

CARIBBEAN BUSINESS

caribbeanbusinesspr.com

THURSDAY, DECEMBER 23, 2010

WEEKLY \$2.00

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2010 in Review

By Carlos Márquez
pages 20-25



Articles:

- Advertising
- Agriculture
- Autos
- Banking/Finance
- Cargo/Transportation
- Construction
- Energy
- Federal Affairs
- Government
- Health
- Insurance
- Labor
- Legislature
- Manufacturing
- Retail/Commerce
- Telecommunications
- Tourism



Fortuño: 'The worst is over' As another year of recession comes to an end, hints of hope for 2011; economy continued to shrink in calendar year 2010, but at a slowing rate

2010

BY CARLOS MÁRQUEZ & CB STAFF
cmarquez@caribbeanbusinesspr.com

It was such a tough decade that when we look back a few years from now, we will be surprised that so many businesses and jobs survived the first decade of the 21st century.

The economy in Puerto Rico on Dec. 31, 2010 will be smaller than it was on Jan. 1, 2000, having shrunk during the intervening 10 years. It will have been a lost decade as far as economic growth and development goes. Puerto Rico will finish 2010 with 4.8 years of a recession that is still going on.

According to CARIBBEAN BUSINESS sources, the island gross product (GP) will range between a contraction of 1% and an improvement of 1% for the current fiscal year (FY) 2011, which ends June 30, 2011, a clear improvement over the approximately 3.6% reduction in FY 2010, which ended June 30, 2010.

"For the calendar year 2010, we probably will see a contraction of another 3%," said Juan Lara, chief economist at Advantage Business Consulting.

This follows economic contractions of approximately 3.6% to 3.9% in FY 2010, after contractions in GP of 3.7%, 2.8% and 1.2% in FY 2009, FY 2008 and FY 2007, respectively, making this the most prolonged and deepest recession in Puerto Rico since the Great Depression in the 1930s. Some people have felt that nearly five years of continuous recession has actually been our own private depression.

This is only the second time since 1948, and the first time in almost 30 years, that Puerto Rico suffered two straight years of negative economic growth. Unfortunately, this time it has been five years.

The last time was during the U.S. recession of the early 1980s, when the economy in Puerto Rico receded 2.6% in FY 1982 and another 2.6% in FY 1983. Even during the world recession of the mid-1970s, Puerto Rico's economy grew every year, except for FY 1975 when it suffered a 1.9% reduction.

This is the first time in Puerto

Rico's modern economic history that the island has faced a recession independent from the rest of the U.S. Puerto Rico's recession started two years before the U.S. recession and is still going five years later. The U.S. recession during this period lasted only 18 months and the national economy has been recovering, albeit at a slow pace.

Although the Planning Board has said the current local recession officially started in March 2006, CARIBBEAN BUSINESS anticipated that the island economy could be entering a period of stagflation in 2005 and that a recession was in the making in April 2006, before the Planning Board finally decided in late 2006 to officially accept that the economy was in a recession.

"This was the first decade since the 1940s in which real per-capita income will be lower at the end of the decade than it was at the beginning. Puerto Rico will have experienced negative growth rates in five of the last 10 years," said José Joaquín Villamil, chairman of Estudios Técnicos. "Contraction in FY 2010 was 3.4%. The best estimate for calendar year 2010 is of a contraction on the order of 2.2%."

"As such, the question in everybody's mind is when, if ever, are we going to get out of the doldrums?" said Carlos Colón de Armas, economist and finance professor at University of Puerto Rico's Graduate School of Business.

Nevertheless, Villamil pointed out that the economic-activity index (EAI) prepared by the Government Development Bank (GDB) reflects an improvement in October, the last month for which information is available.

This year, almost all key economic indicators reflected negative trends, but to a lesser degree than in previous years.

As of December, \$4.6 billion of the \$6.8 billion in American Recovery & Reinvestment Act (ARRA) funds slated to pour into Puerto Rico had been disbursed. Another \$2.2 billion is expected to be spent during 2011.

Continued on next page

Continued from previous page

In total, Puerto Rico in calendar year 2010 will have received \$20.7 billion in federal funds, according to a study by CARIBBEAN BUSINESS (CB, Dec 9). That was an average of \$1.7 billion monthly, including \$2.5 million in ARRA funds and after deducting \$3.4 billion local residents and businesses paid to the federal government in Social Security, Medicare and unemployment insurance in FY 2010.

