

*Collateral Damage*

# What Next? Where Next?

*What to Expect and How to Prepare*

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## The Year(s) Ahead

As they go into 2012, business leaders need to prepare for a difficult year, and perhaps for several difficult years. They should consider at least four scenarios:

- *Successful Muddling Through.* Governments and politicians partly address global imbalances, generate moderate inflation, restructure debt where necessary, and stabilize the euro zone and the financial system. Further recession is avoided; the West experiences a long period of low growth and deleveraging, while emerging markets reorient their economies toward more domestic consumption—and thereby enjoy continued reasonable growth.
- *Recession with Deflationary Pressure (“Japan”).* Muddling through could easily fail. The OECD already says that there is a significant risk of recession in 2012. This would increase the pressure on debtors, leading to even lower demand and so to more austerity measures. Such a scenario could replicate the Japanese experience of the last two decades, but this time it would affect 41 percent of world GDP.
- *Significant Inflation.* The longer the economy remains in recession and the more central banks try to support the process of deleveraging with aggressive monetary policies, the higher the inflation risk. So far, monetary easing has indirectly effected inflation (through higher commodity prices). If the economy starts to recover or the public starts to lose trust in money, we could see a sudden spike in inflation. Even relatively moderate inflation of 5 to 10 percent would have significant implications for companies. (See *Why Companies Should Prepare for Inflation*, BCG Focus, November 2010.)
- *Breakup of the Euro Zone.* Given the significant downside risks, company leaders need to address this scenario, too, taking sensible precautionary measures to prepare for such an eventuality.

## What Should Companies Do to Prepare?

A CEO recently said to us: “It would be very surprising if any well-run company were not preparing itself for the worst scenarios, however remote those event risks may be.” So what exactly does that mean? Let’s look at a range of scenarios.

**Scenario 1: Japan.** If the experience of Japan—which benefited from strong exports in a booming world economy—was repeated, we would face a prolonged recession and a very slow recovery that could take years to rebound. Today, this would require the combined fast-growing but still smaller economies of Asia to take up the burden. But consumption in the developed world is still four times greater than in the rapidly emerging economies of the east. Economically and socially, we would see the following:

- A continued balance-sheet recession with low (or even zero) interest rates and a massive oversupply of money. In those countries still enjoying trust in financial markets, we would see increasing government debt. Monetary policy loses effectiveness in a deleveraging world—as Japan’s longstanding inability to prevent prices from falling shows.
- Falling prices would increase the real burden of all debts, leading to a vicious cycle of deleveraging and economic contraction.
- This, in turn, would cause many businesses, factories, and supporting sectors to close, resulting in rising unemployment and falling living standards.
- Increased social tensions, political radicalization, and protectionism.

There would be many implications for companies if a Japan-style Lost Decade took hold:

- Many sectors have already experienced falling prices due to increasing labor productivity, competition from emerging-market players, and technological progress. However, more sustained, more widespread, and stronger price declines pose additional challenges because consumers delay spending in anticipation of even greater bargains later, leading to weak consumption and sliding prices.
- Corporate profits would suffer, especially if costs were not reduced in line with falling prices. A deflationary world is one of single-digit earnings growth and meager stock-market returns.
- Liabilities (borrowings) would increase in real terms while the value of assets, including inventories, would decline.
- The problem of excess capacity and supply of all kinds of goods would be aggravated as emerging markets devoted more resources to building up export industries.

- Business and personal bankruptcies could soar as debt burdens became increasingly onerous.
- Less vulnerable firms would not be immune, for example, if critical suppliers went out of business, disrupting the value chain, or if big customers went bankrupt, thereby crystallizing credit risk.
- Possible increased protectionism could disrupt supply chains and impair competition.

In such a scenario, management should emphasize costs and efficiency, while looking for growth opportunities in emerging markets and through innovation:

