Pop! Went the Profit Bubble

In an era of boom-and-bust cycles, this was one for the history books. How the Fortune 500's earnings went from record gains to a shocking fall as revenues collapsed faster than companies could cut costs.

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AMERICA IS GETTING used to the sound of bubbles bursting—the collapse of tech stocks in 2000, the blowup in corporate bonds that rumbled late last year, the housing debacle that's still resonating. Now it's official: The sumptuous profits America posted over the past few years weren't part of a new world order, but a bubble that, like the others, went out with a bang. And what a bang. It was just recently, in 2006, that Fortune 500 earnings reached an incredible, historic pinnacle that dwarfed all previous peaks. This year the group established another record, but in the opposite direction: It suffered by far the largest two-year fall in profits in the 55-year history of the list. Of course, corporate earnings always retreat after years of strong growth. That's the nature of the business cycle. As Fortune noted in its 500 issue in April 2007, "Sad to say, the historic rise won't continue."

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What's extraordinary is how quickly and brutally plenty turned to hardship, and how many idols of the boom saw their record earnings dissolve into staggering losses. Why so fast? The economy's fall was precipitous, leaving companies little time to adjust and pushing the 500 from the summit to something resembling an earnings depression. "We've never seen such a sudden, severe decline in profit performance," says John Lonski, chief economist for Moody's Investor Service.

The numbers tell the story. From the all-time high of $785 billion in 2006, Fortune 500 earnings slipped to a robust, even bubble-level, §645 billion in 2007. The real damage came last year, when profits plunged to $98.9 billion for 2008, a decline of 87% from. 2006, (In general, we'll compare 2008 results with 2006, since it was the previous profit peak.) For every dollar in profits the 500 garnered two years ago, its members made 13$ in 2008. In fact it was in the last four months of 2008 that forces converged to sweep away the profits of corporate America. It would be difficult to invent the full range of vicious currents that came together in that period, from a free fall in U.S. demand to collapsing exports to falling prices. Especially damaging was a jump in labor costs, a big surprise given the rise in joblessness. The onset of trouble was so sudden that despite millions of layoffs, managers couldn't cut labor costs fast enough to match cascading revenues.

The plunge is hitting industries from banking to gaming to mining, but it has a common theme: It mirrors the fading fortunes of the American consumer. The problem is that households are heavily, often ruinously, in debt—at the same time their major assets, their homes and investment portfolios, are shrinking in value. Many are so stretched that they're defaulting on mortgages and credit card lines, especially the rising ranks of jobless; most are sharply reducing their spending to cover monthly interest and pay down their debt. The radical retrenchment, after golden years when Americans spent lavishly and reliably paid their loans, is hammering profits with special savagery in two broad areas: financial services and discretionary consumer goods and services, from hotels to toys to cars.

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WHERE THE STORM HIT HARDEST

Banks and securities firms that bet recklessly on the housing boom suffered epic losses as their assets turned toxic, most notably the packages of risky mortgages known as collateralized debt obligations (CDOs) that have collapsed in value as millions of Americans default on their home loans. The losses from those toxic instruments, which take the form of massive write-downs, have been overwhelming. During 2008 the companies most affected by toxic-asset fallout rang up five of the 11 biggest deficits posted on *Fortune* 500 lists since 1994: AIG (-$99 billion), Fannie Mae (-$58.7 billion), Freddie Mac (-$50.1 billion), Citigroup (-$27,7 billion), and Merrill Lynch (-$27.6 billion).

Major consumer banks have suffered from another kind of consumer crisis, one that has yet to play out: a meltdown in their staple businesses of providing mortgages and credit card and auto loans. They were forced to pile on ever-rising credit costs as 2008 progressed. Those costs came in two parts: charge-offs for the loans customers defaulted on today, and ever-increasing reserves on loans likely to go bad in the future. Bank of America, J.P. Morgan Chase, and US Bancorp didn't suffer the huge losses that hobbled the players consumed by toxic securities, but their profits dropped-from towering to puny. And in the harsh fourth quarter, Bank of America and Wells took substantial losses.