Colón de Armas pointed out that during this year, the government has demonstrated continuing progress toward attaining fiscal stability. This progress was evidenced by positive rating reports issued by credit agencies Moody's Investors Services and Standard & Poor's (S&P).

He explained that as this fiscal stability began to be achieved, the government started to turn its attention toward the rest of the economy. Accordingly, the success achieved in the public sector has started to spill over to other sectors of the economy, allowing for some guarded optimism regarding the growth prospects for Puerto Rico's economy. This economic success, however, has only recently begun to emerge; therefore, some caveats are still in order.

IMPROVEMENT IN ECONOMIC INDICATORS

The EAI bears a 98% correlation with Puerto Rico's GP, which means that the index is a highly reliable indicator of the overall economy performance.

Three out of the four EAI-GDB components registered an increase in October. Payroll employment, an important EAI-GDB component, continued its upward trend, adding 7,000 jobs in October, a 0.8% increase over September, when it had grown 0.7% over the previous month. The services sector added 12,300 jobs between October 2009 and October 2010, a year-over-year growth of 4.1%.

Cement sales grew 2.9% in October as compared with September. Cement sales have averaged 1.5 million bags per month over the last seven months, a sign of stabilization in the otherwise depressed construction sector.

Electrical-energy consumption registered a 1.2% uptick in October. For the first 10 months of this year,



Gov. Luis G. Fortuño

electrical-energy consumption has increased 2.6% compared with the consumption registered during the same period last year.

Only gasoline consumption registered a decline in October (-4.7%) in comparison with September, but it showed a 0.9% increase over October 2009, for a total of 94.7 million gallons, the third consecutive month registering above-average consumption.

Although the EAI-GDB year-over-year comparison still showed a 2.6% decline in October, it was the smallest decline since April 2008, which means that if the trend holds, the index will reach positive territory in the first quarter of 2011.

"This is evidence that the series of initiatives we have implemented as part of our 'Strategic Model for a New Economy' are yielding results," said José Pérez-Riera, secretary of Economic Development and Commerce. "We still have a lot to do, but the signs are very positive. As we have witnessed in the last few days, retail activity has experienced an upswing that we hadn't seen in Puerto Rico in years. This reflects greater consumer confidence, which in turn is very positive."

Fortuño noted that the additional push our economy needs to reach a pattern of sustained growth is the administration Tax Reform.

"There is no doubt that when you leave more money in taxpayers' pockets, whether individuals or small and midsize businesses, the



Carlos M. García, chairman of the board and president of the Government Development Bank

economy gets stimulated. This is because people then have more money at their disposal to spend, save or invest. All three options—consumption, savings and investment—generate more economic activity, which in turn translates into more income and jobs for all," Fortuño said.

On a year-to-date basis, eight out of nine indicators performed better in calendar year 2010 as compared to 2009. Four of these indicators (electrical-energy consumption, guests registered in hotels, motor-vehicle sales and retail sales) actually increased in 2010, after decreasing in 2009.

The trend in motor-vehicle sales was particularly noteworthy, showing a double-digit increase in 2010 after a double-digit decrease the previous year. Four indicators (number of construction permits, cement production, cement sales and bankruptcies) worsened in 2010, but did so at a slower pace than the previous year. Only the value of construction permits decreased at a faster pace in 2010 than in 2009.

On the employment side, the economy continues to show weaknesses, as demonstrated by an unemployment rate that has consistently hovered in double digits since May 2008, while the participation rate has been declining. Officially, there are more than 200,000 people unemployed (seeking jobs). However, with a participation rate of only 42% compared to close to 60% in the States, it is hard to tell how many have given up

seeking work. Since June and July of this year, however, the trend in the unemployment rate has shown some signs of beginning to turn in the right direction. In fact, unemployment figures from November released last week showed a modest improvement month over month and year over year.

