ROLAND BERGER STRATEGY CONSULTANTS

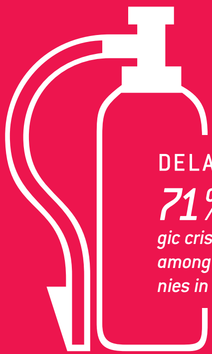
think:act CONTENT

Fresh thinking for decision makers

Act – don't react! | Start introducing flexibility into strategy, operations and financing of your company | Retain your competitiveness even in difficult economic times |

JUNE 2008

[RESPONSES TO INITIAL SYMPTOMS OF A CRISIS ARE OFTEN TOO LITTLE, TOO LATE]



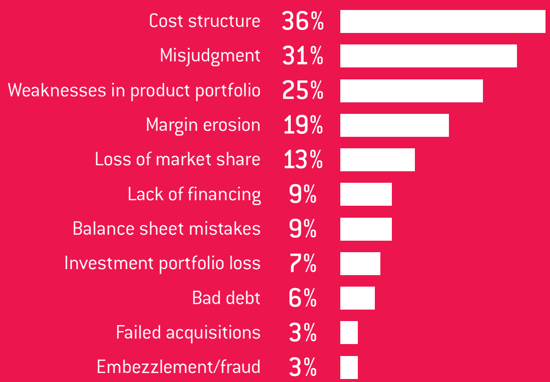
DELAYED REACTION TO CRISIS SYMPTOMS:

71% of the companies surveyed do not take action before a strategic crisis has turned into a profit or liquidity crisis, according to a survey among European CEOs and managing directors of approx. 2,600 companies in various industries

Source: Roland Berger

MOST COMMON MANAGEMENT CHALLENGES:

Cost structures are not adjusted to the changing business environment, and key data, such as operating profit and cash flow, are being ignored. (Findings of a Roland Berger survey in cooperation with the weekly "Wirtschaftswoche".)



Source: Roland Berger, Wirtschaftswoche

TRANSATLANTIC VIEWS:

While American CEOs expect the US dollar to consolidate at a high level, their European counterparts beg to differ:

US CEOs (49%)

$1.50 – 2.00

European CEOs (69%)

$1.00 – 1.50

Exchange rate development over the next 2-3 years
[number of participants/%]

Source: Roland Berger, CEO Survey 2008

LEADERSHIP SKILLS ARE KEY DURING RESTRUCTURING:

Leadership 73%

Communication 41%

Culture 18%

Employee involvement 14%

"Sense of urgency" 14%

Incentives 9%

Source: INSEAD (Transformation Paper)

IN TIMES OF LOOMING MACROECONOMIC CRISIS, FLEXIBILITY IS ALL THE MORE IMPORTANT:

340%

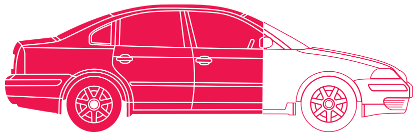
of gross domestic product – the amount of national debt in the US. In 1929, this figure was 300%.

I. NO TIME TO BE IDLE – RESTRUCTURING MUST REMAIN HIGH ON THE CORPORATE AGENDA

It seems as if the bad news never stops: As central banks inject billions into the markets to offset a liquidity crisis, banking giants are facing daily depreciations. Although the impact of the perceived crisis is seen differently in the United States and Europe, the markets' interdependency is fueling uncertainty among companies and consumers alike. Already, the dangerous 'R'- word – recession – is no longer a whisper. US Federal Reserve Chairman, Ben Bernanke, admits the signals are not good. Consumer trust is strained at best. Exporting companies in Europe remain dependent on US market developments. They are watching their revenues dwindle due to the weak US dollar, but still face high Euro-based factor costs. Until now, analysts have drawn a positive economic outlook for Europe's export-oriented countries. But can it last? It is high time for companies to increase their flexibility to ensure that they can respond. True champions don't sit back and wait: They start restructuring measures even when they are still experiencing profitable growth. But many companies still have a lot of groundwork to cover in this area, according to an exclusive Roland Berger survey.

