

The Outsource Group: Interview with Michael Marks

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1.) In your personal experience running a massive global enterprise with a highly responsive supply chain, what would you say the top two or three issues to consider are when building a global supply chain?

Marks: Well the first is obviously what is happening from a cost perspective, but this changes regularly so clearly you have to have flexibility in the supply chain. So for example, China, which has been the simple answer for hardware manufacturing for at least the last ten years is no longer necessarily the right answer in every case. Today it makes a real difference where the raw material is coming from and what the overall logistics system looks like. For example the cost of everything is going up in China, at the same time the primary logistics costs – freight – is also going up pretty dramatically. These developments in many cases are outweighing the lack of robust material supply chain in Mexico for example so you are starting to see some movement there.

Another issue is around currency fluctuations. As the dollar gets really weak, the costs of things abroad go up quite quickly and executives need to be able to respond to this and react in the supply chain. Because of that, big companies just cannot afford to be in only one place because of the amount of fluctuation we are seeing in these things. So to answer your question I'd have to say (1) cost, (2) flexibility and the need to respond and adapt, (3) where the materials are coming from and the location of the supply base. If I could throw in a fourth answer it would be that things change fast – so pay attention.

2.) The entire world is de-leveraging and tighter credit persists across the global financial markets. How will this impact EMS companies and their OEM customers?

Marks: Well I think this problem is not just an EMS problem, its one that is affecting everyone. But for the EMS companies I'd have to say that they really have to pay attention to the financial viability of their suppliers. Truly for the first time in my life this is a major concern and everybody needs to take a look at their suppliers and see if they are going to survive – especially if they make custom parts where there aren't many other suppliers. On the EMS customer side it's the same. As you know, the EMS companies are among other things banks to their customers, and the financing of inventory has become increasingly important in the offering. The EMS customers are going to have to take a long hard look at their EMS partners and vice-versa. As some of the customers lose

their ability to pay or go out of business, some of the EMS players are really going to get whacked here. This will be particularly problematic for some of the smaller EMS companies as they deal with a lot of smaller customers with limited access to capital – especially in these markets.

As the customers take a closer look, you'll see the larger; more stable, better capitalized EMS players benefit here and take even more share. Selecting a company like Flex or Hon Hai that is too big to fail is going to be a much easier choice. The upside of this downturn and credit crunch will clearly accrue to the benefit of the larger players – much as you would expect. Finally, the really big guys are going to be in the best shape they have ever been in to raise prices. They'll be able to say *"look, we are not getting a fair return here and we are going to have to raise your prices. If you want to stay, here is the new price, if you want to go somewhere else we completely understand."* You're going to see a lot of that coming over the next few quarters.

3.) What are some of the key financial metrics that OEMs should use – besides debt/equity, to evaluate the health of their EMS or ODM provider?

Marks: Well you are right there; Debt to equity is clearly the obvious and most important one. In this market I would be clearly looking at operating profit and inventory turns. A balance sheet is one thing, but lack of profitability and poorly turning inventory in this market can eat through even a pretty strong balance sheet very quickly. If inventory isn't turning then you know a bunch of that inventory is bad and will never get turned back into cash. There is no credit out there so burning through your cash, or holding a bunch of dead inventory right now is heading down a road to disaster. I would not want to be doing business today with any EMS company that is not making money. Beyond that looking at a company's total liquidity and access to capital is increasingly important – but any capital lines that haven't been drawn down are suspect in this environment.

4.) It seems the major EMS players are ridiculously undervalued in the public markets, will private equity players scoop up a few of them? When will investors jump back in?

Marks: No, Private equity firms will not get interested in these names – at least not any time soon. There just isn't any credit out there to do a deal like take out a major EMS player – and if there was, that credit would flow somewhere else to one of the undervalued companies in some other industry. Even if there was credit I don't think they'd get interested in the space. The margins are extremely low, which doesn't give you a lot of room if you take on a bunch of debt to do the

deal. The EMS business is a tough, ugly, low margin business and this is just not where most private equity firms traffic.

As for the public markets, if you're asking when the public markets will get interest..... we'll the public markets may never get interested. I have this concern that the EMS industry is forever going to be the disk drive industry. Seagate and Western Digital just couldn't run their business any better – but nobody cares, they still end up trading at something like 5 times cash flow. Its going to be the same with the EMS space - low margins, low multiples and low investors interest.

So I guess it depends on what you mean when you say will the markets get interested?? Will you see Flextronics trade at \$9 again instead of \$4.50 – sure you will. But will you ever see it trade to \$15, I just don't know. I just don't think the markets think it is a very good business to be in for the long term. Capital goes to where it is treated well.

