

## Preparing for a slump in earnings

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Historic trends suggest earnings may fall more than most executives expect. Companies should prepare for steeper declines and take steps to strengthen their positions when times improve.

As the aftershocks of the subprime-lending crisis rumble on, executives understandably find it difficult to read the conflicting US economic and business indicators they rely on to make strategic choices. Some are encouraged by sharp interest rate cuts, fiscal help, and export growth resulting from the dollar's weakness, hoping that these will save the US economy from a prolonged recession. Others observe that although corporate earnings were considerably lower in the fourth quarter of 2007 than they were in the same period a year earlier, earnings forecasts from consensus analysts point to a rebound later this year, with overall US 2008 earnings growth expected to grow by more than 10 percent.

Investors, executives, and boards might therefore be tempted to face the rest of 2008 cautiously, but not to feel any need to develop radical contingency plans for a substantial and sustained reduction in earnings. Yet giving in to that temptation would be a mistake because such plans will probably be needed. A study of historic trends shows that corporate earnings might well retreat by as much as 40 percent from their 2007 levels.

Few companies as yet anticipate such a blow to their earnings and general economic health. Fewer still have begun to put in place the rigorous contingency plans needed to weather it and to build the financial and operational flexibility that would make them more competitive at a time of substantial and sustained reductions in corporate earnings.

### Booms and busts

Valuation multiples and corporate earnings drive stock market valuations. A look back at the US stock market's peak, in 2000, can help illuminate the dynamics behind booms and busts.

Between 1973 and 2000, rising price-to-earnings (P/E) multiples drove the market's growth.<sup>1</sup> Falling real interest rates and lower inflation were the underlying reasons, and these trends, unfortunately, are not repeatable. From 1996 to 2000, P/E multiples rose especially sharply, particularly for Internet-related stocks. The bullish psychology underlying much of that market activity reflected a mistaken belief among many investors that the Internet age had so changed the economic fundamentals that historic ratios were irrelevant and could safely be ignored.

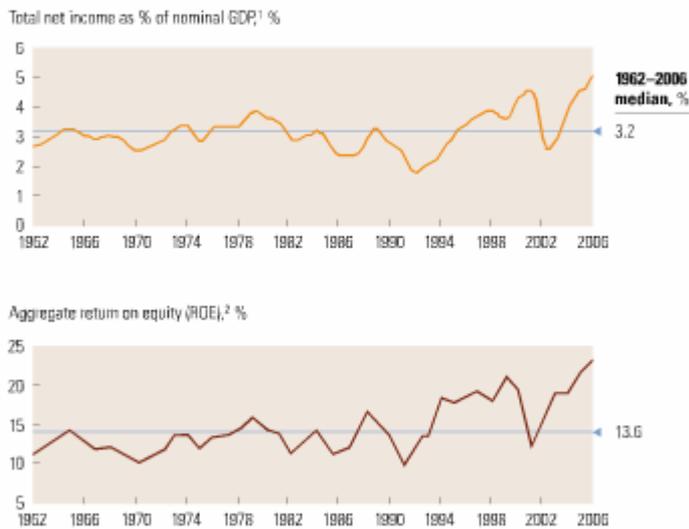
This belief in a paradigm shift generated P/E multiples that reached a high of around 25 at the stock market's 2000 peak, compared with a long-run average of 14. Acquisitions at inflated prices became increasingly common. Of course, a four-year bear market decline of 40 percent followed the peak as multiples reverted to levels more in line with the long-run average. Earnings, too, dipped, as companies wrote off the goodwill associated with the high-priced acquisitions made at the time of the stock market peak.

The underpinnings of the 2004–07 stock market rally were quite different from those of the earlier ones. During the recent run-up, P/E multiples weren't unusual, hovering around the levels seen in the late 1960s—which was also a time of low interest rates. Instead, strong corporate earnings drove the market's growth.

How strong? Gauged either by earnings as a share of GDP or by returns on equity, US companies apparently fared better than they ever had, at least during the 45 years of our data (Exhibit 1). Between 2004 and 2007, the earnings of S&P 500 companies as a proportion of GDP expanded to around 6 percent, compared with a long-run average of around 3 percent, with the increase most acute in the financial and energy sectors.

## New heights for corporate earnings

For all companies in S&P 500



<sup>1</sup>Before extraordinary items; adjusted for goodwill impairment.  
<sup>2</sup>Adjusted for goodwill and goodwill impairment.

At the heart of this widely enjoyed earnings growth was a sales-driven expansion of net income rather than improved overall operating margins, growth in investments, or invested capital, each of which grew only slightly. In effect, companies increased their capital efficiency by selling more without making proportionate investments. In the nonfinancial sector, this meant squeezing greater capital efficiency from plants and working capital, so that returns on capital employed rose some 40 percent above the long-run US trend.<sup>2</sup> Credit-driven consumer expenditures provided much of this revenue boost.