Our analysis revealed that around 8% of Europe's large companies exhibit all the classic symptoms of a strategic crisis. Their competitive position has gradually deteriorated for one of two reasons. Either they have held onto unprofitable businesses for too long, or they have been too slow in responding to major changes in patterns of demand. Nearly 20% of the companies examined are in fact already struggling with acute earnings or liquidity crises. Fewer and fewer entrepreneurial options are still open to the management. Creditors, suppliers and customers want more than just regular information: In a volatile environment, they want guarantees. In some cases, companies are having to make extensive concessions and having to submit to the terms of strict covenants. In other words, over a quarter of the companies examined are mired in a crisis of some sort. For many of them, thorough and painful restructuring is the only way out. Our study didn't examine the behavior of niche players. We investigated a thousand large, publicly traded companies that each generate annual sales of more than EUR 500 million – the very heart of Europe's economy. In recent years, the best of these key players have significantly improved revenues, productivity and profitability. They have also nearly doubled free cash flow and are now much better placed to service debts. At first glance, even the worst of the lot do not appear to have done too badly for themselves, boosting their revenues by almost one fifth. But don't be fooled by outward appearances. A closer look reveals glaring discrepancies: Profits are stagnating, cash flows have dropped by nearly 10% and servicing debt has become a serious problem. The alarm bells are ringing loud and clear.

For some time, the strong macroeconomic environment rewarded top companies with record earnings and even mediocre companies with a reasonable rate of return. In light of such stark deficits, however, this may turn out to be more of a curse than a blessing – and these effects may already be visible in the medium term. The next downturn is only a matter of time. Macroeconomic data and future perspectives have grown considerably bleaker over the past few months. Commodities such as steel and oil remain as expensive as ever. The weak dollar weighs heavily on Europe's export-oriented economy. Meanwhile, via the agency of the capital markets, the subprime crisis is hitting more and more companies outside the finance industry. Traditional means of corporate financing are thus becoming more expensive and increasingly difficult to obtain. On the other hand, alternative options such as bond issues and IPOs are possible only at substantial rate cuts. Private equity investors are recalculating – and are increasingly reluctant to part with their money.

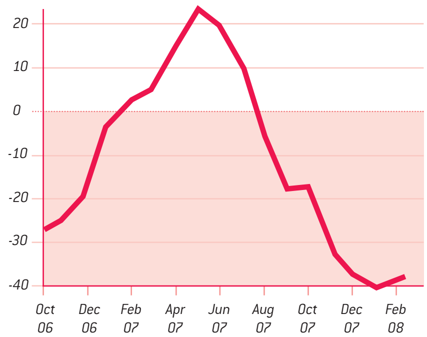


SYMPTOMS OF ACUTE CRISIS

Nearly 2/3 of employees in Europe's automotive industry work at companies that exhibit symptoms of acute crisis

WAY BELOW ZERO

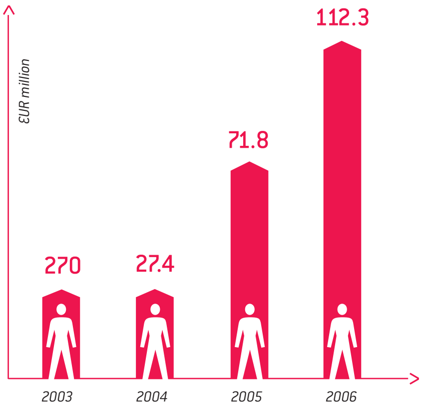
The economy is still growing strongly. Early indicators such as the ZEW index are sounding the alarm, however. The Mannheim-based Center for European Economic Research compiles this index based on the expectations of analysts and institutional investors. The respected economic barometer has been plunging consistently for months.



Source: Center for European Economic Research

RAPID GROWTH

The amount of money pooled in private equity investors' funds nearly quadrupled between 2004 and 2006. Awash with all this cash waiting to be put to good use, financial investors are stepping up the pressure on the corporate sector.



Source: EVCA Yearbook 2007, p. 39

II. PARADIGM SHIFT IN THE RESTRUCTURING BUSINESS

Clearly, restructuring has to remain a top agenda item – even in good times. But the face of restructuring has also changed dramatically over the past five years. The wind has grown colder and the rules of the game are stricter than ever.