- *Build a sustainable cost advantage.* When prices go down, a company must ensure that its costs go down as well (relative to competitors, that is). They need to reassess their cost base from scratch. It's not enough to make across-the-board cuts; what is needed is a thorough reengineering of the cost base throughout the entire value chain. Some Japanese companies have been able to slash costs—and therefore prices—by as much as 50 percent.
- *Rigorously manage pricing.* Besides simply lowering costs and prices, companies need to understand the ways in which deflation changes consumer psychology—and be far more sophisticated in setting prices. For example, a company can reduce perceived prices by simultaneously decreasing prices through smaller package sizes, unbundling products and services in order to offer the lowest possible base price, attracting customers with an initial low offer and following up with additional services and features, setting prices to mitigate customer risk or uncertainty, or coupling price increases with an increased number of discounts.
- *Reengineer the pricing function.* At most companies, there is considerable pricing volatility and leakage via discounting. In general, pricing decisions are too decentralized—and salespeople have too much autonomy in cutting special deals. Instead, companies need to manage pricing more centrally, in an integrated, end-to-end fashion, rather than in the siloed manner that is typical today. Consider appointing a chief pricing officer.
- *Focus on innovation.* Fundamental innovations will be the foundation of new industries, which will generate more growth in the future. And even in the toughest times, innovation helps differentiate and attract customers. This was true in the 1930s, in Japan since 1990, and also during the recession of 2009. Companies should therefore relatively overinvest in R&D (an approach supported by many investors today). Companies can also fight price declines by creating new customer needs and serving them with new products and services. Just look at Apple.
- *Look for new growth options beyond the home market.* In order to avoid the “top line cliff” if domestic demand declines on the back of deflation, look for growth options abroad, especially in emerging markets—organically or by acquisition. Of course, so will many of your competitors. The key is to act decisively and aggressively.
- *Make decisive moves that change the game.* In addition to better management of both costs and prices, companies should be considering bold strategic moves to fight deflationary headwinds. Just as the best time to invest in the stock market can be during a downturn, a deflationary environment may be the best time to make aggressive corporate investments. Think about acquiring a struggling competitor in order to consolidate the industry and thereby protect prices and margins in the core business. Alternatively, invest in marketing innovation to maintain current price points.

**Scenario 2: Inflation.** Many business leaders underestimate the implications of inflation in the belief that deflation would be much worse. In our view—and as the experience of Japan shows—mild deflation, although unwelcome, can be dealt with relatively easily. Inflation, on the other hand, has a significant impact on profitability and free-cash flow. In addition, most of today's managers have had no experience with inflation. In the following paragraphs, we summarize what we have said previously about responding to inflation.<sup>12</sup>

Senior executives should start now to think through the consequences of inflation for their business, to understand their company's exposure, and to prepare for an inflationary scenario that may materialize sooner than they expect. There are three basic steps.

First, assess the potential impact of inflation on your company's profit-and-loss statement. Whether a company can avoid seeing its profits severely harmed by inflation depends on two factors: the degree to which it can limit price increases by its suppliers and the degree to which it can impose price increases on its customers. It's not enough to know your own exposure to inflation; you must know the exposure of your suppliers and customers as well. So review the design of your company's contracts, estimate the price sensitivity of key customers, and analyze the balance of power in the industry to determine who is likely to be able to impose the costs of inflation on others. The intensity of competition and your competitive position will greatly influence the impact of pricing decisions, so these factors must also be assessed.

Second, estimate the potential impact of inflation on your company's balance sheet. As inflation goes up, the amount of cash needed to meet a company's investment program increases—sometimes significantly. Assess the impact of these changes on the two main components of capital expenditure: net working capital (inventories, payables, and receivables) and future fixed-capital investments.

Third, put organizational structures and processes in place to support effective decision-making in a turbulent, rapidly changing environment. Make sure you have full transparency on what drives your own prices and collect real-time information on the prices of your competitors. Insist on frequent communication between your procurement and sales organizations. Tell your business units to include simulations of different inflation scenarios in their plans and to use inflation-adjusted metrics for management reporting. These measures will provide a clear view of your degree of exposure to inflation and put you in a position to develop a comprehensive inflation-protection plan.

Such a plan needs to be holistic, not fragmented. Establish a cross-functional task force responsible for developing an integrated, companywide anti-inflation program and for establishing an early-warning system to monitor leading indicators. Should the company confront inflation in any of its key markets, the task force will direct and oversee the response.

But don't just set up a near-term inflation-protection system. Instead, create long-term impact by developing an inflation mindset on the part of employees across the organization. Keep in mind that the vast majority of managers and employees today have not experienced a major period of inflation during their career. As a result, everyone will need to rethink their assumptions and adjust their expectations.

Finally, the inflation protection program should be strategic, not just operational. Inflation can have a significant impact on corporate and business unit strategy. The relative importance of different sources of competitive advantage may shift. By planning for the strategic implications of inflation in its industry, a company is better positioned not only to protect itself from inflation's negative impacts but also to exploit inflation opportunistically in order to strengthen its competitive advantage. Exhibit 5 summarizes the levers companies should pull in preparing for an inflationary scenario.

Clients we support in preparing for a scenario of higher inflation tend to focus on improving their fundamentals, notably through pricing and through efforts to reduce working capital and to allocate it more efficiently. In addition, leading organizations engage with their investors today, explaining their vulnerability to higher inflation and the countermeasures they are considering. Investors have, of course, already included the issue of higher inflation in their assessment of any company.

**Scenario 3: Breakup of the Euro Zone.** Although we expect governments to find a way to stabilize the euro zone (for a time), the implications of a breakup are so severe that companies should prepare. We focus on the implications for companies that operate in the euro zone.

