



# Cometh the hour...

MCR Interview with Jon Moulton, Chairman, Better Capital LLP

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## MCR - What is your perception of the opportunity for Better Capital in the next few years?

"The simple position is that the economy obviously had a shocking year last year. The country is fantastically indebted at every level and we are operating in territory which is terra incognita. We just don't know. In 1975 the country went into the IMF with 45% of GDP in interest bearing debt, going up at 8% per year. Now we are at 70% plus going up at 12-13% per annum. Are we likely to head for the IMF? Well, we could. Are we going to have trouble funding our debt overseas? Yes we will. Will interest rates right suddenly at some point? Yes, they will. When that occurs, what is currently a very unnatural world dominated by low interest rates, state owned banks, politically run insolvency and restructuring processes, massive amounts of money held by HMRC as funding for companies ...all this lot will reverse when interest rates rise. It has to and we will have an enormous number of companies seeking funding and reconstruction. So, at Better Capital, we are in place, ready and waiting for that tidal wave. At the moment we have a good steady current but it is as nothing compared with what will come."

## MCR - Have we the resource to deal with this wave of work?

"We haven't when it comes but we have been waiting for a while because nobody anticipated that we would be in the depths of a recession with a 0.5% base rate with banks with strategies of 'extend and pretend' or the even better one of 'the rolling loan gathers no loss' which dominates the behaviours of the banks at the moment."

## MCR - But experience runs a hard school and people in the UK have experienced 10 years of low inflation, entitlement, etc.

"And we keep solving the problem of too much debt with more debt, which of course you can for a while. And debt etc means generational transfer. I was in Kuwait last year and they put

10% of GDP into a fund called 'the fund for future generations'. That's very moral because they've got an oil-based economy and one day it will run out. And what do we do? We put 13% of GDP into debt for future generations! The morality of what is going on is very adverse. We are absolutely shovelling debt onto our kids and grandkids. No-one seems to be writing down proposals for the debt to come down in a period that's less than the length of World War II. I'm very concerned by this."

## MCR - So what ways have we got to get rid of the debt?

"We could try and inflate it away. That's very painful. It would give rise to a chaotic economy rather like the 1970s and early 1980s. We could cut public spending. Maggie Thatcher never cut public spending and the most optimistic current estimate of the need for a reduction is about £55 billion a year. It's a big number. We can't tax our way out of it. There's no conceivable way we can do more than £10 billion of increased taxes and the deficit keeps rising. The government currently has £3 of income and £4 of expenditure. We have a completely artificial interest rate environment, driven by quantitative easing, which the Romans would have called debasement and has exactly the same effect."

"This will inevitably give rise to economic stresses of scale, opportunities for equity, opportunities for restructuring skills of every type and at some point that will come into us in crisis mode because no one's dealing with it in a managed and orderly manner."

## MCR - Do we have the resources needed to deal with this problem?

"I'm sure that resource will arrive because it will be organised at short notice but it will be very ineffective. Several banks have grown the thick end of 1,000 people into a workout unit from a core of 30 people in 30 months and you can't do this effectively."

**MCR - I read that Better Capital is ready and willing to invest in Eire where Brian Lenihan, the Minister of Finance, is cutting costs.**

"They have to hit living standards and they are doing so. They have to cut. The scale of the problem in Ireland is just amazing. They have got everything wrong that you can imagine. Bust banks, a huge deficit, a weak local economy. The economy was so driven by property that it was fundamentally very unstable. The collapse of the construction and property markets has caused great grief. They have no ability to devalue the currency. So the only thing that they can do is to drop living standards a long way. They are facing reality. They too have felt the pressure of people being unwilling to buy Irish debt."

**MCR - Do you see a similar experience coming here?**

"Absolutely indeed, of course it is. We can at least watch our currency evaporate - albeit at the cost of inflation and living standards here. We don't just have to cut wages, which is fundamentally the only way you can reduce living standards to make it tie together. We can allow our currency to go to hell as well, thus reducing our ability to buy consumer goods, dropping living standards and importing inflation. It's all very unstable. In the UK we are well out there. We have more debt than virtually all the Europeans bar Ireland. We are going up even faster than Ireland and Greece in terms of our deficit and then of course you have the 125% of GDP or some similar number which is debt, not booked. It's very hard to get the numbers right because we talk about a deficit for this last year of about £168 billion (by the way if you go back to the March 08 budget, that talks about a surplus of £4 billion, so the ex-Chancellor is only about £170 billion out!")

