



THE BOSTON CONSULTING GROUP

# Collateral Damage

*Part 1: What the Crisis in the Credit Markets Means  
for Everyone Else*

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# Collateral Damage

## *Part 1: What the Crisis in the Credit Markets Means for Everyone Else*

*Given the dramatic events in the capital markets, everyone is wondering what will happen next—and what the implications are for the wider economy. This paper is structured into five chapters. The first three chapters explain some of the background to the crisis both in the capital markets and now in the broader economy; the fourth chapter explores likely future economic scenarios and the challenges facing companies outside of the financial sector; the final chapter highlights some of the actions companies should be taking in order to respond to these challenges.*

### **1. The Current Financial and Economic Situation**

The week of September 15, 2008, marked the end of the United States' Depression-era financial system. Where some had hoped that the earlier collapse of Bear Stearns presaged the end of the crisis, that event turned out to be only an early warning. With Lehman Brothers in bankruptcy, Merrill Lynch arranging a forced sale, Goldman Sachs and Morgan Stanley reorganizing as banks and seeking emergency investors, and AIG accepting a government bailout, the U.S. financial-services landscape changed irrevocably—and virtually overnight. The subsequent fall of Washington Mutual, the takeover of Wachovia by Wells Fargo, and European government intervention in Fortis, Dexia, Hypo Real Estate, and others have only accentuated the gravity of the moment. And beyond the uncertainties facing the real banks, there is mounting concern around the rest of the shadow banking system: hedge funds, PE funds, and other alternative investors. What began as a leverage crisis and a credit crunch has turned into a full-blown insolvency problem as well.

The modern financial system rests on three pillars: capital, liquidity, and confidence. Unprecedented losses (about \$250 billion in the United States, \$200 billion in Europe, and \$100 billion in Asia in the 12 months to August 2008) have depleted financial institutions' capital faster than they can raise new capital (about \$400 billion in the same period). Illiquid capital markets have made it hard for them to finance their own debt. Falling confidence has damaged interbank lending and made depositors jittery. Not since the crash of 1929 has the global financial system been subjected to such a severe shock.

Although the financial system is at the center of this turmoil, the ramifications will spread throughout the broader economy. The rapid industrialization of emerging markets, the globalization of supply chains, and the march of entrepreneurship have all been fueled by the easy availability of plentiful capital and cheap debt. Any disruption to this dynamic will inevitably slow economic growth around the world—even if debt-burdened consumers, particularly in the United States and the United Kingdom, have any capacity to spend more to restore growth. While no one can predict with certainty the severity and duration of the global economic slowdown, a recession now seems inevitable and is likely to be relatively long.

### **2. The Roots of the Current Crisis**

The credit crisis is the consequence of aggressive risk taking by highly leveraged financial institutions that funded unsustainable economic growth, particularly in the United States. Underlying this dynamic were three widely held misconceptions: that the creditworthiness of borrowers was strong, that investors were sophisticated, and that credit risk was widely distributed.

The first belief was perhaps the most reasonable—at least on the surface. For years, credit losses had been relatively limited, so borrower creditworthiness did indeed appear to be strong. There was, how-

ever, a dangerous circularity to this logic. Lender and investor perception of healthy homeowner credit drove spreads lower, causing marginal borrowers to appear to be more financially attractive than, in fact, they were and making it easier to justify providing them financing. This was further fueled by the belief that any financially constrained borrowers would be covered by ever-rising home prices via home equity release products. The unintended result was highly imprudent lending to people who could not afford the homes they were buying.

With the bursting of the housing bubble, the problem was there for all to see. So far, U.S. housing prices have fallen about 20 percent, not yet bringing the market to long-term historic price levels. In late 2006, default rates on subprime loans were only 1 percent; a year later, they were at 10 percent. Today, Moody's estimates that banks made in the neighborhood of 15 million high-risk mortgage loans in the United States between 2004 and 2007 and that a full two-thirds will ultimately end up in default.

