



THE BOSTON CONSULTING GROUP

# Collateral Damage

*Part 2: Taking Robust Action in the Face  
of the Growing Crisis*

**David Rhodes, Daniel Stelter, and Shubh Saumya**

---

24 October 2008

# Contents

<b>1. Introduction</b>	<b>1</b>
<b>2. Governments Step In, Act 1</b>	<b>2</b>
<b>3. Governments Step In, Act 2</b>	<b>3</b>
A. The Purchase of Preferred/Common Stock of Leading Banks	3
B. An Increase in Deposit Insurance Limits	3
C. The Guarantee of Bank Debt	4
D. The Purchase of Illiquid Assets	4
E. A Change in Accounting Rules	4
F. The Purchase of Short-Term Commercial Debt	4
<b>4. The Implications of Government Interventions</b>	<b>4</b>
<b>5. The Real Economy: The Crisis Has Arrived</b>	<b>5</b>
<b>6. How to Deal with the Difficult Times Ahead</b>	<b>8</b>
A. Define the Size of the Problem	8
B. Understand Where and How to Address the Problem	8
C. Take Action	12

# Collateral Damage

## Part 2: Taking Robust Action in the Face of the Growing Crisis

*In our first paper in the Collateral Damage series, we explained some of the background to the current global financial crisis, explored likely future economic scenarios and the challenges facing companies outside the financial sector, and suggested some actions that companies should be taking in order to respond to these challenges.*

*In this second paper, we analyze the impact of recent government actions around the world, update our view on the implications for the wider economy, and explain in some detail the actions that many—perhaps most—companies need to take.*

*We are not optimistic about the economic outlook for 2009. Nor do we believe that the bank recapitalizations (welcome as they are) address the problems in the “real economy.” However, we do believe that there is much that well-run companies can and should be doing. Chief executives should be taking actions designed to prepare their companies for short-term pain, but they should also be keeping an eye on longer-term opportunities created by the impact of the crisis on less effective competitors. After all, in a world with 7 billion people, not everything can stand still.*

### 1. Introduction

In the first installment of BCG’s Collateral Damage series, we described how the week of September 15, 2008, marked the end of the United States’ post-Depression-era financial system.<sup>1</sup> The collapse of Bear Stearns turned out to be only an early warning. By mid-October, what followed was a full-scale rout, not just of Wall Street but also of major institutions all over the United States and Europe. Beyond the uncertainties facing banks, there is mounting concern about the so-called shadow banking system: hedge funds, private-equity funds, and other alternative investment vehicles. What began as a leverage crisis and a credit crunch has turned into a full-blown insolvency problem as well.

Our first paper estimated that financial institution losses were likely to reach at least \$1.5 trillion worldwide—meaning a \$19 trillion decline in credit capacity, which translates directly into a reduction in global growth of almost 2 percentage points.

In the three weeks since the first paper, the situation has deteriorated. As of October 20, total losses for the year at banks and insurance companies have risen to \$661 billion on a global level: about \$408 billion in the Americas, \$228 billion in Europe, and \$25 billion in Asia. Taking into account the mark-to-market losses on related securities with the losses on U.S. consumer and corporate loans, the IMF now estimates crisis-related losses of nearly \$1.5 trillion on the worldwide holdings of U.S. assets alone. So our first estimate of loan losses in the range of \$1.5 trillion globally looks conservative now.

What is more, our fears about the credit default swap (CDS) market are proving to be well founded. The bankruptcy of Lehman Brothers alone cost insurers \$100 billion, according to the latest estimates, and we fear that we will see many more losses in the near future. Another area of concern is the continuing deleveraging pressure on hedge funds. As investors can only withdraw at specific dates—normally once a year in the autumn—hedge funds are trying hard to convince them to remain invested. Given the recent disappointing performance of these funds (-16.7 percent on average since the beginning of the year) and the liquidity needs of investors—around \$43 billion in redemptions in September alone—many experts

---

1. To obtain a copy, please e-mail [bcg-info@bcg.com](mailto:bcg-info@bcg.com).

expect a wave of paybacks, and even fund closures, which will add to the pressure across all asset markets. For every \$1 repaid to investors, funds have to sell \$3 to \$4 in assets because of the leveraged business model. In some cases, the leverage is significantly higher.

Some observers hope that there will be a big boost to the economy as a result of the bank recapitalization. But recapitalizing does not increase lending capacity; it just helps bring leverage ratios to more stable, if not yet sustainable, levels. The need to deleverage will remain, although the pressure to do so quickly has been somewhat relieved.

In addition, we should not forget that the true problem for the banks is the deteriorating left side of their balance sheet—the overleveraged consumer and some corporations. As we observed in our first paper, the credit crunch is taking place against a backdrop of an enormous long-term increase in consumer indebtedness not only in the United States but also in several European countries, such as the United Kingdom and Spain. Curbing this debt-fueled growth will have a significant impact on economic growth worldwide.

