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Perspectives on Corporate Finance and Strategy

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2 Risk: Seeing around the corners
Risk-assessment processes typically expose only the most direct threats facing a company and neglect indirect ones that can have an equal or greater impact.

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A series of interviews with 14 CEOs and chairmen of major companies sheds light on the foundations of corporate leadership.

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Koushik Chatterjee discusses the Indian multinational’s approach to outbound M&A—and its response to the global financial crisis.

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A more consumer-centric Chinese economy would generate more jobs, spread the benefits of growth more equitably, and even grow more rapidly. Global companies should take note.
The financial crisis has reminded us of the valuable lesson that risks gone bad in one part of the economy can set off chain reactions in areas that may seem completely unrelated. In fact, risk managers and other executives fail to anticipate the effects, both negative and positive, of events that occur routinely throughout the business cycle. Their impact can be substantial—often, much more substantial than it seems initially.

At first glance, for instance, a thunderstorm in a distant place wouldn’t seem like cause for alarm. Yet in 2000, when a lightning strike from such a storm set off a fire at a microchip plant in New Mexico, it damaged millions of chips slated for use in mobile phones from a number of manufacturers. Some of them quickly shifted their sourcing to different US and Japanese suppliers, but others couldn’t and lost hundreds of millions of dollars in sales. More recently, though few companies felt threatened by the outbreak of SARS (severe acute respiratory syndrome), its combined effects are reported to have decreased the GDPs of East Asian nations by 2 percent in the second quarter of 2003. And in early 2009, the expansion of a European public-transport system temporarily ground to a halt when crucial component providers faced unexpected difficulties as a result of credit exposure to ailing North American automotive OEMs.

Risk-assessment processes typically expose only the most direct threats facing a company and neglect indirect ones that can have an equal or greater impact.
What can companies do to prepare themselves? True, there’s no easy formula for anticipating the way risk cascades through a company or an economy. But we’ve found that executives who systematically examine the way risks propagate across the whole value chain—including competitors, suppliers, distribution channels, and customers—can foresee and prepare for second-order effects more successfully.

**Risk along the value chain**

Most companies have some sort of process to identify and rank risks, often as part of an enterprise risk-management program. While such processes can be helpful, our experience suggests that they often examine only the most direct risks facing a company and typically neglect indirect ones that can have an equal or even greater impact.

Consider, for example, the effect on manufacturers in Canada of a 30 percent appreciation in the value of that country’s dollar versus the US dollar in 2007–08. These companies did understand the impact of the currency change on their products’ cost competitiveness in the US market. Yet few if any had thought through how it would influence the buying behavior of Canadians, 75 percent of whom live within 100 miles of the US border. As they started purchasing big-ticket items (such as cars, motorcycles, and snowmobiles) in the United States, Canadian OEMs had to lower prices in the domestic market. The combined effect of the profit compression in both the United States and Canada did much greater damage to these manufacturers than they had initially anticipated. Hedging programs designed to cover their exposure to the loss of cost competitiveness in the United States utterly failed to protect them from the consumer-driven price squeeze at home.

Clearly, companies must look beyond immediate, obvious risks and learn to evaluate aftereffects that could destabilize whole value chains, including all direct and indirect business relationships with stakeholders. A thorough analysis of direct threats is always necessary—but never sufficient (Exhibit 1).

**Competitors**

Often the most important area to investigate is the way risks might change a company’s cost position versus its competitors or substitute products. Companies are particularly vulnerable to this type of risk cascade when their currency exposures, supply bases, or cost structures differ from those of their rivals. In fact, all differences in business models create the potential for a competitive risk exposure, favorable or unfavorable. The point isn’t that a company should imitate its competitors but rather that it should think about the risks it implicitly assumes when its strategy departs from theirs.

Consider the impact of fuel price hedging on fares in the highly competitive airline industry. If the airlines covering a certain route don’t hedge, changes in fuel costs tend to percolate quickly through to customers—either directly, as higher fares, or indirectly, as fuel surcharges. If all major companies covering that route are fully hedged, however, that would offset changes in fuel prices, so fares probably wouldn’t move. But if some players hedge and others don’t, fuel price increases force the nonhedgers to take a significant hit in margins or market share while the hedgers make windfall profits.

Companies must often extend the competitive analysis to substitute products or services, since a change in the market environment can
make them either more or less attractive. In our airline example, high fuel prices indirectly heighten the appeal of video-conferencing technologies, which would drive down demand for business travel.