The second belief provided even more false comfort. With unprecedented access to data and analytics, lenders and investors were assumed to be exceptionally sophisticated. Advanced financial technology meant that risk could be finely tailored to their specific needs. Strengthened by credit insurance and blessed by rating agencies, this risk was assumed to be nearly bullet-proof. Consequently, the capital applied against it was minimized.

Finally, market participants believed that risk was widely distributed among global investors. Even if credit worsened and analytics failed, the absence of concentrated risk would prevent systemic problems. This belief, more than any other factor, explains why people—instead of being wary of a market bubble—were under the impression that this time, it was different.

Unfortunately, not only was homeowner credit suspect, but the market had misread this risk. In the ensuing panic and consequent liquidity crisis, the safety net of risk analytics and ratings was seen to be an illusion. When investors realized that the risk was largely concentrated on bank balance sheets, their confidence in the financial system eroded rapidly.

One might ask: Why did global capital markets grow as fast as they did and why were they able to absorb all this—in retrospect—risky borrowing? The answer lies as much in investor demand for fixed-income securities that offered good returns as it does in the insatiable appetite of consumers for debt to fuel their spending (which we discuss in chapter 3). By 2000, the total pool of global fixed-income securities had reached \$35 trillion. It had taken hundreds of years to get there. Yet it doubled over the next six years. In the early 2000s, Alan Greenspan—the former chairman of the Fed—had publicly asserted that the Fed funds rate would be kept low for the good of the economy. This meant that U.S. Treasury bonds would offer a low return for the foreseeable future. So Wall Street filled the void, packaging higher-yielding mortgage debt into (apparently) AAA-rated securities. The problem was that the incentives driving the mortgage originators and the securities distributors created a moral hazard: their rewards were not aligned with sound credit underwriting principles or the distribution of assets backed by sound collateral. Credit was granted to uncreditworthy individuals, packaged into securities, and pushed out into the market. And seemingly unlimited investor demand inflated this bubble further.

At the same time, the derivatives market for so-called credit default swaps (CDS)—instruments originally intended to trade and insure credit risk—exploded from a notional amount of less than \$500 billion in 2000 to \$62 trillion in 2008. (By comparison, global GDP for 2008 is also forecast at \$62 trillion.) Now, as part of the credit risk on which these swaps were written materializes, many CDS need to be settled. This could have severe consequences if the counterparties who wrote the CDS cannot perform on their liabilities. Initially, this would mean that these counterparties will default. But it also implies that the respective CDS buyers—who bought these instruments to insure against credit events—would be left without insurance and so be likely to suffer further losses. Such losses could then drive these buyers into bankruptcy as well. In order to prevent this from happening, the U.S. government bailed out AIG, which had written \$78 billion of CDS on securitized mortgages, or so-called collateralized debt obligations (CDOs). The worrying conclusion is that the CDS market might conceivably hold an even bigger problem to come.

As of now, the resulting chaos from their misjudgments has forced bankers to revisit all their assumptions. Driven by spiking defaults (starting in high-risk mortgages but now spreading to standard mortgages and likely on to consumer debt, highly leveraged private equity deals, and corporate debt), banks are tightening lending standards on all loans. Banks and rating agencies are clamping down on financial engineering and innovation, thereby reducing the flexibility of terms and instruments available to borrowers. Finally, a reduced ability to place debt with investors implies that banks will now have to hold more of it on their own balance sheets. At the same time, the capacity of their balance sheets is shrinking as they reduce their leverage. Thus, the debt available for their customers is constrained and the price for it is materially higher. Credit spreads have expanded by more than 100 basis points (bps) for loans rated BBB—and by more than 300 bps for those rated BB. Issuance of asset-backed securities fell by more than 75 percent in the second half of 2007 compared with the first half of the year and has virtually ground to a halt in 2008. And even issuance of plain debt has fallen by more than 75 percent from the steady levels of 2003–2007.

