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Rethink Your Strategy
An Urgent Memo
To the CEO



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EXECUTIVE SUMMARY

If you are a chief executive officer, a business unit general manager, or a line officer in any major company around the world, the events of October 2008 should cause you to rethink the strategy for your business. The purpose of this article is to explain why this is so important and what to do next.

As a business leader, you need to readjust your mind-set for a future that looks very different than it did just a few months ago. In the last decade, there have been three bubbles in rapid succession—in Internet and telecom companies, real estate, and commodity prices. During bubbles, the pressures on the strong and the weak are the same: to ride the wave of growth, regardless of whether it's based on permanent value or transient speculation.

But the speculative bubbles have burst, and now, the most critical thing is to see the dynamics clearly—not as an investor, but as a decision maker with a company to steer.

Given the potential for discontinuous changes in the structure of your industry, playing your hand well means changing your stance. It also means preparing your company to move aggressively to seize strategic opportunities. These opportunities will likely present themselves sooner rather than later. That's why the preparation cannot be postponed. The prescriptions for the weak are different from those for the strong.

MAKING SENSE OF THE STORM

How quickly the world's expansion, driven by the spiral of easy credit and rising house prices, has come to a crashing halt! The world economy is falling into a pronounced recession, with the Organisation for Economic Co-operation and Development (OECD) economies leading the way. Even China's economy is slowing enough that its government recently announced a stimulus package worth more than half a trillion U.S. dollars. Consumers in the U.S. reported in the Booz & Company Consumer Spending Behavior Survey, conducted in October 2008, that they have cut back their spending in significant ways and they expect to cut back more in the months to come (see Exhibit 1).

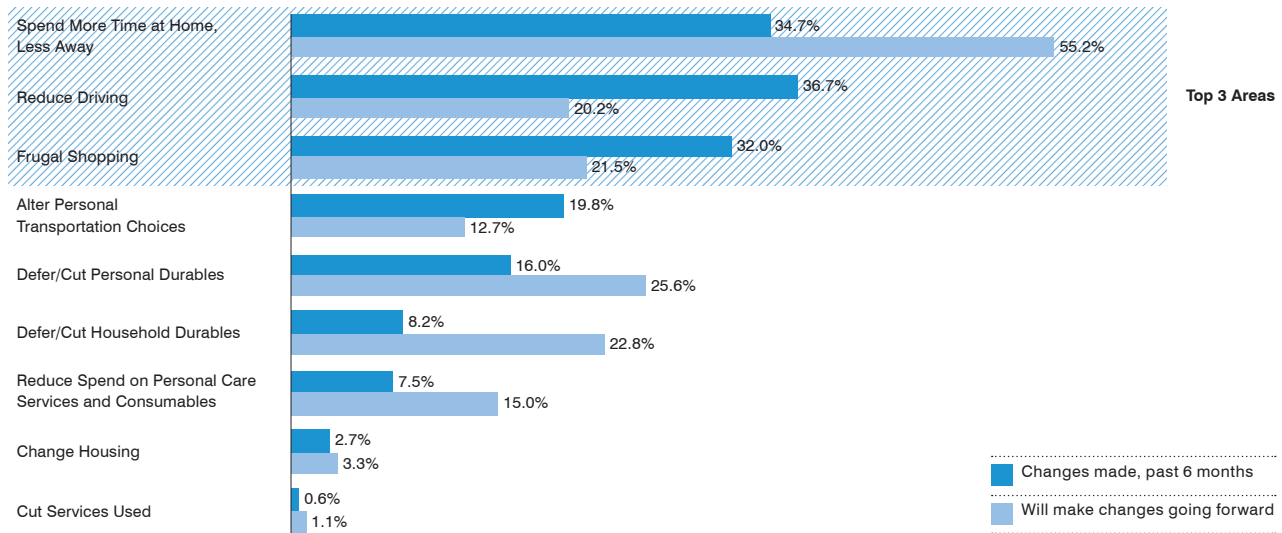
Already it's clear that the banking system will not be destroyed, as it was in the 1930s. The activist Federal Reserve System in the U.S., and its counterparts in other countries, will get legitimate credit flowing again. But recovery will be neither fast nor easy. Recessions are usually deeper and longer than anticipated, and this one is generally expected to be at least as bad as that of 1982.