The whirlpool sinking financial services is one of the most shocking events in Fortune 500 history. Banks, securities firms, and insurers were the biggest winners in the fat years, posting $257 billion in profits in 2006, about a third of the 500'$ total. Last year the financial sector suffered a loss of $213.4 billion. The $470 billion swing in profits explains almost 70% of the total dollar fall since the heights of 2006.

The consumer's sudden turn toward radical restraint is inflicting heavy damage on a second sector that could be called "anything you normally like to do or buy but can put off." In fact, this group saw the second-biggest drop in dollar earnings behind the financials. In the Fortune 500 it's composed of 101 companies in a category called consumer cyclicals. It includes purveyors of goods and services big and small, hornebuilders like Centex and D.R. Horton, retailers from Lowe's to Nordstrom, automakers GM and Ford, hotel operators like Starwood, and gaming giant MGM Mirage. "These are things that you can either do without for a while or don't need to replace right away," says Dirk van Dijk of Zacks Investment Research, a firm that compiles earnings forecasts from, analysts. Americans are saying, "I'll cook at home instead of going to Olive Garden," or "I won't buy a new car until I'm sure I'll keep my job," or "We'll delay that vacation to Bermuda until next year."

More than any other sector, the consumer cyclicals suffered from a severe downdraft in sales. "It's a top-line story," says Ken Matheny, an economist with the research firm Macroeconomic Advisers. The force that made the category so profitable from 2002 to 2006 totally reversed. As volumes declined, so did margins. Hence, the operating leverage that increased profit for every toy or refrigerator sold as sales rose in the good years turned negative. The results are daunting: Frcjru 2006 to 2008 the cyclicals careened from total profits of $38.3 billion to losses of $42,3 billion. Hardest hit were automakers General Motors (-$30.9 billion) and Ford (-$14.7 billion). Hotels and casinos, publishing, and homebuilders all swung from big profits in 2006 to steep losses. The stay-at-home consumer also left air-

lines in the lurch: Carriers went from a gain of $15 billion in 2006 to a deficit of $19 billion last year.