One feature of the financial system that has been changing over recent years is this: the identity of the risk-takers. Traditionally, the lubrication for many markets came from investors and speculators. These people risked their own cash. By 2007, however, financial institutions had become more leveraged, committing ever more of their own equity in order to increase the levels of proprietary risk—thereby shifting what had once been investor risk onto the banking system itself. In other words, historic intermediaries had themselves become major holders of risk.

How bad will the credit crunch be? We estimate that financial institution losses are likely to reach at least \$1.5 trillion worldwide, with losses from personal lending and corporate debt possibly exceeding the losses from mortgages. At a 12.5:1 ratio of capital to assets, that loss would mean a \$19 trillion decline in credit capacity—a net contraction representing about 7 percent of current global credit levels. Given that roughly \$4 of credit are necessary for every \$1 growth in GDP, such a contraction would lead to a massive global economic slowdown directly reducing global growth by almost 2 percentage points—even before any second- and third-order effects take hold.

### 3. The End of Debt-Fueled Demand

The credit crunch is taking place against a backdrop of the long-term rise in consumer indebtedness in the United States. For years, U.S. consumers have been living beyond their means. Between 1972 and 2008, U.S. consumer indebtedness, as a share of GDP, grew from 60 percent to 120 percent. Even when you exclude mortgage debt, U.S. consumers are carrying more than \$2.5 trillion in consumer credit—up more than 50 percent from \$1.6 trillion in 2000. Indeed, the explosion in mortgage lending was, in part, driven by consumers using the boom in housing prices to take on more debt in order to fuel further consumption—on the theory that still higher prices later would pay for money borrowed today.

The wide availability of cheap debt was a key factor fueling the growth of the U.S. economy—and, to the degree that the U.S. economy has been an engine of global economic expansion, that of the world economy as well. U.S. household consumption accounts for an unusually high—and unsustainable—70 percent of U.S. GDP. As a consequence, the savings rate of U.S. households, barely above zero, has reached the lowest level since the Great Depression.

But, of course, it is not just consumer debt that has driven the growth of the U.S. economy. Between 2000 and 2007, corporate and government debt also grew, causing total U.S. debt to climb from 250 percent to 350 percent of GDP. (By contrast, in the 30 years between 1950 and 1980, total U.S. debt stayed between 125 percent and 155 percent of GDP.) Financial institutions used debt to boost returns. (The top five U.S. investment banks, for example, increased their leverage from 21x to 30x between 2000 and 2007 in order to compensate for a sharp fall in their return on assets; this increase in leverage allowed them to boost their total asset base from \$1.5 trillion to \$4.3 trillion.) In parallel, outstanding debt of the total U.S. financial sector grew from \$10 trillion in 2002 to \$16 trillion in 2007. Corporations used debt to fund global

expansion. And, of course, the federal government increased its debt to increase spending while keeping taxes low.

But debt cannot grow faster than income forever. Now both consumers and financial institutions need to deleverage. The days of such extreme debt-fueled expansion in the U.S. economy are definitively over.

#### 4. What the Crisis Means for the Real Economy

The combination of less available (and more expensive) credit and stagnant or even declining demand will hurt even healthy companies. Corporate financing decisions are typically driven by demand-side factors (e.g., economic growth and the capital equipment replacement cycle) and supply-side factors (e.g., the cost of money). In the current situation, both are likely to limit new investment by companies.

On the demand side, unsustainable levels of consumer debt will put a major dent in demand, as people save more both to pay down debt and to save for retirement. And in the financial sector, where the industry's share of total U.S. corporate profits rose from 10 percent in the early 1980s to 40 percent in 2007, deleveraging will shrink returns materially and reduce the sector's contribution to total GDP. The expected decline in demand and the likely fall in capacity utilization will cause companies to cut back on new investments in capacity and expansion, stalling growth further. It will also reduce their need for external capital.

On the supply side, even those companies that want to invest will find available credit scarce and more expensive. As financial institutions focus on rebuilding their depleted capital base and decreasing leverage, their appetite for making aggressive loans even to creditworthy borrowers will decline. At a minimum, banks will differentiate between the highest-quality borrowers and everyone else. The former (mostly large, diversified multinationals and some middle-market companies) should be able to get financing at relatively competitive levels. Others will get financing selectively and at significantly higher spreads than they have been used to.