The weaker players should be scared, but the strong should not. For the latter, the meltdown could prove to be a blessing in disguise. Both strong and weak should prepare to move quickly, but only the strong can invest for the longer term.

In response, policy makers are reacting much more swiftly than they did to similar circumstances in Japan in the 1990s (see Exhibit 2, page 3).

Exhibit 1
Consumer Spending Is Down and Shifting

PERCENTAGE OF RESPONDENTS MAKING SIGNIFICANT CHANGE¹



¹ Percentage responding 5 or above on a 7-point scale in more than one-third of surveyed actions in each area
Source: Booz & Company Consumer Spending Behavior Survey, October 2008

IMPLICATIONS FOR THE WEAK

If your company is not well positioned right now, it is time to face the facts. You are probably going to be up against the wall—or, at best, your business will be much reduced. It doesn't matter how you rationalize the circumstances that brought you here. The important thing is to prepare to take bold action to save as much value as you can. Denial will not add value.

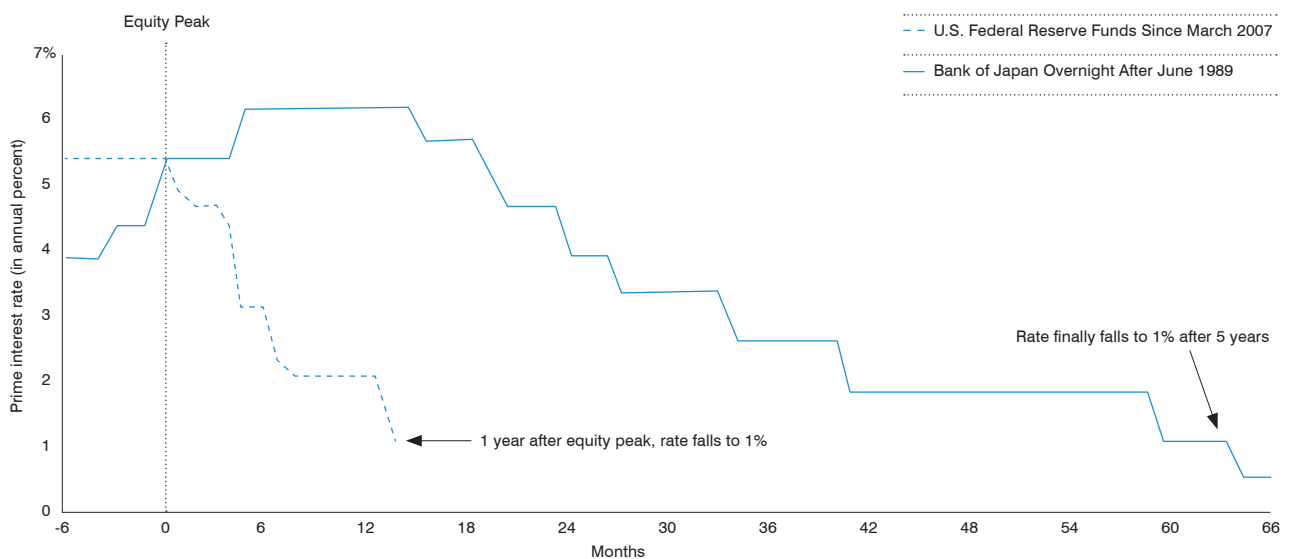
The most precious thing you have is time—and you may not have much. Do not waste it as some others recently have, notably at The Bear Stearns Companies and Lehman Brothers Holdings. Instead, look dispassionately at your business. Judge its relative position honestly, by answering a few tough, value-testing questions:

- Could you survive the worst downturn in volumes and prices in your industry since World War II, and for how long?

- How good are your business positions? Are you number one or number two in your market? If your business went away, could others fill the gap?
- How will capacity be rationalized in your industry or industries? Who is the marginal player? Is it you?
- In this environment, into which of your businesses would you invest your own money?

