

# BCG

## Collateral Damage

Origins and Impact of the current  
global financial crisis

December 2008

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# There is not one crisis, but three

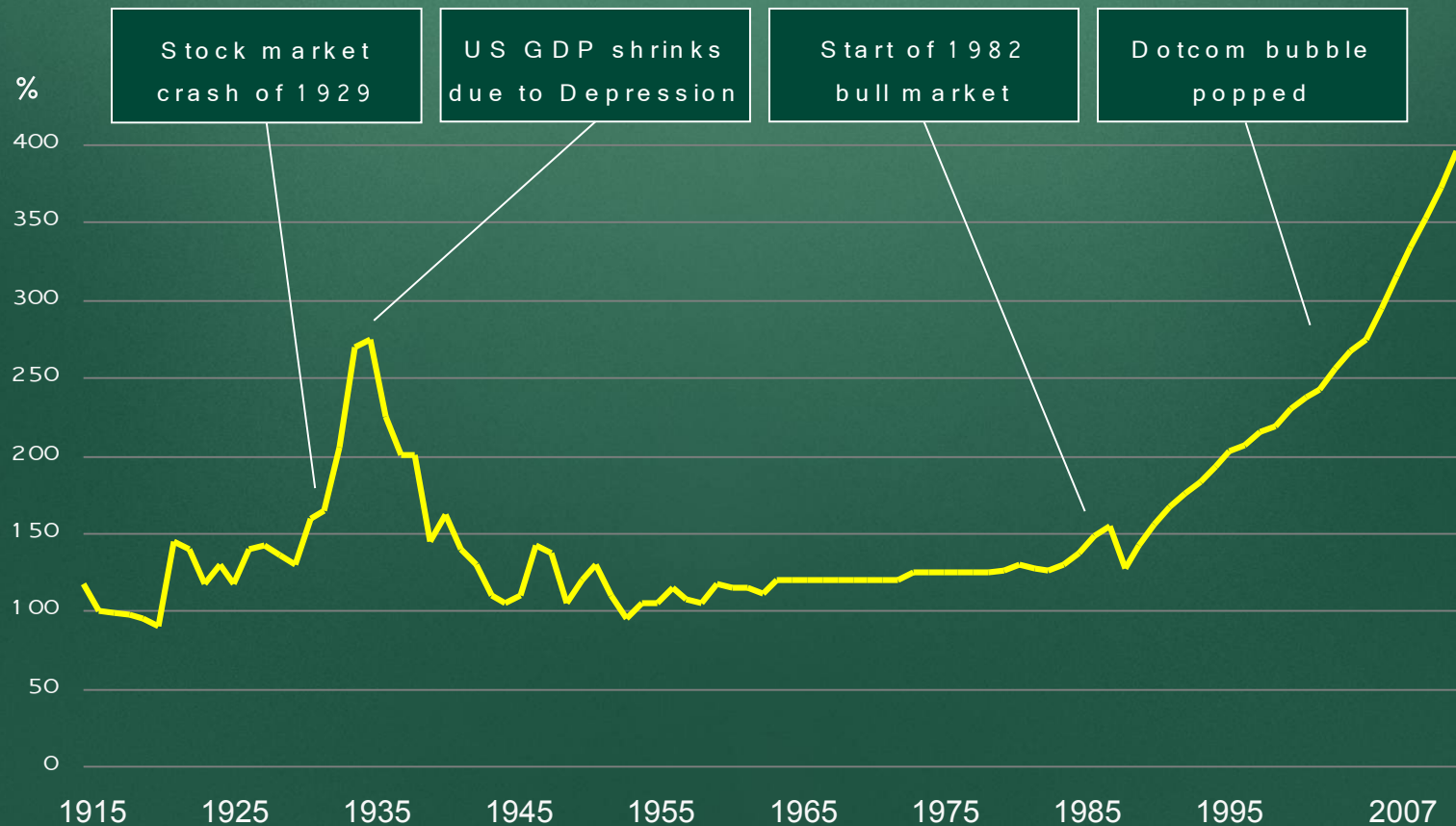
## Three gambles mixed a deadly cocktail for the financial system and the economy



