



THE BOSTON CONSULTING GROUP

# Collateral Damage

*Part 6: Underestimating the Crisis*

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# Contents

1. Introduction	1
2. The Survey: A Summary	2
3. The Effects of the Downturn So Far	3
4. The Corporate View of the Global Economy	4
5. What Companies See on the Road Ahead	5
6. What Actions Are Companies Taking?	7
7. The Action Orientation of the Market Leaders	10
8. Treat Your Company like a Turnaround	11
9. Investors Want Companies to Confront Economic Realities	13

# Collateral Damage

## Part 6: Underestimating the Crisis

*In this sixth paper of our Collateral Damage series, we consider the actions taken by companies around the world in light of the unfolding economic crisis. The source of our information is a new BCG survey of more than 400 major companies based in seven countries around the world. Our key finding is that too many companies appear to be doing too little, too late.*

*We also offer some thoughts about how to instill a sense of urgency into your organization. Even good companies, we argue, should treat their companies like a turnaround. Finally, we have also surveyed a large number of investors and security analysts. The message from them is that they have already written off 2009; their hope is that management will accept the economic realities and use the crisis as an opportunity to equip their companies for the future.*

### 1. Introduction

Newspapers everywhere are full of stories reporting the seriousness of the economic crisis. Opinion pieces debate the likely depth and breadth of the recession. Given the high degree of uncertainty—and the very clear downside risk to most companies—the critical question for stakeholders in any business is this: How well prepared is your company to weather the storm?

In autumn 2008, we urged companies to prepare for the possibility of a serious downturn, while recognizing that businesses in different industries and regions would be affected differently.<sup>1</sup> We argued that all companies should start by defining the magnitude of any potential problem, developing stress-test scenarios—including a worst-case scenario—and identifying early warning signals of any deterioration. We then described a series of actions that we felt companies should take to protect their financial fundamentals, shore up their business fundamentals (ranging from operating cost reductions and cutbacks in capital expenditures or R&D to closures and divestments), and lay the groundwork for taking advantage of the opportunities that all downturns offer. We urged companies to create a crisis-monitoring team to oversee this action plan.

The history of company responses to previous recessions yields a simple, stark lesson: companies that outperform in a recession tend to see it coming and move rapidly to reduce their cost base. (See Exhibit 1.) They respond in a measured way that allows them not only to avoid the need to slash costs but also to spend less to restore business momentum as the recovery takes hold.

In November 2008, the International Monetary Fund reduced its forecast for global GDP growth in 2009 to 2.2 percent, forecasting a severe recession in the developed economies—and a material slowdown in the developing economies. This provided the economic context for an informal survey of 65 companies worldwide that we conducted in early December 2008 in order to gauge the extent to which companies were following our prescription.<sup>2</sup> To our surprise, most—with the exception of those in the automotive and construction industries—were assuming that the crisis would have a very modest impact in 2009. Given that companies in our December sample were generally not planning for any significant volume growth in 2009 (in contrast to the preceding boom years), few had conducted a comprehensive scenario-planning exercise in order to establish what serious volume or price shortfalls could mean for their company.

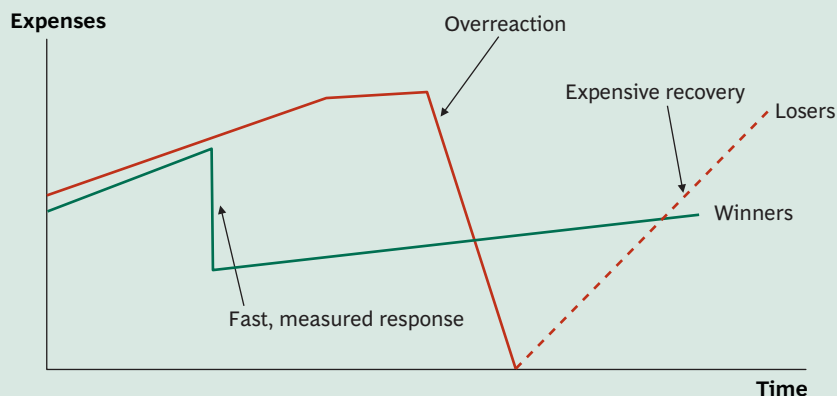
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1. See *Collateral Damage, Part 2: Taking Robust Action in the Face of the Growing Crisis*, BCG White Paper, October 2008.

2. See *Collateral Damage, Part 4: Preparing for a Tough Year Ahead: The Outlook, the Crisis in Perspective, and Lessons from the Early Movers*, BCG White Paper, December 2008.

## Exhibit 1. Winners and Losers Approach a Recession Differently

Illustrative example based on empirical research from the recession of 1992



**Typical crisis management results in cyclical overshooting:  
Too late! Too much! Too random!**

Sources: Sequoia Capital; P.A. Geroski and P. Gregg, *Coping with Recession: UK Company Performance in Adversity*, Cambridge University Press, 1997.

Since early December, bad news has continued to be the rule rather than the exception. In January 2009, the IMF substantially lowered its forecasts to 0.5 percent global GDP growth in 2009, representing a 2.0 percent contraction in the developed economies and a much-reduced growth rate of 3.3 percent in the developing economies. In mid-March 2009, we decided to undertake a much larger and more structured survey in order to determine the changing view of the crisis and the actions companies were taking to tackle it. As our March survey was being administered, the IMF announced that it would further lower its GDP forecasts and is now projecting the first global economic contraction since World War II (–0.5 to –1.0 percent). All the developed economies are expected to be in a severe recession, collectively contracting between –3 and –3.5 percent. The developing economies are now expected to grow at only about half the rate projected as recently as January.