If you honestly conclude you are weak, time is of the essence. Figure out how to best position your assets and your people and take the right steps to give every piece of your company its best chance to succeed, even if under different ownership.

*Exhibit 2
Central Bank Crisis Response: 1990s Japan and Current Global Situation*



Source: CBCI World News

FOR THE STRONG—AND THOSE WHO CAN BE STRONG

For everyone else—all those companies that aren't up against the wall—the first objective is to become as strong as possible, as fast as possible. We are entering a period in which it will be enormously valuable to be able to act decisively from a position of strength and in a long-term, genuinely strategic manner.

These times call for a new kind of leadership on your part. Gone are the days when you could let the action agenda bubble up from the middle. There's not enough time for that. Instead, you must drive the new agenda from the top and quickly refocus your key decision makers on the issues that are now paramount. Five main lines of action are worth embracing (*see Exhibit 3*).

*Exhibit 3
Strategic Moves in a Crisis Environment*

THEMES	ACTIONS
Focus on Your Future	<ul style="list-style-type: none"> - Concentrate your portfolio of businesses on long-term winners - Target your most valuable customers
Prepare to Weather the Storm	<ul style="list-style-type: none"> - Lower your breakeven to remain profitable under the worst-case scenario - Reduce capacity, complexity, and fixed costs - Husband your balance sheet
Anticipate the Future Industry Structure	<ul style="list-style-type: none"> - Create a view of how your industry should restructure - Understand the impact of government intervention
Resolve Your Game Plan	<ul style="list-style-type: none"> - If the industry needs to consolidate, decide whether you are a buyer or a seller - Allow for selective share increases through smart pricing - Do not sacrifice R&D or capital expenditures; prioritize and use these investments offensively
Prepare to Take Intelligent Risks	<ul style="list-style-type: none"> - Get ready for the upturn - Watch and prepare for a rekindling of price increases, particularly on commodities - Prepare to recapitalize your debt if the stimulus packages overshoot

Source: Booz & Company

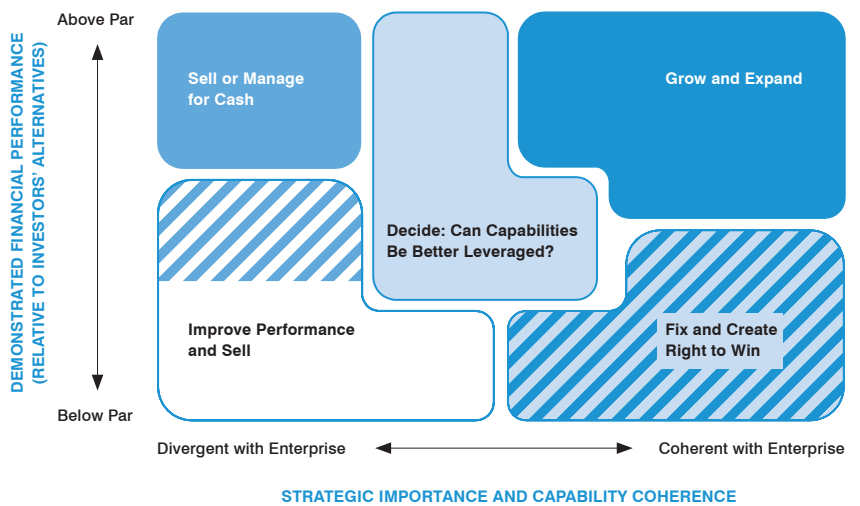
FOCUS ON YOUR FUTURE

First, reexamine your portfolio of businesses and shed the marginal ones. That designation is defined, first, by financial performance; second, by the degree to which an individual business employs mutually reinforcing capabilities that cross business unit lines and distinguish the enterprise as a whole. For each business, ask: Is it core to your company's future value? Can you envision it as the basis for a sustaining stream of attractive growth opportunities?

Does it offer a path to building financial performance that is greater than what investors can earn elsewhere in their equity portfolios? (See Exhibit 4.)