**The need of banks for deleveraging and derisking spawns a vicious circle**

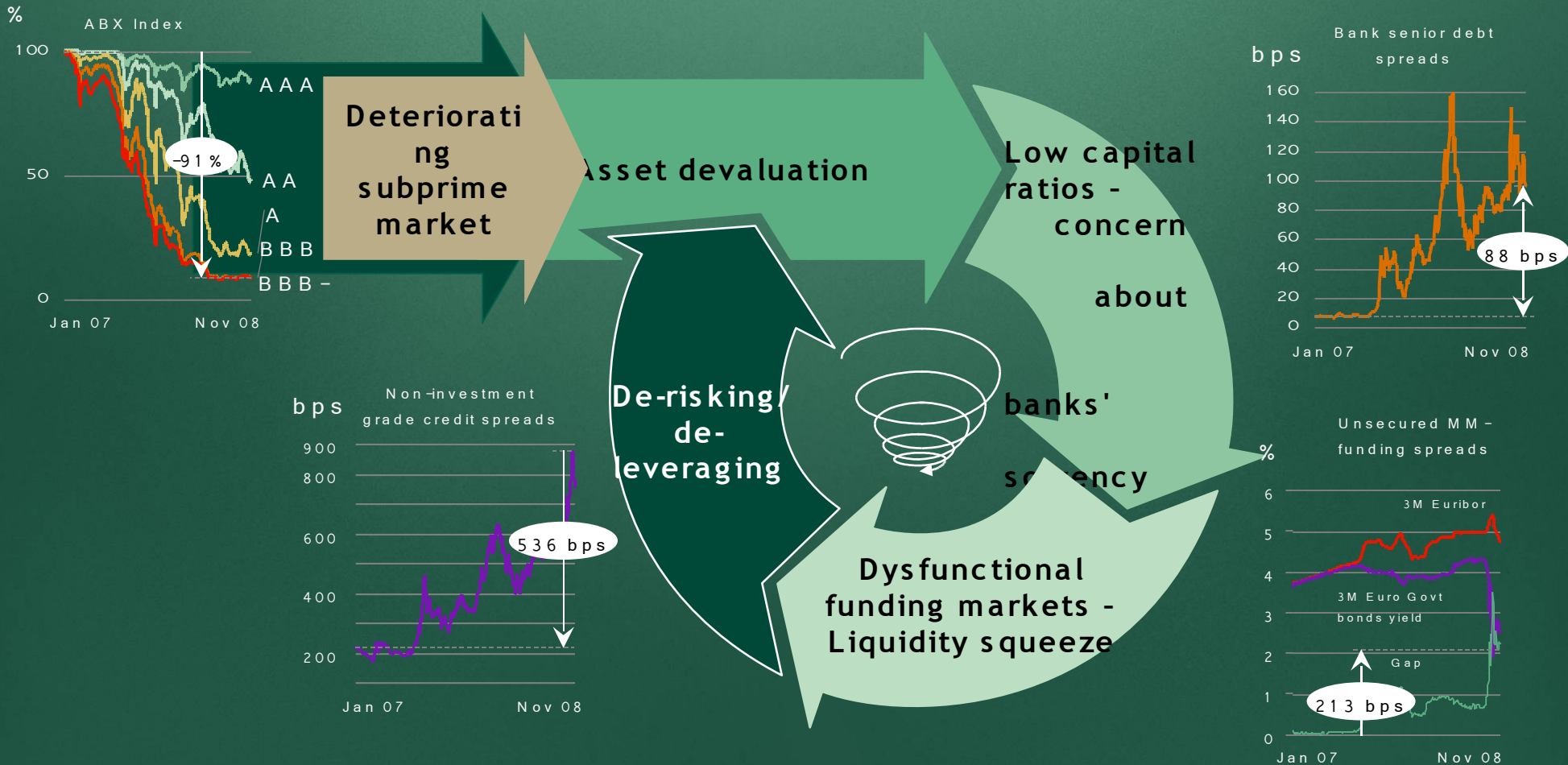
# Record levels of US household debt

## Indebtedness of private and public US households and US corporations as % of GDP



Source: Thomson Financial Datastream ; US Federal Reserve; Bureau of Economic Analysis; Barron's; Elliot Wave International; The Gabelli Mathers Fund; BCG estimate

