THE BOSTON CONSULTING GROUP

Collateral Damage: Function Focus

Valuation Advantage: How Investors Want Companies to Respond to the Downturn

Jeff Kotzen, Eric Olsen, and Frank Plaschke

April 2009

Contents

Collateral Damage: Function Focus

Valuation Advantage: How Investors Want Companies to Respond to the Downturn

Over the past six months, BCG has been publishing a series of white papers titled Collateral Damage *to help our clients meet the challenges posed by the global financial crisis and subsequent economic downturn.*[1] *In early papers, we focused on explaining the crisis and identifying the immediate steps that companies must take to secure their financial health during the downturn. In subsequent papers, we explored how companies might take advantage of the downturn to improve their competitive position. In this paper, we focus on how investors think companies should respond to the downturn, based on a survey and interviews of 160 professional investors and equity analysts that BCG conducted in the first quarter of 2009.*

Introduction

As executive teams struggle to minimize their company's vulnerability to the global recession, the lion's share of management attention has turned inward. Many senior executives are, quite rightly, focused on the cost cutting and restructuring necessary to maximize cash flow, strengthen the balance sheet, and ensure their company's liquidity and immediate financial survival. In the process, relatively few are giving much thought to the investors who own their company, what those investors think the company's priorities should be, or how those views will affect the company's market value.

Indeed, many executives have begun to doubt the relevance of investor perspectives in an equity market that (to take the United States as an example) has experienced the second-biggest six-month drop in history (second only to 1932 at the height of the Great Depression) and remains extremely volatile. And some have come to question the very principle of managing for shareholder value itself. Even Jack Welch, former chairman and CEO of General Electric—a company famous for its year-after-year delivery against quarterly earnings-per-share (EPS) consensus estimates—now says that "on the face of it, shareholder value is the dumbest idea in the world."[2]

BCG has long believed that a company can consistently deliver above-average shareholder returns only when its businesses enjoy sustainable competitive advantage and when the company allocates its resources appropriately among those businesses. We have always urged companies to focus on the long term and have consistently opposed reducing the idea of managing for shareholder value to an obsessive focus on quarterly earnings.[3]

And yet, we also believe that companies cannot neglect the perspectives of investors during the downturn—for the simple reason that their perspectives may matter even more in the years to come than they did during the days of the bubble economy. Why? At a time when gaining access to external capital can be difficult and expensive, investors remain a critical stakeholder. But even more important, the very inward focus necessary to reduce a company's near-term financial vulnerability runs the risk of causing companies to miss what may be a big long-term opportunity.

In a recent paper in this series, we pointed out that recessions typically accelerate the forces reshaping industries and create new winners and losers in the struggle for competitive advantage.[4] Mature industries face growing pressures to consolidate; companies with inefficient business models are weeded out by the

1. For a comprehensive treatment of the global downturn and its implications, see BCG's *Collateral Damage* series at www.bcg.com.
2. See Francesco Guerrera, "Welch condemns share price focus," *Financial Times,* March 12, 2009.
3. For BCG's views on shareholder value management over a ten-year period, see our *Value Creators* series at www.bcg.com.
4. See *Collateral Damage, Part 5: Confronting the New Realities of a World in Crisis,* BCG White Paper, March 2009.

tougher economic climate; and those companies that figure out how to exploit the downturn to improve their competitive position emerge as the new leaders of their industries. In effect, the downturn is creating a playing field where what may appear to be small differences among competitors are going to translate into major—and potentially game changing—differences in the ability to create competitive advantage.

This is where investors' views of a company and the degree to which those investors support management's agenda become important. One of the differences that can have a big impact is what we call *valuation advantage*—that is, a company's ability to command a valuation multiple that is strong relative to those of its peer group or competitor set (irrespective of whether absolute valuations are the highs of yesterday or the lows of today). A valuation advantage can improve a company's access to capital. It can also offer an advantaged acquisition currency that helps position a company to be predator rather than prey at a time when the downturn is accelerating consolidation in many sectors and when the financial weakness of many companies is expanding opportunities to acquire valuable assets at relatively low prices.

How investors respond to the decisions executives make today will in large part determine which companies enjoy a valuation advantage and which do not. That doesn't necessarily mean executives have to do exactly what investors want them to do. Sometimes, there may be good strategic reasons to "just say no" to Wall Street. But at a minimum, managers should know in advance the likely impact of their strategic decisions on investors' expectations for their stock and convey the logic behind their strategy through active and transparent investor messaging.

To aid them in this process, BCG recently surveyed a broad cross section of professional investors and equity analysts in the United States and Europe to ask them how they think companies should be responding to the downturn. (See the sidebar "The BCG Investor Survey.") The results are encouraging—and may surprise those whose views of investor priorities were formed during the recent boom years. Three important findings stand out:

- Contrary to what many executives may think, the investors we surveyed aren't focused on whether companies are going to hit their 2009 earnings guidance. More than at any moment in the recent past, they are giving companies permission to focus on the long term. In their view, it is more important today for companies to have a clear and compelling strategy for creating long-term competitive advantage than to hit their guidance over the next few quarters.