5.) How much more consolidation do you expect in the EMS and ODM industry? Who will the players be in 5 years or, even 10 years?

Marks: I think it's just like any industry – there will be chains and boutiques. Flextronics and Hon Hai are the chains, Benchmark, Venture, maybe Plexus and a bunch of others guys are the boutiques, and the guys in the middle just get whacked. The guys like Celestica and Sanmina - there is just no room left for them to play. It's like the home building industry; if you are KB Homes and build thousands of homes a year, you are probably going to be alright. So is the little guy down the street that builds 6 homes a year and provides really high service. It's the guys building 150 homes a year that goes down.

Look, I can guarantee you that Sanmina is not an independent company in three years, and I don't think Celestica will be either. I'm not sure what happens to Jabil, but Flex will be there, Foxconn will be there, and hundreds of little boutiques will be there. But every industry consolidates down to chains and boutiques, and downturns generally accelerate this process.

6.) So how does this downturn compare to 2001 in the EMS industry

Marks: I don't know, that's a hard one. The world is systemically more risky today than it was in 2000. Look..... in 2000 we had the exact same thing – suppliers were going to go out of business, customers were going to go out of business – but the difference is that in 2000 at least there was credit. So today,

even healthy companies are going to wind up getting in trouble because there is no credit. Maybe that have some short term financing that they need to roll over or some longer term maturities coming due – without access to credit some of these otherwise healthy companies could just go away – that’s the difference. So the analysis that companies have to do is much trickier, it’s a much more complicated analysis. It is no longer just about the cash flows of your suppliers and customers, but also about debt maturities and borrowing facilities. You’d have to be an economist to figure out what the longer term trend is from all of this – I just don’t know, I don’t think anybody knows frankly.

7.) You are currently, among other things such as writing for Forbes and teaching a class in Supply Chain Management at Stanford, running a private equity firm. What kind of new companies or emerging industries are you looking to invest in?

Marks: The emerging industries I find attractive here are those around different aspects of Green Tech. Solar, wind, battery technologies, biofuels etc. – I guess the same as a lot of investors. There are an awful lot of players here so it’s hard to pick the winners. But as with any major investing cycle this one will see some really major companies get built and you just have to pick the right ones. But these are all getting a little frothy here for my taste so I guess we will just have to wait and see.

As for some of the others you mention, I don’t know. Right now there are just so many good businesses out there trading at very serious discounts, it’s hard to even look at some of the emerging opportunities when there are so many great deals today in proven businesses with real customers, real technology and serious cash flows.

8.) You recently made an investment in Riverwood Solutions, a services company providing outsourced operations support and supply chain management services founded by some of your old Flextronics execs. How much money did you put in and how is Riverwood Solutions’ different from other operations & supply chain consulting practices such as McKinsey, PRTM, Boston Consulting Group, etc.

Marks: The investment was not inconsequential, but it was not a lot of money either.

I personally know all of these guys at Riverwood Solutions and a lot of them are the ones that helped build Flextronics from \$100M to \$20B back in the day. BCG, McKinsey, PRTM – all of these are great consulting companies, but Riverwood Solutions is just what it says – a Solutions Company. These guys don’t write some academic report and tell you how to do it – they roll up their

sleeve, bring in an experienced team and get it done. This isn't some group of 28 year old MBAs, these are senior operations and supply chain executives with unparalleled global experience building and ramping supply chains for the world's leading product companies. They've assembled a team of real subject matter experts – the type that most small to mid-sized companies could never go hire on a full time basis. Matt Ryan, their CEO, is one of the best operations guys on the planet. These guys just took a look at a company I have some involvement in and found \$20M that can come out of the supply chain just like that. I think Riverwood Solutions will turn out to be a very strong investment for us. Their offering is pretty focused around operations and supply chain, and I think they'll do just fine differentiating themselves from the larger, more broad-based guys.

9. So some of these new changes in FASB rules around mark-to-market accounting, will they affect the balance sheets of the big EMS and ODM players??

Marks: I'm not sure that changes in mark-to-market accounting really impact the EMS providers that much. They don't have much on the books in terms of derivatives or exotic products for which there is no market price. About the most sophisticated instrument they might have is a foreign currency hedge or possibly some interest rate swaps – but nothing of consequence. I doubt seriously that Hon Hai or Jabil is sitting on a way of CMOs or is invested in some levered up SIV. For the EMS players inventory is the big game and accounting for that is pretty clear – the lesser of cost or market.