

Collateral Damage

What the Crisis in the Credit Markets Means for Everyone Else

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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 then explores likely future economic scenarios and the challenges facing companies outside the financial sector; and the final chapter highlights some of the actions companies should be taking in order to respond these challenges.

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1. The current Financial and Economic Situation

The week of September 15, 2008 marked the end of America's Depression-era financial system. Where some had hoped that the earlier collapse of Bear Sterns presaged the end of the crisis, it turned out that it was 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 (or Citigroup?), 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 as of August 2008) have depleted financial institutions' capital faster than their ability to 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 inter-bank lending and made depositors jittery. Not since the crash of 1929 has the global financial system been subject to such a severe shock.

Although the financial system is at the centre of this turmoil, the ramifications will travel throughout the broader economy. The rapid industrialization of emerging markets, the globalization of supply chains, and the march of entrepreneurship have all been fuelled 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 U.S. and UK, had any capacity to spend more to restore growth in the first place. 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 which funded unsustainable economic growth, particularly in the U.S. 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, however, 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 fuelled by a belief that any financially constrained borrowers would be covered by ever-rising house prices via the 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 sub-prime loans were only 1 percent; a year later, they were at 10 percent. Today, Moody's estimates that banks made in the neighbourhood of 15 million high-risk mortgage loans in the U.S. 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 near 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, 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 that impression that “this time, it’s 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 the risk was largely concentrated on bank balance sheets, their confidence in the financial system eroded rapidly.

One might ask oneself 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 did in the insatiable appetite of consumers for debt to fuel their spending (see below). 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 drove 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 – for comparison, global GDP for 2008 is also forecasted to be \$62 trillion. Now, as part of the credit risk on which these swaps are written materializes, many of these CDS need to be settled. This can have severe consequences if the counterparties who wrote these CDS cannot perform on their liabilities. Initially, this means that these counterparties will default. But it also implies that the respective CDS buyers – who bought these instruments to insure against credit events – will be left without insurance and so are likely to suffer further losses. Such losses could then also drive these buyers into bankruptcy. In order to prevent exactly 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 takeaway is that the CDS market might conceivably hold an even bigger problem to come.

As of now, the resulting chaos from their misjudgements has forced bankers to revisit all their flawed 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 flexibility of terms and instruments available to borrowers. Finally, a reduced ability to place debt with investors implies banks 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 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 to the first half of the year, and has virtually ground to a halt in 2008. And even issuance of plain debt has fallen more than 75 percent from the steady levels of 2003-2007.

One feature of the financial system that has been changing over the years is precisely where the risk is taken. In the past, the lubrication for many markets came from investors and speculators. These third parties risked their own cash. By 2007, the increase in Institutional proprietary risk, supported by their own equity (and leverage), had shifted a lot of this risk onto the banking system itself. 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 as losses from personal lending and corporate debt could even exceed 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 four dollars of credit are necessary for every one dollar growth in GDP, such a contraction would lead to a massive global economic slowdown directly reducing global growth by almost 2 percentage points—before any second- and third-order effects.

3. The End of Debt-Fuelled Demand

The credit crunch is taking place against the 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 of GDP 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 in fuelling the growth of the U.S. economy—and to the degree that that 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. During the same period, corporate and government debt also grew, causing total U.S. debt to climb from 250 percent to 350 percent of GDP between 2000 and 2007. (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 5 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, total U.S. financial sector debt outstanding 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-fuelled 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 with stagnant or even declining demand will hurt even healthy companies. Corporate financing decisions are typically driven by demand side factors (e.g., economic growth, capital equipment replacement cycle) and supply side factors (e.g., 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, de-leveraging will shrink returns materially and reduce the sector's contribution to total GDP. The expected decline in demand and likely fall in capacity utilization will cause companies to cut back on new investments in capacity and expansion, stalling growth still 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 companies will have to contend with is the increased risk aversion and tighter lending standards of banks. It might also take a while for confidence to return to the capital markets. This scenario favours companies with stronger credit profiles as they will still be able to raise funds not just from banks in home markets but from global financing sources. They can also look at acquisition opportunities supported by modest leverage. Having said this, the cost of credit will be higher for most borrowers, and therefore it would 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, arriving at a clear conclusion: recessions induced by financial crisis are deeper and worse. According to the IMF these recessions tend to be "two to three times as deep and two to four times as long" and, "leading 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 leveraged consumers in the U.S. are the main reasons to be worried. So, realistically, companies need to be prepared for a serious recession. Firms have to plan for a situation in which banks continue to fail, decline in consumer demand persists, and developed economies—not only the United States and the United Kingdom but also Ireland, Germany, France, Spain and Japan—fall into recession. Although non-export 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 are the likely specifics most companies in the real economy will face?