- Even more, they believe that for some companies, the downturn represents a "once in a lifetime opportunity" to strengthen their competitive position and, in some cases, leapfrog competitors. To be sure, companies with weak balance sheets or immediate liquidity problems can do little more right now

The BCG Investor Survey

Because BCG often helps clients improve their strategies for delivering shareholder value, we have developed over the years a broad network of contacts with professional investors and equity analysts in the United States and Europe. In January, we invited 500 of them to share their views in an online survey about how they think companies should respond to the downturn. We received 135 responses (a response rate of 27 percent) from individuals responsible for more than $60 billion in assets under management, covering a wide range of industries and geographies. We also supplemented our online survey with 25 in-depth interviews, making for a total of 160 respondents.

We were interested in synthesizing the perspectives of professional investors and equity analysts not because we believe they necessarily have a crystal ball on the future. Rather, we thought that the very people who experienced firsthand the massive wave of value destruction of the past six months might have a useful perspective on how companies need to respond. After all, these are some of the people who, in effect, will be "putting their money where their mouths are" in the years ahead. So their attitudes and beliefs ought to be key inputs for any public-company executive team as it tries to think through its strategy for surviving—and, if possible, thriving—during what are proving to be very hard times.

than focus on surviving the downturn. But those companies with strong balance sheets and no serious liquidity issues can exploit the downturn, and investors have strong views on precisely what steps these companies should be taking and how they should be investing their cash. Many investors worry, however, that these companies are not being aggressive enough.

- Finally, the investors we surveyed want active engagement with the companies they invest in and more transparency about how a company is affected by the recession. They are not especially worried about bad news in the near term, as long as a company has a clear strategy that will allow it to profit from the downturn over the long term. They also believe that investor engagement and communication is a key area in which companies need to improve.

In effect, these investors are urging companies to "never let a crisis go to waste." They want the companies they invest in not only to survive the downturn but also to use it as a springboard to a stronger competitive position. And they are prepared to award a valuation advantage to those companies with a compelling strategy to do so.

A Sea Change in Investor Priorities

BCG's investor survey suggests that the downturn is creating a major sea change in investor perspectives and priorities. During the past two decades, when the global economy was growing rapidly, many investors became focused on near-term results, primarily in terms of growth in revenues and EPS. Steady growth in these indicators was important because investors believed it signaled the sustainability of a company's valuation and the degree of its future total-shareholder-return (TSR) potential. And because valuation multiples were at historic highs, the least sign that a company was not meeting its earnings guidance was a signal to unload the stock, causing the company's multiple to plummet.

In the light of the downturn, however, investors appear to have shifted away from this short-term focus on earnings toward a new willingness to support management teams that want to manage for the long term. They are giving companies permission to focus on doing what they need to do to create long-term competitive advantage. That's not to say that careful cost cutting and tight management won't remain critical in the downturn—for all companies but especially for the most financially vulnerable. However, the investment professionals we surveyed were adamant that even as companies do what is necessary to secure their financial viability, they should avoid what some called "burning the furniture"—that is, cutting so much that a company damages its future growth prospects—just to meet quarterly EPS guidance.

For example, 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 EPS guidance over the next few quarters. As one investor we spoke to put it, "This is a unique time in history to gain share and keep it. No one is pricing stocks on 2009 anyway." Another said, "Even if the stock price does go down for a few months, that's better than starving future growth."

Indeed, instead of worrying that companies will take too many risks, these investors believe that 2009 is the time for game-changing moves, and they worry that well-positioned companies are not being aggressive enough in pursuing them. Eighty-four percent of respondents to our survey agreed with the statement that the current downturn represents a "once in a lifetime opportunity" for some companies. And nearly 40 percent wish that those companies would be more aggressive. "Not enough companies are recognizing that this environment is an opportunity to align your forces and use strategic positioning and assets to better your position in the market," said one investor.

This shift in perspective is partly explained by how these investors see the market evolving in the years ahead. On the whole, they are quite bearish about the prospects for equity markets in 2009. When we surveyed them in the first quarter of this year, they believed that the market had yet to reach its bottom and could drop still further—anywhere from 5 to 15 percent in the United States and perhaps even more in other regions of the world. (In the month after we conducted our survey and interviews, the U.S. S&P 500 dropped roughly 20 percent; as of this writing, it is down 8 percent for the year.) Paradoxically, this pessimism about the near term has caused many of these investors to become less concerned about a company's near-term earnings performance. There is just too much uncertainty about how far (and for how long) earnings will decline for near-term earnings to be an especially meaningful signal of a company's long-term viability.

In a sense, these investors have already written off 2009 performance and are looking to 2010 and beyond. And when it comes to that future, they are more optimistic. A majority (62 percent) believe the recession will end in the United States at some point in 2010 (and in 2011 in Europe) and that the upturn in equity markets will precede the economic recovery by 6 to 12 months. "Even if the economy doesn't recover this year, I think stocks will look ahead of a recovery and bounce back," said one respondent. This is not to say that these investors think equity markets will return to their previous highs anytime soon; a bare majority, 52 percent, thought that this might happen by 2013 to 2015, but an additional 21 percent thought it might take even longer. (See the sidebar "Reading the Market Tea Leaves.")