With consumers overburdened with debt and suffering from declining home and equity values, many have no capacity to borrow. And even if they do have that capacity, looming job insecurity and deflating asset prices will make them less willing to do so. Lending to businesses will be equally challenging because companies facing lower demand will also be less inclined to borrow.

At best, the programs are stabilizing banks; they are not stabilizing the real economy.

## 2. Governments Step In, Act 1

Lehman Brothers' bankruptcy was a rude shock for the market. The U.S. government had allowed the failure of an institution that supposedly was "too big to fail." At the same time, Henry Paulson, the U.S. treasury secretary, made it clear that the U.S. government was not there to protect shareholders. This injected confusion and uncertainty into already febrile markets. The very same week, the government injected \$85 billion into AIG and supported Merrill Lynch's sale to Bank of America. These seemingly contradictory actions created material uncertainty about the U.S. government's approach to distressed institutions. Interbank lending dried up, as many banks were deemed vulnerable amid uncertainty about government support.

Lehman's failure also had a material impact on the \$3.4 trillion money-market fund industry. The Reserve Primary Fund, America's oldest money-market fund, "broke the buck." In other words, it lost investor principal due to losses on Lehman IOUs. This was a dangerous development because money-market funds provide much-needed corporate financing through their purchases of commercial paper. The U.S. government quickly moved to guarantee these funds to prevent massive investor redemptions, but this proved inadequate, as risk aversion by the funds led to the drying up of liquidity in the commercial paper market—itsself a major source of short-term financing for banks and nonfinancial corporations alike.

Deeply concerned about these developments, the U.S. government proposed an ambitious \$700 billion Troubled Asset Relief Program (TARP) to relieve banks of illiquid assets and to restore investor confidence. However, this was a unilateral initiative that did not enjoy popular support domestically. Nor did it take effect immediately, address the core issue of the weak housing market, or inject sufficient capital into the banking system. It was also unclear whether banks had sufficient capital to absorb likely additional losses resulting from sales of distressed assets to TARP.

The market's initial support for TARP gave way to alarm for two reasons. First, no such action was forthcoming outside the United States. European responses, in particular, appeared piecemeal and uncoordinated. When Ireland and Germany broke ranks with their European Union (EU) partners and guaranteed retail deposits in order to prevent a run on their banks—although in Germany this was more of a

political promise than a real guarantee—it appeared that each country would be left to its own resources to handle the crisis. Second, investors had no greater transparency into the quality of the assets remaining on bank balance sheets. Stock markets responded by going into free fall, forcing the hand of governments worldwide.

### 3. Governments Step In, Act 2

Governments around the world seem to have concluded that it is too dangerous to let systemically important banks and broker-dealers fail. The coordinated global response by governments has taken multiple forms. It is worth outlining these in some detail and examining their implications.

#### A. The Purchase of Preferred/Common Stock of Leading Banks

Led by the United Kingdom's £37 billion plan to purchase stakes in RBS, HBOS, and Lloyds TSB, governments worldwide have announced substantial direct capital injections in their leading banks. The United States, for example, has redirected \$250 billion from the approved TARP funds to acquire preferred shares in major banks while ensuring limited dilution of existing stockholders. Switzerland strengthened its largest bank, UBS, by giving it \$5.3 billion in exchange for a 9.3 percent stake. UBS will also be able to transfer up to \$60 billion in toxic assets to a fund supported by the Swiss central bank.

Germany has indicated an interest in recapitalizing its banks to the tune of €80 billion, while France has plans to inject €40 billion. The Netherlands has guaranteed a total of €35 billion, Belgium €25 billion, Austria €15 billion, and Greece €10 billion. By limiting dilution, governments have also attracted some coinvestment from other large investors, such as MUFG's crucial \$9 billion investment in Morgan Stanley.

These actions have been very helpful in terms of assuring banks of near-term capital. The post-Lehman uncertainty about government approaches to the survival of large banks has been addressed. Consequently, there are early signs of improvement in the interbank market, with the overnight LIBOR falling by 20 basis points.

#### B. An Increase in Deposit Insurance Limits

In addition to providing capital relief to leading banks, governments have moved to reassure depositors. In the United States, the Federal Deposit Insurance Corporation (FDIC) has raised retail deposit insurance limits from \$100,000 per account to \$250,000. In addition, 100 percent of noninterest-bearing business checking accounts will be protected until next year. Germany and Ireland have guaranteed 100 percent of retail deposits, and other European governments have also issued guarantees. European finance ministers agreed to raise the level of deposit guarantees to €50,000. Furthermore, the European Commission put forward a revision of EU rules under which the minimum level of coverage for deposits will be increased within one year to €100,000.

These measures are aimed at preventing an old-fashioned run on banks. Several banks—including Wachovia (recently acquired by Wells Fargo) and Sovereign (recently acquired by Banco Santander)—have seen very significant depositor withdrawals: \$5 billion in just one day at Wachovia and almost 9 percent of all deposits at Sovereign. By expanding depositor guarantees, governments have sought to ward off potential risks to a crucial source of bank system liquidity.