UNPRECEDENTED STEPS TO SOLVE THE GOVERNMENT FISCAL CRISIS

"The fiscal crisis that put us on the verge of bankruptcy and edged our credit rating a step away from a noninvestment-grade rating is now under control," Fortuño said. "We have reduced the deficit we inherited—which at 44% of revenue was the worst in the nation—to just over 10%. And we have a plan in place to eliminate it altogether by 2013. We had to take unprecedented steps to bring Puerto Rico back to solvency and avoid an economic depression, but we are seeing the results now; Moody's improved our rating three notches and S&P changed our outlook to positive."

"That doesn't just happen. The fact is that they have independently come to the conclusion that we are delivering the results we told them we would achieve with our plan when we came into office. And so, therefore, the old practices of overestimating our revenue to meet our budget are over. We have, for the past two years in a row, been meeting or surpassing our revenue projections; we intend to continue doing so and we will continue containing costs and strengthening our collection efforts as well."

"We have established strong and predictable cash-flow management, and we have ended in a positive cash position for every quarter of FY 2010 and the first quarter of FY 2011. In the last 22 months, we closed a gap in our budget, which actually represented about 44% of our revenue just 22 months ago, to about 10.9% today."

"I'm convinced that what we've done so far in just 24 months positioned us to get a positive change in outlook from S&P."

The governor reiterated that his administration's work is far from over.

"We have proved with our actions that indeed we have stayed in the

Continued on page 22

Continued from page 21

course in spite of any difficulties that we have found on our way, and we intend to stay in the course for the next two years as well," he said. "We are committed to full transparency for the investment community as we regain our fiscal, economic and financial health and economic growth.

"We continue to operate under very challenging circumstances, but I'm convinced that we are ahead of the curve as compared to most states and many countries in doing what needs to be done in order to bring back economic recovery and fiscal responsibility.

"You just have to look around at what is happening not only in the States, but also in Europe. Last week, Moody's downgraded Ireland five notches from 'Aa2' to 'Baa1'. Greece, Spain, Portugal...the examples abound of economies that have refused or delayed putting in place the kind of fiscal controls needed. Here, we had the vision and the determination of doing what was right, fully aware that we were going to be criticized, but convinced that it was the right medicine for an ailing economy. Result: the worst is over and we're hopeful recovery is around the corner."

TAX REFORM

"I'm convinced that now that we have our fiscal plan in place, already yielding positive results, the next step we needed to take to consolidate our economic stabilization and move onward to recovery was to leave more money in people's and businesses' pockets. That is what is going to jumpstart our economy," the governor added. "And that's why we are embarking on a major tax reform that will represent a net gain to both corporate and individual taxpayers across the board. It is the most comprehensive and aggressive tax reform in our history. Actually, over a six-year period it will lower taxes on individuals by almost 50%, and it will lower taxes on corporations generally by 30%."

Puerto Rico's top corporate tax rate is 41%, and under the new Tax Reform it will come down to 30% this January.

"As a matter of fact, people already started to see the benefits of the Tax



*José Pérez-Riera,
secretary of Economic Development
& Commerce*

Reform, when they saw their net take-home pay increase in December, and received their Christmas bonus checks without a deduction as a result of the portion of the Tax Reform already approved," Fortuño said. "And the effect on our economy was immediate, with retailers reporting increases in Black-Friday-weekend sales on the order of 10% compared with last year.

"We also are taking steps to avoid tax evasion, and I'm convinced that this will spur economic activity and job creation in the near future."



*José Joaquín Villamil,
chairman of the board
of Estudios Técnicos*

PERMITTING PROCESS AND HEALTH REFORM

The governor added that this December the total overhaul of the island permitting process took hold and commenced full operation.

"We have been merging all of these agencies and the permitting process will do away with about 26 regulations, and we'll only have one regulation that will cover this area," he said.

On the healthcare front, the administration launched the New Integrated Health Model, better known as Mi

Salud, in October. Mi Salud, which replaced the Health Reform system, has made several changes aimed at improving access and quality of healthcare provided to beneficiaries. It will switch from an independent-practice association (IPA) to a preferred-provider network organization (PPO) model, and expand coverage by lowering eligibility criteria and imposing deductible payments for unauthorized emergency-room visits. It also is shifting most economic risks from doctors to insurers in a bid to improve quality.

"We have embarked on refurbishing our healthcare plan," the governor said. "Although we don't fully participate in the federal program, with the Medicaid funding we have put together a plan that actually is also a tool for economic development."