Reading the Market Tea Leaves

In trying to assess the impact of the global recession on equity markets, there are essentially two schools of thought. Call them the "modest optimists" and the "committed pessimists."

Modest optimists acknowledge that the recession is severe. But they tend to see it as a "normal" cyclical downturn that, sooner rather than later, will be followed by a recovery. As a result, without exactly being bullish, they believe there is considerable opportunity to create value in today's down market, that equities look relatively cheap (especially compared with other asset classes), and that a rebound in stock prices will precede the recovery of the real economy.

Modest optimists point to the fact that corporate bond spreads are currently discounting as high a level of defaults as they did in the 1930s, while the average dividend yield on U.S. and British equities is higher than the government bond yield for the first time since the 1950s. According to Lombard Street Research, for example, the U.S. market has been cheaper than it is today for only 26 months in the past 140 years: during 1920 and 1921, 1932, 1942, and 1982. What's more, optimists point out that capital markets could see rallies even if the global economy remains weak. (Two of the best years for Wall Street in the twentieth century were 1933 and 1935, despite the severity of the Great Depression.)[1]

Committed pessimists, by contrast, see the current recession as structural rather than cyclical—the product of a "perfect storm" of a bursting housing bubble, global financial crisis, and unsustainable levels of both consumer and business debt. As a result, they believe that we may be only at the beginning of a once-in-a-generation correction in equity markets—a "Grand Supercycle bear market" or "Ice Age multiple contraction."[2] Some predict that the S&P 500 could drop as low as 500 (which would represent a roughly 70 percent decline from its 2008 peak). And all point to the sobering cautionary example of Japan, where in 1990 the Nikkei 225 was at 38,000 and today, 19 years later, remains mired below 9,000.

As readers of the *Collateral Damage* series know, we think that it is prudent for companies to prepare for the pessimists' scenario. And as this paper suggests, the investment professionals we surveyed are more on the side of the optimists. Who is right? Well, BCG doesn't call the market—and we urge you to avoid trying to do so. Whether or not valuation multiples or TSR as a whole cluster around the long-term historical average will depend on GDP growth, corporate profitability, the impact of possible new taxes on dividends and capital gains, and a host of other hard-to-predict factors. The debate between optimists and pessimists won't be over anytime soon. It's best for companies to prepare for both scenarios.

1. These data are drawn from the new blog of Buttonwood, the pseudonymous financial-markets correspondent of *The Economist* at Economist.com/blogs/buttonwood.
2. See Robert Prechter, "More Evidence of a Grand Supercycle Turn," *The Elliott Wave Theorist,* November 2008; and Albert Edwards, "What next?" *Global Strategy Weekly,* Société Générale Cross Asset Research, September 18, 2008.

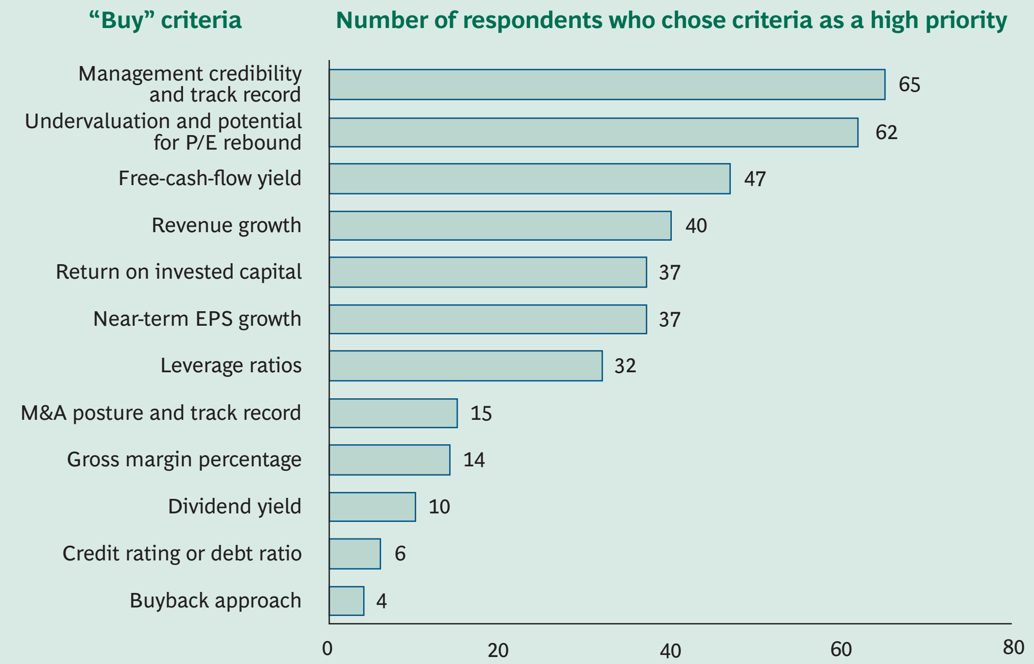
Another shift in perspective concerns the nature of these investors' priorities in today's bear market. Typically, different investors have distinctive investment styles with different priorities and preferences for growth, risk, the best uses of cash, and the like. During the boom, for instance, it mattered whether a company's investor base consisted mainly of growth, growth-at-reasonable-price (GARP), or value investors because these different types of investors had different criteria for valuing a company and were attracted to different types of companies and different sectors of the economy.