Yet the first doubts have already emerged regarding some governments' ability to guarantee deposits. Such concerns started with Iceland—which is virtually bankrupt—but have now spread to other countries. The price for insuring against a default of the United States has gone up visibly. Available data of the last six months show that the CDS spread on U.S. Treasuries increased in October to 21.3 basis points, from 3.4 basis points in April.

### C. The Guarantee of Bank Debt

To ease longer-term liquidity concerns, the U.S. government has guaranteed new senior unsecured debt issued by some banks for a period of three years. Similar initiatives have been taken in Europe. For example, Germany has offered €400 billion in guarantees, France has set aside €320 billion, and the United Kingdom will guarantee £250 billion.

These measures allow banks to reduce their dependence on short-term financing both from central banks and from the volatile interbank market.

### D. The Purchase of Illiquid Assets

In addition to the TARP program in the United States, the Swiss government has reached an agreement to acquire \$60 billion in distressed assets from UBS. These steps are designed to remove ongoing market concerns about lingering mark-to-market challenges. By removing the overhang of illiquid assets, governments are seeking to create a clean balance sheet for banks and thereby encourage them to resume their lending activities.

### E. A Change in Accounting Rules

Mark-to-market accounting has contributed to the worsening of the crisis because illiquid securities have had to be marked down to the current “market price” (essentially fire-sale prices). In a move to limit this downward spiral, the accounting policy bodies—after some strong encouragement from authorities—have defined rules under which banks can reclassify these assets as longer-term investments and apply a more favorable valuation.

### F. The Purchase of Short-Term Commercial Debt

Given the illiquidity in the U.S. commercial paper market, the Federal Reserve has set up a facility to directly purchase commercial paper issued by highly rated companies. The facility is expensive, with an up-front fee requirement and above-market discount yields, so it is to be used only as a fallback option. The hope is that the assurance of backstop liquidity from the government will encourage market participants to begin trading with one another.

## 4. The Implications of Government Interventions

Government responses have been substantial, coordinated, and designed to address the systemic nature of the crisis. In the short run, they have, by directly injecting capital into the banking system, provided some relief to the faltering stock market. These steps are a very welcome development, as they have removed material uncertainties about the financial sector. In the long run, however, the implications of partially nationalized banking systems are less clear.

While banks have gained some breathing space as a result of government interventions, they continue to face strong headwinds from a rapidly weakening global economy. Some banks are likely to use the newly injected capital just to absorb additional credit losses from their balance sheet assets. Others will remain quite risk averse amid highly volatile markets in order to prevent a recurrence of the vulnerability they have just experienced. This will keep them from being aggressive in extending credit, even to borrowers with relatively good credit histories.

Even if the bank recapitalization programs address some of the weaknesses in the financial system, the success of these measures will ultimately depend on the prospects for business being positive. And that raises the critical question of what is happening in the real economy.

## 5. The Real Economy: The Crisis Has Arrived

In our first paper, we outlined two possible economic scenarios: a soft recession and a more serious one. Since then, our view has hardened. We expect the United States and Europe to suffer from deep and prolonged recessions. Asia is in better shape but will not be unaffected. Let us turn first to the United States.

“While the stock market is dominating the headlines, the more important story is the grim news about the real economy,” stated the *New York Times* on October 17. “Rescuing banks is just the beginning: the nonfinancial economy is also in desperate need of help.” A series of indicators point to the fact that there is no doubt that the U.S. recession is already under way.

- ◇ In September, U.S. industrial production suffered its sharpest drop in 34 years (-4 percent month to month), partly due to a “dramatic fall in new orders” (the drop was exaggerated by Hurricane Ike and a strike at Boeing).
- ◇ Sales of construction equipment are expected to slow this year by 24 percent, with a further drop of 21 percent expected for 2009.
- ◇ The junk-bond market is signaling the expectation of a deep recession. Current risk premiums of around 15 percent suggest a spike in the default rate to a level last witnessed in the 1930s.
- ◇ The real estate market continues to be under pressure. Roughly 12 million U.S. households, or 16 percent of the total, hold negative equity in their home, up from 4 percent in 2006. And pundits expect a further slide of prices by 10 to 15 percent.
- ◇ There has been a decline of almost 800,000 in payroll employment since the beginning of this year (20 percent of which occurred in September). The unemployment rate has increased from 4.4 percent to 6.1 percent.
- ◇ Weak labor market figures, combined with an already record-high level of debt (around 130 percent of yearly income) and the deflating value of assets (stocks and real estate), explain why U.S. consumer confidence plunged to 57 percent in September, down from 80 percent just a year ago.
- ◇ Retail sales have decreased for three consecutive months (even during the important back-to-school sale season). This raises the specter that this time American consumers will not help to drag the U.S. economy out of recession.
- ◇ Credit card companies have announced heavily increased provisions on the back of deteriorating credit quality. Between August 2007 and August 2008, write-offs rose by nearly 50 percent, to 6.82 percent.