# A vicious circle that sent the broader financial market into a downward spiral

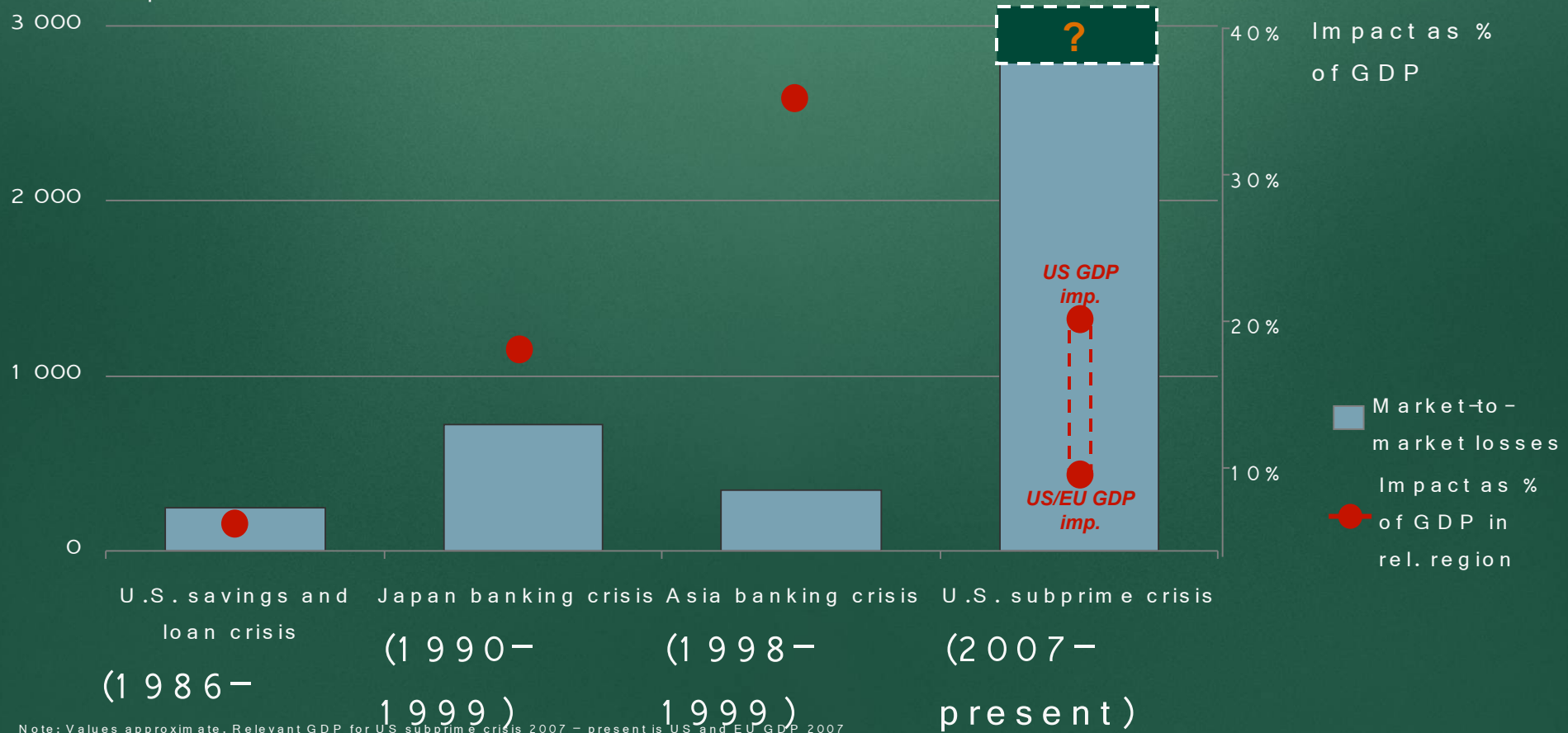


# Current crisis is clearly exceptional

## Losses from subprime event with significant impact on US/EU GDP

### Comparison of financial crises

B\$ at 2007 prices

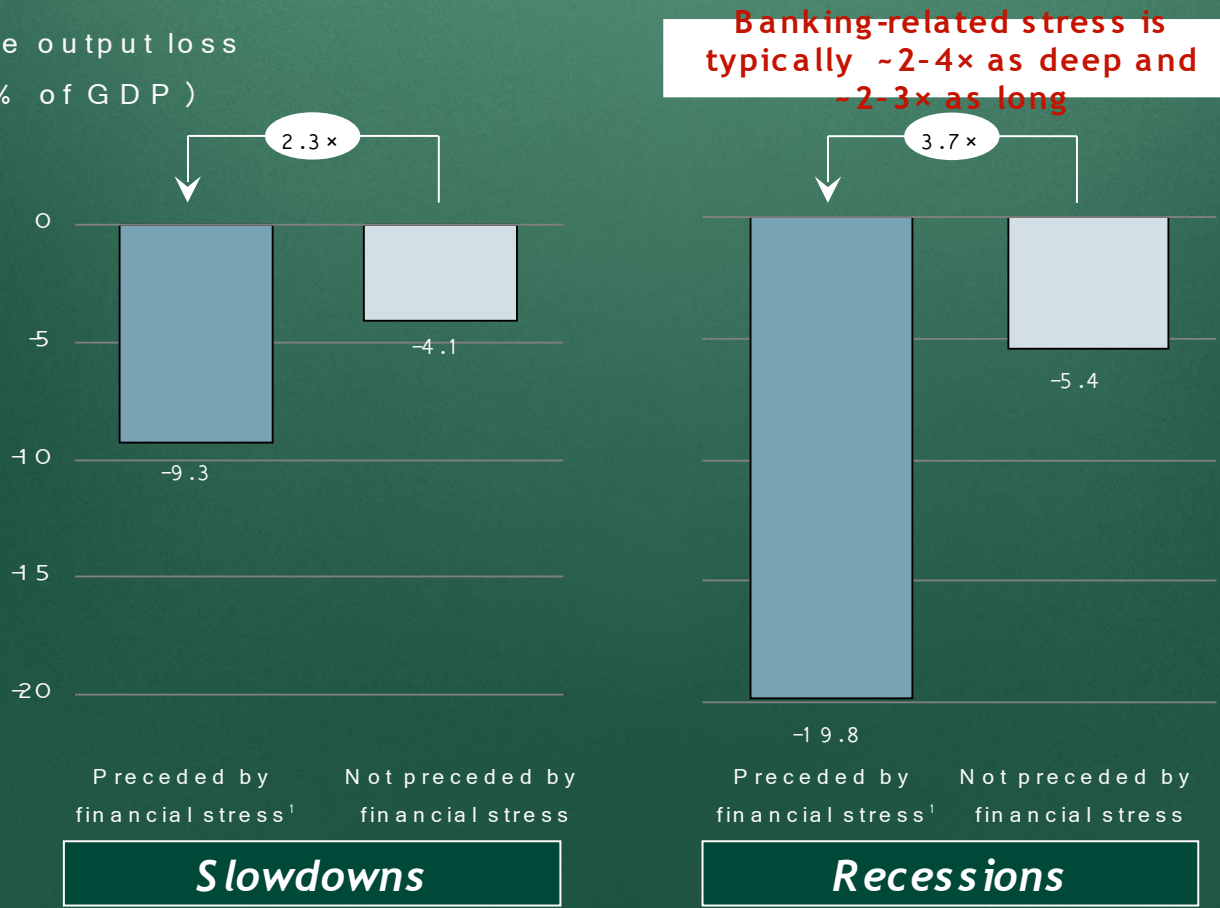


Note: Values approximate. Relevant GDP for US subprime crisis 2007 - present is US and EU GDP 2007  
 Source: The Financial Times; Bank of England Financial Stability Report October 2008; IMF World Economic Outlook Database, October 2008

# IMF empirical research: this crisis likely to be high impact and long duration

## Financial stress worsens the effect of downturn

Cumulative output loss  
mean (in % of GDP)