The slowdown started in the United States and came later to a number of other “trade deficit” economies such as the United Kingdom, France, and Spain, before hitting the “surplus” countries such as Germany and China. But by the time our March survey was administered, all respondents had had months of exposure to the deteriorating global economy: falling consumption, shrinking output, increasing unemployment, and general pessimism. Given this context, some of the responses are startling.

In the next section, we highlight the results from our survey.

## 2. The Survey: A Summary

Our survey provides a view of how companies in the developed economies are responding to the deteriorating economic conditions. Our sample comprised the following:

- ◇ 439 companies in 13 sectors (excluding financial services) with sales above \$1 billion
- ◇ Companies drawn proportionately from the United States, the United Kingdom, Germany, France, Italy, Spain, and Japan
- ◇ 86 companies with reported sales above \$20 billion and 173 companies with reported sales between \$5 billion and \$19.9 billion

- ◇ 258 companies that described themselves as a “top-three competitor” in their industry, with 65 of these companies defining themselves as market leaders (at least in the country for which the respondent was answering the survey)

Astonishingly, companies are still underestimating the size and scope of the economic crisis. They are generally too optimistic about their own performance and believe that they have taken sufficient steps to respond to the crisis. They often tend to be too inward looking in their forecasts, relying on their own 2008 experience rather than fully assessing the changing external environment: managers do not like to create or accept negative plans. Consequently, although taking action, companies have not adopted the steps either to protect themselves from the worst effects of the downturn or to prepare for the upturn. Companies that were the first to feel the effects of the crisis are busy fighting fires, while those that have not yet been affected are still scouting for opportunities and have not invested in getting prepared.

We believe that this is worrisome news. In the absence of early, measured responses, companies risk having to hit the panic button—overreacting to events somewhat late in the day. These exaggerated responses can cause significant harm to individual businesses; if repeated on a large scale, they will have material negative consequences across economies, amplifying the scope of the downturn.

Companies outside the top three in their industry have been slower to act and will likely suffer disproportionately from the recession. In contrast, market leaders, even though they have not been as badly affected as their lower-ranked rivals, are doing more to address the crisis. Too many companies are focused on taking easy measures: cutting travel, entertainment, internal meetings, and the like. Far fewer are even contemplating taking measures that would increase their long-term competitiveness.

If, as we argued in our fifth paper, there are some sobering new realities with which to contend over the long term, then companies should expect a long postrecession period characterized by slower growth and lower profitability.<sup>3</sup> In such an environment, planning more robust long-term reductions to cost bases is a course of action that we think should be started now.

### 3. The Effects of the Downturn So Far

In a nutshell, although the downturn was already hitting hard by the last quarter of 2008, it was typically not yet reflected in company financials. Consequently, it was hard to instill a sense of urgency. Overall, most companies were slow to adapt because many management teams had not accepted the speed and severity of the downturn.

Nearly a third of the companies in our survey suffered a moderate sales decline (between zero and –10 percent) in 2008 compared with 2007. One in ten of our survey respondents suffered a more severe sales decline. Market-leading companies typically suffered less of a decline than did companies in challenger positions, while one-third of our sample continued to experience growing sales in 2008. Although three times more companies experienced higher rather than lower input costs (presumably reflecting the high commodity prices that prevailed for a significant period in 2008), only 39 percent of companies felt able to raise prices, with 28 percent lowering prices. By the time these competing forces had played out, half of our sample had suffered a decline in profitability in 2008, while one-third had increased profits.

When we look behind these data, we find that market-leading companies are significantly less affected than the rest, reinforcing the classic strategic adage about the importance of targeting a top-three position in any business in which you compete. For example, 55 percent of market leaders grew revenues in 2008, compared with 40 percent for the second and third players in a market, and only 22 percent of companies outside the top three grew their revenues. Similar patterns emerged for changes in price realization. When the different effects are consolidated in profit realization, the leading competitors tended to increase profitability even in a tough year (58 percent increased profitability in 2008), with less than a third seeing

3. See *Collateral Damage, Part 5: Confronting the New Realities of a World in Crisis*, BCG White Paper, March 2009.

declining profits. In contrast, for companies outside the top three, 61 percent suffered declining profitability in 2008 compared with 2007, with only 21 percent seeing improvements.

#### 4. The Corporate View of the Global Economy

In spite of the IMF's projecting a contraction of all developed economies, more than a third of the companies in our survey were still forecasting GDP growth in 2009. Although this clearly means that most companies expect conditions to worsen in the short term, more than half were assuming a recovery from mid-2010 on and were planning accordingly. More surprisingly, although the companies in our sample were surveyed in March, more than 60 percent were taking a more optimistic view of their economy than the IMF had projected two months earlier. They were therefore even more badly out of line with the subsequent downward revision by the IMF in March. This is just one example of the many responses to our survey that persuade us that many companies are unable (or unwilling) to consider sufficiently the effects of external economic events on their businesses. Consistent with this, only a third of the companies said that they had a team actively monitoring the external economic environment, although this proportion increased to half among market leaders.

Companies in the United States and Germany are the most optimistic about the timing of the recovery, with two-thirds believing that their government actions will improve economic conditions. Across our sample, only 17 percent expected an L-shaped recession. This was distorted by the high number (22 percent) in Spain and an astonishing 41 percent of companies in Japan that expect an L-shaped recession. Arguably, the Japanese companies have seen all this before and have based their expectations on bitter experience.