The bottom line: we are facing a very tough environment and (we would argue) certainly a recession in many countries. The only question is: How severe will it be? Some observers have argued that it will be relatively short and shallow. They point to the relative flexibility of the U.S. economy and the rapid intervention of the U.S. government (in contrast to the passive role of the Japanese government in the 1980s). So, if government intervention in the financial system proves successful and if the Fed continues to keep money supply at a high level and interest rates low (thus helping U.S. consumers cope with falling home prices, higher unemployment, and slower real wage growth), then any recession could largely be limited to the United States and a few other countries facing real estate issues. The rest of the world economy would be only mildly affected.

In this scenario, the main issue that companies will have to contend with is the increased risk aversion and tighter lending standards of banks. It might also take awhile for confidence to return to the capital markets. This scenario favors companies with stronger credit profiles because they will still be able to raise funds, not just from banks in home markets but from global financing sources. They will also be able to look at acquisition opportunities supported by modest leverage. Having said this, the cost of credit will be higher for most borrowers, and therefore it will be prudent for all companies to look at their cash flow from operating activities as a key source of ongoing financing.

However, we do not find the soft-recession scenario especially credible. The International Monetary Fund (IMF) has studied more than 100 past recessions around the world and arrived at a clear conclusion: recessions induced by a financial crisis are deeper and worse. According to the IMF, such recessions 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." In the current situation, the overall high level of credit, the real estate bubble, and the highly lev-

eraged consumers in the U.S. are the main reasons to be worried. So companies need to be prepared for a serious recession. They have to plan for a situation in which banks continue to fail, consumer demand continues to decline, and developed economies—not only the United States and the United Kingdom but also Ireland, Germany, France, Spain, and Japan—fall into recession. Although nonexport growth in rapidly developing economies (RDEs) will be, to a degree, protected, export-led growth in RDEs such as China could be halved—or more.

So what, specifically, are most companies in the real economy likely to face?

### **A. No Access to Funds**

Corporate treasurers face an increasingly difficult environment for their short-term financing needs. Given record interbank borrowing rates, banks are deleveraging, scaling back open credit lines, and seeking to renegotiate lending terms with corporate borrowers. The ordinarily liquid commercial-paper market has contracted by over \$200 billion (11 percent) in just over three weeks, and securitization of any asset class has become nearly impossible, meaning that capital markets are effectively closed to most borrowers. Even some blue-chip utilities are currently unable to place new bonds in the market. Companies therefore need to revisit their financing strategy and make sure that they can refinance outstanding loans and secure more credit if needed. In addition, they need to close the funding gap (gross investment less retained cash flow). Overall, the funding gap of the nonfinancial sector in Europe was €327 billion in the second quarter of 2008. This will need to be reduced. For companies with weaker credit, all this means difficulties in financing even their working capital.

Over the medium term in the United States, the \$700 billion Troubled Asset Relief Program (TARP) should help. Under this program, banks will be able to sell illiquid mortgage assets to the U.S. government. Not only will this restore some market confidence in banks, it will also inject new cash and free up banks' lending capacity. This, in turn, should ameliorate the stress in corporate lending. But even if some measure of confidence and liquidity returns to credit markets, banks will remain highly conservative in their lending practices. They will compete aggressively for companies with strong credit profiles—over time, bringing down the borrowing cost of such companies. But expect companies with weak credit histories and high debt to continue to have difficulty refinancing their debt except at substantially higher cost. Additionally, significant uncertainty remains regarding the actual effectiveness of TARP. Recessionary conditions are likely to worsen consumer and commercial credit performance, which will constrain corporate lending by banks. Banks and investors could remain risk averse for quite some time, preventing any meaningful change in credit market conditions.

