



After an extraordinarily eventful year, we would like to step back to offer some reflections on 2008 and provide insights into the key forces that we believe will shape the industrial sector in 2009.

The past year has, of course, been exceptionally volatile and destabilizing, featuring geopolitical drama, wild fluctuations in commodity prices and exchange rates, and a credit and financial system crunch of a magnitude unknown to the current generation of business leaders. Fearing another Great Depression, governments around the world have taken virtually unprecedented steps to intervene in the financial markets.

We must admit that even though we were quite concerned about the U.S. economy a year ago, we did not expect that the subprime mortgage problem would turn out to be merely the spark that ignited a firestorm in the global financial system. We now face the prospect of the most prolonged downturn since at least the early 1980s, and many industrial firms will face a structurally different world at the end of this economic cataclysm.

The current environment is bleak. Consumers, who account for more than two-thirds of U.S. gross domestic product, have lost trillions in home equity and retirement savings. In October, consumer sentiment hit the lowest point that it had reached in 40 years of measurement. Worse, unemployment is forecast to peak at levels as high as 10 percent in 2009. We can only hope that 2010 does not prove to be worse, although some leaders in the industrials sector are privately predicting it will be.

Declining demand throughout the consumer and business sectors will hit industrials hard. The effects are already showing: Overall industrial production decreased at an annual rate of 6 percent in the third quarter. Capacity utilization for raw steel production was 65.2 percent in the week ending November 8, down from 88.5 percent a year ago. The auto industry, one of the largest markets for steel, is grappling with a decline in annual vehicle sales from 16 million to 11 million. As just one example of how quickly and deeply some industrial segments are retrenching, U.S. steelmakers are currently in the process of shutting 17 of the nation's 29 blast furnaces.

Amid these dire straits is uncertainty surrounding the arrival of a new U.S. president and members of Congress with their own agendas for tax and fiscal policy. On a positive note, a government commitment to investment in alternative energy may signal new opportunities for a broad swath of the industrial sector. Global trade patterns may also be in flux, with the possibility of protectionist barriers rising around the world to insulate companies and workers that are struggling to survive a widespread economic downturn.

The new world that eventually takes shape will reflect altered relative factor costs for industrial producers. Volatile exchange rates, labor costs, and commodity prices have conspired to fundamentally alter established supply chains. Some industries will be transformed with new leadership and business models. As the government settles into its new role as a player and owner in not only the financial sector, but perhaps also the automotive industry and beyond, increased oversight and tighter regulation will not be far behind.

The challenges are enormous, but today's crises will ultimately yield opportunity. Companies that respond quickly and effectively now, with an eye toward the future, will be able to leverage this once-in-a-lifetime opportunity to surpass competitors and go on to dominate their industries.

Although there are no pat answers that apply to all companies, we can put forth some guiding principles for these troubled times. The key to managing through hard times is to drive dual strategies simultaneously: One is geared toward today, the other focused on tomorrow.

Strategies for Today

The companies hit hardest by recession are those without liquidity. Consider that the difference between low-rated nonfinancial commercial paper and high-grade paper increased from less than 100 basis points for most of the year to more than 450 basis points in October. Similarly, the premium on 10-year bonds has increased to 5.5 percent over T-bills for BAA-rated firms, versus 2.5 percent for AAA-rated firms. Given this dramatic increase in the cost of maintaining a weak balance sheet, the first agenda item needs to be to aggressively manage liquidity and strengthen balance sheets.

One approach is to seek out one-time sources of cash from a mix of "quick hits" and near-term operational changes, with close and unforgiving

scrutiny of selling, general, and administrative (SG&A) expenses. We have seen many companies focus on working capital and achieve significant improvements through strict inventory management and improved operating procedures. Liability management tactics – such as hoarding cash flow, establishing backup credit lines, and making use of flexibility in contracts – can also enhance liquidity.

The current economic environment, which features dramatically reduced stock prices and market valuations, demands action. Businesses that can be improved through select acquisitions must get priority, even over businesses that may be historic crown jewels but cannot be substantially improved through acquisitions because of market share or other concerns. The Manitowoc Company, for instance, showed vision and courage this year when it agreed to sell the shipbuilding business that marked its heritage to Italy's Fincantieri Cantieri Navali Italiani SPA. It quadrupled down instead on its smallest portfolio business, foodservice, with the US\$2.7 billion acquisition of Enodis PLC.

We see too many industrial conglomerates that become complacent with their portfolios. The concept of portfolio stewardship creates value only when companies actively improve their businesses. Given the inherent cost of a conglomerate hierarchy, simply holding on to clear winners without adding any value to them is a form of value destruction. Our research has shown that diversified industrial firms that strategically manage their portfolios and add operational value from the corporate center have the best sustained performance.

But rigorous portfolio management is difficult, given that the numbers that companies typically use to make decisions about portfolio restructuring are often unreliable. Allocations skew profitability compared to an asset's stand-alone value or its potential value with a different owner. Transfer pricing distorts real economics for tax planning and political reasons. Absorption accounting allocates fixed overhead costs more or less indiscriminately, placing a sometimes unwarranted cost burden on select products and customers. We find it more helpful to estimate external market values by business unit from the total enterprise value, market multiples, precedent transactions, and leveraged buyout values. Then we estimate the intrinsic value from management forecasts and historical financial performance to identify what we think of as "value gaps" between external market value and intrinsic internal value. Opportunity lurks in these gaps.