If our survey is any indication, however, today more and more investors are shifting to a value mindset. Thirty-six percent of respondents said that they have become "more value oriented" (in contrast to a meager 4 percent who said they are now "more growth oriented"). Of the respondents who said they had modified their investment philosophy since the downturn, nine out of ten said they had become more value oriented.

One consequence of this migration to value (entirely understandable given the uncertainty about future earnings momentum) is that these investors are far more focused on a company's balance sheet, liquidity, and cash situation. As one investor we interviewed put it, "Now, it's only about cash flow." Another added, "I pay more attention to cash flows, especially to the security of those cash flows."

Also consistent with this new value orientation, these investors have become less focused on sector-specific investment strategies in favor of targeting individual stocks. Nearly 60 percent of respondents believe that in the near term, the market for equities will be a narrow "stock picker's" market in which investors will be looking to buy relatively undervalued companies with strong cash flows and led by high-quality management teams. As one investor told us, today's market is "an opportunity to build up stock by stock." And when asked to list in order of importance their top three criteria for investing in a company today, the most frequently cited were "management credibility and track record," "undervaluation and potential for P/E rebound," and "free-cash-flow yield." (See Exhibit 1.)

Exhibit 1. Since the Downturn, Many Investors Have Shifted to a More Value-Oriented Investment Thesis



Source: "Investment Thesis for 2009 and Beyond," BCG Survey.
Note: Respondents were asked, "Which of the following metrics or characteristics would be most important for you in deciding whether to invest in (or give a buy recommendation for) a financially healthy company over the next 12 to 18 months?" The exhibit reflects the number of times each criterion was chosen first, second, or third. Not all survey participants responded to this question.

At a time when valuation multiples have declined precipitously to the point where they are below long-term historical averages, the emphasis on "P/E rebound" requires further explanation. Before the downturn, when multiples were high on average, major improvements in a company's multiple were difficult to achieve and, therefore, investors expected them to be a minor contributor to future TSR. But precisely because multiples are so low now, they are likely to be a key source of TSR in the future. Indeed, 60 percent of our survey respondents believe that P/E multiple expansion will be either an important or an extremely important driver of TSR over the next three years. "A company may be missing on earnings," one investor said, "but the stock will go up because the rate of change will be improving. People will realize that the worst is over, and the stock will start to move."

Another reason for their optimism about the potential of undervalued companies to experience significant revaluation is that these investors think roughly 30 percent to 40 percent of the steep declines in late 2008 were due to short-term capital-market dynamics, not economic fundamentals. Late 2008 saw a massive flight of capital from equities (of at least $550 billion) as investors pulled their money out of mutual funds and hedge funds and fund managers cut back on their exposure to stocks. Our respondents estimate that roughly a third of this outflow was the product of market dynamics—including fear—rather than economic fundamentals. "The fundamentals weren't that disastrous," said one investor. "Without a question, there are companies that are very undervalued out there."

One quantitative indicator that supports this view is the fact that, according to an analysis done by Goldman Sachs, the dispersion of valuation multiples has reached an all-time low. In other words, companies with high valuations, based on strong economic fundamentals before the market selloff, were hit comparatively harder than those with weaker valuations based on poor fundamentals. If there comes a point when substantial portions of the money that moved into cash in late 2008 start returning to the equities market, these undervalued companies could benefit disproportionately. That's why the Goldman Sachs study describes today's market as "an opportunity to buy structural winners at a relative discount and to sell structural laggards at a relative premium."[5]

Based on their responses, it would appear that the investors we surveyed share this view. They are making bets based not on a company's short-term earnings performance but on the strength of its cash flow and balance sheet, the degree to which the company is undervalued in the current market (and, thus, has potential for a strong P/E rebound), and the credibility of its management team to use the downturn to strengthen the company's competitive position in the long term.

The New Capital-Markets Segmentation

Of course, not all companies will meet these criteria. One important consequence of the downturn has been the emergence of a new segmentation in today's capital markets. BCG has developed a simple model of that segmentation that emphasizes three fundamental factors:

- *Financial strength,* or the degree to which a company has a strong balance sheet, substantial cash on hand, access to financing, low liquidity risk, and strong free cash flow
- *Business strength,* or the degree to which a company's portfolio is "recession resistant"
- *Valuation strength,* or the degree to which a company's valuation multiple currently has or is in a position to develop a relative valuation advantage

We call companies that score low on these three dimensions the *have nots.* Their primary challenge is to ensure their near-term financial survival—for example, by cutting costs dramatically, restructuring the business, and ruthlessly managing cash. But, of course, this is just table stakes for staying in the game. Many of

5. See "Capitalising (and recapitalising) on bifurcating business models," Goldman Sachs Global Investment Research, January 21, 2009.