### **B. Significantly Higher Cost of Capital**

Investors are asking for hefty risk premiums across all asset classes. In particular, credit spreads have widened and will stay high for the foreseeable future—with significant volatility. Even for companies with good credit, this means a higher cost of borrowing (e.g., the discount rate for investment-grade borrowers has spiked to ~600 bps for 60-day maturities). The conditions for longer-term borrowing are no better. The yield spread on investment-grade corporate debt has widened to a record 487 bps. Currently, companies with a BBB rating pay around 8 percent per year (compared with 4 to 5 percent in 2006), while the spreads on some high-yield debt are at 1,200 bps, the highest in a dozen years. Under any scenario, we will not return to the overly cheap debt pricing that prevailed before the crisis, when credit spreads had fallen to all-time or near all-time lows (e.g., to only 250 bps even for junk bonds, which, by the way, now require spreads of more than 600 bps over Treasuries).

### **C. Weak Stock Markets**

Low valuations (DJIA, S&P 500, FTSE, DAX, and other major indices are down approximately 30 percent for the year with, for example, the S&P 500 being at its lowest level since October 2004) make it less attractive and much more difficult to raise new equity. Companies will be forced to tap alternative sources of funds, such as PE firms or major investors. But this will be extremely expensive. Just consider the case of Goldman Sachs, which agreed to give Warren Buffet, at a discount, \$5 billion of preferred stock paying

a guaranteed annual dividend of 10 percent, together with an option on another \$5 billion of stock that is already in the money.

#### **D. Bonus for Cash**

Until the autumn of 2007, companies were at risk of being attacked by activist shareholders/PE funds if they had a significant cash position on their balance sheet. These investors pressed for special dividends or buyback programs. The opposite holds true today: companies get a “safety bonus” for having a solid cash position. Companies like the Dutch chemical group Akzo have already suspended buyback programs and are using the funds to pay down debt. This will be the norm in the coming years.

#### **E. Reduced Cash Flow**

All industries and companies will be affected by the worldwide slowdown. Volumes and prices will come under pressure. We believe that growth will be substantially below the long-term trend and turn negative. Most companies should, therefore, plan for significant volume reduction (up to –10 to –20 percent) and additional price reduction (between –10 percent and zero) in their markets.

#### **F. Credit Losses**

Companies that finance their customers will see a major jump in credit losses because of bankruptcies. This holds true for consumers but also for industrial customers. Economists expect default rates on U.S. credit-card debt to rise sharply over the next 12 months, followed by defaults on loans made for purchases of electronics and automobiles. Companies will need to manage much more aggressively both the extension of credit facilities and their receivables. Remember: in God we trust—all others pay cash.

#### **G. Significant Balance-Sheet Risks**

Deleveraging, by definition, leads to asset price deflation—that is, assets become cheaper. For example, U.S. home prices have already fallen by approximately 20 percent and will have to fall further if they are to revert back to historical levels. Asset price deflation poses a major risk not only for banks and insurance companies but also for industrial companies. For example, intangible assets, especially goodwill from acquisitions, could be devalued. Under current IFRS rules, companies have to do an impairment test every year. This test could lead to reduced values resulting from lower cash flows and higher cost of capital. Since impairments of intangible assets directly reduce book equity, even blue-chip companies face the risk that their entire equity will get wiped out if they need to write off their intangible assets.

#### **H. Bursting of the Profit Bubble**

Profits as a share of GDP are at all-time highs in the Western economies. In Europe, profits are currently 40 percent above trend. Experience shows that an “overshooting” beyond trend tends to be followed by another below trend. This will mean significantly lower profit levels in the years to come. Therefore, companies should not expect a return to pre-bubble levels until the next bubble (which will occur once the generation that experienced the current real-estate bubble in the United States has moved on).

