normal operating procedure would have been to negotiate a very detailed contract and then place it on the shelf. From that point, work goes ahead on a good-faith, good-performance basis. They expect you to make trade-offs in good faith.

While the board of directors needs to control capital expenditures by its foreign operations, it must be flexible enough in managing these foreign operations to allow its "in-country" managers a good amount of freedom in decision making. I am aware of another company working in Saudi Arabia, for example, which needed to change a particular compressor. As a concession for the change, the Saudis wanted the project manager to build a desalinization plant. He agreed and informed the company in the U.S. of his decision. Apparently its board of directors or some senior manager said that it wasn't the right thing to do, so the concession was withdrawn. The Saudis responded by saying, "OK then, you don't make the change, but you are the loser." The company lost $300 million in the deal just because the project manager did not have the authority to make decisions independently of the parent company in the U.S.

How to Make Decisions in the World Market

International Competition

Let me say something here about competition. To export from the U.S. you need an export license. This covers the materials you use for brochures, and bids, as well as the products you manufacture in the U.S. and ship to customers abroad. All this leads to an involved situation in which you have the State Department competing against the Defense Department, due to the differing requirements that both have in trying to satisfy the best interests of the nation.

In many cases, the State Department will want to sell to foreign countries in order to develop a strong international tie, while the Defense Department will not, because it is concerned about exporting technology. Even when the Defense Department is not involved, the Commerce Department can enter the picture and make it impossible to find a clear-cut, simple way to go through Washington, D.C. to obtain the clearances required.

The U.S. Government also has a right, by statute, to take money off the top of a foreign military sale, which they call "recoupment" of R&D costs experienced previously. However, those R&D costs were part of a prior contract that they had negotiated at a fair price, so they reach in again to take some money for the government. It is like a tax, if you will. Who does it hurt? All of us. Those costs are included in the foreign bid price, and that decreases our competitive advantage, especially when you are bidding against a competitor which receives subsidies from its government to help win foreign contracts. You often will discover that not only are you *not* competitive, but that you are too late with the bid by the time you have obtained permission to go at all. This situation is clearly a handicap to American industry and to the nation's efforts to improve its position in international trade.

Even more onerous, in my opinion, is the fact that these foreign companies now are investing in businesses and building plants in the U.S. Why? Because the stability of our nation is still beyond their own, both economically and politically. We clearly afford the most attractive marketplace, and even with our problems it is better here than in the socialistic environments encountered elsewhere.

In all honesty, these foreign companies are receiving a competitive edge in the U.S. marketplace, as well as internationally, to the detriment of U.S. industry. They have freedoms that we do not have by virtue of their foreign ownership and the support they receive from their governments. They are ahead in the implementation of automation and mechanization techniques. They outspend us in R&D. And, in some cases, they beat us in design. These people are making the investments in capital improvement and clearly are getting into a position of improved productivity, while America is still just talking.

Let me give you an illustration of what America is up against. Litton won a competition for the Cruise Missile Navigation System. We have a plant in Woodland Hills, Calif., one in Canada, and another in Freiburg, West Germany. All have the capability to build these very sophisticated products and to build them with interchangeable parts, as we did back in the days of the F-104 aircraft program. Our Woodland Hills plant won the contract, and when the government wanted another supplier, we competed for and won the second source award for our Canadian plant.

We won because of the extensive cost saving which would accrue to our government from commonality. The government agreed to this arrangement on the condition that we keep the two plants separated in bidding so that there would be true competition. For this contract, the Canadian plant will receive a no-interest loan from the Canadian Government to help secure the export capability and the employment of its workers.

It is exciting to contemplate what American industry could do if our government were more aggressive in its support of increased exports and of an improved competitive position in relation to foreign businesses. We do a very good business in Canada, and it works well—everybody makes out. Their export is real; America's is only talk.

I have said many things here, but I don't want to convey the idea that I am discouraged. I am not. But I am damn concerned how our free enterprise system is working. Litton is continuing to supply world markets, and our continuing challenge is to decide how that should best be done. Meanwhile, I want to assure you that we are not turning our backs on foreign opportunities. We are following an aggressive policy that tries to balance the risk, the political stability, and the social climate. Thus, we are strong in defense production, both nationally and internationally. And we are investing increasing amounts of money in the development of high technology.

But competing in the world market cannot be left to corporate America alone. The entire nation must do it head-on if it is to win. Yes, we can compete, if we will just start. But we sure aren't going to get it done by regulating and embargoing our way out of business.