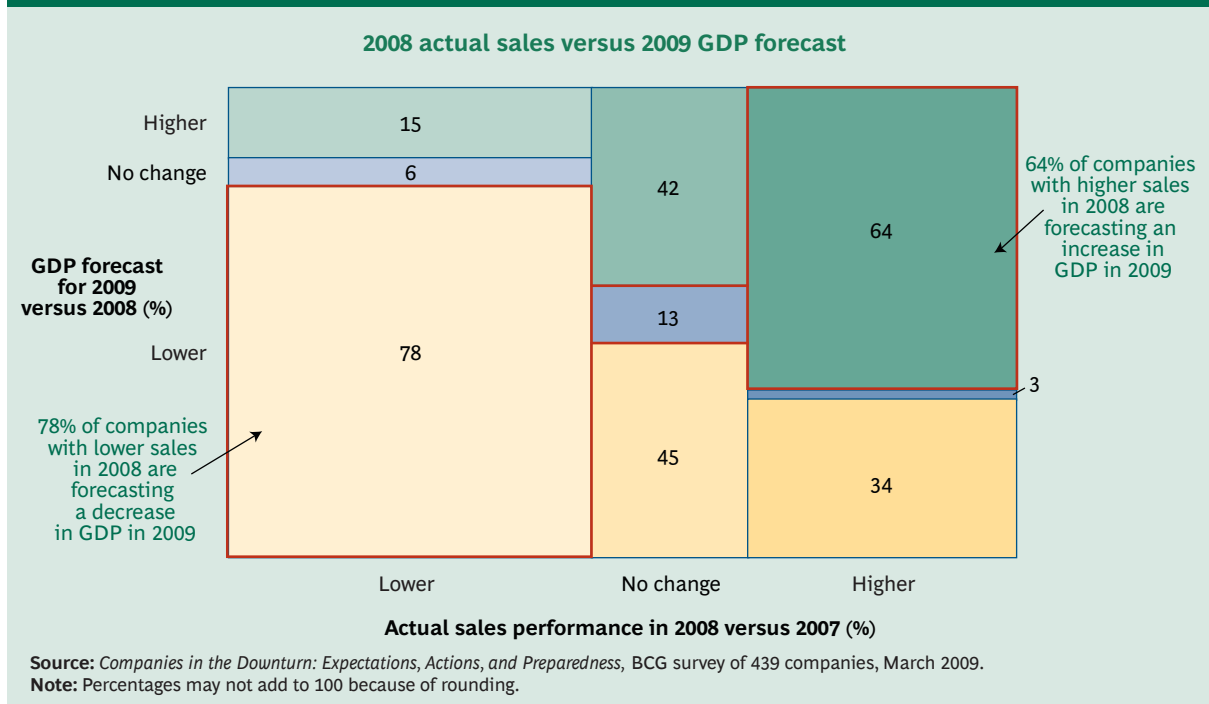
Given their optimism regarding their own company's fortunes, respondents were surprisingly pessimistic about some of the developing new realities in the global economy. Companies in the United States, the United Kingdom, and France expect increased levels of regulation in their economies beyond the financial services sector. Interestingly, while around two-thirds of respondents from countries with a trade deficit (the United States, France, Spain, and the United Kingdom) expect increased protectionism, reduced global trade, and a move toward reindustrialization of their economies—probably driven by the political rhetoric to which they are exposed—those countries with a trade surplus (Germany and Japan) believe that such changes are less likely. The risk for companies in the deficit countries is that they fail to prepare for the possibility of a more constrained global economic order, basing their worldview on the perspective formed by the security of a surplus economy in which protectionism and industrial decline are far less of an issue.

At the sector level, the energy and utilities, health care, and commodities sectors are the most concerned about protectionism, with nearly two-thirds of them expecting it to increase—particularly the more insidious, informal type. The automotive, industrial goods, energy and utilities, and construction industries are the sectors most concerned about a postrecession reduction in global trade, with nearly three-quarters of them expecting a long-term decline.

We have been consistently concerned about the prospect of deflation in the short term—and the risk of inflation in the long term as government fiscal-stimulus programs and quantitative easing initiatives take hold and governments react too late to neutralize the inflationary pressures. It would appear that most companies do not share our short-term concerns: more than half of the companies in our survey expect inflation to increase. In France, Germany, the United States, and Italy, fewer than 20 percent expect inflation rates to decrease, although nearly half the companies in the United Kingdom and Spain expect inflation to drop markedly.

In analyzing our respondents' answers, we realized that the external perspectives of many companies tended to be shaped not by external forecasts (or, indeed, the realities) of the macroeconomic environment but rather by what happened to their own business in the preceding year. Companies that experienced sales growth in 2008 were four times more likely to forecast GDP growth for 2009 than were companies that experienced sales declines. (See Exhibit 2.)

## Exhibit 2. GDP Forecasts Are Driven by a Company's Own Sales Experience



This tendency to wish away the external environment, which was common to the responses of companies in the survey, was also manifested in a disconnect between the pricing assumptions built into business plans and the observations made about the external environment. Approximately two-thirds of our respondents expected to see increased price sensitivity among their customers, a greater threat of bankruptcy among both customers and suppliers, and reduced company profits. In spite of this, companies did not adapt their plans or forecasts. Companies still expected to pass on increased input costs to their customers. Price realization assumptions turned out to be highly correlated with input price expectations—but not with expectations of increased price elasticity among customers. This suggests that company profitability in 2009 will turn out to be lower than expectations.