#### **I. Continued Volatility**

One silver lining is the likely easing of pressure on commodity prices—although we expect to see continued volatility. Current markets have seen oil price swings of more than 40 percent within six weeks, the dollar appreciating/depreciating more than €0.5 a day, and raw material prices showing major jumps. Although we will see higher raw material prices over the longer term, major deleveraging will lead to big swings and unexpected events in the short term. For example, one might expect the U.S. dollar to depreciate given the major debt crisis in the U.S. But, in reality, investors in so-called carry trades, who took out loans in U.S. dollars, now need to repay—and buy dollars. This does not imply that the dollar might not depreciate significantly in the medium term. But companies also have to pay attention to short-term movements and be flexible in their purchasing strategies.

## **J. Protectionism**

So far, we have seen no visible trend toward reduced trade freedom. But this trend is likely to occur when the recession deepens. It will become more difficult to export. And companies shifting production to low-cost countries could face issues in re-importing their products. Politicians such as Democratic presidential candidate Barack Obama are already asking for trade restrictions.

## **K. Wave of Industry Consolidation**

We will see either a wave of bankruptcies in nearly all industries or a big increase in “restructuring mergers.” Banks have already experienced this, and it is likely to happen in other industries as well. Companies need to secure their own financial situation and understand that of their competitors in order to prepare the ground for a favorable acquisition.

## **L. More Government Intervention**

We do not believe that the TARP program is the end of the crisis. It might soften the pressure for a few months, but it cannot stop the deleveraging and the need for households in the United States, the United Kingdom, Spain, Ireland, France, and other countries to restore their finances. Governments will implement measures such as infrastructure investments to support demand. Be prepared to see measures similar to those enacted during President Roosevelt’s New Deal. (If you have ever driven Route 1 from Monterey to Carmel, you’ve seen a lot of bridges; all of them were built in the 1930s.)

## **M. Re-regulation**

In all industries, not only in banking, we will see more government intervention. The liberal, free-market times are over for the foreseeable future. The topic is too complex to address in this paper, but the failure of the regulatory authorities to manage the burgeoning bank risk is one of the most salutary lessons from this crisis.

## **N. Change in Consumer Behavior**

Saving will be more attractive than consuming. Many of the trends we have seen in the past, such as trading up and the New Luxury, will stop or be reversed for many consumers—so companies cannot simply extrapolate from trends of the past 20 years. The first signs are already clearly visible: consumer sentiment indices have fallen sharply around the world—in the United States, by more than 30 percent from their peak in 2007. Across the High Street, retail sales are falling, particularly in nonessentials.

## **O. Every Industry Will Be Affected**

Banks, insurance, and real estate are the industries most obviously affected right now, but others will follow. Retailers are suffering as customers instantly respond to the bad news with belt tightening. Theaters, bars, and restaurants are reporting a fall in demand. Companies producing durable consumer goods will be hit hard (as the automotive industry shows); next will be companies producing machinery and industrial equipment. German industry overall already reports a big drop in new orders, with printing machinery producers (a traditional early indicator) already under severe pressure. Even “safe” industries will be affected. In France, the sale of yogurt has fallen this year, partly owing to a shift to lower-priced private labels and partly owing to reduced demand. Industries such as health care and utilities will be affected by more regulation and cost-saving efforts by public authorities.

## **P. A Sidebar of Good News**

The enormous losses described in this paper are mostly provisions rather than actual realized losses. The accounting conventions, most notably “mark-to-market,” require banks to carry their investments at market value. In illiquid instruments, market upheavals can drive down value dramatically—and out of all proportion to the value that would be realized if these instruments were held to maturity. This means that over time, banks should be able to write back some of their provisions, partially repairing their capital position. However, this is some time away. Second, it is worth repeating that the United States has responded quickly and decisively and, despite criticism, remains the world’s most flexible economy. In the broader

nonfinancial economy, the flexibility of the labor force will allow painful adjustments to be completed quickly before growth resumes on a more prudent basis.