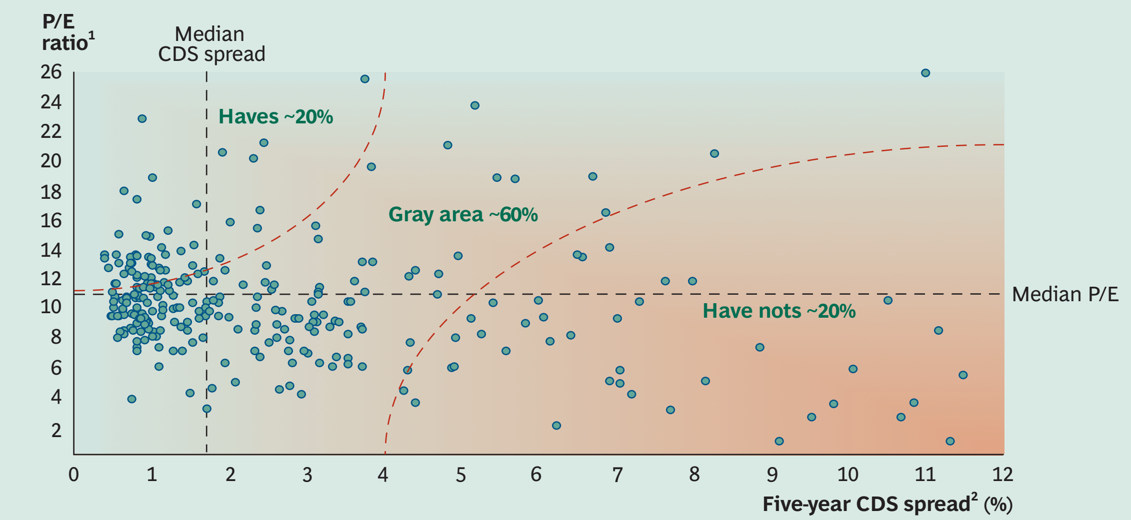
these companies need to face the unfortunate possibility that they will be (or are already) fundamentally disadvantaged for the long term. For some, exit may be the only option.

By contrast, companies that score high on the three dimensions are *haves.* Such companies are in the best position to move aggressively to position themselves for the future. What's more, they either already have or are well positioned to attain a relative valuation advantage (that is, a higher valuation multiple relative to peers) and create a "virtuous circle" in which that advantage can help them achieve their long-term strategic goals. Their challenge will be defining a clear-cut strategy for creating long-term competitive advantage and convincing investors that their plan for executing that strategy is sound.

Finally, many companies are in an in-between *gray area.* They tend to be strong on some dimensions of the above typology but weak on others. For example, they may have a reasonably healthy balance sheet and modest recession exposure, but for whatever reason a below-average valuation multiple for their peer set. Or perhaps their balance sheet and relative multiple look good now, but they are at significant risk if the recession turns out to be longer or deeper than company executives have anticipated. These companies need to figure out what moves will protect them from stronger competitors or even catapult them from the gray area into the haves segment; and at the same time, they must be careful not to expose themselves to too much risk.

What is the relative size of these three groups? To get a rough idea, we analyzed a subset of companies in the S&P 500 and tracked each company's five-year credit-default-swap (CDS) spread (a measure of default risk) against consensus estimates for the company's forward P/E multiples through 2010. This analysis indicates that roughly 20 percent of the sample companies are haves, an additional 20 percent are have nots, with the remaining companies in the gray area. (See Exhibit 2.) This is, of course, only an approximate order-of-magnitude estimate. Still, when we asked our survey respondents what their own estimate of the breakdown would be, the answer was roughly similar—in the neighborhood of 25-25-50. At any rate, the meaningful signal for any individual company is its position relative to its peers; so in order to know where a particular company stands, it is essential to do this same analysis by industry or peer set.

Exhibit 2. BCG Analysis Indicates That Roughly 20 Percent of Companies Can Be Considered Haves



Sources: Bloomberg; Thomson Reuters; BCG analysis.
Note: The sample consists of 281 companies in the S&P 500 with positive earnings forecast for 2010 and available data on CDS spread; data as of February 3, 2009.
[1]Forward looking price-to-earnings (P/E) ratio through 2010, based on consensus estimates.
[2]CDS is a credit derivative contract between two counterparties. The buyer makes periodic payments to the seller and in return receives a payoff if the underlying financial instrument defaults. CDS spread reflects the default risk of a company as viewed by the market. A five-year CDS spread reflects the annual price premium as a percentage of nominal value to insure a five-year bond against default (1 percent = 100 basis points).

The Best Uses of Cash

The respondents to our survey also had strong opinions about how the haves should use their financial advantage to improve their competitive position and break out of the pack in their industry. The top priority (chosen by the most respondents as either their first or second choice) was organic investment in the business. (See Exhibit 3.) "I want them to grow," said one investor. "Put money to work on the sales front or, if there's a wounded competitor, go after it."