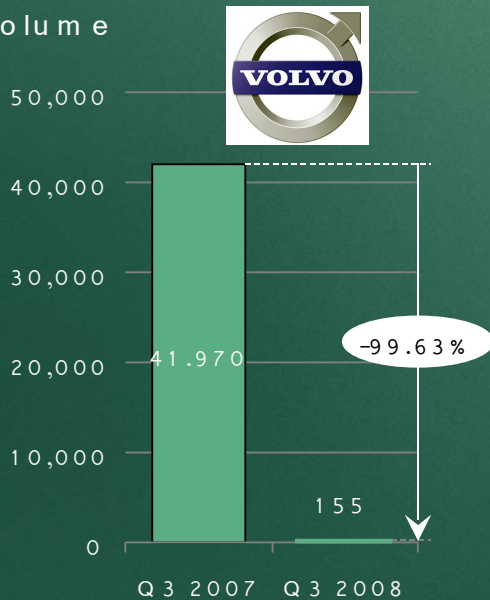


<sup>1</sup> Banking related  
Source: IMF World Economic Outlook 2008 – October version

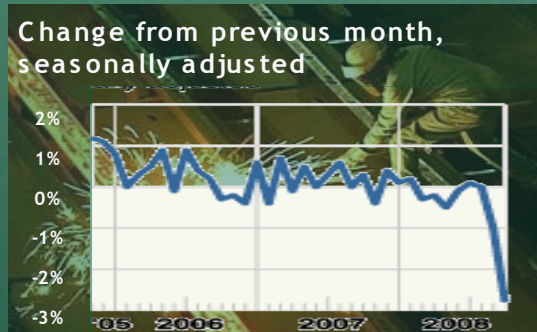
# Real economy is already suffering

European order volume for VOLVO trucks collapsed

Order volume



US Industrial production  
Worst drop in 34 years



- Fastest drop since December 1974
  - Seasonally adjusted drop of 2.8% in September 2008
- Manufacturing activity in the mid-Atlantic registers greatest drop ever

US Auto sales  
Worst month in 25 years



- Overall annual auto sales down 32% in October 2008
  - GM (45%)
  - Chrysler (36%)
  - Ford (30%)
  - Mercedes-Benz (26%)
  - Toyota (23%)
- Worst month of sales for GM since WWII<sup>1</sup>

1. Adjusted for population

Source: Global Insight, Financial Times (24 Oct 1008), Federal Reserve, Philadelphia Federal Reserve Autodata

# Rising risk premiums increase cost of debt for

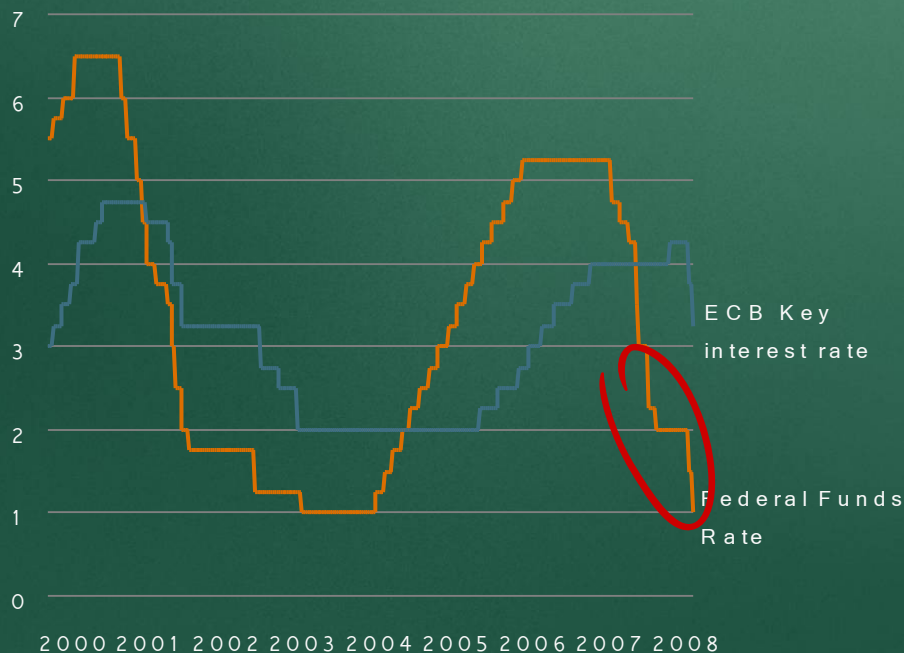
## companies

### Despite decreased Funds rate, financing for corporates more expensive

FED interest rates currently back on historically low 2004 level, while ...