Companies within the euro zone need to expect the following:

- Severe, unknown impact of currency turbulence on earnings
- Unclear impact on existing contracts and outstanding credits (will outstanding company debt be redenominated or remain in euros? what will be the law governing the contract if the currency basis changes?)
- Massive disruptions to the supply chain across regions
- Drastic change in competitiveness and decline in exports for strong-currency countries
- Changes in industry pecking orders due to changes in competitiveness among companies
- Significant risk of protectionism
- Greater importance of domestic markets
- Strong divide into strong-euro and weak-euro markets

Obviously, companies would have to adjust many key aspects of how to do business:

- *Finance.* Restructure and recalibrate the entire finance function:
  - Treasury would need to separate “good euros” from “bad euros”
  - Ring-fence cash and debtor pools in good-euro countries

- Implement multiple currency frontiers in finance systems
- *Marketing and Sales.* Sales offices would need to be ready for vastly more sophisticated order and invoice processing in multiple currencies (review existing contracts for necessary postbreakup adjustments before any breakup of the euro zone).
- *Procurement.* Supply chain management would drastically change: companies would need to revise natural hedging strategies for the former euro zone and consider the effect of revised relative exchange rates on their global procurement strategies.
- *Local Sourcing, Manufacturing, and Distribution.* This may suddenly become financially more attractive compared with the recent trend of exporting such jobs to Asia. All the conventional wisdom around outsourcing and offshoring could be turned on its head.
- *Accounting and Control.* Cost-cutting programs would need to be executed to protect margins against newly introduced tariffs and trade barriers.
- *Organization.* Rethink the entire organizational setup in light of the need to serve a “strong Europe” (Germany, France, the Netherlands) and a “weak Europe.”
- *Major Administrative and Support Investments.* These would be required for new treasuries, legal entities, and communication systems and would be hard to finance against a backdrop of market insecurity, looming inflation/deflation, and possible bank runs.

While it will be possible to adapt to inflation or deflation as the situation evolves, the breakup of the euro zone would come as a shock. It could happen as a planned “overnight” event, combined with bank holidays, capital controls, and predefined new exchange rates (which would require robust and totally confidential preparation—and more than a night to implement). Alternatively, it could be disorderly, starting with the surprise exit of one country and leading to a fast chain reaction. Or it could involve simply the exit of one or two marginal countries. Companies should prepare now for all eventualities, including some no-regret moves that can be implemented immediately:

- *Assess regional focus.* The first priority will likely be to reduce dependency on the most burdened peripheral countries (except for the minority of companies whose business model benefits from the crisis).
- *Focus on emerging markets.* Next, move more aggressively into faster-growth emerging-market economies, which will be the global growth engine for years to come. This strategy will become increasingly competitive.
- *Continue to focus on cash and cost flexibility.* This is what distinguished winners from losers during the 2008–2009 downturn.
- *Consider diversification.* Smoothing of earnings across diversified divisions may prove helpful in weathering the massive uncertainty and increasingly volatile outlook in individual markets.
- *Curb the financing headwind.* Companies with strong balance sheets might think of ways to help their customers (and even strategic suppliers) to fund themselves.
- *Prepare to attack.* Deploy cash to higher-value uses such as M&A. Pressured privatizations and distressed deals will yield valuable opportunities for the daring. As an article in *The Economist* put it, “If things work out well, eggs will be broken on a scale that promises some industrial omelet-making.”<sup>13</sup>

These “checklists” are illustrative; they are neither complete nor appropriate to every situation. It is worth considering in a structured way the fallout from these scenarios.

## As Reality Catches Up with Our Writing

Regular readers know that we have tended to take a rather pessimistic view of the economic outlook for the developed economies. We are more optimistic about the emerging markets but do not expect that they will come to the rescue.

In the coming years, we will see upswings and new recessions in a more volatile world. We will see surprising actions by governments and central banks, some with positive and some with negative implications. But the basic theme will not change: what we are witnessing is the great slowdown of the twenty-first century, at least in the West. Although we do not expect a repeat of the 1930s, there are some features of today's environment that at least echo the past. The downturn follows a credit

boom of significant size, hits several countries at the same time, and is amplified by the euro zone mechanism rather than by the gold standard.

Luckily, we can benefit from the lessons of the 1930s and avoid some mistakes. It looks like our great slowdown won't be nearly so pronounced or economically debilitating—but it may be as long. And in the end, we will get a debt restructuring of some kind to allow for a new start.

Our wives have told us not to talk about crisis. But actually we are quite optimistic. It is clear from history that even in the most damaged economies, individuals and companies can thrive.

#### NOTES

12. *Why Companies Should Prepare for Inflation*, BCG Focus, November 2010; available at <http://www.bcg.com/documents/file66757.pdf>; *Making Your Company Inflation Ready*, BCG Focus, March 2011; available at <http://www.bcg.com/documents/file72671.pdf>.

13. "Business and the euro crisis: Under the volcano," *The Economist*, October 8, 2011; available at <http://www.economist.com/node/21531424>.

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