We also think that Europe does not offer a more positive picture. As in the United States, there are strong data indicating that the Eurozone (plus the United Kingdom) entered a recession in this quarter. With two consecutive quarters of real GDP decline, this would mark a “technical” recession in the Eurozone.

- ◇ The composite Purchasing Managers Index (PMI) of the Eurozone, an important business sentiment indicator, decelerated further in September to its lowest level since November 2001, driven mainly by a fall in new orders.
- ◇ Monthly retail sales have been decreasing steadily since February compared to the previous year’s data for the same month.
- ◇ Spain, Ireland, and the United Kingdom have their own real estate bubbles to cope with—all of which have burst. Meanwhile, Germany—which, by virtue of its status as the world’s largest exporter has long been deemed to be a stabilizing element in the Eurozone—has experienced a steep reduction in orders in its export industries.

- ◇ The IMF announced assistance to Ukraine and Belarus, and Hungary has raised interest rates by a full three percentage points, to 11.5 percent, in order to protect its currency. These actions indicate that the repercussions are not restricted to the developed economies.

As for Asia, its economies are in much better shape than they were ten years ago. They mostly enjoy solid public and private finances and a cash surplus built on successful exports. Even so, signs of a slowdown are visible.

- ◇ The Baltic Dry Index, the benchmark for global freight costs, has fallen 50 percent since September and is at its lowest level since February 2003. This is clearly a sign of shrinking global demand for commodities—and reflects slowdown signals in Asian economies.
- ◇ Major mining companies see lower demand from China and other Asian countries, with these exporters not being immune to a slowdown in Europe and the Americas.
- ◇ Key raw materials such as copper and oil have halved in price since this past summer's peak. CRB, the global commodities index, has lost more than 40 percent since July.
- ◇ Lower raw material prices will lead to lower income and might affect import demand, further slowing the economies of the West.
- ◇ Moreover, several Asian countries are seeing their currencies depreciate rapidly against the U.S. dollar due to outflows of funds from their countries. India's central bank is intervening heavily and has just cut its repo rate from 9 percent to 8 percent.
- ◇ South Korea recently followed Europe and the United States in standing behind its banks, guaranteeing \$100 billion of its banks' foreign currency borrowing, as well as providing \$30 billion in liquidity.
- ◇ The IMF still forecasts a growth rate of 7.7 percent in 2009—down from an average of 8.2 percent in recent years. China's growth rate has fallen by nearly a quarter. This clearly marks a decrease—but it is still far away from a recession.

A review of this scattered data has led us to conclude that it is not a question of if we will see a recession in many countries, but of how deep and long it will be. The IMF forecasts a global GDP growth rate of 3 percent in 2009—adjusting its June projection by -0.9 point to the lowest growth rate since 2002. After a couple of years with average growth of 5 percent, this clearly points to a sharper slowdown with global impact.

There are many lessons to be learned. While it is not our purpose to explore these in this paper, we would observe that the hubristic claims by some politicians to have solved the inevitability of economic cycles (the promise of no more boom and bust) have proved to be empty. During their watch, the leading central banks focused on controlling consumer inflation but allowed asset inflation to get out of hand. While they thought this would help them beat the economic cycle, it actually meant that they were storing up even worse problems for when the bubbles burst. They would have been well advised to follow the implicit advice of Stephen Harper, the Canadian prime minister. In explaining that Canada's government had taken all the precautions necessary to shield Canada from the credit crunch a year ago when it announced tax cuts worth C\$60 billion (\$54 billion), he observed, "It wasn't raining when Noah built the ark."

As stated in the first installment of our Collateral Damage series, the IMF has warned that recessions accompanied by financial crisis tend to be "two to three times as deep and two to four times as long" and to lead to "negative growth of 4.5 percent of GDP." Several factors increase the risk of a prolonged and severe downturn.

- ◇ **Record-high levels of debt.** The underlying cause of the current difficulties are the record-high levels of debt of households and the private sector in major economies such as the United States, the United

Kingdom, and Spain. As households struggle to restore their balance sheets amid deflating asset values, zero savings rates, and the increasing risk of unemployment, demand will continue to be weak.

- ◇ **Unclear effects of recent government interventions.** The effectiveness of the recent measures to stabilize the financial sector remains to be seen. Open risks in the market for CDS (totaling about \$58 trillion) are still unclear.
- ◇ **The refinancing needs of corporations and cities.** According to Standard & Poor's, some \$800 billion of outstanding debt will need to be refinanced by the end of 2009. About 30 percent of this amount is "speculative" grade, and it will be challenging for companies with weaker speculative-grade credits to get capital. For investment-grade companies, refinancing should be available, although at significantly higher costs than in the past. Beyond the corporate sector, some municipalities face serious debt problems similar to those experienced by New York City in the 1970s.
- ◇ **The increased risk of protectionism.** In our first paper, we argued that there is a clear risk of increased protectionism. If we take the example of the auto industry, we can already see the first signs of a worrying trend: the U.S. government subsidizing Detroit with \$25 billion to support development of new technologies and France supporting its auto industry—directly by supporting R&D and indirectly by structuring tax laws in favor of smaller cars. Such signals are being amplified in the corporate sector, with companies favoring domestic manufacture and cutting it abroad. Other countries, such as the United Kingdom, are poised to impose stricter rules on immigration in order to protect local labor markets. And now we have the proposal from President Sarkozy of France to take direct stakes in industrial companies in order to protect them from foreign ownership. This proposal follows the German government's declared opposition to foreign ownership of broadly defined strategic industries. Indeed, there is a risk of increased tensions not only between global regions but also within Europe itself—and the recession has only just started.