... risk premiums rising significantly above 2002 levels

Federal Funds/ECB interest rate (2000-2008) in %



Risk premium for bonds in basis points<sup>1</sup>



1. Risk premium for bonds above treasuries of 10 year maturity in basis points (US-Industrials)

Note: ECB key interest rate resp. Federal Funds Rate per November 12, 2008. Risk premiums for bonds per November 24, 2008

Source: Funds rates - Thomson Reuters Datastream November 14, 2008; Risk premiums - Bloomberg, November 24, 2008

# Default rate forecast to swing to a new record

## Trailing three year cumulative default rate on BB + and lower grade bonds



S & P forecasts the three year cumulative default rate of "speculative grade bonds" to swing from a 25 year low to an all time high by 2010

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# The real economy faces significant challenges

## Access to financing will be difficult and costly

**No access to funds:** increasingly difficult to secure short-term financing

**Weak stock markets:** less attractive and more difficult to raise new equity

**Significantly higher cost of capital:** higher borrowing cost and return requirements

**Bonus for cash:** cash premium (or "safety bonus") for firms with significant cash positions

## Profitability under pressure from all sides

**Reduced cash flow:** volumes and price under pressure, with growth below long-term trendlines

**Continued commodity price volatility:** potential easing of pressure on commodity prices, but continued volatility

**Change in consumer behavior:** declines in luxury goods, falling/stagnant sales in discretionary spending

## Governments will become more involved

**More government intervention:** bailout funding, equity stakes, and infrastructure investment

**Re-regulation:** paradigm shift, with growth in government intervention

**Protectionism:** increasing trade restrictions and higher difficulties in exporting

## Other significant issues to manage

**Credit losses:** major jump in losses due to bankruptcies

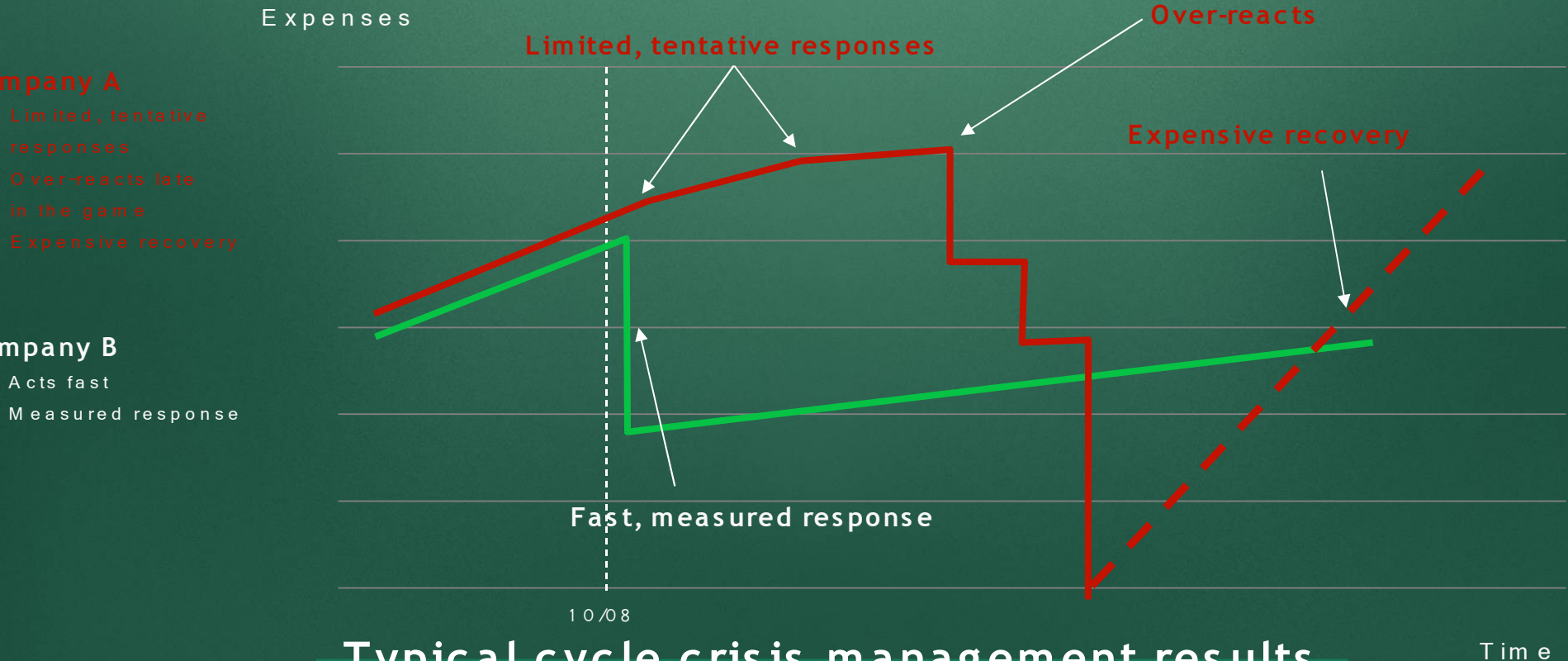
**Significant balance sheet risk:** asset price deflation—both tangible and intangible