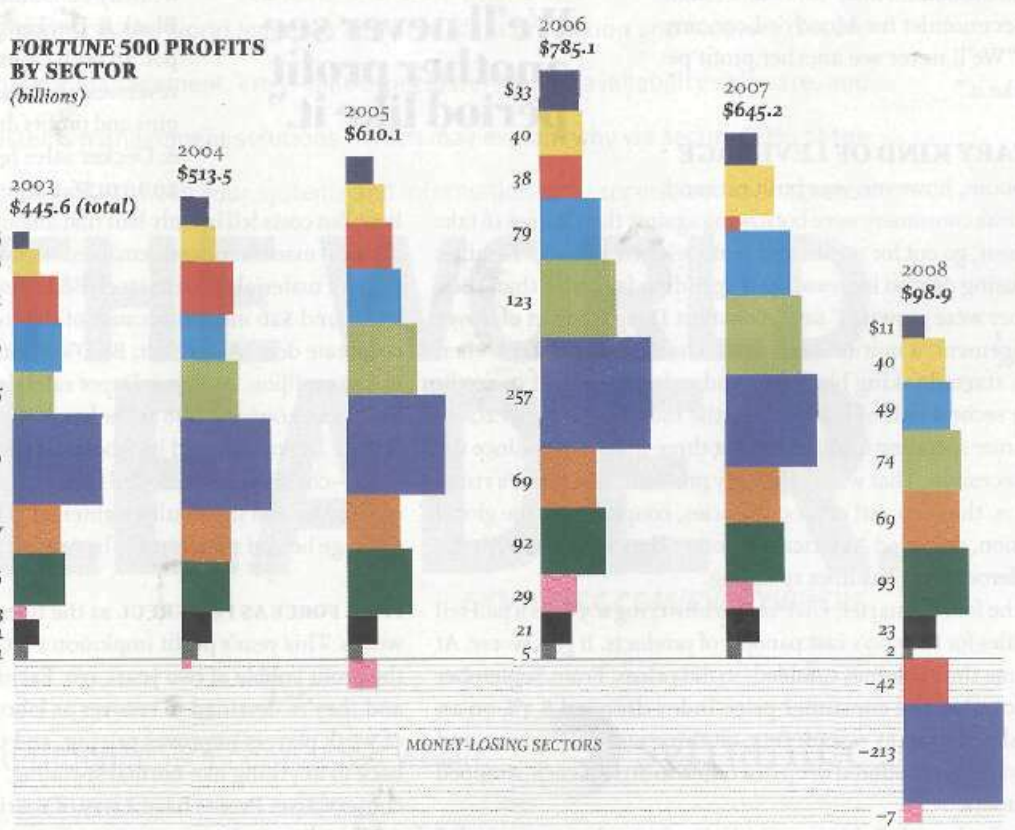
Only two sectors posted profit increases over 2006. Health care, a spending item most consumers won't do without, showed a tiny increase, to $69.1 billion. Among the stars were drugmakers, a group that typically shines in a recession, including Johnson & Johnson ($12.9 billion), Merck ($7.8 billion), and Abbott Labs ($4.9 billion). Technology also showed a minuscule gain, to $92.8 billion. In part, that's because tech companies never participated in the earnings bubble. Their profits ballooned in the late 1990s as companies gorged on fiber-optic networks, routers, and workstations. Since then they've been mostly flat. So while they didn't spike in the boom, they've remained stable in the bust. Clearly, tech customers aren't rushing to expand as they did in the '903, but they're handing the tech giants a steady flow of business updating and servicing their systems. Microsoft ($17.7 billion), Cisco ($8 billion), Oracle ($5.5 billion), and Apple ($4.8 billion) stand tall as some of the most reliable profitmakers in the Fortune 500.

HOW THE PROFIT BUBBLE INFLATED

To understand the profits disaster, it's important to review the forces that created the bubble. From 2003 to 2006 the economy provided a perfect environment for earnings. A major contributor was a strong rise in revenue growth. It was driven by two factors. The first was a powerful surge in volume—unit sales of everything from cars to toys. The driver was buoyant consumer demand that raised GDP an average of 3.3% a year. The second force was the tail wind from rising prices. In that period the dollar fell sharply, forcing foreign companies to charge more for their products imported to the U.S. That gave U. S. companies plenty of space to raise their prices. In that period *Fortune* 500 revenues jumped 9% ayear.

OUR COLOR-CODED DAMAGE REPORT

Not all sectors suffered alike: Financials and consumer cyclicals plunged into a netherworld of losses, but technology held steady.



The bounty didn't stop there. Labor costs, which account for two-thirds of all corporate expenses, barely budged during the glory days. Faced with a pro-business administration, unions didn't push aggressively for wage increases. Workers were generally pleased with the ample job opportunities, while the rising values of their homes and investments gave them a strong feeling of security. Wages rose modestly. And the mild increase in pay per hour was totally offset by a potent surge in productivity. Since U.S. companies had loaded up on high-tech capital equipment in the 19905, they were able to harness those workstations and software programs to dramatically reduce the time needed to assemble a car or process a mortgage application. That's the definition of productivity: the hours required to produce a good or service. The fall in hours canceled the increase in wages.