On the positive side, the relatively solid situation in Asia could help stabilize world growth. Across Asia, there is low private household debt and little or no government debt (the Chinese government is currently running a budget surplus of 2 percent of GDP).

Moreover, some experts argue that the intervention of governments in the financial markets has indeed—if rather late in the day—helped stabilize the situation and therefore reduced the risk of a deep and prolonged recession.

But consider the situation after both the crash of 1929 and the Japanese malaise of the 1990s. One needs to keep in mind that, contrary to popular belief, the Federal Reserve lowered interest rates quickly after the crash in 1929 and supported banks as well. And Japan, while not acting fast enough to counter the implications of the bursting real estate bubble of the late 1980s, could build on a very high savings rate and low government debt to support domestic demand.

The Swedish crisis of 1992 is often taken as a best-practice example of how to deal with a crisis in the banking system. Indeed, Sweden's nationalization of banks did help to stabilize the market. What is often forgotten, however, is that Sweden at the same time started a program to support the real economy that was worth 5 percent of GDP. A devaluation of the kroner and a growing world economy helped as well.

In our view, governments need to take urgent additional action to support the real economy in order to avoid a recession comparable (at least) to the 1982 crisis. Bernard Bernanke, the chairman of the U.S. Federal Reserve, recently changed his view and called for greater government intervention. This is still in discussion. But if such intervention is to be effective, it will be very important to act fast. Unfortunately, many of the signs are not good, with European governments still mostly in wait-and-see mode.

All measures should lead to a direct stimulation of aggregate demand, as lower taxes will be used by households to pay down debt or increase savings. It looks as if the private sector will not (indeed, cannot)

spend enough. This implies that a program of infrastructure investments or tax incentives will be needed to spur investment and consumption. Keynesian economics are back in fashion.

In some countries, the burden of debt is drowning households. Troubled countries are being helped to restructure their debt, and corporations can file for protection from their creditors. In the same way, it may be necessary to launch a program to help distressed households—especially since it looks increasingly as if inflation will not come to their rescue. This could mean replicating the Home Owners' Loan Corporation of the 1930s.

Ultimately, the challenges for companies that we explained in our first paper seem, if anything, even more relevant. Companies need to get prepared *now*.

## 6. How to Deal with the Difficult Times Ahead

In our previous paper, we described a series of actions that companies should take to deal with the downturn. We have now had time to develop these further, organizing them into a holistic three-step approach. In our view, companies need to act rapidly and systematically to:

- A. Define the size of the problem
- B. Understand where and how to address the problem
- C. Take action

Well-run companies will reach step 3 in the space of around four to six weeks, taking a series of “no regrets” actions from the start. (See the exhibit.) For some companies, the outcome will be a program of immediate actions that can be regarded as business as usual. For others, it will be a painful realization that nothing short of an urgent corporate turnaround will suffice.

The first objective is to protect the business from downside risk and to ensure liquidity. But after ensuring stability, the best companies will look for ways to capitalize on the downturn for longer-term success.

Of course, none of this process should be carried out in a vacuum. It is critical to understand your own strengths and weaknesses relative to those of your competitors. Your direct competitors will have different cost structures, financial positions, sourcing strategies, product mixes, customer focus, and so on. It follows that the downturn will have varying impacts on competitors across any given industry. To emerge in a leading position, you must challenge the actions that you plan to take in light of the actions that your competitors will likely take.