ENERGY DIVERSIFICATION

The Fortuño administration has been particularly resolute in following through on its promise to wean the island off its dependency on foreign oil for energy production.

"We also have a very aggressive energy-diversification strategy, which includes renewable energy, as well as replacing oil with not just renewable-energy projects, but also with natural gas, which is cheaper, cleaner and safer as well," the governor explained. "We have a multitrack public-private-partnership [PPP] program that is well on its way, and actually this initiative will enhance not just our infrastructure, but also the influx of capital into our economy."

FISCAL COMPLIANCE

GDB Chairman & President Carlos M. García said Puerto Rico continues to be on track with the implementation of the fiscal and economic reconstruction plan.

"Twenty-four months ago, we outlined the three major goals of the administration, which have been achieved: stabilizing the fiscal situation, strengthening our credit and rebuilding our economy," he said. "Puerto Rico has lost a decade in its economic development and we simply can't lose another. We must achieve annual real growth of at least 3%, raise the credit rating of Puerto Rico's general-obligations debt to



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‘A,’ improve the island competitiveness and reduce the unemployment rate to at least 10%.

“We also must realign promotional strategies and foster Puerto Rico’s exports and knowledge economy, develop a world-class physical infrastructure and reform the institutional and regulatory framework to strengthen the private sector. We must restore economic growth based on an effective implementation of short-term stimuli and the long-term development of the productive base.”

García’s sense of urgency, and that of other administration officials, remains high despite modest signs that recovery may be on the horizon for Puerto Rico. Some indicators showed signs the slide was slowing in the second half of the year.

“On a year-to-date basis, eight out of the nine indicators examined performed better in 2010 as compared to 2009. Four of these indicators [electrical-energy consumption, guests registered in hotels, motor-vehicle sales and retail sales] actually increased in 2010, after decreasing in 2009,” Colón De Armas said. “As we look toward the future of Puerto Rico’s economy, and as we strive to turn the tide, the most important problem we face, and our utmost challenge, is to promote growth in the economy of the island. For growth to occur, however, productive investment, from both the public and the private sectors, must occur.

“To promote public investment, we need to strengthen the finances of the government public corporations, which have been languishing while all the attention was directed at the General Fund. Returning these public corporations to their financial health should be at the top of the agenda for 2011.

“In the private sector, the new Tax Reform, whose early stages have already been implemented, should prove invaluable.”

Businesses and households may have felt more squeezed than ever before, but that is exactly what one should expect near the bottom of a five-year recession.

An across-the-board, sector-by-sector look at the most important industries in Puerto Rico finds tepid signs the coming year will be better



Juan Lara, chief economist at Advantage Business Consulting

than 2010, but the shadow of recession, uncertainty and lack of confidence continues to hover over nearly every economic area.

“Calendar year 2010 might have been the year when the first phase of Puerto Rico’s Great Recession—the phase of the steep decline—finally approached its end,” Advantage Business Consulting Economist Lara said. “It wasn’t necessarily the beginning of the end, but maybe the end of the beginning, to paraphrase Sir Winston Churchill, former British prime minister.



Carlos Colón de Armas, economist and finance professor at University of Puerto Rico's Graduate School of Business

“Does this mean that we are about to see a strong rebound in 2011? Not likely. It means that we should be seeing more and more signs of a gradual turnaround in the coming year.”

CONSTRUCTION INDUSTRY STILL IN HARD TIMES

The construction industry is still going through one of the worst economic periods in island history. The industry is only employing 50,000 workers versus 90,000 three years ago, and is yet to feel the full impact of the new housing incentives.

There has been no improvement for the industry in 2010 and few investments in new construction projects. Industry sources say PPPs have not been effective in creating new projects or jobs; the process has been slow. The bank-consolidation process not only took time, but also acquiring banks have had to restructure their construction loans, which in general brought more restrictive conditions and terms to everyone. The Federal Deposit Insurance Corporation (FDIC) has been extremely strict in enforcing lending practices, thereby restricting the extent to which the banks can help local businesses.

On the other hand, the private sector and the government were able to produce an innovative housing stimulus bill.