M&A came in a close second. Although respondents cautioned companies to be careful not to overpay—especially now when there still remains a pricing gap between potential buyers and sellers—many felt strongly that companies with clear strategic opportunities to acquire shouldn't hesitate. "Eight times out of ten, companies wait too long and end up paying three times more than what they would have, had they taken advantage of the situation when times are bad," one investor told us. "Now is the time to step on the throat of the competition and pick something off." This view is confirmed by BCG research showing that acquisitions made during downturns have a higher probability of success and generate substantially higher long-term returns than transactions executed in periods of above-average economic growth.[6]

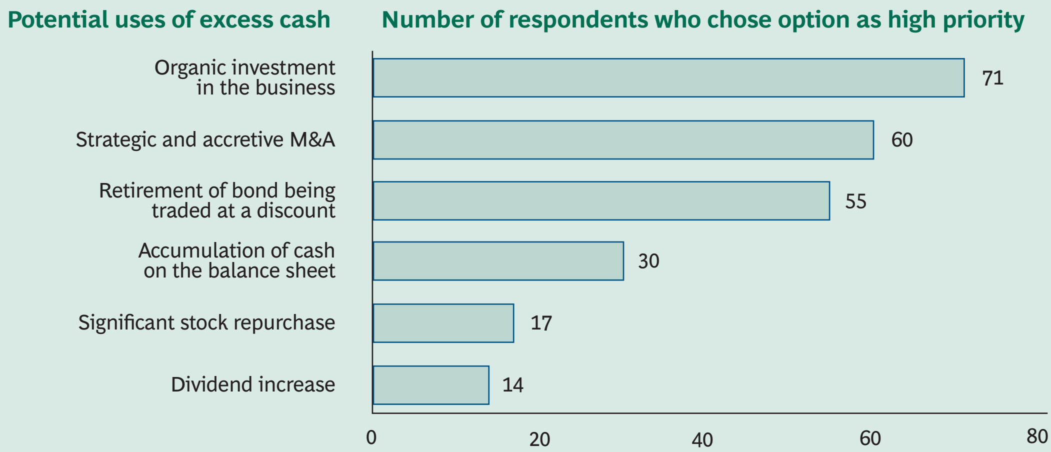
There was also a surprisingly high comfort level on the part of these investors with the idea of using equity for such transactions when the acquirer enjoys a relative valuation advantage. Sixty-three percent of the respondents said they were either comfortable or very comfortable with such a move. "Most managers look at their stock as currency today and see its value cut in half," remarked one investor. "They don't understand the relative value of their equity currency." Another added, "Using stock is okay if what you are buying is cheaper. If the math works in terms of relative valuation, I'm okay with that." This newfound comfort with equity-based transactions may be a consequence of the higher cost and restricted availability of debt in the downturn environment (as well as the desire for companies to carefully manage their cash).[7]

Of course, no company should be thinking of either of these moves if it hasn't already gotten its debt under control—a reason why the retirement of debt that is trading at a discount showed up as the third high-

6. See *The Return of the Strategist: Creating Value with M&A in Downturns,* BCG report, May 2008.

7. BCG research suggests that companies that systematically pursue growth through acquisitions tend to have TSR performance superior to those that grow mainly through organic expansion. See *Growing Through Acquisitions: The Successful Value Creation Record of Acquisitive Growth Strategies,* BCG report, May 2004.

Exhibit 3. Investors Want Haves to Make Organic Growth and M&A Their Priority Investments for Excess Cash



Source: "Investment Thesis for 2009 and Beyond," BCG survey.
Note: Respondents were asked, "If a company generates excess cash well beyond its committed debt payments and dividend, how would you rank the following options based on your preference for use of this excess cash?" The exhibit shows the number of times each option was selected first or second. Not all survey participants responded to this question.

est priority on our respondents' list. Companies in the gray area will need to decide how strong a balance sheet they will need in order to ensure financial health and avoid liquidity risks.

Finally, as the exhibit suggests, giving cash back to investors in the form of dividends or share repurchases were the lowest priorities for our respondents. "It's better to keep the cash on the balance sheet and be prepared," was the typical response. Such a view is understandable given the way the downturn has revealed the financial vulnerabilities of many companies. However, some of our in-depth interviews (as well as recent BCG client work and previous BCG research) reveal a more nuanced picture.

It is highly likely that lower GDP growth, declining profitability, and declines in returns on equity due to deleveraging will result in a lower market-average TSR, even after the recovery begins. When we asked our survey respondents what they thought the "new normal" average annual TSR is likely to be, 50 percent gave an estimate in the neighborhood of 7 to 9 percent, which is below the long-term historical average of 10 percent. Another 16 percent thought it could be even lower. In a lower-average-TSR environment, a company's dividends become a relatively more important contributor to TSR. "The guaranteed return on capital from dividends makes a stock very attractive," said one of our interviewees.

What's more, both our research and client work have shown that dividends not only contribute directly to TSR but can also contribute indirectly through their often positive impact on a company's valuation multiple.[8] The reason: savvy investors recognize dividends as a powerful signal of management confidence in the sustainability of a company's performance. Indeed, one of the investors we interviewed went so far as to say that "a healthy dividend is the strongest signal you can send of your strength. It is the number one way that the haves should be allocating cash."

The downturn may be exacerbating this signaling function of dividends. For example, the 20 companies in the S&P 500 that actually raised dividends after September 15, 2008 (in other words, during the major market selloff), increased their relative TSR (that is, relative to that of their industry peer group) by 3 percent, on average, five days after the announcement. And those that increased their dividend substantially (by 20 percent or more) increased their relative TSR by 6.3 percent. Similarly, companies that have reduced their dividend have seen their valuation multiple decline as a result. So, while dividends may be a relatively low priority compared with investments in future growth or strategic M&A, a company should think carefully about whether it is in a position to use its dividend policy to signal management's faith in the company's future.