### A. Define the Size of the Problem

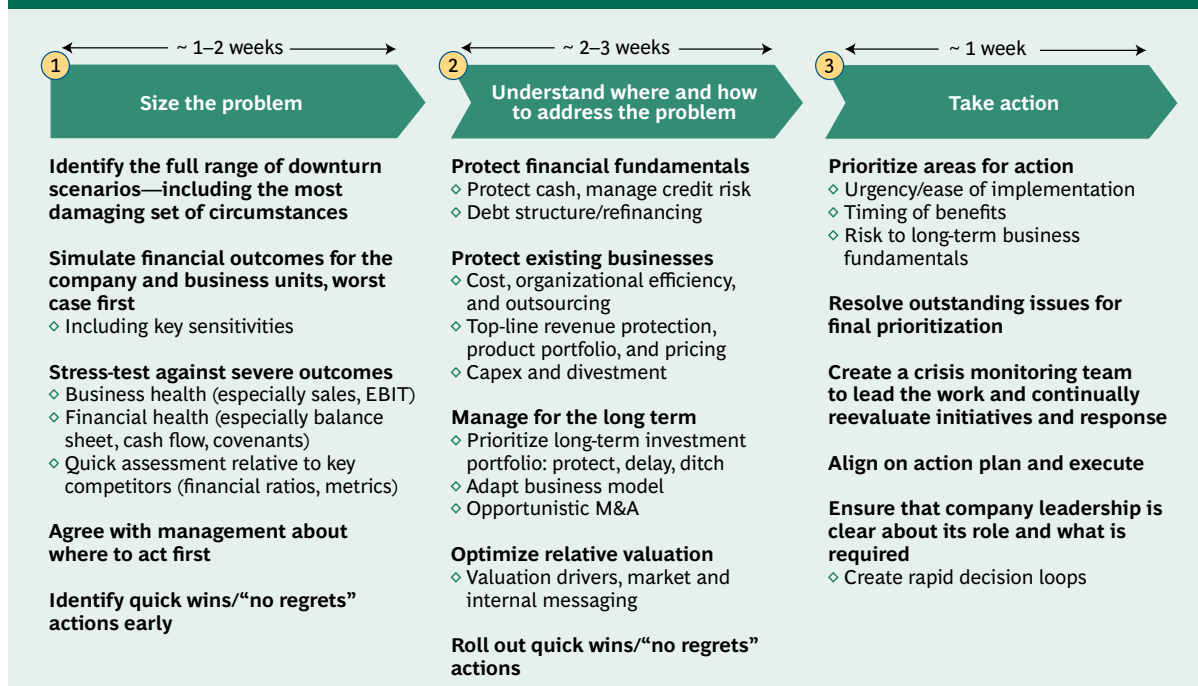
Businesses across different industries and geographies will be affected differently by the downturn. Management must define the magnitude of the problem and develop a stress-test scenario. How would a recession affect each of our businesses and the company overall?

Take worst-case scenarios (such as -20 percent in volume, -5 percent in prices) and identify early-warning signals for a deterioration of the situation. Simulations show that even for many still-healthy companies with EBIT margins of around 10 percent, a sales drop of 20 percent is sufficient to turn profits into huge losses and to send cash flow deep into the red. Only once these sensitivities are understood can effective and timely countermeasures be planned and executed.

### B. Understand Where and How to Address the Problem

Once you understand how your business could be affected by the downturn, you will need to define what it will take to maximize your company's performance in order to weather the storm and emerge in a strong

## From diagnosis to action in three to six weeks



position. In our view, there are four key actions: protect the financial fundamentals; identify ways to protect the existing business; manage for the long term; and optimize the relative valuation of the company.

**Protect the financial fundamentals.** Ensuring adequate cash flow, access to capital, and liquidity are of primary importance in dealing with the downturn. A lack of liquidity creates obvious short-term issues, but it is also critically important to maintain the ability to make smart investments for the future of the business. There are three major tasks that a company should carry out to protect financial fundamentals:

- ◇ **Protect cash and manage credit risk.** Install a tight cash management system, reduce and postpone spending, and focus on cash inflow. How much spending you postpone depends on the severity of your downturn assumptions and how far such spending is discretionary. Produce a weekly report on your cash position and midterm development based on expected payments and receipts. In addition, take action to improve the cash flow of the business. For example, trade credit should be reduced. Customers will try to rely more on trade financing, but the risks will increase. Therefore, segment your customers and be directive as to where you invest.

A surprisingly large number of companies are not very focused on working capital management and have poor processes to monitor their working capital. So it is no surprise that the potential savings from optimizing a company's working capital can be substantial and easily reach \$1 billion and more for larger companies. As a rule of thumb, most manufacturing companies can free up cash equivalent to approximately 10 percent of sales from net working capital optimization by addressing inventories (including production and sourcing processes) and receivables, and by using trade credit providers. If possible, view asset productivity from a total system perspective in order to recognize the dynamic interactions.

- ◇ **Optimize your financial structure.** The recent past was the age of leveraging, with constant pressure to operate with lower equity. This trend has rapidly reversed, and we assume that it will be some time before higher leverage ratios come back into fashion. This reinforces the need to improve balance sheet structures as soon as possible. Some refinancing that looked expensive just three months ago looks cheap now. Companies need to define their appropriate financial leverage and secure financing while

they still have access to extra funds. Strong companies have already started to link their interest rate to CDS, which means that the interest rate will be reduced if the risk premium comes down. This way they will benefit from lower rates once markets have normalized. It also allows lenders to differentiate better between “risky” and “less risky” debtors. Companies should also look for additional equity funding from sovereign wealth funds, private equity firms, or cash-rich investors.