Until a few years ago, continental European firms could rely on their regular banks to provide sufficient loans. Thus, most of them could operate with comparatively low equity ratios. Since then, however, the Anglo-American financing culture has largely taken over. International investors – especially private equity investors and hedge funds – have stepped into the ring and established new financing instruments and forms, such as mezzanine arrangements. While these new investors are a breath of fresh air in the financing market, new challenges have emerged. These days, you can often find over a dozen investors sitting around the table deciding the fate of large corporations and SMEs alike. Nor are such constellations restricted only to crisis situations. These players expect a higher yield and make shorter commitments than offered through regular bank loans.

More players with higher yield expectations and, in some cases, completely divergent interests can turn financing negotiations into tricky balancing acts. Above all, in radical restructuring all subjects are fair game. Our analysis substantiates the view that in the future, insolvencies will play a significantly greater role in restructuring. Bankruptcies can also be a chance to start afresh.

These changes have drastically altered the way in which the restructuring game is played over an extremely short time period. Our experience working with clients in this changed environment allows us to identify typical attributes that are common even to widely varying projects.

RESTRUCTURING AND GROWTH MUST BE SWIFT AND SIMULTANEOUS

Restructuring and growth should not be mutually exclusive. On the contrary, both streams must be pursued concurrently. The days in which a company could gently cut itself down to size before embarking on a new, healthy growth phase are officially over. "V curve" strategies are obsolete.

The earlier a company takes the signs of a crisis seriously, the better. The best time to tackle necessary restructuring is always today, not tomorrow. Corporate history is replete with story after story of firms that misread fundamental changes or responded too slowly – and nearly didn't live to tell the tale. Loewe, Agfa and AEG are merely the tip of the iceberg.

And then there are the success stories that have become corporate legends. Take the crisis-ridden niche computer hardware and software provider that developed a tiny music player. The company itself became a music provider – and created new multibillion-dollar business. Or take the automotive supplier that took its customers' capacity problems seriously. The company willingly assumed responsibility for production peaks during volume rollout, and did the same for residual production as old models were phased out. Today, that company is one of the most successful players in this market segment. Apple and Magna Steyr are only two of many examples of corporate turnarounds that saw restructuring and growth not as diametric opposites, but as two sides of the same coin.

STRATEGY, OPERATIONS AND FINANCING: SUCCESSFUL RESTRUCTURING ALWAYS SEES THE BIG PICTURE

If you are going to turn a company around, do it properly. Strategy, operations and finance are inseparably intertwined – and must all be subjected to close scrutiny. Workable solutions must

be developed for all three areas. Only then can a company be sure that one reorganization will not quickly lead to another.
TA Triumph-Adler AG has shed its skin completely since the mid-1990s and serves as a blueprint model for end-to-end restructuring. The reputable German firm founded at the end of the 19th century as a bicycle factory ultimately became known throughout the world for its typewriters. Around the mid-1990s, the company was visibly losing its way. The management was courageous enough to take radical action: It weeded out a number of business lines and approved divestments that cost it several hundred thousands of euros in sales in the process. At the same time, it ramped up one of its core activities – document business – in what was essentially a bold redesign of the entire company. Legal structures were simplified, administrative costs were slashed, financial analysis was modernized, and both sales and technical services were given fresh direction. Corporate finance was adjusted in line with the new service-oriented business model. And the company eased its liquidity situation, partly to finance acquisitions as a further way to invest in core business.
The bold transformation paid off. TA Triumph-Adler did not join the corporate giants in the trophy case of past glories. Instead, the company is now a leading specialist in the document business, especially in Germany. TA Triumph-Adler provides tailored analysis and advice to corporate customers, implements efficient (paper-based and electronic) document workflow solutions and delivers ongoing after-sales service.