When it comes to share buybacks, however, companies need to be careful. Although today's low valuations may make repurchases seem extremely attractive (as one investor pointed out, "roughly 45 percent of companies are trading below replacement value") and can potentially result in a one-time high return if markets rebound, they are not particularly strategic. And our research shows that, unlike dividends, they do not cause a revaluation by themselves. (Indeed, sometimes, their impact on the valuation multiple is actually negative.) So a company should consider repurchases only if they will not constrain its ability to make necessary long-term investments and if executives are confident that the stock is likely to be revalued in the near future. Even in such cases, there are likely more strategic uses of the cash.

The Imperative of Managing Investor Expectations

Finally, our survey suggests that as companies make moves to exploit the downturn, they must work equally hard to achieve and maintain credibility with their investors and carefully manage investor expectations. Remember, when asked for the most important criteria that would lead them to buy the stock of a company today, "management credibility and track record" came in first. "The more credible the management team, the more the company will have freedom strategically," said one investor.

8. See *Missing Link: Focusing Corporate Strategy on Value Creation,* The 2008 Value Creators Report, September 2008, pp. 24–26.

Respondents also would like to see companies put a higher premium on transparency, clear investor communications, and a compelling long-term plan for creating value. "The best strategy is to lay everything out there—including the bad stuff—and start the dialogue," one told us. If a company has to reset guidance, then it should do so, but it should also come clean about any hidden problems and make a persuasive case for how the investments it wants to make today will lead to advantage down the road. Nearly half (46 percent) of the survey respondents believe companies do a poor job of this kind of transparent communication today—and a full 71 percent believe that the investor-relations performance of companies either hasn't improved (51 percent) or has actually gotten worse (20 percent) over the past two years.

Last but not least, respondents see a critical need for improvement in the alignment among a company's corporate strategy, its financial policies, and its approach to and communications with investors. On average, they believe that fewer than 25 percent of the companies they invest in have appropriately aligned these three dimensions. "For some companies, I really wonder whether what they say to us has anything to do with their corporate strategy," said one investor. "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 another.

Pathway to Advantage

The investor survey and interviews confirm what BCG has been hearing from investors recently in the course of our client work. There are many opportunities to deliver superior shareholder value during the downturn. But the way companies go about creating value needs to change. During the past 20 years, many management teams have grown accustomed to focusing on growth in their P&L and consistently delivering quarterly earnings per share that meet or beat consensus estimates (sometimes with the help of easy access to debt). In short, they have been managing against quarterly EPS estimates and basing their annual business plans on relatively static assumptions about changes in the business environment.

But the shocks now rippling through global capital markets and the real economy are changing these priorities rapidly. Investors clearly want companies that are in a position to do so to exploit uncertainty rather than simply manage it—specifically, to use the crisis to reposition and restructure for competitive advantage.[9] There are four basic steps.

Determine your exposure. As we have discussed at length in previous papers in BCG's *Collateral Damage* series, the first step is to identify and aggressively manage the full range of risks associated with the downturn. If a company hasn't done this by now, it is already behind the curve.

For example, instead of managing to a single plan, it's better to develop a range of possible economic scenarios—modest downturn, more severe recession, and even a full-blown depression—and quantify their potential effects on the business. While many companies have begun to move in this direction, in our experience, the most common mistake they make is to underestimate the downside of the current crisis. What effect would, say, a 20 percent decline in sales volume and a 5 percent decline in prices have on your overall financial performance?

But it's not enough just to run the numbers. It's also essential to identify the precise trigger points that will signal when a particular scenario is actually playing itself out and plan in advance the business moves you will make in order both to minimize the company's financial vulnerability and to take advantage of its impact on competitors.

Of course, you won't know how to do the latter until you do this scenario analysis not just for your own business but also for that of your rivals. Every company in your peer group will have a unique profile of

9. For a fuller consideration of how to use the downturn to create competitive advantage, see David Rhodes and Daniel Stelter, "Seize Advantage in a Downturn," *Harvard Business Review,* February 2009.

strengths and weaknesses. How do yours match up against those of your competitors? How might you use your strengths to exploit their weaknesses (and vice versa)?

The outcome of this scenario-building process should be a clear sense of where a company stands, not only in terms of the downturn but also relative to its peers. Which companies in the sector are the haves, the have nots, or in the gray area? And for those companies in this last group, which ones have enough financial strength to contemplate moving up into the group of the haves? Until you know your company's starting point and current competitive position, you won't really know what your strategic options truly are.

Focus on cash flow and the balance sheet. Instead of managing the P&L as the top priority, today companies need to focus, first and foremost, on improving cash flow and having a sound balance sheet. That means relaxing the inordinate attention given to quarterly EPS targets or to guiding toward smooth earnings. Some executives today may be reluctant to revise their earnings guidance downward out of fear that it will have a negative impact on their share price. But our survey and interviews show that many investors are already expecting near-term shortfalls in EPS—whether the consensus estimates reflect them or not. Their focus now is more on the careful management of cash and yours should be too.