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

Many executives wonder what all of this means for their companies and which areas now require their special attention. In our view, companies need to focus on 14 key measures:

### A. Introduce a Crisis-Monitoring Team and Stress-Test Scenario Planning

A core team should monitor the key early-warning indicators, the development of scenarios, the competitive landscape, and the implementation of measures. How would a recession affect your businesses? Take worst-case scenarios (e.g., -20 percent volume, -5 percent price) and define countermeasures. Identify early-warning signals of a deterioration in the situation. Simulations show that even for many currently still very healthy companies with EBIT margins of around 10 percent, a sales drop of 20 percent is sufficient to turn their profits into huge losses and to send their cash flow deep into the red.

### B. Watch your Cash

Install a tight cash management system, reduce and postpone spending, and focus on cash inflow. Prepare a weekly report on your cash position and on medium-term developments based on expected payments and receipts.

### C. Reduce Trade Credits

Customers will try to rely more on trade financing, but the risks will be too high. Therefore, segment your customers and be directive where you invest.

### D. Start Working Capital Initiatives

Most companies have poor processes to monitor their working capital. So it's not surprising 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 achieve an additional cash flow of approximately 10 percent of sales from net working capital optimization.

### E. Restructure Your Debt

Secure financing as long as you have access; reassess dividend and buyback policies. Look for additional funding by sovereign wealth funds or cash-rich investors. Leverage ratios have to be conservative.

### F. Act Now on Cost and Organizational Efficiency

Implement all those measures today that can be executed without risking major opportunities—in case the recession does not develop as we predict. Delaying and the lowering of breakeven points are always good ideas—whatever the market conditions. Use external market turbulence to justify significant transformational moves.

### G. Reassess Your Investment Program

Michelin, the French tire manufacturer, just stopped a major investment program in Mexico. In most industries, capacity will not be scarce in the coming years. Instead, look for consolidation mergers. U.S. capacity utilization just fell to 78.7 percent and will probably fall even lower. Compared with the long-term average of 81 percent from 1972 to 2007, more than enough capacity currently exists in most industries, with no need for further investments.

### H. Reevaluate Offshore Manufacturing

The economics of offshore manufacturing can change significantly with changing trade direction (e.g., fewer U.S. imports) and trade barriers.

### **I. Manage Financial Policies and Investor Messaging**

Some of the banks have been hit extremely hard because investors did not understand how toxic or how safe their assets were. In addition, share buybacks, dividend policy, and total shareholder return (TSR) management need even more careful attention.

### **J. Adapt Your Product Portfolio**

Purchasing behavior will change in the recession. Luxury goods will be used “at home” and in a less visible manner. Consumers will shift to lower-price alternatives, such as private labels. In the 1930s, there was a huge trend in the United States towards cheaper, canned food. A more recent example is the \$1 menu at McDonald’s, which is highly successful. And GM is about to sell its Hummer brand while pumping enormous resources into the new Chevrolet Volt.

### **K. Look for “Out of the Box” Pricing**

Customers will not be in a position to pay as before; some might be under financial pressure. In this context, alternative ways of pricing should be considered. It was during the Great Depression that GE developed its innovative strategy to finance its customers’ purchase of refrigerators.

### **L. Divest Noncore Businesses**

Companies should not wait for “better” times to sell nonperforming/noncore assets. As BCG’s research shows, the market reaction to divestitures is very positive, even in recessionary times. And there are still buyers around. Of the respondents to BCG’s recent M&A survey, 70 percent said that disposals, spinoffs, and demergers are currently a good means of focusing the business.

### **M. Look for Opportunities and Engage in Selective M&A**

A recession will change some of the long-standing “rules of the game” in many industries. Use the weakness of your competitors to redefine your industry. BCG’s research shows that the best deals are made in downturns. Downturn mergers generate about 15 percent more value, measured by TSR, compared with boom-time mergers, which on average exhibit a negative TSR effect. This is the best time for consolidation and cost mergers. Therefore, closely monitor your target companies, especially their financial health.

### **N. Plan for the Upturn**

Investments that strong companies make now in R&D, IT, or new infrastructure will only come onstream once the recession is over. And the cost of these investments will be correspondingly lower during a period of reduced competition for resources.

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**C**ompanies 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.

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