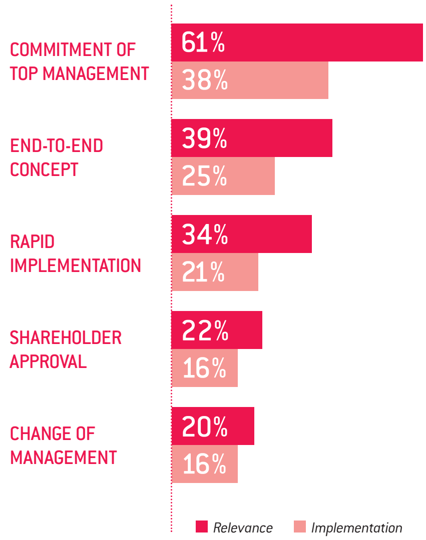
But numbers – in the form of share prices – paint an even more dramatic picture in favor of end-to-end restructuring over the long term:

- On average, the share prices of companies that have completed extensive restructuring exercises are 136% higher after two years. By contrast, companies that focus only on boosting productivity and cutting costs see their share price rise by just 54% – considerably less than half as much – on average.
- The discrepancy is even more striking when one compares only the top 20% of either group. Two years after completing end-to-end restructuring exercises, the most successful companies in this bracket boasted average increases of 483% in their share prices (in the sense of aggregate adjusted excess return). Those companies with a very narrow restructuring focus managed just 245%.

Roland Berger Strategy Consultants has long adopted an integrated approach to realignment and restructuring. This approach combines traditional analytical methods with change tools borrowed from a variety of disciplines. However, as much as individual restructuring plans need to vary, three key elements must always be included:
Put simply, STRATEGIC realignment explores what lines of a business can achieve what short- and long-term profitability with which product portfolios. It also maps out the actions that must be taken to give the company a promising position for the future. There can be no taboos if such a realignment is to succeed. Only then can truly radical change come about. Examples include the way Arcandor realigned almost its entire midmarket business portfolio and the way IBM turned its back on hardware production.
OPERATIONAL restructuring focuses on improving operating efficiency. This can be done, for example, by optimizing organizational structures, making core processes leaner or deploying human resources more effectively (e.g. by raising their level of qualifications or by introducing systematic succession planning).

KEY SUCCESS FACTORS

If an end-to-end restructuring concept is to succeed across all levels, top management must be fully committed to it.



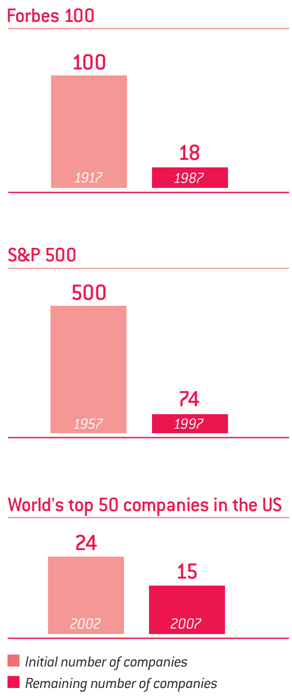
Source: Roland Berger

483%

is the amount by which the top 20% of companies that successfully restructured were able to increase their returns

TOO LATE

Companies that haven't responded to change were squeezed out of the market



Source: Young Managers Conference, Burkhard Schwenker, September 2007

On the other hand, FINANCIAL restructuring seeks to create the conditions for sufficient equity and liquidity to weather the crisis. At the same time, careful cash flow management lays the foundation for future growth. As a rule, restructuring plans that solely address the immediate crisis symptoms are far from adequate.

All aspects of analysis and planning must be combined into an INTEGRATED BUSINESS PLAN. In our experience, such a plan is vital to the lasting success of any restructuring exercise. It models both the visible impact of short-term actions and the more remote impact of long-term actions. Having said that, it is more important for the business plan to set a clear direction for the steps to be taken and to enable fast, resolute implementation, than to guarantee accuracy to the third decimal place.

III. THE FOURTH DIMENSION: FLEXIBILITY

Restructuring processes place heavy demands on management. They must be formulated almost overnight and rigorously adhered to. The plans must adequately reflect the interests of all stakeholders, including the views of lenders, the company's shareholders, its customers and employees. Yet in many cases, different stakeholders would prefer running for the exit rather than sitting out a painful restructuring phase. Motivating change is the most challenging exercise for a CEO and an extremely delicate balancing act. Restructuring projects are thus akin to the "modern pentathlon in a pressure cooker".

Yet comprehensive restructuring programs also present tremendous opportunities for companies to prepare for the next round of global competition. The examples cited earlier are proof of that fact. One quality is crucial if such opportunities are to be realized successfully. Unfortunately, too many CEOs the world over pay it lip service but too little practical attention. We are, of course, talking about flexibility.

