

## 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.*

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 behavior:** 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 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 the value of these instruments dramatically – and out of all proportion to the value that would be realized 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 labor force means that the painful adjustments can be completed quickly before growth is resumed on a more prudent basis safe their assets were. In addition, share buy-backs, dividend policy and TSR management need even more careful attention.

**17. 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.

**18. 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.

**19. 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.

## **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 organizational 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 behavior 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 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.

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