Concentrate your corporate strategy on the businesses for which you can answer "yes" to all three questions—and monetize the rest. There will be too many good opportunities for you to build on this core to bother with anything else.

Exhibit 4
A Guiding Matrix for Portfolio Decisions



Source: Booz & Company

It might be tough to sell your “dogs” in this environment. If so, maintaining them for cash might be the right option. It is certainly better than using precious capital for a less-than-adequate return.

Also answer this question: Who are your most important customers? Focusing on your most valuable customers will be just as important as focusing on your most valuable businesses.

On the demand side, these are the customers whose missions will grow the fastest and who reward you with loyalty and respect. If you are a business-to-business producer, seek out customers who recognize your product or service as the one that delivers the greatest surplus value relative to their next best alternative—regardless of its price or your profits. *(For an example of this type of analysis, see Exhibit 5.)*

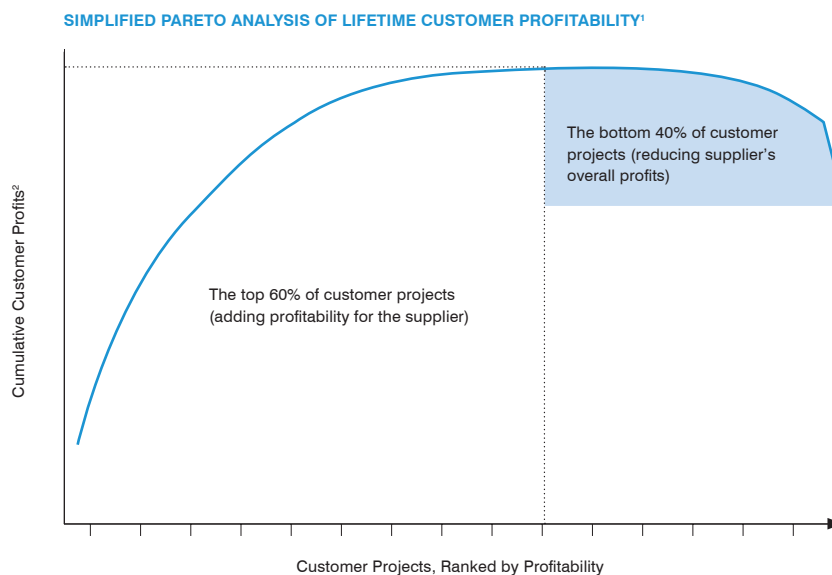
On the supply side, your most valuable customers are those with critical needs for the products that offer you the greatest ability to compete not just on price but on value. Forget about your also-ran, me-too offerings. Bet your business on the products and services in which you have a competitive advantage through your

capabilities: your technology, your cost position, your design and manufacturing skills, and your ability to reach and serve customers effectively.

If you are strong, you will always see opportunities to better serve your most valuable customers and to gain

more market share. You only have to be willing to challenge yourself to look. Spare extra cash for the customers that matter. Stay focused on your best businesses, your best products, and your best customers.

Exhibit 5
Differentiating the Customer Base



¹ Derived through a Pareto analysis conducted for an automobile industry supplier, the blue curve shows cumulative profitability for each customer project (and all more profitable projects). The steeper the curve going upward, the more profitable; where the curve is flat or tilts downward (at right), the project is draining the supplier's profits.

² Grouping each customer project with all higher-ranked customer projects
Source: Booz & Company

PREPARE TO WEATHER THE STORM

We are and will continue to be in a recession. Consumer demand is not coming back to superheated levels anytime soon, and pressure on prices and margins will only increase. So don't wait. Reduce your breakeven now—by a lot.

If at all possible, you should make your company profitable even in the worst-case scenario, if for no other reason than to demonstrate its staying power. This means lowering your break-even volume, your break-even volume as a percentage of capacity, and your capacity, all at the same time. If you succeed, odds are your business will fare better than expected in the recession—and you will reinforce its ability to be strategically aggressive.

Lowering your breakeven to this degree means getting rid of significantly more cost than is needed to offset the coming falloff in demand.