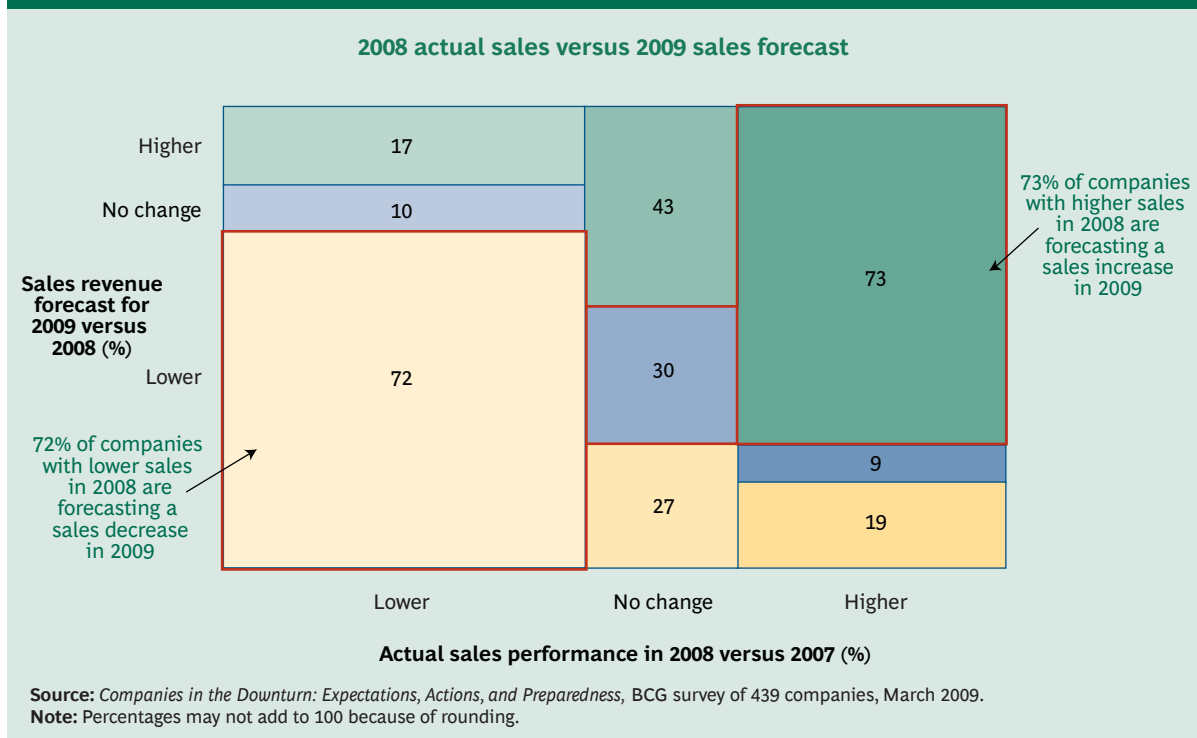
### 5. What Companies See on the Road Ahead

The companies in our survey were evenly divided regarding whether their sales would increase or shrink in 2009. However, their perspective was clearly shaped by their own sales performance in 2008—companies that experienced sales growth in 2008 were four times as likely to project sales increases in 2009 as those that experienced sales declines in 2008. (See Exhibit 3.)

When we de-average the sales numbers by industry, we see far more dispersion in 2008 sales results by sector than we do in the forecasts. In 2008, the automotive, construction, and industrial goods sectors were the worst hit, while health care, commodities, and energy and utilities were relatively unaffected. For 2009, the health care sector is the most optimistic, although we expect that some of the newly confident interventionist behavior displayed by governments around the world may turn the spotlight on health-care profit margins. More surprising, half of the retailers in our survey expected things to improve in 2009—either because they were hit so hard in the last quarter of 2008 that they do not see how there could be further deterioration or because they expect to benefit from efforts to stimulate consumer demand.

For 2010, half of the companies in our survey are expecting higher sales compared with 2009 (with only a third still expecting lower sales). For 2011, only 19 percent are still expecting sales to be lower than the previous year.

### Exhibit 3. A Company's Sales Forecasts Are Driven by Its Own Sales Experience



The market-leading companies are somewhat more optimistic than their less well-placed challengers. They expect to increase sales each year for the next three years, while the companies outside the top three are fairly evenly split regarding whether 2010 will be a better sales year than 2009. It is only in 2011 that most companies expect their fortunes to improve. Those companies ranked second or third in their market expect their fortunes to improve in 2010.

Overall, it seemed that most companies, while telling us that they expected a U-shaped recession, were behaving as if it were more likely to be V-shaped. As we noted earlier, a relatively small number (outside of Japan) expect an L-shape.

We also asked the companies in our survey about how they saw their industry profitability developing. While nearly two-thirds of them told us that their industry profitability would decline, more than 40 percent forecast higher profitability for their own companies—demonstrating either a disconnect between their internal planning processes and the external world or a strong expectation of outperforming their competitors. We also wonder whether this was an example of the unwillingness of senior management to plan for anything less than continued improvement—and whether such behavior inhibits an effective planning process in times of crisis. We know of many companies in which business unit executives who plan for a contraction are asked to rethink their planning. In our discussions with executives around the world, many comment on the use of unsupported assumptions in company plans—either undefined cost savings or revenue enhancements. In a similar vein—and even more marked—more than 70 percent of the executives we questioned predicted increased price sensitivity in their customer population. Remarkably, however, more than one-third of respondents were nonetheless budgeting for increased selling prices, while only a third expected their own prices to decline.

On the subject of executives shying away from bad news, we were struck by some observations from Chip Heath, a professor at Stanford Business School who studies how bad news circulates. There has clearly been a lot of bad news in business lately. And arguably a lot of it is a result of leaders who ignore bad news—until it turns into worse news. According to Heath, “There’s a bias for optimism in humans and in organizations. Individuals don’t ever go looking for bad news, and we don’t like telling it to others. So bad

news is unlikely to get to the people who can actually do something about it.”<sup>4</sup> This behavior is embodied in a Danish company in which it is forbidden to talk about the crisis. The CEO has designated an assistant to cut all news related to the crisis from the newspapers every day. While we applaud such optimistic spirits, we would argue that ignoring the crisis is a recipe for disaster. (See the sidebar “A Major Consumer-Goods Company Was Less Well Positioned Than It Thought.”)