MANUFACTURING CONTINUES TO DECLINE

Manufacturing jobs continued to disappear largely due to the consolidation of companies and operations in the pharmaceutical industry, which faced an increasing number of expiring patents for blockbuster drugs, a lack of approved new brands and double-digit growth in lower-cost generics, as well as a series of product recalls.

Manufacturing, nevertheless, continued to be the single biggest component of the island GDP as other industries, especially banking, lost ground in the recession and the value of locally made drugs and medical devices grew, albeit more slowly.

The year ended in uncertainty for the industry, as local and U.S. trade organizations charged that Fortuño’s administration damaged Puerto Rico’s investment climate by enacting Law 154, passed in late October, which places a special excise tax on offshore firms with island production. That levy was approved without public hearings just days before Fortuño presented his sweeping tax reform plan at the Capitol on Oct. 25.

TELECOMMUNICATIONS CONTINUED TO GO WIRELESS

Island consumers not only continued to abandon landline phones in favor of cell phones, but they also stepped up to the next level of mobile-phone technology by acquiring



Continued from page 23

smartphones with access to faster Internet service.

Telecommunications technology continued to merge with computer technology with the introduction of smartphones with more gigabytes of memory storage and the latest operating systems.

TRANSPORTATION INDUSTRY ON THE UPSWING

Industry observers agree that 2010 has been a fairly good year for the transportation industry.

"We estimate that cargo volumes in the maritime-transportation industry had a 7% to 9% increase this year over 2009," Hernán Ayala, president of the Puerto Rico Shippers Association, told CARIBBEAN BUSINESS.

The same situation applies to air cargo. Tropical Air's President Harrison Ramos reported that company's volume has seen an increase of almost 15% during 2010.

TOURISM OFF TO A GOOD START

The year got off to a good start for local tourism industry, with hotel occupancy and average daily rates slightly better than expected with minor, but welcome, signs of improvement compared with the dismal performance of the past couple of years.

"Occupancy rate and total hotel registrations were increasing during 2010, with the hotel occupancy rates at 68% to 72% in the past four quarters. Hotel registrations are almost 5% year over year," GDB's García said.

EXPORTS IMPROVING AS RETAIL SALES REMAIN STABLE

Exports also are reflecting a positive movement on a year-over-year basis, with a 6.4% increase between the second half of FY 2010 and the second half of FY 2009, García said.

In the retail sector, meanwhile, consumers, at least those with jobs, will be once again in the driver's seat as providers continue to offer sweeter and sweeter deals to generate sales.

The year 2010 marked the fifth consecutive year with no growth for the island retail industry. Including modest holiday sales, total retail-



industry sales will remain at the \$35 billion mark.

Despite difficult economic times, the majority of industry executives interviewed by CARIBBEAN BUSINESS agree that while 2010 was tough, it was slightly better than the year before as consumers have gotten used to—and have made the necessary adjustments for—living with considerably smaller family budgets, and businesses have trimmed down in light of present economic realities.

The January–September Infoventas report from the Puerto Rico Trade & Commerce Company (CCE by its Spanish acronym) shows retail sales totaling \$25.65 billion, a 1.18% increase over 2009's \$25.34 billion during the same period. If sales continue at the same monthly pace throughout the holiday season, it will bring the industry to the \$35 billion mark.

NOTEWORTHY IMPROVEMENT IN MOTOR-VEHICLE SALES

The trend in motor-vehicle sales was particularly noteworthy, showing a double-digit increase in 2010 after a double-digit decrease the previous year.

The local industry reached 9,153 units in November, for a growth of 20% over the same month in 2009.

End-of-year 2010 sales are estimated to range between 91,000 and 93,000. This will represent an estimated growth of 17% for 2010.

HISTORIC DECISIONS

"I don't like it when people abuse with the word 'historic,' but 2010 was a year of historic events for the Puerto Rico economy," Lara said.

Early in the year, three banks were laid to rest by federal regulators, an unprecedented action in its system-wide implications.

"Toward the end of the year, the Fortuño administration came up with a special tax on multinational manufacturing firms that may change Puerto Rico's industrial promotion policies in a fundamental and permanent fashion," he said. "The adjustment in the banking system and the construction industry is still ongoing. So is the government's fiscal cleanup."