It also means extracting a full measure of the potential benefit from simplifying your business. In normal times, decisions about what to do incrementally are emotionally easy. Right now, you will need to make the hard decisions about what *not* to do. This is a very good time to make the difficult, clean-sheet-of-paper, strategic choices that will let you experience prosperity and not merely hang on in the quarters to come. As a strong company, barring a return to rising commodity prices, your variable cost drivers should already be under control. This is not necessarily true of fixed or period costs. Strong and weak companies alike may have too much capacity, too much manufacturing overhead, too much business overhead, and too much staff.

Complexity creeps in everywhere: in variations in your product line, in your willingness to customize in ways customers won't pay for, and in focusing excessively on process excellence and doing things the right way, rather than concentrating on getting better at doing the right thing.

Complexity and capacity are the handmaidens of excessive overhead. Now is the time to rethink how much complexity and capacity you

really need and how much fixed cost you can really support. During the good times of the past few years, you "baked in" plenty of complexity-driven selling, general, and administrative expense (SG&A). Now you need to cut out all the costs that are not valuable (and that you cannot afford) and retain only the essentials (*i.e., eliminate the blue squares in Exhibit 6*).

Thinking strategically about reducing fixed costs is critical because it will lead to more far-reaching action. It should not be treated as a tactical adjustment.

To weather this storm, a strong balance sheet is also essential—and in a way that has not been true since the decade of easy credit began. You will need to generate as much investment capital as possible from within your company. Maximize the cash proceeds from reconcentrating your portfolio. Raise profits by cutting period cost. Triage your R&D and capital expenditures, focusing them on your core businesses. Secure whatever preexisting low, fixed-rate debt you may have. Minimize operating working capital. Set aggressive targets for all of the above—and get the cash.

Exhibit 6
Driving Out Discretionary Costs

COST-SCREENING CATEGORY

	EXTERNAL CUSTOMER	OPERATIONAL VALUE ADDED	LEGAL/REGULATORY
4	Directly touches end customers, who are willing to pay for the services	Department directly running line organization	Department required by law or directly involved in preparing compliance reports/audits
3	Directly touches end customers who are not willing to pay for the services but who would notice their absence	Supports line organizations and adds noticeable value that line would pay for	Directly involved in reducing legal/regulatory risk
2	Supports areas that touch end customers who would notice their absence	Supports line organizations, is requested by line, but only on a "nice to have" basis	Plays preventive role in reducing legal/regulatory risk
1	Customers would not notice absence	Supports line organizations, but is not requested by line: "corporate-driven"	Collects information on compliance/risks
0	Does not touch external customers	Does not support line organizations	Not involved in legal/regulatory compliance

Source: Booz & Company

ANTICIPATE THE FUTURE INDUSTRY STRUCTURE

If there are five main players in your industry today, should there be three tomorrow? Whom might you consolidate with and whom should you simply let go by the wayside? How interventionist will the government be in preserving existing players or forcing arranged marriages?

To answer these questions, you need to do your economic homework and decide how your industry should be structured as it moves into recovery. Anticipate that major changes may now be possible whereas before you may only have thought incrementally. This downturn is a once-in-a-century opportunity to redefine your competitive position.

There will be competing points of view within your company, and they will often be given voice by the strongest personalities. Voices arguing for simple, rapid solutions should be suppressed. The situation you are in is unique and you probably do not yet know enough. Most likely, you

do not already have an established process within your business for rigorously constructing fact-based industry perspectives. You need to direct your company to create such a process.

The building blocks are simple. What will underlying demand look like post-recovery, and how fast will it grow? Will price elasticity increase, decrease, or remain the same? How differentiated are your product and service offerings? How capital- and R&D-intensive is your business? Is it the same for competitors? Are there opportunities for competitors to build advantaged business systems that systematically turn out products whose intrinsic margins are superior to yours—or is your company the one with this competitive advantage? How strong are the effects of economies of scale in your industry, and how much pure scale benefit can be created by increased business scope? What is the cost of this scope in terms of added complexity?