Supply chains
Classic cascading effects linked to supply chains include disruptions in the availability of parts or raw materials, changes in the cost structures of suppliers, and shifts in logistics costs. When the price of oil reached $150 a barrel in 2008, for example, many offshore suppliers became substantially less cost competitive in the US market. Consider the case of steel. Since Chinese imports were the marginal price setters in the United States, prices for steel rose 20 percent there as the cost of shipping it from China rose by nearly $100 a ton. The fact that logistics costs depend significantly on oil...
prices is hardly surprising, but few companies that buy substantial amounts of steel considered their second-order oil price exposure through the supply chain. Risk analysis far too frequently focused only on direct threats—in this case, the price of steel itself—and oil prices didn't seem significant, even to companies for which fluctuating costs may well have been one of the biggest risk factors.

**Distribution channels**

Indirect risks can also lurk in distribution channels: typical cascading effects may include an inability to reach end customers, changed distribution costs, or even radically redefined business models, such as those recently engendered in the music-recording industry by the rise of broadband Internet access. Likewise, the bankruptcy and liquidation of the major US big-box consumer electronics retailer Circuit City, in 2008, had a cascading impact on the industry. Most directly, electronics manufacturers held some $600 million in unpaid receivables that were suddenly at risk. The bankruptcy also created important indirect risks for these companies, in the form of price pressures and bargain-hunting behavior as liquidators sold off discounted merchandise right in the middle of the peak Christmas buying season.

**Customer response**

Often, the most complex knock-on effects are the responses from customers, because those responses can be so diverse and involve so many factors. One typical cascading effect is a shift in buying patterns, as in the case of the Canadians who went shopping in the United States with their stronger currency. Another is changed demand levels, such as the impact of higher fuel prices on the auto market: as the price of gasoline increased in recent years, there was a clear shift from large SUVs to compact cars, with hybrids rapidly becoming serious contenders. Consider too how the current recession has shrunk the available customer pool in many product categories: demand for durable goods plummeted among consumers holding subprime mortgages as their access to credit shrank, and demand for certain luxury goods fell as even financially stable consumers turned away from conspicuous consumption.

**Effects on a company’s risk profile**

Risk cascades are particularly useful to help assess the full impact of a major risk on a company’s economics. Exploring how that risk propagates through the value chain can help management think through—imperfectly, of course—what might change fundamentally when some element in the business environment does.

To illustrate, let’s examine how the risk posed by new carbon regulations might affect the aluminum industry. Aluminum producers would be directly exposed to such regulations because the electrolysis used to extract aluminum from ore generates carbon. They’re also indirectly exposed to risk from carbon because the suppliers of the electrical power needed for electrolysis generate it too. The carbon footprint can be calculated easily and its economic cost penalty determined by extrapolation from different regulatory scenarios and the underlying carbon price assumptions. This cost penalty would of course depend on the carbon efficiency of the production process and the fuel used to generate power (hydropower, for instance, is more carbon efficient than power from coal).

In general, large industrial companies believe they are “carbon short” in the financial sense—their profits get squeezed when carbon prices increase. Is that always true? A different story emerges
from a closer look at the supply chain, which stiffer carbon regulations would change in many different ways. The cost of key raw materials, such as calcined petroleum coke and caustic soda, would increase, along with logistics costs and therefore geographic premiums. The US Midwest market premium, for example, reflects the cost of delivering a ton of aluminum to the region, where demand vastly exceeds local supply. Not all competitors in the industry would be affected alike: this effect favors smelters located close to the US Midwest, because they could then pocket the higher premium. Some suppliers might even benefit from their geographic position.

Moreover, in a carbon-constrained, tightly regulated world, aluminum becomes a material of choice to build lighter, more fuel-efficient cars. Since automobile manufacturing is one of the largest end markets for aluminum, carbon regulation could substantially accelerate demand, thus helping to support healthy margins and attractive new development projects. Clearly, a high carbon price would enhance aluminum’s value proposition—positive news for the industry.

Finally, carbon regulations would affect not only a particular company but also its competitors, changing the economics of the business. For commodity industries, the cash cost of marginal producers sets a floor price. In a world where carbon output has a price, the cost structure of different smelters would depend on their carbon intensity (such as the amount of carbon emitted per ton of aluminum produced) and local carbon regulations. It’s possible to show how any regulatory scenario could influence the aluminum cost curve (Exhibit 2). In nearly all the plausible scenarios, the curve steepens and the floor price of aluminum therefore increases. For most industry participants, especially very carbon-efficient ones (such as those producing aluminum with hydropower), a meaningful margin expansion could be expected.
A simple risk analysis suggested that one of our clients would be carbon short and that its profits would therefore decrease under new carbon regulations. But a more extensive view of the way carbon risk cascades through the industry value chain shows that this company would actually be carbon long: as carbon prices increase, the company benefits economically thanks to its high carbon efficiency, its desirable geographic location (proximity to the US Midwest), and the potential added demand for aluminum.