A company's flexibility is essentially its ability to respond to unforeseen and unpredictable changes in the conditions within which it operates. When applied to the three key dimensions of realignment/restructuring explored here, flexibility takes the following forms:

STRATEGIC FLEXIBILITY allows a company to review its business model at any time, quickly redefine it and thereby realign itself. This can involve chartering new lines of business or abandoning existing ones. Analytical and systemic skills are critical in such situations. One example is the ability to quickly realign the business portfolio and the organizational structure in response to changed conditions.

The extent to which OPERATIONAL FLEXIBILITY can be increased largely depends on production methods and the parties involved in the relevant processes (alongside the fundamental conditions in the given industry, of course). Outsourcing aspects of production to third parties, using temporary staff and integrating system suppliers in internal processes are typical models that can make a company more flexible. Although all these approaches and more have received considerable attention, their efficiency is often left underexploited. In our project experience, making those last – and most difficult – decisions is what actually spells success. Management must decide which skills and processes are genuine core competencies and are therefore "untouchable." We often encounter "sacred cows" whose *raison d'être* has never really been questioned. Yet crises frequently afford a unique opportunity to critically review – and, where appropriate, make changes to – supposedly immutable processes.

We also frequently discover substantial room for improvement in companies' FINANCIAL FLEXIBILITY. Few companies fully exploit all the potential offered by the capital markets. Most shy away from arrangements such as mezzanine funding and private equity investments.

The example of TA Triumph-Adler AG nevertheless shows just how much room to maneuver can be gained by deploying innovative financing instruments. During its restructuring phase, this company initially opted for a mezzanine loan. It then used tools such as factoring and brand leasing to generate sufficient cash to finance expansion. "The new structure saves us around EUR 5 million in interest expenses," says CFO Dr. Bernd Köhler. "We now have far fewer covenants, too."

The fundamental challenge is for companies to be flexible enough to quickly adapt their corporate strategy to external changes. External changes happen when, say, a new competitor enters the market, a new innovation renders current technology and standards obsolete or when commodities become more expensive. Roland Berger Strategy Consultants has identified four critical success factors:

- Companies need to have **FLEXIBLE RESOURCES** that can be mobilized rapidly if they are to successfully master new situations. They need financial reserves, R&D capacity and individuals who can quickly shoulder management responsibility, for example.
- An organization's **ABILITY TO LEARN** is absolutely vital. This ability requires both systemic and personnel skills.
- **SELF-ORGANIZATION** is another key capability. In other words, a company must be able to quickly create functional structures and abandon dysfunctional ones.
- The more modular the **STRUCTURE OF A COMPANY'S OFFERINGS**, the easier it will be to respond to shifts in demand, such as by building up, redeploying or shedding capacity.

Individual industries have shown us just how far flexibility can go. OEMs in IT, mechanical engineering and many other key industries have significantly flattened vertical integration in recent years. System and component suppliers have become integral parts of industry supply chains. All these steps have raised overall flexibility. Fashion chains such as Zara and Hennes & Mauritz are already demonstrating how companies can launch several new collections a year. Flexibility allows them to respond extremely swiftly to changing tastes and shifts in demand.

RESTRUCTURING – A JOB FOR TOP MANAGEMENT

Restructuring is a complex discipline that demands a wealth of knowledge of how strategy development, business operations and corporate finance impact each other. It requires not just in-depth expertise but strong leadership qualities, too. Restructuring, in other words, is a job for top management. It is the greatest challenge – and if successful, the crowning glory – of a chief executive's career. The CEO must map out the direction, define the scope and regulate the speed of restructuring. Above all, he or she must communicate fresh vision and enthusiasm to the entire work force. At many companies, the first step toward restructuring is therefore to draft relevant experience into the management team. Fortunately, at least one thing will never change for the people at the top: Restructuring projects can still serve as powerful springboards for management careers. Successfully reorganizing a company, making it more flexible and competitive has never done any executive's future prospects any harm.

SHOULD YOU HAVE ANY QUESTIONS, PLEASE DON'T HESITATE TO CONTACT US:

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