Furthermore, it is time to reassess your dividend and buyback policies. Dividends can have a strong positive signaling effect, thereby reinforcing trust and relative valuations. Investors and analysts are now much more skeptical of buybacks, and several companies have suspended them already. Companies with solid financials are much less at risk from activists and competitors. On the contrary, they will be the winners in the shakeup.

- ◇ **Improve risk management.** It is quite an understatement that better risk management systems in banks would have helped prevent the current crisis. Yet many nonfinancial institutions also lack appropriate risk management tools. In the corporate world, risk management is often geared towards processes and compliance with corporate policies on issues such as the prevention of fraud and other forms of malfeasance. But risk is a much broader concept. A better understanding and management of market risks (for example, from commodity prices or foreign exchange rates), business risks (for example, from counterparties, consumer demand, or competitor actions), and operational risks (for example, from IT systems or litigation) would help companies limit their exposure to the downturn and protect the financial fundamentals.

**Identify ways to protect the existing business.** After ensuring that the financials of the company are secured, it is critical to take additional actions to protect the viability of the existing businesses. The recessionary environment will present unique challenges, and successful companies are prepared to act quickly and decisively to improve core operations. There are four key levers that must be addressed in order for a business to “sail through” the downturn: act now on cost and organizational efficiency; manage top-line revenue aggressively; adapt the product portfolio and pricing approach; and reassess your investment program and divest noncore businesses.

- ◇ **Act now on cost and organizational efficiency.** Implement all measures today that can be executed without risking major opportunities. Streamlining the organization and lowering breakeven points are always wise steps. Take the opportunity presented by extreme market turbulence to justify significant transformational moves to delayer the organization, increase spans of control, reduce headcount, consolidate or centralize key functions, and delay or discontinue discretionary or low-value-added activities.

Opportunities to reduce materials and supply chain costs will also present themselves in this environment. The economics of offshore manufacturing can change significantly with changing trade directions (for example, fewer U.S. imports) and with trade barriers, shifting currencies, and changes in shipping and other factor costs. Now is the time to pursue a rapid and deep procurement review in order to minimize materials costs. Effective measures are likely to include supplier review, demand management, standardization, and specification redesign.

For many companies, SG&A expenses usually offer significant opportunities to reduce costs. Previous recessions have shown that acting early and in a measured way is far more effective than acting either late and drastically or in a piecemeal fashion. In particular, successful companies cut marketing spend in a thoughtful way, whereas companies that slash it unnecessarily have to spend far more to recover from the resulting lost share of voice.

- ◇ **Manage top-line revenue aggressively.** Managing revenue is of paramount importance. Customer retention initiatives become even more valuable. Consider making tactical changes to sales force activities and reallocating marketing spending behind immediate revenue generation rather than longer-term brand building. It is also important to be strict on policies relating to trade credit. Generally, only

the best and strategically most important customers should qualify for this. There is also the opportunity to raise prices in context with more generous financial terms—provided you have done your homework on financial structure.

- ◇ **Adapt the product portfolio and pricing approach.** Purchasing behavior will change in the recession. Consumers will increasingly opt for lower-price alternatives, such as private labels. So it is essential to understand just how consumers (and corporate customers) are likely to respond. This knowledge will feed directly into your product portfolio and investment choices. Indices measuring consumer sentiment have dropped by more than 30 percent across the world since their peak in 2007. Saving will be more attractive than consuming, and the art of trading down—searching for good value at low prices—will gain momentum. Consumers will still trade up, but in smaller numbers and in fewer categories. Nonessential categories and weaker brands are at greatest risk, and discount retailers and private-label alternatives will be on the rise.

In the 1930s, there was a strong trend toward cheaper, canned food in the United States. Companies might consider responding similarly with low-priced versions of popular products, such as McDonald's \$1 menu or Danone's lower-priced Eco-Pack yogurt in France.

Indeed, customers will not be in a position to pay as before, and many will be under financial pressure. In this context, rethinking the company's pricing policy can be a major lever to mitigate top-line effects. It was during the Great Depression that GE developed its innovative strategy to finance its customers' purchase of refrigerators.

- ◇ **Reassess your investment program and divest noncore businesses.** Several major companies have stopped significant investments—some openly, some without fanfare. For example, Mittal has just announced a review and possible postponement of a \$35 billion investment program. As most industries have excess capacity today, we assume that this trend will continue. In the United States, for example, capacity utilization recently fell to 78.7 percent of potential output and will probably fall much lower. Compared with the long-term average of 81.0 percent from 1972 to 2007, there is currently more than enough capacity in most industries and no need for further investments. Instead, we expect to see consolidation mergers (which we discuss in more detail below).

In addition to focusing investment decisions, careful attention should be paid to the composition of the corporate portfolio in order to ensure that resources are focused squarely on core businesses. Companies should not wait for "better" times to sell nonperforming or noncore assets. If a business is not critical to your activities and increases your vulnerability to the downturn, you should consider divesting now. Do not be dissuaded by the seemingly bad times and low valuations as compared to last year. Remember, last year's valuations were driven by a buoyant economy and easy credit—neither of which we expect to return soon. Moreover, as BCG's research shows, the market reaction to the right divestitures is typically very positive in recessionary times. About 70 percent of the respondents in BCG's recent M&A survey said that disposals, spinoffs, and demergers are a good way to refocus their businesses. Yet, in spite of this sentiment, there are still buyers around, as the next section explains.