**MCR - I'm going to bring you back to Better Capital.**

"We are going to deal with loss making businesses, most of which are going to require recapitalisation or which will require a change in operating strategy very often of a negative nature including closing, stopping rather than growing. Some of the companies we will grow out at the other end but first you must stop the haemorrhaging. It's not sector specific. We're not mugs. We are in turnarounds so we not looking for hopeless cases that we can stretch out for a couple of years. We hope not to bring them in and then leave them in intensive care until they go to the mortuary. That does mean that some

sectors are pretty hard to do a deal in. It's unlikely for example that we'd do a deal in automobile components. It's capital intensive and moving towards the East.

"When we look at a company, there are four tiers. If you look at the top quartile, they are not going to come into us because even if they are badly managed they are the very best businesses. We see a few at the bottom end of the second quartile which are reasonably good businesses with a bit of growth prospect. We see third quartile, which are typically companies going nowhere, and then as you get towards the bottom of the fourth quartile you are into the companies that are doomed. So we operate mostly from the bottom of the second to the middle of the fourth. This refers to the quality of the businesses, a pretty vague statement but it talks about sustainability, profitability and cash flow generation. People can make money out of a slowly declining cash generating business but there are not many of these. Most businesses in decline cease to generate cash very quickly. We are in the business of making money out of investments; good for the business, good for the people in the business, good for the people around the business. It's much cheaper, it's much better to rescue a viable company than to close it and start a new one which costs an enormous amount of time and disruption in human terms and in financial terms; so rescuing viable businesses is what we are about.

"We invest between £5 million and about £30 million into a single situation and we are optimistic that we will upgrade our financial capacity beyond that before the year is out. We're not seeing very large numbers of big cases at the moment. Whilst we are busy, we live in the belief that come the interest rates rise, you'll be quite lucky to be able to see us within a month if you book up in advance. The volumes of pent up demand are huge. Bear in mind that so far we have only seen corporate failures at something like some 25% of the rate that was experienced in the early 90s when we have had a recession that was something like three times the scale of the previous one. Is there a lot of pent up demand? Yes, there is. In the early 90s we didn't have the HMRC support which is possibly somewhere in the mid-teens of billions. We don't really know because the government won't tell us. There's £5 billion in properly organised schemes. From the pre-budget report you could easily form the view that it looks like £17 or £18 billion. There's more flexibility in the workforce, weaker unions, a bit more part-time working, unemployment hasn't risen anything like as much but the dominant feature is the low interest rate. We have not admitted the problem. We have printed £200 billion of fresh capital.

"The country is in a very weak financial state. We need strong public sector cuts. We will either do them in a managed and orderly way, which will be painful enough, or we'll have it done for us at some point by the markets and the IMF. The most rational thing is that we will wake up one morning and discover that foreigners are not going to buy any more of our debt. As it is, the government is announcing that it's going to have to sell far more indexed linked debt. The market is already speaking. Index linked doesn't have an implicit high cost but it will very rapidly have one. It has a very unattractive characteristic for the government because, in a weak currency, high interest rate environment, the cost of servicing the debt will rise quickly and if the cost of the rise in servicing the debt exceeds the growth rate of the economy, the economy will go backwards."

### **MCR - Given this outlook, aren't you tempted to retire?**

"I've no real intent to retire. I've diversified a bit and have committed to do a hundred days a year for Better Capital. My wife has quite a view on this subject!

"We're in a phoney war. The tanks will come across the border. Think 1940. I think that I am right in saying that the deficit is rising at the greatest rate since 1944. So last time we had to invade France to get the deficit going up as fast as it is now and the UK economy grew behind the rest of the world for a very long time while it dealt with that war debt load."

### **MCR - Sixty years on, what is your perception of our education system?**

"Our education system is better than it was in 1945, but we have fallen behind in relative terms in our education. We have a system that churns out 50% of the youth as so-called graduates with a very large number of them having qualifications that are of no use to them or to society. It's pathetic what comes out. We need to cut down the number of people in universities. We need to have more vocational training. That's very widely accepted even by most of the union leaders who would happily agree with you on that."