**Industry consolidation:** wave of bankruptcies and restructuring mergers

**Changing business models:** crisis issues potential for changing "rules of the game"

# Act fast! The difference between winners and losers

Illustrative example of two different companies –  
but based on empirical research from UK recession of 1992



**Typical cycle crisis management results  
in overshooting: Too late! Too much! Too  
random!**

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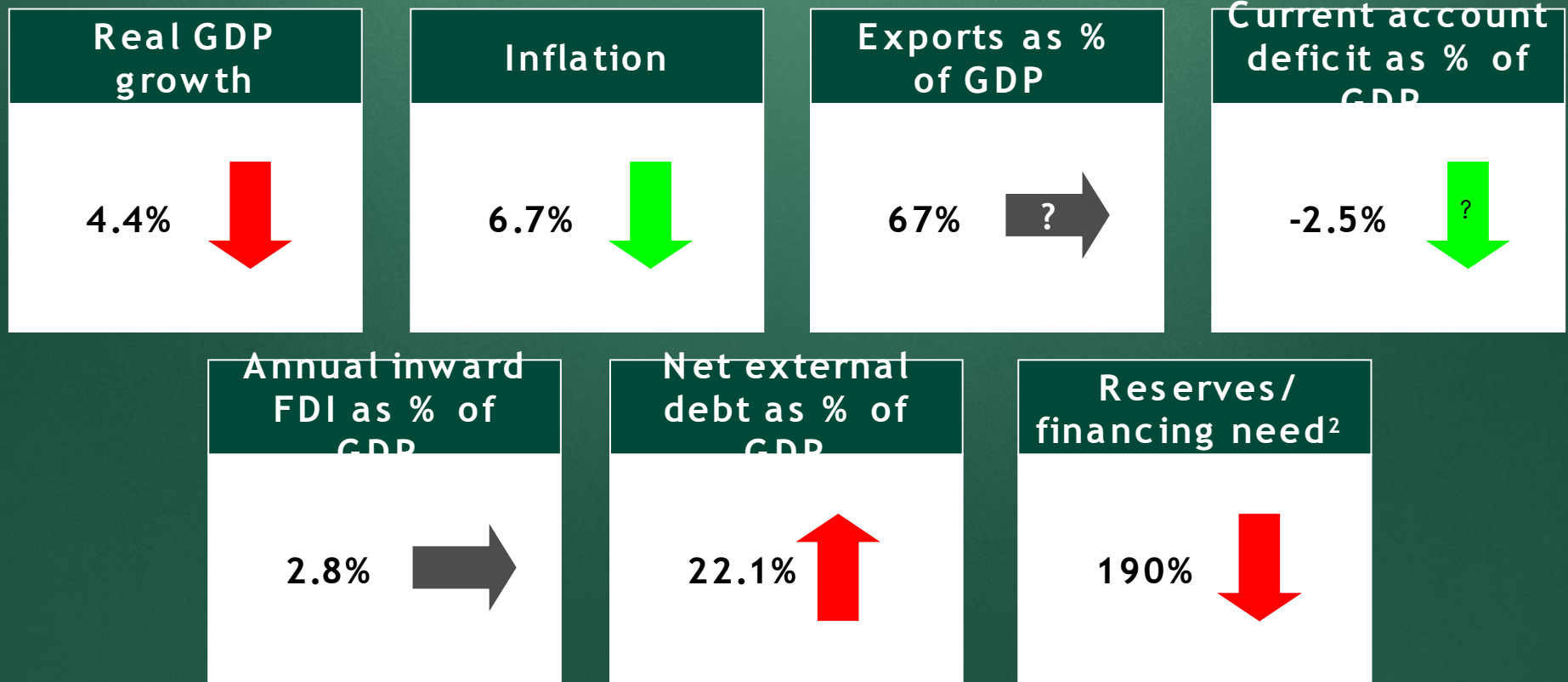
# Identify where and how to take action