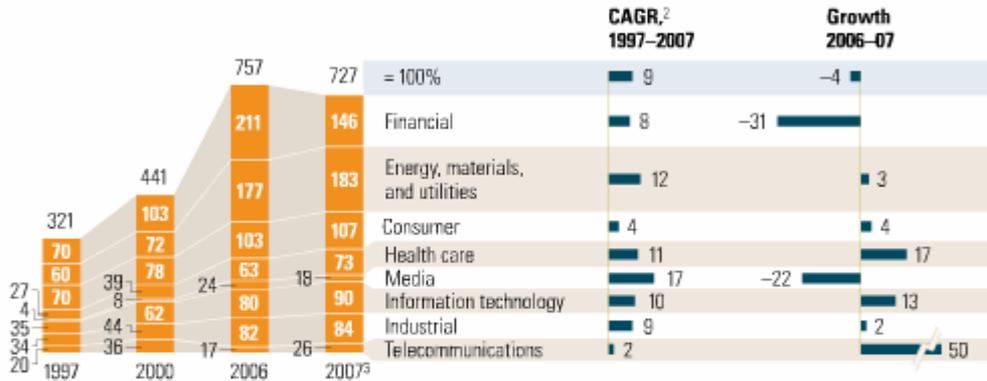
In the financial sector, higher volumes and fees stoked returns on equity that were around 60 to 80 percent above the historical trend. Some of these returns, however, came from subprime products and instruments—such as collateralized debt obligations, or CDOs—which created an earnings bubble that has now burst.

All fall down?

Some reversion to the norm is already under way. The decline in earnings during last year's fourth quarter took place largely in the financial and energy sectors (Exhibit 2). How far could earnings fall? If we exclude the energy and financial sectors, they would have to drop by at least 20 percent from their 2007 levels to reach long-run average levels and by around 40 percent to reach the low points in the previous earnings cycles.

## Some reversion has begun

Total net income by sector for S&P 500 before extraordinary items and adjusted for goodwill,<sup>1</sup> \$ billion



<sup>1</sup>Figures may not sum to 100%, because of rounding.

<sup>2</sup>Compound annual growth rate.

<sup>3</sup>Based on reported net income and preliminary net income from continuing operations (314 companies) and available analysts' earnings forecasts (177 companies).

Source: Company filings; DataStream; McKinsey analysis

For S&P 500 earnings overall—including the energy and financial sectors—to reach their long-run average proportion of GDP, they would have to decline by 30 percent from the 2007 level. And they would have to drop by as much as 60 percent for earnings to reach the lower points of previous cycles, such as in 1991. This scenario is less likely, since the current strength in the energy sector is less dependent on the general health of the US economy.

#### Preparing for a downturn

The recent fiscal stimulus by central banks (particularly in the United States), combined with strong ongoing Asian growth and historically low interest rates, could well mitigate the effects of a radical reduction in earnings to mean levels. What's more, the dollar's weakness will support US exports and thus boost manufacturing. Even if the US economy adjusts well to the current turmoil, however, the process will probably take longer than most executives and analysts optimistically assume.

Against that backdrop, executives should more actively take precautions against a sharp economic downturn or a prolonged earnings slump—or both. The starting point for such preparations is to understand the history and microeconomics of your industry and know how a downside scenario might look. What did companies do during past downturns, and how did some of them position themselves to be more successful afterward?

The prospect of a prolonged downturn should lead to the introduction of more severe contingency plans for managing credit risk, freeing up cash, selling assets, and reassessing growth. But executives should also think through the opportunities that a downturn provides. Research shows that it is at the start of a downturn—when costs such as capital expenditures, R&D, and advertising are low—that executives who have planned in advance can make countercyclical moves to build competitive advantage when times improve. A downturn can be a great opportunity to hire talent, to continue spending on long-term strategic initiatives, and

to target acquisitions.<sup>3</sup> Companies that now enjoy strong balance sheets have a good position to take advantage of current credit market conditions and reap outsized value for shareholders.

In many cases, building in financial and operational flexibility forms the core of efforts to benefit from a downturn. Executives must therefore understand how to make costs more variable, and CFOs need to understand how to get their balance sheets ready to do so. The desirable moves include shaping the investor base to generate support for ideas that might seem to go against conventional wisdom in a downturn and could require a reduction in dividends. Companies shouldn't rule out investigating and approaching potential financial partners, such as private-equity players or sovereign wealth funds, whose resources could help their allies to make the most of a slump.

If the past is prologue, corporate earnings may face a more substantial and prolonged decline than the current consensus expects. Boards and executives shouldn't postpone efforts to plan for a downturn—plans that might include initiatives to seize the competitive opportunities a slump might unearth.

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