MONUMENTAL BANK CONSOLIDATION, SLOW-TO- DEVELOP EFFECTS

The banking-industry consolidation that wiped out three of the 10 local financial institutions was a painful but necessary step in Puerto Rico's economic recovery, industry and government officials concurred at the time.

By strengthening the island's more viable financial institutions at the expense of its weakest, the FDIC-assisted consolidation was aimed at fortifying the entire sector with the expectation that lending activity would increase, an urgent requirement for the languishing Puerto Rico economy to get back on track. But that has yet to happen.

It was Puerto Rico's largest bank consolidation in more than two decades as well as one of the FDIC's biggest resolutions of failed banks in the financial crisis that struck in the fall of 2008.

LABOR MARKET STILL A CHALLENGE

Puerto Rico's job market continued to be challenging in 2010, with unemployment hovering above the 16% for much of the year. That is up from the 11% range at the onset of the local recession.

As of September, the island labor-participation rate was 41.8%, down from 42.8% a year ago. Employment in September was 1.083 million, down from 1.103 million a year before, or a loss of 20,000 jobs. There were 210,000 people unemployed.

Still, some sectors continued to add jobs, with health and education services leading the way, as construction and manufacturing shed employment.

SHORT-TERM MEASURES

While federal ARRA funds will surely continue to provide a spark over the next 12 months, the federal stimulus alone won't spur rapid growth before running out in December 2011.

The island government is severely restricted in its traditional method of providing stimulus through spending, so the immediate short-term solutions appear to rest on changes to the institutional framework.

The Fortuño administration and the Legislature are pursuing this route through the new Public-Private-Partnerships Law and the overhaul of the entire permits system.

ADVERTISING IMPROVING

During tough times it is important to invest and market. Many companies are doing just that after evaluating operational costs and understanding the importance of keeping brands in the eyes of the consumer, industry experts have said.

This is shown in the latest data provided by Ibope Media, which indicates advertising investment last year fell by 16% to \$1 billion, from \$1.2 billion in 2008. This year, numbers show that advertising investment went back up to \$1.2 billion. These numbers are based on rate cards but don't take into

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account the actual investment after frequency and other discounts.

REFORMS FROM THE GOVERNMENT

The Fortuño administration has launched a series of reforms aimed at reshaping Puerto Rico into a much more competitive investment destination, including a new streamlined permitting process that debuted this month, and energy legislation that provides incentives for the development of private renewable-energy projects.

The administration also implemented an incentives package aimed at stimulating home sales, and launched a tax reform that is currently being considered by the Legislature.

NEW HEALTHCARE ARENA

With an Oct. 1 kickoff, Mi Salud program is still in its implementation phase, with the heart of the program—the creation of the new preferred-provider network—still being formed as doctors, laboratories, health clinics, hospitals and other facilities, and healthcare professionals sign on to the program.

There are fewer insurers in the government health program than in previous years, and large players, notably Triple-S, are no longer participating. The Health Insurance Administration chose two insurance companies, Humana Health Plans of Puerto Rico and Medical Card System (MCS) to provide physical-health coverage, while APS Healthcare was chosen to provide mental-health services.