## 6. What Actions Are Companies Taking?

Almost every one of the companies surveyed has put in place some sort of downturn management process. Two-thirds of respondents have reviewed their 2009 plans within the last three months, and almost all of them have revised their plans downward. Some 80 percent have put in place some form of crisis-monitoring team to track important internal measures. However, only a third are tracking the external environment closely.

The downturn action plans vary significantly. Companies that were already materially affected in 2008 tended to be busy firefighting—discounting prices, cutting capacity, and laying off employees. Those that

4. From *Fast Company*, <http://www.fastcompany.com/magazine/62/badnews.html>.

### A Major Consumer-Goods Company Was Less Well Positioned Than It Thought

A U.S. consumer-goods company was a market leader in many segments, with growing sales, profits, and market share and enjoying strong profitability. A large group of its sales and marketing senior executives met in late 2008 with the objective of understanding the impact of the downturn—especially on key strategic initiatives—and reviewing priorities for 2009 and 2010. In a survey prior to the meeting, most of the management saw the downturn as representing an opportunity for the company.

The first thing the executives did at the meeting was to think through the likely reaction of their retail-company customers to the crisis. From a long list of reactions, they identified several that retailers would likely pursue in light of the economic downturn: increase promotional activity, extend payment terms, push their private-label business, reduce inventories, and delist more of the secondary brands. Out of a long list of potential retail-company responses, only two seemed to offer opportunities for this consumer-goods company. The rest were threats to both sales and profitability.

The executives then asked themselves which initiatives were important if the company was to thrive during the downturn. They developed another long list of important actions, including how well the company did the following:

- ◇ Understood its exposure to the downturn

- ◇ Focused on the most promising initiatives
- ◇ Prioritized and directed its marketing expenditures toward high-impact opportunities
- ◇ Reprioritized R&D and capital expenditure initiatives
- ◇ Understood the weaknesses of major competitors
- ◇ Renegotiated costs with suppliers for 2009, particularly so that the company would have the flexibility to increase sales and marketing investments
- ◇ Prepared contingency plans with trigger points
- ◇ Identified M&A opportunities

Without exception, their self-diagnosis was that they were not in a good state of readiness, having failed to properly think through most of these priority areas for action.

We would argue that in planning for 2009 and 2010, too many companies have not adequately considered the impact of the downturn on their customers and suppliers. It is not possible to get prepared in a vacuum. From customers come changing needs and price pressure; from some suppliers come reduced innovation and financial distress. How do these dynamics affect your plans for 2009 and 2010?

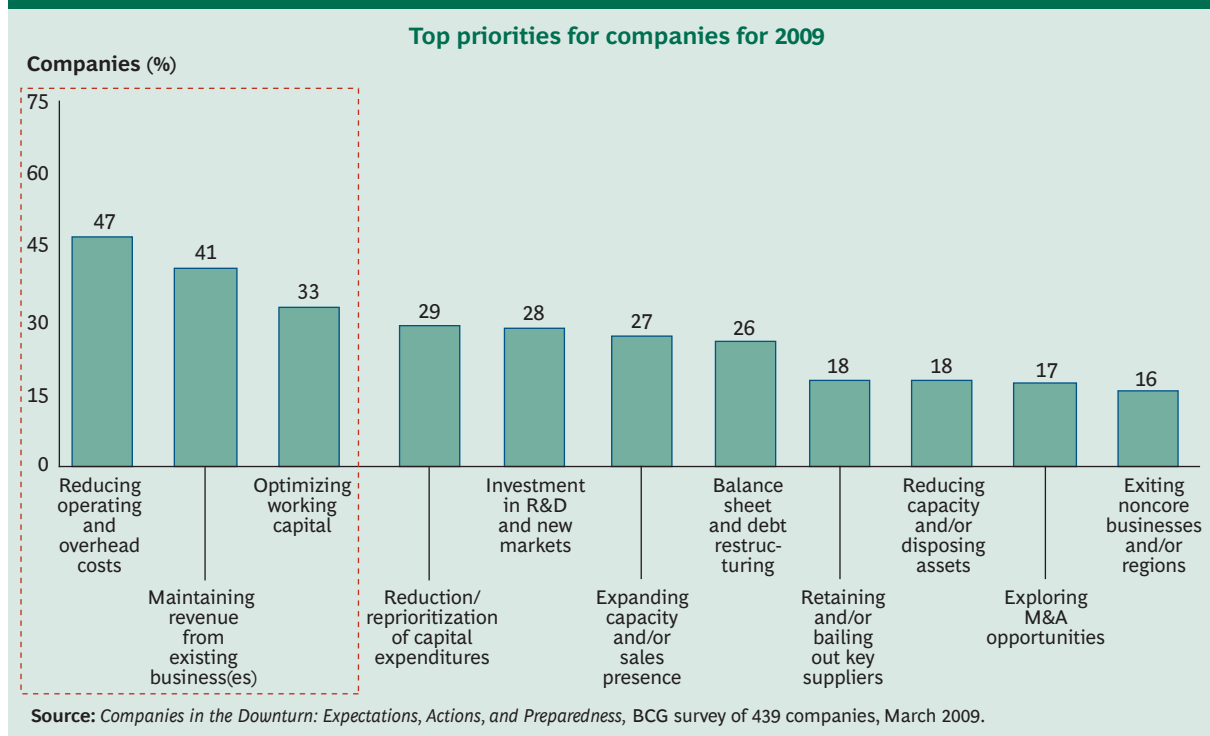
were relatively unaffected in 2008 but expected their markets to decline over the next year were more likely to be “getting prepared”—typically, putting in place programs to conserve cash, preparing cost reduction contingencies, and considering whether to exit businesses. Those that were unaffected and expected their markets to continue to grow were expanding carefully. These companies were focusing on growth options such as new-product launches and M&A opportunities, as well as securing strategic suppliers by, for example, speeding up payables or even making loans to suppliers—mechanisms that clearly take into account the realities of the crisis.