Some companies, for example, are creating a centralized cash-management system that tracks cash flow on a weekly or monthly basis (depending on the volatility of the business). It's also important to manage counterparty risk by segmenting your customers by degree of risk and assigning them differentiated credit ratings. There are many initiatives a company can undertake to improve cash-flow generation—for example, reducing net working capital, delaying capital expenditures that may be "nice to have" but are not immediately necessary, and considering the sale of noncore or nonproductive assets. Finally, it is necessary to start redesigning business plans and key performance metrics and incentives around cash generation and the maintenance of a strong balance sheet.

Exploit the downturn. At the same time, however, every company should be identifying and assessing strategic options to improve its competitive position in its industry landscape. Now is the time to tackle those tough, intractable issues that you know will improve the business but were always too difficult or politically controversial to address in the past. Here are some of the moves you should be considering:

- In addition to simply cutting costs, are there steps you can take to fundamentally change your cost structure—for example, by speeding up the restructuring of supply chains through lower-cost sourcing and manufacturing?
- Can you increase market share through the downturn—for example, by innovative pricing strategies, investments in sales force effectiveness and improved customer service, and new-product innovation?
- Are you in a position to use M&A to drive consolidation in your industry or to exploit the financial weakness of competitors to pick up "crown jewel" assets cheaply in a forced sale?
- Are there any financial moves—for example, a modest dividend increase—that would send a strong signal of confidence to investors and perhaps drive improvements in your relative valuation multiple?
- If you can establish a relative valuation advantage, can you then use your equity as an advantaged currency to attract the best people in your industry or do strategic deals?

Of course, not every company will have the same degree of freedom to pursue such opportunities. Have nots that still face major liquidity issues or debt problems will have to focus on getting their financial house in order simply to survive. Gray area companies will have to carefully consider the tradeoffs between opportunities and potential risks. Haves will be in a position to be the most aggressive—but even they will need to pursue their opportunities in ways that either win the support of their current investor base or attract new categories of investors to their stock.

Align corporate strategy, financial strategy, and investor strategy. Just as investors have reshaped their priorities in response to the changing circumstances for the downturn, so too will companies have to reshape their strategy for attracting investors and managing their expectations. The first step is to make sure your corporate strategy, financial strategy, and investor strategy are aligned with one another. Without such alignment, it's unlikely that a company's long-term strategy will be financially sustainable—and even if it is, investors are unlikely to value it fully.

Whether a company is a have, have not, or in the gray area, creating alignment among a company's corporate, financial, and investor strategies requires answering four key questions:

- What investments, whether for funding growth or building competitive advantage, should be core elements of your corporate strategy—and will they provide attractive returns to investors in the medium and long term?
- What is your plan for ensuring funding for investments in growth and competitive advantage, asset replacement, and cash payouts to investors—and is your return on invested capital high enough given your target debt-to-capital ratio and credit rating?
- Do you have the appropriate investor base—that is, one that will fully value your corporate strategy—or do you need to migrate to different investors?
- How do your answers to each of these questions affect your answers to the others?

Of course, it's not enough for a company to align its corporate, financial, and investor strategies. If investors don't perceive that alignment and find it compelling, a company risks confusing them about its value proposition and eroding the credibility of senior management. So, the final step is to communicate the logic behind a company's strategy to investors and analysts.

Today more than ever, the focus and quality of a company's communications to the investment community are at a premium. In an uncertain environment, management credibility and a clear strategic intent are especially important to investors. Be open and objective about how the company is positioned to weather the recession. Emphasize the worst-case scenario with enough information about revenues and margin drivers that investors become comfortable not just with the possible outcomes but also with the thoroughness of management's consideration of them. Establishing this comfort zone with investors is key to enabling a valuation rebound.

But management also needs to make sure that a company's investor communications emphasize the strategies and capabilities that will allow the company to improve its long-term competitive position during the crisis. The last thing investors want to see is a surprise announcement that appears to come out of nowhere and with no compelling strategic logic behind it. If you have well-aligned corporate, financial, and investor strategies, it should not be difficult to make a persuasive case for whatever moves you decide to make.

As our survey suggests, investors today are looking for engagement and are amenable to changing their traditional views about a company's prospects. And they are ready to dig in on the details about the drivers of margins, cash flow, and balance-sheet strength. Instead of fighting them, the best companies should work with them. When they do, they may discover that a company's managers and its shareholders have more in common than either side thinks.

About the Authors

Jeff Kotzen is a senior partner and managing director in the New York office of The Boston Consulting Group and the firm's regional leader in the Americas for value creation strategy.

Eric Olsen is a senior partner and managing director in BCG's Chicago office and the firm's global leader for value creation strategy.

Frank Plaschke is a partner and managing director in BCG's Munich office and the firm's regional leader in Europe for value creation strategy.

The authors would like to thank the 160 professional investors and equity analysts who participated in our survey and interviews. They would also like to thank Joe Brilando, Michael Hagenau, Gerry Hansell, Robert Howard, Martin Link, Lars-Uwe Luther, Vatsa Narasimha, Tim Nolan, Brett Schiedermayer, Dirk Schilder, and Daniel Stelter for their valuable contributions to this paper.

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.

© The Boston Consulting Group, Inc. 2009. All rights reserved.

4/09