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BUS501 - Strategic Management Foundations

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Financial Crisis and Its Impact

This paper will evaluate the financial crisis which began in 2008. It explores factors of the financial crisis such as the root causes and its impact. In later sections, the paper focuses on the possible impact and rectifications of the crisis on the company that we plan to develop in the BUS501 project.

2008 Financial Crisis

According to Peter Temin [1], 2007-08 financial crisis, also called as subprime mortgage crisis is a severe contraction of liquidity in global financial markets that originated in the United States as a result of the collapse of the U.S. housing market. It threatened to destroy the international financial system; caused the failure of several major investment and commercial banks, mortgage lenders, insurance companies, and savings and loan associations. It is the worst economic downturn since the Great Depression. [1]

Based on the paper published by Peter Eigner and Thomas S. Umlauft [2], the main factors which caused the crisis are the growth of subprime mortgages, federal reserve rate changes and widespread practice of securitization. The Federal Reserve, the central bank of the United States, reduced the federal funds rate from 6.5 percent to 1.00 percent. This encouraged banks to lend even to "subprime," or high-risk, customers. [3] The share of subprime mortgages among all home loans increased from about 2.5 percent to nearly 15 percent per year from the late 1990s to 2004–07 [4] The widespread practice of securitization also fueled to the crisis. [5]

We'll focus on the impact of the crisis on USA as our company's target market is United States. In 2012 the St. Louis Federal Reserve Bank [6] estimated that during the financial crisis the net worth of American households had declined by about $17 trillion in inflation-adjusted terms, a loss of 26 percent. Approximately 7.5 million jobs were lost between 2007 and 2009, representing a doubling of the unemployment rate, which stood at nearly 10 percent in 2010. According to International Monetary Fund, Economies worldwide slowed during this period, as credit tightened, and international trade declined. [7]

Over the long term, the financial damage from the 2008 meltdown will cost every American roughly $70,000 during their lifetime, according to research. [8] According to John W. Schoen, The dampening effect of the financial crisis of 2008 also depressed American households' income over the course of the last decade. [9] Employment levels for the education and health-care sectors, for example, are up by more than 28 percent. The construction, information and manufacturing sectors, on the other hand, are still below employment levels seen in September 2008, according to the latest BLS data. [10] Based on inflation adjusted data for S&P 500 earnings provided by Yale economist Robert Shiller, corporate profits also cratered in 2008, falling sharply as the economy slammed into reverse. Though profits have recovered in recent years, they are still well below the long-term gains seen in three of the last seven cycles. [11]

Effect on of financial crisis on our company – VitalWatch

As a part of the BUS501 course project, we are building a smart health watch manufacturing company, VitalWatch. This section analyzes how a similar crisis like 2008 could affect plans of our company.

The first negative impact would be our ability to raise money to develop our product. According to a report from Nicole Gelinas, nearly one-third of the US lending mechanism was frozen and continued to be frozen for several months after the bailout package. The banking system didn't have enough capital to lend funds to other investment firms. [12] This would mean that for our product, the traditional methods of raising money from banking firms were out of reach. As the bond and stock market was highly volatile, raising money via issuing bonds/stocks wouldn't work in our favor too. We'd have to rely on private investments for funding.

Assuming that we somehow managed to get enough funding and have a product that is ready to be sold – we'd hit with another roadblock of reduced purchasing power of market. Our current business model is also cash flow heavy as we thought to invest our profits into additional product research. According to World Economic Outlook, millions of jobs were lost, and the unemployment was at highest level during crisis. [7] This meant that people didn't have money to spend lavishly on lifestyle product like ours. Our product isn't essential to life, it is an augmented device to help ease life. I predict that people wouldn't have spent money on our product. We'd be hit with massive downturn in sales.

This downturn in sales would mean that we'd have to reduce our operations costs by laying off employees and cut off manufacturing new watch units. This will start a vicious cycle in which no one would buy our product and thus no new units will be manufactured. In the worst case, we'd have to file for bankruptcy. In the average case, our company would still be alive but with significantly small scale. In the best case, we magically survive temporary demand shortage and still keep striving.

Strategies to thrive even in financial crisis

This section explores possible ways to deal with financial crisis situation like 2008.

One problem that was outlined in the section above was excessive unsold inventory in case of sudden financial crisis. The inventory will remain unsold as people don't have money to buy non-essential electronic gadgets. So to clear unsold inventory, I'd suggest we sell the product for massive discounts (90%). The sale would have a contract that customers would need to pay back full price in 2 years, in whatever installments they like. Since our watch price is $200, they would've to just spend $20 to get a product that functions as regular watch as well as sophisticated smart watch. Another advantage of selling is brand awareness. Even though we'd sell at huge losses, people will be able to remember and be aware of VitalWatch brand. Therefore, once the crisis gets over people would give VitalWatch a try at least.

Second optimistic opportunity that I see is takeover/acquisition of competitors. According to a CNBC report, the 2008 economic slowdown affected every industry. [9] With the slowdown in sales, our competitors would also be in trouble and looking for a way out. Being optimistic, I'd assume that our company operated with decent financial discipline and we had enough cash reserves when economic recession started. We could use these cash reserves to acquire our competitors. Due to recession, their market valuation would've gone substantially down and thus VitalWatch can acquire them at cheap rates. This would help is kill competition as well as acquire resources in cost efficient way.

Third alternative is pivoting business strategy to build entertainment centric device instead of a health watch. According to source [13], home entertainment companies like Netflix thrived even during economic crisis. The possible reason was that people would spent most of their time at home due to unemployment and thus will seek some form of entertainment. Therefore pivoting product strategy to build a device that can work as personal entertainment device, a watch that can play music, videos or games would be a better bet than a health centric watch.

References

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