The companies in our survey generally displayed a strong optimism about the effectiveness of their actions. More than two-thirds of the sample described as “satisfactory” or “very satisfactory” the speed of their company’s reaction, the quality of the action plan, and the capability of both senior and middle management to address the economic challenges effectively. Fully 55 percent expected their organization to emerge stronger from the crisis; only 15 percent expected to emerge weaker, but this hid the fact that only 7 percent of market leaders expected to weaken versus 22 percent of those outside the top three. Overall, we believe that this optimism shows that companies are underestimating the impact of the crisis on their businesses. Moreover, it conflicts with our belief that postrecession global (and corporate) growth will be slower for a prolonged period and accompanied by an associated downward pressure on corporate profits.

We questioned companies about more than 50 actions that they could take in the face of the recession, and 69 percent reported taking between 11 and 30 actions to mitigate the downturn. We asked respondents to define the top three priorities for their company. The most important areas of focus were reducing operating and overhead costs (47 percent), maintaining revenue from existing businesses (41 percent), and optimizing working capital (33 percent). At the other end of the spectrum, there was far less emphasis on reducing capacity or disposing of assets (18 percent), exploring M&A opportunities (17 percent), or exiting noncore businesses or regions (16 percent). (See Exhibit 4.)

We found that companies tended not to de-average their response to the crisis. For example, companies that were focused on reducing costs (through contracting head count or cutting capacity) tended to pursue

#### Exhibit 4. There Are Clear and Specific Downturn Priorities Emerging for 2009



this course single-mindedly; only a third of the companies addressing cost reduction were selectively adding employees or capacity in one area while reducing in another. For a selection of other actions—such as making acquisitions and divestitures and adjusting product lines and target segments—the single-minded focus was even more apparent. Given the difficult market conditions, it was perhaps least surprising to see that more than half of the 60 percent of respondents addressing their target customers were seeking to extend the range of customer segments with which they dealt. In a recession, a competitor's customers or more marginally profitable customers can seem very attractive. But if every company goes after the same customers, competition will be tougher and price pressure will increase. The market leaders were significantly more likely to de-average their responses, with nearly half of them pulling both the expansion and the contraction levers. Even here, however, conservatism is the order of the day.

Companies that saw sales fall in 2008 were twice as likely to be prioritizing actions to reduce costs as those companies for which 2008 had been less traumatic. In contrast, this latter group was 50 percent more likely to increase investment in R&D and seek M&A opportunities.

We turn now to the details of what companies are doing to respond to the downturn.

**Protecting Financial Fundamentals.** In context, 23 percent of our sample described their businesses as cash rich, while 14 percent considered theirs to be cash constrained. In a recession, cash is king. We were therefore surprised to discover that, regardless of a company's cash position, conserving cash was not a sine qua non: 82 percent of our sample were taking at least one measure to improve their cash position. The most popular measures were to reduce inventory levels (49 percent of our sample), introduce a top-down review of cash management and cash flows (48 percent), and postpone expansion plans (47 percent). Market-leading companies were nearly twice as likely to reduce working-capital requirements as the companies outside the top three.

What was somewhat surprising to us was that only two-thirds of the cash-constrained companies had kicked off a top-down review of cash flows, and only approximately half had put in place a plan to reduce working-capital requirements and inventory levels.

**Protecting the Business Fundamentals.** Nearly all our respondents were taking at least one short-term cost-reduction initiative, 80 percent were taking medium-term initiatives, and 63 percent were addressing long-term cost reduction. We asked our respondents to tell us which short-term, quick-to-implement cost-reduction initiatives they were pursuing. A quarter were taking only one or two actions, while a third were taking more than four. The three most frequently cited actions were reducing marketing expenditures, cutting travel and administrative costs, and adjusting wages—typically, through bonuses or hours worked. As we have mentioned previously, cutting marketing expenditures is a very common response, but it is one that can backfire. The evidence from previous recessions is that—after a recession was over—those companies that had continued to support their products and services typically outperformed companies that had, less thoughtfully, slashed marketing expenditures when the downturn hit. We do not argue for no cuts—rather that cuts be carefully balanced in the context of competitors' actions.

Some of the medium-term cost-reduction actions are tougher to implement and, consequently, have been pursued (so far) by fewer companies. As the recession's bite worsens, we expect to see more attention turned to these areas. Just over 40 percent of our sample were reducing employee numbers, 37 percent were renegotiating lower rates for contract workers, 31 percent were reducing production capacity, and 30 percent were reducing sales presence.

Toughest of all are the long-term cost-reduction initiatives. It is possible that we are too early in the cycle for many companies to be convinced that such actions are necessary, but, as readers of this series have seen, we are fairly convinced that preparation for a different economic environment should begin now. Nevertheless, companies were already acting: 38 percent of companies in our sample were using the downturn as an impetus for exiting certain product lines, 35 percent for exiting certain regions, and 30 percent each for divesting businesses and exiting certain customer segments.

**Maintaining or Expanding the Top Line.** Our respondents have acted to both protect existing revenues and find new markets. In terms of revenue protection, approximately half of the companies are increasing their focus on key-account management. The same number are increasing the use of promotions and discounts. Other approaches include increasing sales force incentives (41 percent), marketing expenditures (37 percent), and trade credit (30 percent).

In terms of revenue expansion, half of the companies in our survey plan on expanding into new customer segments and the same proportion plan to launch new products. Similar emphasis is also being placed on launching additional sales channels, extending geographic footprint, and enlarging sales presence. In shrinking global markets, we can expect increasingly tough competition. Broken or inefficient business models and uncompetitive products and services are far more likely to be found wanting under such conditions.