**Manage for the long term.** The best companies do more than survive during a downturn. They position themselves to thrive during the subsequent upturn. There are three key actions a company should consider in order to exploit the downturn: invest for the long term; pursue transformative and opportunistic M&A; and redefine business models.

- ◇ **Invest for the long term.** Investments made now in R&D, IT, and new infrastructure by strong companies will only come onstream once the recession is over. And the cost of these investments will be lower during a period of less competition for resources. Companies should continue to assess the benefits and challenges of offshoring, outsourcing, and other opportunities to reduce costs. Now is also a good time to upgrade the quality of your management teams. Competition for top people will be lower, availability higher, and the cost correspondingly lower.

- ◇ **Pursue transformative and opportunistic M&A.** The recession will change several of the long-standing rules of the game in many industries. Use the weakness of your competitors to redefine your industry. The best deals are made in downturns—a fact borne out by BCG’s research. Indeed, downturn mergers generate about 15 percent more value—measured as total shareholder return (TSR)—compared with boom-time mergers, which on average actually exhibit a negative TSR. So the best time for consolidation and cost mergers is now. A proven methodology is to closely monitor the financial and operational health of your competitors. Not all companies in your industry will have enough of a financial cushion to benefit from the recession, and some might struggle either to stay in business or to secure financing. Unique opportunities will arise. General Motors benefited during the Great Depression to become one of the world’s largest car manufacturers. A precondition for the ability to do M&A is to have a firm and solid understanding of your potential target’s current and future cash position. This is needed to limit the risks and to convince management teams and supervisory boards of the feasibility of active moves.
- ◇ **Redefine business models.** Downturns can be a time of considerable transition for companies and industries. The economics of the business may change due to increased competition, changing input costs, government intervention, or new trade policies. New competitors and business models may emerge as companies seek to increase revenue through expansion into adjacent product categories or horizontal integration. Successful companies will anticipate these changes to the industry landscape and adapt their business models ahead of the competition to protect the existing business and gain advantage.

**Optimize the relative valuation of the company.** Some banks have been hit extremely hard because investors did not understand how toxic or how safe their assets were. Industrial companies are assessed differently by the markets: balance sheet strength (and clarity)—particularly low debt levels—and secured financing are yielding a premium. Share buybacks, dividend policy, and TSR management need to be reassessed. Companies should identify the drivers of relative valuation and carefully craft communications to investors designed to maximize investor interest and relative valuation. For a company planning active moves, especially in the M&A arena, the relative valuation of a company assumes the highest importance.

### C. Take Action

Put in place immediately a core crisis management team to monitor the key early-warning indicators, the development of scenarios, and the development of improvement initiatives. The crisis management team should strictly prioritize initiatives. You will not have the organizational capacity to do it all today. Therefore, you must carefully consider the total financial impact, the timing of particular actions, the ease of implementation, and the risks to the long-term business when defining a set of priority measures. The result will be a portfolio of actions with the right blend of short-term and long-term focus.

It is our view that companies taking these measures will not only be better placed to master the current turmoil and the likely recession—they will also have a substantial opportunity to take advantage of the changing environment, emerging ahead of the competition as the current crisis unwinds.

## About the Authors

**David Rhodes**, a senior partner and managing director in the London office of The Boston Consulting Group, is the global leader of the firm's Financial Institutions practice area. You may contact him by e-mail at [rhodes.david@bcg.com](mailto:rhodes.david@bcg.com).

**Daniel Stelter**, a senior partner and managing director in BCG's Berlin office, is the global leader of the firm's Corporate Development practice area. You may contact him by e-mail at [stelter.daniel@bcg.com](mailto:stelter.daniel@bcg.com).

**Shubh Saumya** is a partner and managing director in BCG's New York office. You may contact him by e-mail at [saumya.shubh@bcg.com](mailto:saumya.shubh@bcg.com).

The authors are grateful to Donald Chae, Hans Montgomery, Jendrik Odewald, Katrin van Dyken, and Philip Crawford for their help.

The Boston Consulting Group (BCG) is a global management consulting firm and the world's leading advisor on business strategy. We partner with clients in all sectors and regions to identify their highest-value opportunities, address their most critical challenges, and transform their businesses. Our customized approach combines deep insight into the dynamics of companies and markets with close collaboration at all levels of the client organization. This ensures that our clients achieve sustainable competitive advantage, build more capable organizations, and secure lasting results. Founded in 1963, BCG is a private company with 66 offices in 38 countries. For more information, please visit [www.bcg.com](http://www.bcg.com).

© The Boston Consulting Group, Inc. 2008. All rights reserved.

10/08