Hence, the dollars required to make a single airplane part or ton of packaging, a crucial measure called unit labor costs, didn't increase from 2003 to 2006. It also helped that volumes were rising, so that more and more goods ran through the highly productive plants with the same lean workforces. With prices per unit rising and labor costs staying flat, the result was an explosion in margins, or profit per appliance or home sold. In the peak profit year of 2006, the average margin of Fortune 500 companies hit an all-time record of nearly 8%. "All of the increases in productivity went right to the bottom line," says Mark Zandi, chief economist for Moody's Economy, com. "We'll never see another profit period like it."

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A SCARY KIND OF LEVERAGE

The boom, however, was built on sand. America's consumers were borrowing against their homes to take vacations, go out for meals, and remodel their houses. "Families were using debt to increase their spending far faster than their incomes were growing," says economist Doug Cliggott of Dover Management, a mutual fund firm. The crunch hit hard when banks started taking big losses and radically reined in credit in the second half of last year. In the fourth quarter of 2008, consumer spending took the biggest three-month drop since the 1982 recession. That wasn't the only problem. The dollar's rising value vs. the euro and other currencies, coupled with the global recession, pounded America's exports. They dropped with the same ferocity as consumer spending.

In the fourth quarter, GDP sank a blistering 6.3%, as a pall fell over sales for the 500´s vast panoply of products. It gets worse. At the same time volumes tumbled, so did prices. From September to December the consumer price index dropped 8.3% on an annualized basis as restaurants, clothing outlets, casinos, and hardware stores offered deep discounts to attract cash-strapped consumers.

Here's where the jolting reversal in operating leverage crippled profits. Not only did the Fortune 500 suffer from a sharp decline in units being sold because consumers switched from spending to saving, but profits were also hit by a disastrous shrinkage in margins. That shrinkage came in two parts. The first was the fall in prices for each shirt or lawn mower. The second proved a painful surprise: Unit labor costs actually rose in the heart of the downturn.

How did that happen at the same time unemployment rose painfully fast? The simple answer is that the deterioration in business was so sudden and stunning that companies couldn't cut their workforces nearly as quickly as their output dropped. As plants slowed down, workers had less to do. "So the hours spent on each unit rose," says Zandi. That translated into a decline in productivity. General Motors eliminated shifts at its plants, and AK Steel idled factories. In January auto systems manufacturer Visteon put workers on a four-day week for the month. But wages paid per hour actually rose because of bonuses and raises promised earlier in the year, when the labor markets were still fairly tight. All told, unit labor costs jumped 5.7% in the fourth quarter, at the same time prices for those shirts and lawn mowers crumbled. Hence, the margins for those products either became whisker-thin or turned into a loss for every unit sold. That shrinkage in margins is what constitutes the negative operating leverage plaguing the Fortune 500.

Let's examine what the collapse in operating margins did to the profits of two healthy consumer cyclicals, toolmaker Black & Decker and retailer Home Depot. In both cases the recession pounded revenues while costs fell far less, so margins and profits dropped sharply. At Black & Decker sales fell from $6.45 billion in 2006 to $6.1 billion in 2008, or 6350 million. But costs fell by only half that amount. B&D's labor costs, as for most manufacturers, remained sticky, and it battled the rising price of materials such as steel. B&D's interest expense also rose by around $26 million because of the steep increase in rates on corporate debt. As a result, B&D's profits fell from $486 million to $294 million. At Home Depot sales dropped 21%, to $71.3 billion, from 2006 to 2008 as the home-remodeling boom deflated. (Home Depot also sold its wholesale distribution business.) But costs—chiefly personnel—fell 18%, or $3.5 billion less, so margins on lumber and light bulbs tightened. The decline in operating leverage helped shave profits by 61%, to $2.26 billion. •

IT'S A FORCE AS POWERFUL as the tide, but we know how that works. This year's profit implosion isn't any more durable than the profit bubble of two years ago. Earnings move in big cycles, and they're destined to recover as labor costs fall, the demise of weak players improves pricing, and the consumer is coaxed back to anything like normal spending, even if families remain conservative. Profits have a way of roaring out of steep slumps. And th is one is about as steep as they get.

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