- 1. No access to funds:** Corporate treasurers face an increasingly difficult environment for their short term financing needs. Given record inter-bank 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 whatever asset class has become nearly impossible meaning 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 non-financial sector in Europe was 327 billion Euro in the second quarter 2008. This will need to be reduced. For companies with weaker credit, all this means difficulties financing even their working capital.

Over the medium term, 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 should this restore some market confidence in banks, it will also inject new cash and free up their lending capacity. This, in turn, should ameliorate the stress in corporate lending. But even if some measure of confidence and liquidity returned 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 on 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 quiet some time preventing any meaningful change in credit market conditions.

In Europe things are no better. At the time of writing, the disjointed and inconsistent response of European governments has done little to ease market worries

- 2. 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 higher borrowing cost, e.g., the discount rate for

investment grade borrowers has spiked to ~600 bps for 60 days 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 p.a. (comparing to 4-5 percent in 2006), while the spreads on some high yield debt are at 1200 bps, the highest in a dozen years. Under any scenario, we will not return to the overly cheap debt pricing that prevailed pre-crisis, when credit spreads had fallen near or to 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.

3. **Weak stock markets:** Low valuations (DJIA, S&P 500, FTSE, DAX and other major indices are down approximately 30 percent for the year with e.g. 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 funds, e.g. PE firms or major investors. But: this will be extremely expensive as well. Just consider the case of Goldman Sachs which agreed to give Warren Buffet \$5 billion of preferred stock paying a guaranteed annual dividend of 10 percent at a discount together with an option on another \$5 billion of stock which is already in the money.
4. **Bonus for cash:** Until the autumn of 2007 companies were under the 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 buy-back programs. The contrary holds true today: companies get a "safety bonus" for having a solid cash position. Companies like the Dutch chemical group Akzo have already suspended buy-back programs and decided to use the funds to pay down debt. This will be the norm in the coming years.
5. **Reduced cash flow:** All industries and companies will be affected by the worldwide slowdown. Volumes and prices will come under pressure. We believe growth will be substantially below the long term trend and turn negative. Most companies should therefore plan for significant volume reduction (up to minus 10-20 percent) and additional price reduction (of between minus 0-10 percent) in their markets.
6. **Credit losses:** Companies who finance their customers will see a major jump in credit losses because of bankruptcies. This holds true in particular 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 then by loans made for electronics and car purchases. 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.

- 7. Significant balance sheet risks:** The deleveraging by definition leads to asset price deflation, i.e. assets become cheaper. For example, U.S. house prices have already fallen approximately 20 percent and have to fall further if they are to revert back to historical levels. Asset price deflation does not only pose a major risk 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 due to lower cash flows and higher cost of capital. Since impairments of intangible assets directly reduce book equity, even several blue chip companies face the risk that their entire equity gets wiped out if they need to write off their intangible assets.
- 8. 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, is followed by another below trend. This will mean significantly lower profit levels for the years to come. Companies should therefore not expect a return to pre-bubble levels until the next bubble (and this will come once the generation that experienced the real estate bubble in the U.S. has moved on).
- 9. 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 6 weeks, the dollar appreciating/depreciating more than 5 Euro Cents a day, raw material prices showing major jumps. Although we agree that longer term we will see increased raw material prices, the major deleveraging will lead to big swings and unexpected events in the short term. For example, one could currently expect the US-Dollar to depreciate given the major debt crisis in the U.S. But in reality there were so-called carry-trades, investors who had taken out loans in US-Dollar. Now they need to repay – and buy Dollars. This does not imply that the Dollar might

not depreciate significantly in the mid term. But companies have to pay substantial attention also to short term movements in the current environment and hence be flexible in their purchasing strategies.

- 10. Protectionism:** So far we have seen no visible trend to reduce trade freedom. But this is likely to come when the recession deepens. It will become more difficult to export. And companies shifting production to low cost countries might face issues in re-importing the products. Politicians like Democratic presidential candidate Barack Obama are already asking for trade restrictions.
- 11. Wave of industry consolidation:** We will see either a wave of bankruptcies in nearly all industries – or a big increase in "restructuring mergers". The banks have started this way; it is likely to happen in other industries as well. Companies do not only need to investigate and secure their own financial situation but also that of their competitors.
- 12. 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 U.S., UK, Spain, Ireland, France, etc. to restore their finances. Governments will implement measures to support demand, e.g. infrastructure investments. Be prepared to see similar measures as during the "new deal"-policy of President Roosevelt. If you have ever driven the Route 1 from Monterey to Carmel you will see a lot of bridges: all these bridges were built in the 1930s...
- 13. Re-regulation:** In all industries, not only in banking, we will see more government intervention. The liberal, free market times will be restrained for the foreseeable future. Although too detailed for this paper, the failure of the Regulatory Authorities to manage the burgeoning bank risk is one of the most salutary lessons from this crisis.
- 14. Change in consumer behaviour:** Saving will be more attractive than consuming. Many of the trends we have seen in the past, like trading up, luxury etc. will be stopped or reversed for many consumers – so companies must not simply extrapolate the trend of the past 20 years. The first signs of this are already clearly visible: consumer sentiment indices have fallen sharply around the world, e.g., in the U.S. by more than 30 percent from their peak in 2007. Across the High Street, retail sales are falling, particularly in "non-essentials".