Companies recognize the pressure being placed on their suppliers. In spite of their own needs to improve working-capital ratios, half of our sample said that they would offer guarantees to suppliers, 41 percent said that they would actually speed up payments, and nearly a third said that they would be making loans to suppliers. Once again, the differences between market leaders and those outside the top three were quite marked, with the leaders far more likely to take these actions.

## 7. The Action Orientation of the Market Leaders

Although market leaders have been less affected by the downturn so far, they are doing more to prepare for the downturn—both for short-term protection and to benefit in the long term. In contrast, middle-of-the-market players run the risk of losing even more ground during the downturn: they have been more severely affected already, yet they are doing less to counter the downturn.

Market leaders are doing the following:

- ◇ Undertaking more frequent reviews of their budgets and plans, typically every quarter
- ◇ Tracking the external environment—both macroeconomic and industry indicators—with far greater seriousness
- ◇ Actively getting prepared for the downturn by acting early to reduce operating costs and overhead while optimizing working capital—even though, typically, they have been less affected than their lower-ranked rivals
- ◇ Aggressively acting to protect cash by reducing working-capital requirements, postponing capital expenditures, and paying down debt
- ◇ Variabilizing fixed costs and reducing breakeven levels by reevaluating outsourcing and opportunities to increase shared services
- ◇ Cutting costs more decisively by reducing production capacity, and more aggressively laying off employees
- ◇ Actively exiting underperforming businesses and divesting assets
- ◇ More than the other companies in the survey, trying to secure future growth by investing in R&D and innovation
- ◇ Protecting and growing their existing revenue base by increasing marketing expenditures and focusing on key accounts
- ◇ De-averaging the actions they are taking by simultaneously cutting costs or capacity or increasing expenditures or capacity in different parts of their portfolios, depending on potential, as well as oppor-

tunistically seeking attractive acquisition opportunities while not shying away from difficult decisions about underperforming businesses

## 8. Treat Your Company like a Turnaround

We have consistently urged management to regularly revisit forecasts and plans as the downturn plays out and to build scenarios explicitly linking the changing macroeconomic and industry environment to business forecasts. Companies need to review their businesses and (if necessary) make changes more frequently. This means identifying specific leading indicators for individual markets, the industry overall, and the company specifically—and using these data to make decisions.

Companies should plan for the worst (while clearly hoping for the best). This means developing contingency plans, protecting cash, and being more selective in addressing expenses: cutting short-term costs while preparing the foundations for being a long-term low-cost competitor. After all, we can see no circumstances under which it would not be attractive to be as low cost as possible.

We believe that an effective way to manage even a well-run company in times of economic upheaval is to follow some of the disciplines typically imposed by a turnaround manager. We do not argue that what follows is a prescription for everyone, but there are valuable lessons and tools for most managers.

Typically, a company calls in a crisis manager when it is on the brink of a liquidity crisis. The crisis manager's immediate goals are to create stability and ensure short-term survival, using tools and processes that are focused heavily on the pragmatic. But in most cases, mere survival is not the ultimate goal. A good crisis manager devises a blueprint for taking advantage of opportunities that the crisis creates, quickly and effectively transforming a struggling company into a competitive entity that is well positioned for future success. Of course, there are risks involved in attempting to turn companies around swiftly. But in such cases, the risks are outweighed by the potential benefits.

Crisis managers generally take action to achieve the following:

**Create visibility on liquidity and time horizons.** Although this is a nondisruptive exercise in prudence and planning, it is surprising how few top executives of companies that are suffering through mild to moderate crises truly grasp their current and (probable) future liquidity positions. Knowing current cash-flow dynamics is obviously important, but it is equally critical to understand the hurdles to drawing on existing credit facilities. Moreover, it is vital to understand time and liquidity relationships in a variety of market scenarios. For example, what happens if a major supplier goes out of business or if a transport provider can no longer provide credit terms?

**Instill urgency by tracking and reporting what is relevant to the business situation.** A company managed with the same processes that were in place before the crisis is probably operating in a state of denial. Overcoming this and instilling a sense of urgency are prerequisites to accomplishing any kind of substantive change. One way of emphasizing the need for urgent change is to monitor, on a biweekly basis, indicators such as order intake, margin development, and backlog.

**Stabilize the company.** In a crisis or at times when external financing is very tight, it is imperative to manage cash. Liquidity must be handled using a shorter-than-normal forecasting cycle—whether it be 13 weeks or shorter. Such increased discipline and attention to detail allow faster decision making and ensure that the right information is in management's hands at the right time. Under such constraints, a crisis manager often freezes capital expenditures, stops internal projects, and imposes a general hiring moratorium. Such steps are not intended to be long-term measures, but they do buy time in a true crisis situation, as well as help communicate a sense of urgency to employees. Also, a crisis manager liberates cash from the balance sheet, managing receivables and payables more aggressively and reducing inventory to a minimum.

Another key element in stabilizing a company is making sure that people focus on their own tasks and do not become distracted. This is especially important for departments or employees operating with a high degree of independence. The sales force, for example, must focus its time on the most important customers and support the communication of key messages in the field.

**Determine the long-term viability of businesses.** Trying to preserve businesses that are no longer viable often contributes to a major corporate crisis. Closing or divesting such activities is an absolute must. What is more, finding consensus to do so can be easier in times of crisis than in more stable times when, for example, internal politics, company history, or exaggerated linkages with other businesses can create obstacles.

Divesting or closing business units under duress usually yields a less optimal return than it would under better market conditions. Still, having to sell at lower prices is often a better long-term solution than not divesting at all.