## Summary

	Initiatives	Impact/business need
2A <b>Protect financial fundamentals</b>	<b>Protect cash and manage credit risk</b>	<ul style="list-style-type: none"> <li>• Ensure near term liquidity of business, including               <ul style="list-style-type: none"> <li>– Effective cash management and monitoring</li> <li>– Trade credit risk</li> <li>– Working capital optimization</li> <li>– Free cash flow generation</li> </ul> </li> </ul>
	<b>Optimize debt structure and financial policy</b>	<ul style="list-style-type: none"> <li>• Secure financing as long as access is available</li> <li>• Reset financial policies to increase stability and lower risk</li> <li>• Minimize risk on balance sheet and other liabilities</li> </ul>
2B <b>Protect existing businesses</b>	<b>Cost, org efficiency, and outsourcing</b>	<ul style="list-style-type: none"> <li>• Revisit past efforts to ensure targets are in line with current environment</li> <li>• Aggressively cut non-core spend, minimizing long-term risk</li> </ul>
	<b>Top line revenue protection, product portfolio and pricing</b>	<ul style="list-style-type: none"> <li>• Align pricing and product mix with changing customer/consumer needs; address marketing messages; customer retention and sales force mgmt;</li> </ul>
	<b>Capex and divestment</b>	<ul style="list-style-type: none"> <li>• Ensure stringent capital allocation guidelines; align capital plans with revised growth plans; consider divestiture of non-core assets</li> </ul>
2C <b>Manage for the long term</b>	<b>Long-term investments</b>	<ul style="list-style-type: none"> <li>• Prioritize investments in long-term health of business; suspend/decelerate discretionary investments, take advantage of reduced labor/supplier costs</li> </ul>
	<b>Adapt business model</b>	<ul style="list-style-type: none"> <li>• Fundamental shifts in industry landscape, economics, and sources of competitive advantage; adapt to new conditions ahead of competitors (and potential competitors)</li> </ul>
	<b>Opportunistic M&amp;A</b>	<ul style="list-style-type: none"> <li>• Where possible, develop prioritized list of acquisition targets</li> </ul>
2D <b>Develop compelling communication plan</b>	<b>Relative valuation and market messaging</b>	<ul style="list-style-type: none"> <li>• Consider investor objectives and appropriately inform investors about business strategies and risks</li> <li>• Manage internal communication aggressively and clearly</li> </ul>

# Czech Republic's situation generally acceptable but with some concerns going forward

2008 data (2009 trend)



1. Defined as current-account balance plus principal due on public and private medium- and long-term debt and IMF debits

Note: 2008 figures

Source: IMF, EIU, Ministry of Finance, BCG analysis