15. Every industry will be affected: It is already visible which industries are affected, but more will be. Banks, insurance and real estate companies are the most visible ones right now. Retailers are suffering as customers respond to the bad news with an instant belt tightening. Theatres, 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 equipment. For example, German industry overall already reports a big drop in new orders, with printing machinery producers (a traditional early indicator) already under severe pressure. But also "safe" industries will follow. In France the sale of yoghurts has fallen this year, partly due to a shift to lower priced private labels, partly due to lower demand. Industries like health care and utilities will be affected by more regulation and cost saving efforts from public authorities.

16. A sidebar of good news: The enormous losses described in this paper are mostly provisions rather than actual realised 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 the value of these instruments dramatically – and out of all proportion to the value that would be realised if held to maturity. This means that over time the banks should be able to write back some of their provisions, partially repairing their capital position. However, this is some time away. Secondly, the U.S. has actually responded quickly – and in spite of criticisms, remains the world's most flexible economy. So unlike Japan, where dead banks were propped up for years, the U.S. has acted quite quickly and decisively. In the broader economy, the flexibility of the labour force means that the painful adjustments can be completed quickly before growth is resumed 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 16 key measures:

1. **Watch your cash:** Install a tight cash management system, reduce and postpone spending and focus on cash inflow. Have a weekly report on your cash position and the mid term development based on expected payments and receipts.
2. **Reduce trade credit:** 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.
3. **Start working capital initiatives:** Most companies have poor processes to monitor their working capital. So it comes as 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 achieve an additional cash flow of approximately 10 percent of sales from net working capital optimization.
4. **Restructure your debt:** Secure financing as long as you have access; reassess dividend and buy-back policies. Look for additional funding by SWFs or cash rich investors. Leverage ratios have to be conservative.
5. **Develop a stress test scenario:** How would a recession affect your businesses? Take worst case scenarios (like minus 20 percent volume, minus 5 percent price) and define countermeasures. Identify early warning signals for a deterioration of 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.
6. **Act now on cost and organisational efficiency:** Implement all those measures today which can be executed without risking major opportunities – in case the recession does not develop as we think. Delaying and lowering of break-even points is always right! Use the external market turbulence to justify significant transformational moves.
7. **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 (see below). U.S. capacity utilization just fell to 78.7 percent and will probably fall even much lower. Compared with the long term average of 81.0 percent from 1972-2007, there is currently more than enough capacity existent in most industries and no need for further investments.

- 8. Re-evaluate off-shore manufacturing:** The economics of off-shore manufacturing can change significantly with changing trade directions (e.g. less U.S. imports) and trade barriers.
- 9. Adapt product portfolio:** Purchasing behaviour will change in the recession. Luxury goods will be used "at home" and less so in a visible manner. Consumers will shift to lower price alternatives, e.g. private labels. In the 1930s, there was a huge trend towards cheaper, canned food in the U.S. A recent example is the 1\$ menu of McDonalds which is highly successful right now. At the same time, GM is about to sell its Hummer brand while pumping enormous resources into the new Chevrolet Volt.
- 10. 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 fridges.
- 11. Divest non-core businesses:** companies should not wait for "better" times to sell non-performing/non-core assets. As BCG research shows the market reaction to divestitures is very positive, also in recessionary times. And there are still buyers around. 70 percent of the respondents in BCG's recent M&A survey say that disposals, spin-offs, and demergers are currently a good means to focus the business.
- 12. Engage in selective M&A:** The best deals are made in downturns – this is also shown by BCG research. Downturn merges generate about 15 percent more value – measured as Total Shareholder Return (TSR) – compared to boom time mergers which on average actually exhibit a negative TSR effect. This is the best time for consolidation and cost mergers. Therefore install a close monitoring of your target companies; especially their financial health.
- 13. 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 buy-backs, dividend policy and TSR management need even more careful attention.

- 14. Look for opportunities:** The recession will change many of the long standing "rules of the game" in many industries. Use the weakness of your competitors to redefine your industry. An example is the highly attractive price Citigroup wanted to pay for Wachovia (only \$2.2 billion), so attractive that Wells Fargo has stepped in and is now offering \$15.1 billion. This shows that highly attractive deals can be struck these days.
- 15. Install a crisis monitoring team:** A core team should monitor the key early warning indicators, the development of scenarios, the competitive landscape and the implementation of measures.
- 16. Plan for the upturn:** investments made now in R&D, IT or new infrastructure by strong companies will only come on stream once the recession is over. And the cost of these investments will be correspondingly lower during a period of less competition for resources.

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.