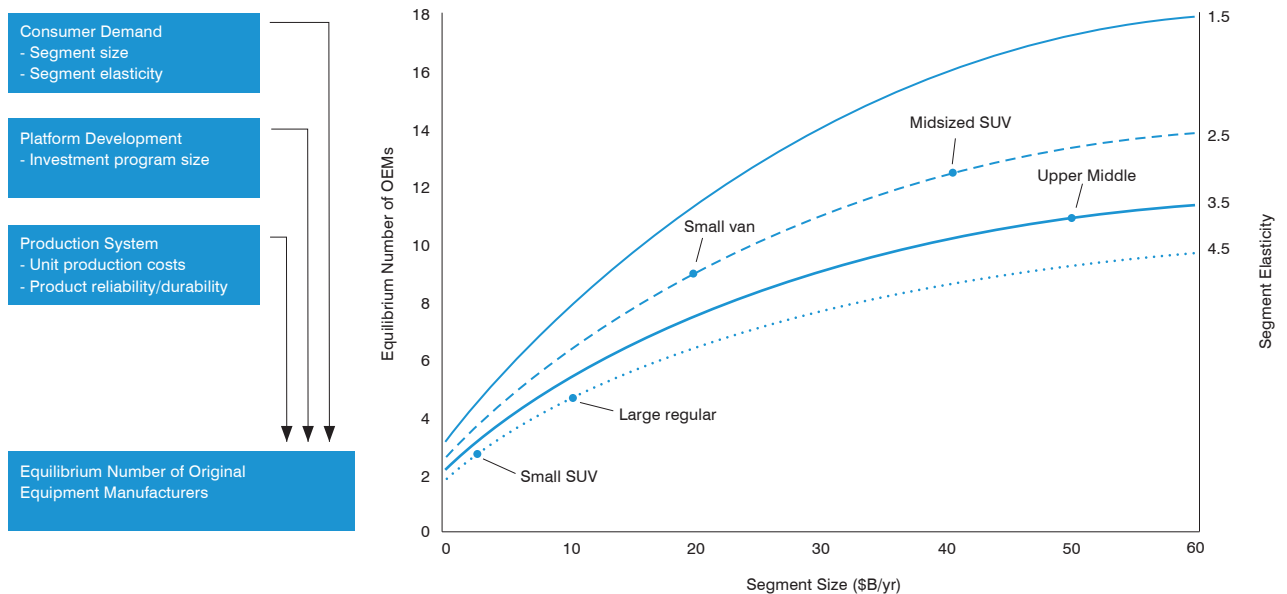
By developing answers to these questions, you can decide who the surviving players should be and set up your company to become one of them. Consider an example from the automobile industry (see Exhibit 7). Based on consumer demand statistics, the size of the investment in new programs, and data about cost and durability, this analysis calculates how many competitors the market can

support for each product segment: only four large regular sedan models, 11 midsize SUVs, and so on.

If you conclude that your industry needs to restructure, you have several strategic questions to answer: How will capacity exit—program by program? Customer by customer? Or will players come together through consolidation?

Furthermore, what role should you play in the consolidation? Can and should you push a competitor to the brink? Alternatively, should you sell your business even though you may be a strong player? You need to create an industry road map and then decide where your position lies in the terrain.

Exhibit 7
A Fact-Based Analysis of Market Capacity for the Auto Industry



Source: Booz & Company

RESOLVE YOUR GAME PLAN

Don't think of R&D and capital expenditures as fixed costs. They are investments. By the time the new products are ready, and the market and the new facilities are in place, you will want these renewed sources of competitive advantage to serve your customers better and further distance your business from competitors.

The key for these expenditures is prioritization. In good times, companies are known to become sloppy with some investments. R&D, new product development, and capital expenditures are the places where your priorities should play out most clearly.

Within your core businesses, you will want to be strategically aggressive—to fight for increased market share and the conversion to your brands of the most valuable product and customer segments. But avoid using pricing to secure the volume you need to cover fixed costs you shouldn't have in the first place. Maintaining both the value you deliver to customers and your ability to get customers to recognize and pay for that value will be particularly critical in the quarters ahead.