**Plan for different revenue scenarios and for minimum efficient scale.** A good crisis manager plans for diverse revenue scenarios, for example, defining the company's minimum-efficient-scale profile on the basis of a skeletal fixed-cost structure and the corresponding minimum revenue required to break even. This approach, in contrast to that of issuing drastic, top-down cost-cutting and revenue directives, can yield achievable business plans and meaningful actions that find sufficient support from all involved and, as a result, ultimately increase competitiveness, instill a fresh sense of purpose, and put the business on a new foundation.

Developing bottom-up business plans for different scenarios is feasible only when the company still has sufficient time to avoid a true crisis. In dire situations, crisis managers are forced initially to take a top-down approach that amounts to cutting  $x$  percent of the cost base to ensure liquidity.

**Lead from the top and ensure buy-in throughout the organization.** During a crisis, employees look for strong leadership. They want to know that plans have been well thought out and are realistic. There is often a tendency toward cynicism that can be beaten back only with sound and transparent plans—especially in companies that have gone through previous restructuring cycles. Typically, to achieve the necessary speed, a company needs to form a small core team of decision makers.

Ultimately, to secure the buy-in and follow-through of the entire organization, internal communication must be frequent and well planned, especially when the number of decision makers is smaller than before.

What is more, in any turnaround situation, there is a great risk of losing key employees. This risk is reduced during tough economic times, but good managers are careful to let key employees know that the company values them and wants to retain them. They focus employees on achieving new goals and align compensation and rewards accordingly, tying bonuses to the achievement of specific results and often reducing the bonus cycle to between three and six months.

Many components of the crisis manager's toolbox amount to sound management techniques under any market circumstances—simply implemented in an accelerated fashion. Others, such as hiring or salary freezes, are not meant to be long-term measures. Closing or divesting noncore activities is typically accomplished quickly. Waiting for the “best time” rarely works. The benefit of acting early and improving the cash situation and flexibility often outweighs the loss incurred by a potentially suboptimal selling price—assuming that the price does not amount to a fire sale and the divestiture does not weaken the company's structural position. Also, closing an unattractive business is typically easier in a downturn than in an upturn.

The crisis manager's approach is an effective one to take in the current economic downturn. Some companies are already in crisis and need to take significant action immediately. Many others still have the

financial resources to adapt to the treacherous market environment that surrounds them, without needing to resort to such drastic steps. It is nonetheless critical for these organizations to make detailed plans for the more threatening market scenarios that could still happen. Facing up to these scenarios, developing action plans for coping with them, and seizing the opportunities they offer is very challenging. It is also prudent management.

## 9. Investors Want Companies to Confront Economic Realities

After years of investors pressuring management to accelerate growth and increase leverage, business leaders may feel that investors have not demonstrated much appreciation of external economic realities. In some quarters, the investment community has been criticized for behaving as if the only way forward were up. At the same time, many investors have been frustrated by the lack of transparency in corporate strategies and financial statements. One thing is clear: executives need to be confident that their company's investors agree with the priorities its executives have set for the company in the face of the recession. Executives need to know how investor sentiments will affect the company's market value.

To find out, BCG has surveyed a broad cross section of professional investors and market analysts in the United States and Europe, asking them how they think companies should be responding to the downturn.<sup>5</sup> The results may surprise those who assume that investors care only about short-term results.

One consequence of the downturn appears to be that investors are focusing more on the long term. Nearly three-quarters (72 percent) of our survey respondents said they favored companies' making long-term investments that strengthen their competitive position—even if it requires lowering earnings-per-share guidance over the next few quarters. In effect, those investors have already written off 2009 and are looking to 2010 and beyond. As one respondent put it: "This is a unique time in history to gain [market] share and keep it. No one is pricing stocks on 2009 anyway."

In an environment that most view as a narrow "stock picker's market," such investors are seeking financially strong companies that also have a clear plan for using the downturn as a springboard to improve their competitive position. A full 84 percent of respondents saw the current downturn as a "once-in-a-lifetime opportunity" for some companies. To be sure, those with weak balance sheets or immediate liquidity problems—the "have-nots" of the current bear market—can do little more right now than focus on survival. But when it comes to those companies that are the "haves"—those with strong balance sheets and no serious liquidity issues—investors believe that 2009 is the time for game-changing moves. Indeed, many (nearly 40 percent) worry that the haves are not being aggressive enough.

Our respondents want active engagement with the companies they invest in and more transparency in how a company is affected by the recession and how it plans to emerge from the crisis in a stronger position. They also think that there is wide room for improvement in companies' investor-relations practices. Nearly half (46 percent) believe that companies do a poor job of this kind of transparent communication today—and nearly three-quarters believe that companies' investor-relations performance either has not improved or has actually deteriorated over the last two years.

Such transparency requires that a company's corporate strategy, financial policies, and approach to and communications with investors be aligned. On average, investors believe that fewer than 25 percent of the companies in which they own holdings have appropriately aligned these three dimensions. "Aligning corporate, financial, and investor strategies is one of the most important actions a company can take today, and I don't see many companies doing it," said one investor.

5. For a detailed account of the findings of BCG's investor survey, see *Valuation Advantage: How Investors Want Companies to Respond to the Downturn*, a Collateral Damage Function Focus that will be available shortly.

Over the last six months, a global slowdown has become a global recession. BCG's survey results suggest that too many companies are reacting late and with insufficient purpose. The actions companies take over the next few weeks may well help determine their long-term competitiveness. The ability to control one's own destiny disappears when the response becomes one of belated necessity rather than early anticipation. This is because the responses become less well thought through, the cuts need to be deeper, and the risk of making poor decisions increases.

We have argued that the global economic landscape will be changed for at least a generation. Preparing for that eventuality now is essential.

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4/09