We believe the most valuable components of any portfolio are those businesses that promise the biggest difference between their market value today and their value in the future once they have been improved. Conglomerates have to be both objective and current in their assessment of how the whole is greater than the sum of its parts – or at least soon will be. Stock markets reward active corporate portfolio managers who acquire and divest. Companies that choose both tactics average excess returns of 7.3 percent in the year after each transaction. For those that only make acquisitions, the returns are just 1.2 percent.

The Danaher Corporation offers an example of a company with a strong portfolio strategy. Using the Danaher Business System, or DBS, it has made a steady stream of acquisitions and developed an infrastructure for integrating new businesses. DBS is a set of values – quality, delivery, customer focus, and innovation – and a series of associated processes that bring discipline in the form of *kaizen*. More important, Danaher has been consistent in focusing on high-growth sectors of the economy where the players are fragmented and it can create value by consolidating assets. Along the way, Danaher has systematically divested businesses in order to keep focusing on the high-growth, active sectors of its portfolio. The strategy has paid off in the form of 20 percent compound annual growth in sales and earnings per share for much of the last decade.

At the same time, companies must protect their basic business in hard times and avoid the temptation to initiate significant cuts in the core value proposition to customers, such as service. Industrial firms should seek out ways to develop sales of goods and services to customers they already have, instead of chasing new prospects. Despite the need to stay liquid, it is important to maintain a minimum critical mass of funding for R&D and advertising. This is also a time to strengthen relationships with key employees, customers, and other business partners.

Strategies for Tomorrow

Downturns don't last forever. Successful companies look beyond knee-jerk reactions to tough economic times and keep an eye out for opportunities to create value that will persist into the future. Unfortunately, managers usually devote an inordinate amount of attention to the immediate crisis. Now is the time to get past recessionary cost cutting and make efforts to

increase top-line revenue and improve the company's long-term strategic position. Across-the-board job cuts are seldom effective in the long term anyway, because the most valued employees are the ones who can always find new jobs and leave.

Assuming a company has a sound capital structure, a recession can allow it to pick up previously overpriced acquisition targets. Typically, companies hit hardest in a downturn carry the highest growth multiples. This means there is a window of opportunity to buy companies that can fuel growth over the long haul.

Many companies do just the opposite: They divest businesses during downturns, and buy when times are good and prices are high. Booz & Company research shows that this approach is exactly wrong. Consolidation taking place in soft markets is five times as likely to be successful, with 84 percent of deals succeeding. For consolidation that occurs during hot markets, 65 percent of the transactions result in significant value destruction. If a company has the balance sheet to support it, the time to acquire is now, rather than during the eventual recovery.

When it comes to making decisions about which businesses to go after, or which to abandon, too many firms make the mistake of using measures that focus on performance, not value. Value is more difficult to measure, as it lacks clear-cut, external benchmarks, but is also a better indicator since it incorporates current and expected future performance. Companies also tend to fail to acknowledge the cost of forgone opportunities. To avoid this error, managers must go beyond looking at portfolio synergies to search for more valuable ways to use company resources such as people, capital, and time.

Hard times can free companies to fundamentally rethink business models and move from the middle of the pack into a leadership position. Consider whether this might be a good time to take a restructuring charge. Share prices are down so low already that the market reaction will be muted. The downturn will also diminish resistance to change from entrenched interests, such as employees, unions, or politicians. In fact, for some companies, a prolonged downturn may be the only time when transformative change in the business is possible. The trick is to use the spirit of crisis to create a new vision for the firm, instead of reverting to indiscriminate and incremental cost cutting.

Consider ArcelorMittal and the value it has created over the last decade by rolling up steel assets at a time when the rest of the world viewed the industry as toxic. The company helped transform a perpetually underperforming sector of the economy into the envy of most other industrial sectors. Today, ArcelorMittal is able to adjust to shifts in the economic outlook with quick changes in capacity – a feature of the industry that was missing prior to its acquisition spree. To capture opportunities in a downturn and emerge stronger, companies need a clear sense of the capabilities they want to enhance or build. Typically, management teams resist investing in the few areas that make a difference, and instead spread SG&A expenses across all categories. This only leads to higher costs and a failure to differentiate the capabilities that are unique to the company and that can create a competitive advantage. In this time of crisis, companies must focus on building their truly essential capabilities while lowering their overall break-even point in order to come out of the downturn stronger.

Companies also tend to build their internal capabilities, such as new systems or human resources, when they are under pressure. A true capabilities-driven strategy is outward-looking and starts and ends with customers. In addition, too many corporations assemble portfolios of complementary businesses; they should instead base their portfolios on mutually reinforcing capabilities that cross business units in acquisitions and divestitures, human capital investment, recruiting, technology, and alliances. One well-known industrial company, for example, chose this year to build on its existing strengths in refrigeration, including controls and compressor technologies, by making a major acquisition to add product and market scale to its core competencies.

Management in These Times

In this time of unprecedented turmoil, we have a generation of American managers who have little experience managing through any major downturn, let alone one this severe. In the coming years, many executives in the industrial sector will confront decisions they have never faced before. Crisis management is a unique skill, and managers who were successful in the past eight years of growth may be ill suited for the current environment. Winston Churchill was highly regarded as a leader during wartime, but was at a loss when the artillery went silent.

Companies may want to complement their current management teams with seasoned warriors, or make changes at the top that suit the harsh new business environment. The winners in the next up cycle will be those who take bold and decisive actions during 2009.

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