Required rates of return have gone up. Market demand is going down. The projects you have committed to should be reevaluated with these truths in mind. And new projects intended to grow and strengthen your core businesses should be subjected to the same tests.

But do not overreact. Form a realistic expectation of your medium-term cost of capital that reflects the new macroeconomic environment but does not give too much weight to current market valuations. Expand the pool of possible investments to include cash acquisitions and repurchase of your own stock. Right now, both of these options may be unusually attractive.

As of today, the market valuations of both strong and weak companies have been hammered with almost equal ferocity. But soon the two will further separate as the recognition that quality is on sale begins to dawn on the more rational investors. When this happens, strong companies with the necessary financial resources should consider acquiring the attractive, complementary pieces of their marginal rivals. Given today's discounted valuations, these investments may offer higher returns than internal projects.

The same may be true about your own stock. This does not mean attempting a leveraged recapitalization in a long-term debt market that is thin and expensive. Instead, think of a buyback as a way to make a medium-term investment in the business you know best, because it is so undervalued. Here, as elsewhere, self-deception is a big risk, especially if you aren't really strong. So you must be scrupulously objective.

PREPARE TO TAKE INTELLIGENT RISKS

For the economy at large, the future is still unclear. Once the larger-scale course corrections have been made, exactly how will your own company get past the current crisis, through a recovery, and return to growth?

The U.S., Europe, and Asia will be getting big doses of fiscal stimuli. It is easy to imagine the next U.S. administration promoting policies to increase incomes if price inflation sets in. It is also easy to imagine a rekindling of global commodity price increases as real demand intersects once again with a steep rise in the long-run commodity supply curves.

As a result, it is far too easy to imagine that in relieving the credit system, the United States and other OECD countries will overshoot the mark, especially when the velocity of money begins to pick up and the finance industry returns to normal. In this scenario, all the classic ingredients of an inflationary wage-price spiral could be in place.

It makes sense to get ready for a worse outcome rather than to simply

hope for a better one. What should you do to prepare? Two things.

First, analyze in depth the supply curves that drive the price levels and availability of your key raw materials—both long-run and short-run curves. With that knowledge, as the recovery takes hold, decide how vulnerable you are to another cycle of demand-triggered, speculation-driven price spirals. Prepare to protect yourself by making fixed-price claims on capacity you know to be reliable, while watching for the signals that should cause you to hedge your exposure.

Second, prepare to recapitalize your debt. It is easy to imagine a bridge period between the recovery and the potential subsequent onset of an inflationary spiral. During this transitional period, long-term credit may be available at rates that do not yet reflect inflation expectations. Should this happen, move fast to secure as much long-term debt at low fixed rates as you can imagine needing for the foreseeable future.

CONCLUSION

The current economy will not get better immediately. We are in for more rough seas. The weak have to take bold action to weather the storm and save as much value as they can. They have no time to spend denying the situation or gambling that more favorable circumstances will save them.

The strong will be stressed too. But we are entering a period in which the value of being able to act strategically and decisively for the long term will increase enormously. Preparing for this moment of opportunity is of paramount importance for your businesses' positions for years to come.

This reality has changed your job. You need to get ahead of the industry shifts that are going to occur. Your role is to set about re-creating your industry and positioning your businesses in the most appropriate, highest-value place.

The basic rules of engagement:

- Do not marginalize your company. Take aggressive actions to secure its place in the present so that you

can seize every opportunity in the future. Understand and plan for the worst-case scenario, and manage your balance sheet tightly.

- Concentrate on your core businesses and on your most strategically valuable customers. These are your only priorities.
- Rethink your growth and investment strategy for those core businesses, anticipating the opportunities that will come to you. Seek out opportunities to restructure the industries around these businesses.
- Understand the potential dangers in the post-recovery phase and prepare now so that you can act with confidence to protect your company at the earliest appropriate moment.

Recognize that volatility is in control and events are moving fast. This is a moment when the captain must be on the bridge.

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