### **MCR - What do we have to rebuild the country from?**

"You need world leading industries. There are tiny fragments all over place but the big ones are financial services and education. These are what we have to build from. So we have to make it pleasant to employ people. The science base is not as strong as it was. In engineering, we've got bits but it's not what it was. Just think of nuclear engineering. We've lost the skills to build nuclear power stations ourselves. We have no presence in advanced aerospace. We are so weak in a quite lot of areas that we would love to be strong in. We are not dead in engineering, chemistry or medicine but we have dropped down the league tables a long way. There are areas of information technology where we are barely present. There is no UK computer manufacturer of any scale. There are no UK computer names of global strength. There are some good small companies absolutely but no big ones. Quite a number of US IT companies are larger than our total IT industry. I was at the UK IT industry conference recently. It was really rather depressing. The number of attendees has been dropping seven years in a row, the average age of the audience makes me feel really at home and there's nothing new and lively coming from the UK of any scale. The outlook is grim."

### **MCR - How do you get the lot back?**

"You have got to get the economy so that income and expenditure of government and humans roughly equates. You have to take the debt down and we then have to make ourselves very attractive to grow what must ultimately be human brain based type activities because we don't feed ourselves, we don't heat ourselves, we don't have the natural resources and we've made a pact with the rest of the globe to provide them. So in terms of growing the economy it's pretty straightforward what you have to do. Some of it will take a long time."

"I have a presentation of the country as a turnaround!

"I think that all this lot means that restructuring and pain is likely to be protracted. We are not going to enter a sort of two year cyclical distressed cycle or something which people talk about. We're likely to enter quite a long period of distress and recapitalisation. If we're lucky it will be U-shaped and if debt service does exceed growth, the economy goes down for a long period. That has happened before but whilst I couldn't rule out a short period of rapid

growth on the rebound out, while inventories are rebuilt and perhaps a bit more debt is shovelled into the economy, that's unsustainable and can only be very short term. So even if we managed to knock together six months of 3% growth, that would be the end of it because all we would be doing again would be pouring more petrol on the fire. The fundamentals are just not in place. We have got to make the state smaller. The state is running at about 50% of the economy but in parts of the country, take Northern Ireland, one third of the workforce works directly for the government, one third works in companies that are dependent on the government and a third works in the private sector: that's the economy.

"Money is shovelled in from the centre and it's not much different in Scotland, Wales and perhaps a little lower in the north east England.

"The UK is the only country that doesn't have a plan to go to no deficit within five years.

"In their young people, China and India have fantastic intellectual horsepower, drive and ambition. I went to a couple of the big IT companies in India recently and went to one of their campuses where they take their people in. The big intake is during a 10 week period each spring when they take 800 graduates on board each week of that period. I came back here and checked how many graduates we produce in this area and found that the annual total was about 2,500 comparable graduates."

### **MCR - I understand that you have a portrait of Churchill on your office wall?**

"Even he frankly might have punched at this lot too. Taking a million civil servants out is a serious task and that is the number of the increase in civil servants during Gordon's time. Our economy can only grow slowly because of the size of the public sector. If we had no debt the impact of the public sector being where it is would be to reduce our natural growth rate to something like 1.5%. Money has been poured into the health service and most studies that have tried to measure the increased outputs have found bugger all!"

### **MCR - Complexity is crushing productivity - no-one can possibly understand everything in Tolley's tax handbook.**

"4353 pages before the changes from the current finance bill. It's too large, like the FSA handbook. Dramatic changes in principle will be required at some point. It will only eventually be forced down your throat. Because as long as we remain in Europe it's difficult to carve into the regulations; very difficult to do something with tax, though we can do something.

"Something will happen; cometh the hour, cometh the man, cometh the action. But it is a bit of shame that you have to rely on something of relatively explosive change because there are a lot of victims of explosive change."

"Go back to Sweden in the early 90s and their crisis. The moment that mattered in Sweden was when the government persuaded the population that they were going to cut government expenditure, which should of course give rise to a recession not a boom, but the public said 'at last' and went out and started spending. They dug themselves out of the mess quite quickly thereafter because they had faced up to short term pain and you just wonder how far we are from this. If Cameron has the nerve to stand up and say that we're going to take £50 billion a year out of public expenditure, yes it will hurt a lot, the economy might not suffer as people imagine because people might gain in confidence, start up businesses, growing things charging ahead as opposed to staring down the barrel of heavy taxation and tinkering around with the problems."