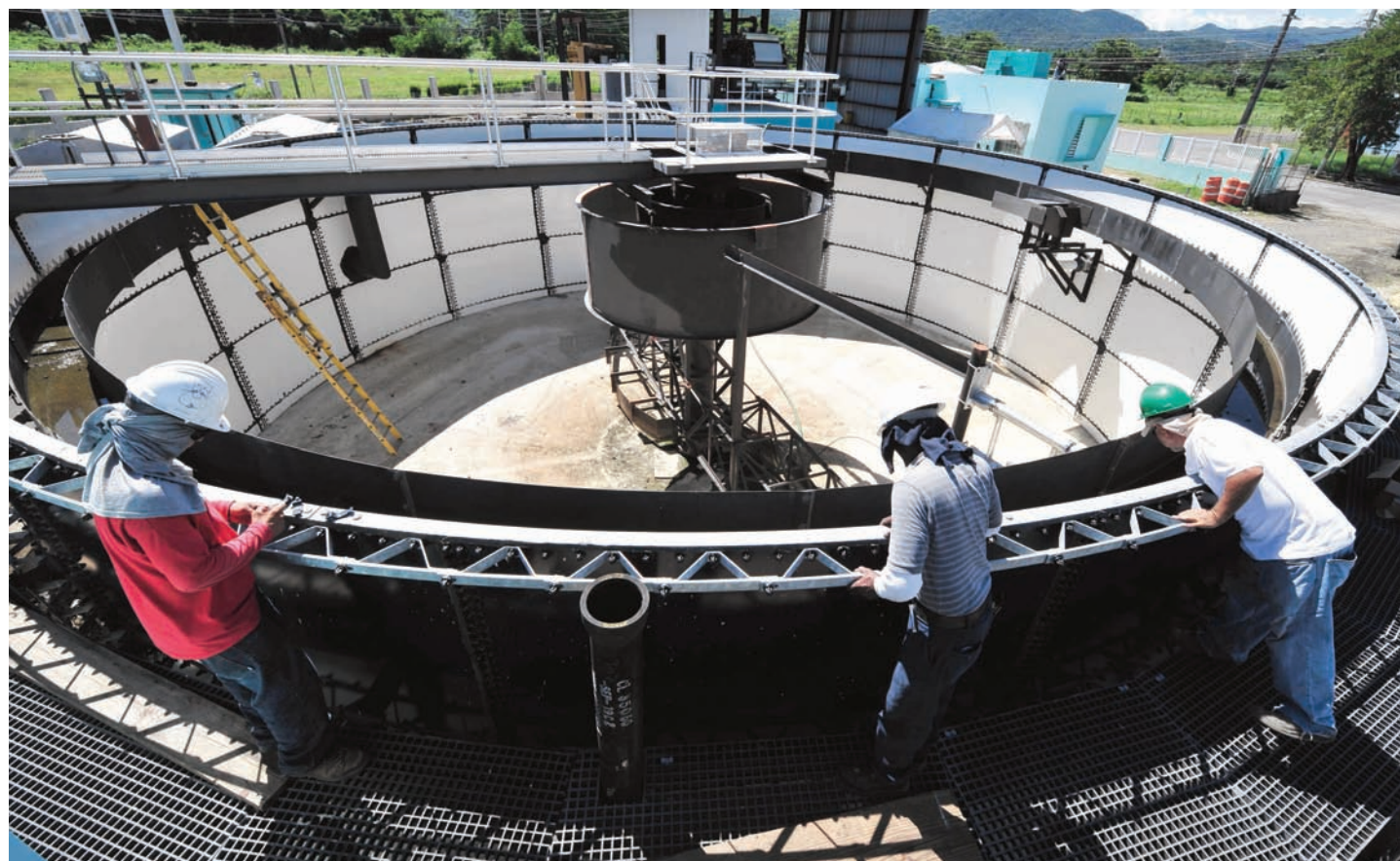
A BUSY LEGISLATURE

One hundred eighty-nine laws had been enacted in Puerto Rico from Jan. 1 to Dec. 8, 2010.

One of these laws grants tax credits for the payment of taxes from income earned this year. Another exempts sellers of newly built homes from income taxes on capital gains and property taxes, and also frees from taxes the income derived from the rental of residences.

Another concedes 30 years of preferential tax rates on the income from certain tourism projects. And yet another exempts from most penalties those who report unregistered real-estate properties.

However, for most of the island trade groups, one single law seems



to outweigh any of those tax benefits legislated this year that brought a fundamental change in what is considered income subject to Puerto Rico taxes.

Under Law 154 of Oct. 25—an offshore company will be subject to local taxes if it purchases the production of an affiliated, island-based manufacturer when those purchases comprise at least 10% of the offshore firm's total purchases, or if the local manufacturer sells at least 10% of its production to that offshore corporation.

Of all offshore companies subject to the new income-Source Rule, those that purchase from affiliated manufacturers that have had sales of \$75 million during any of the past three years will pay an excise tax over the next six years that starts at 4% and ends at a 1% rate.

COST-CUTTING IN THE PRIVATE SECTOR

Many businesses are still trying to survive and have been cutting back very aggressively.

The cost-cutting in the private sector has been going on for five years. During the recession, many companies and small businesses haven't focused on growth, but on whether they have enough cash to stay in business, but it is still ugly out there.

A key question for many firms may be simply about survival. ■