Unknown and unforeseeable risks will always be with us, and not even the best risk-assessment approach can identify all of them. Even so, greater insight into the way they might play out can provide a more comprehensive picture of an industry’s competitive dynamics and help shape a better corporate strategy. Thinking about your risk cascades is a concrete approach to gaining that insight.

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Leadership lessons for hard times

A series of interviews with 14 CEOs and chairmen of major companies sheds light on the foundations of corporate leadership.

During the current global recession, much attention has been devoted to the mistakes that sparked the financial and economic crisis, in hopes of not repeating them. Less has been given to what’s been done well—to learn, for example, how best to lead a company through these tough times.

To contribute to that understanding, we interviewed the leaders of 14 major companies (see sidebar, “Who’s who”), all seasoned CEOs or chairmen, asking them to reflect on what they felt they have learned so far. We were keen not to limit their comments to the current recession and therefore also asked them to consider previous challenges they had faced in a turnaround or a crisis. The companies they lead are in diverse industries, face varied challenges, and have performed quite differently. We are attempting neither to judge their performance nor to draw up a set of rules on how to lead through tough times. Instead, what emerges from the interviews is agreement on some broad principles that can help guide behavior in the executive suite and the boardroom, as well as interactions with employees, customers, and investors.

**Confront reality**

“Always question whether the ‘halo effect’ of a business or business situation is blinding you to what lies on the horizon.”

—Herbert Henkel, chairman, president, and CEO of Ingersoll Rand
Few predicted the magnitude of the current crisis. But those in the corporate world who first detected—and accepted—the fact that something was amiss had a distinct advantage in implementing strategies to help weather the storm.

In the summer of 2008, Ingersoll Rand’s Herbert Henkel noticed that European orders in the company’s transport refrigeration business had slumped, even though business was still booming in other divisions. He was alarmed: a fall in the delivery of perishable foods surely indicated trouble in the supply chain. “I couldn’t help thinking, what if that figure really is indicative of what’s out ahead? What are we going to do about it?”

Henkel, squaring up to what he detected, forecast zero growth in Europe during the third quarter, though analysts thought he was “nuts.” His forecast was wrong: growth fell by 15 percent. Yet Ingersoll Rand got ahead of the curve by quickly putting contingency plans in place, restructuring, and running down inventory. “Of course, we still had to go back and do more,” he reflects. “But by not ignoring that one indicator, we did get a head start.”

Getting ahead of the curve means taking a hard look at what the future might hold, and that requires a degree of courage. The point made by Henkel and others is how difficult it can be for leaders to take action—and to persuade others to follow their lead—if a business seems to be thriving.

Eight years ago, when Michael Jackson arrived at AutoNation, for example, the auto industry was selling as many as 17 million units a year, but its high fixed costs made him fear what would happen if the economic environment changed. At his first management meeting, he therefore announced his desire to find a business model that would let AutoNation break even, even if the auto industry sold only 10 million units. He also wanted to understand what would have to happen for sales to take such a nosedive and how the business would need to be remodeled to survive. “Everybody looked at me like I had six heads,” he recalls. “Eventually, we came to the conclusion that, among other things, it would take a credit crisis to get volumes that low, because in our business, nothing moves without credit. So we got out of the finance and leasing business,” says Jackson. “Without the limitation on risk we put in place, we would be in deep, serious trouble at the moment.”

CEOs also need courage to make hard decisions quickly. Phil Hildebrand, of HealthMarkets, and Steve Miller, of Delphi, both remarked on the importance of decisiveness to prevent problems from escalating. But it can be hard to achieve in the absence of perfect data. “A lot of CEOs are slow to react, and their problems get away from them,” says Edward Breen, of Tyco International. “You have to get as much data as quickly as possible. But you will never get all of it—so you need to make decisions quickly.”

Besides courage, staying ahead of the curve entails having the mechanisms and governance models that allow companies to confront realities unimaginably different from those they would ordinarily expect. Monitoring systems that pick up warning signs are important. So too is an environment, both physical and psychological, where alternative interpretations of the signs can be aired and considered with care and interest.

At Cardinal Health, Kerry Clark wanted to have a better grasp of such potentially unpleasant realities and felt that historical practice—employees were given forecasts and simply told to meet them—was a hindrance. Instead, he made
business leaders accountable for making forecasts and doing everything possible to meet them, while regularly and openly reviewing them. “It’s all too easy for a corporate leader to say, ‘Don’t give me more bad news. Just go fix it,’” muses Clark. “But you have to beat back that kind of attitude and create an atmosphere where people feel they can talk about the forecast, how they can improve it, and what resources they might need.” He says that the new system required a cultural change but is yielding results—for instance, revealing problems earlier.

Sysco’s Richard Schneiders puts it this way: “You have to be open to diverse points of view. Given the speed of change, I don’t know how a business will be able to continue to flourish in the future without being receptive to different points of view.”

At board meetings, put strategy center stage
“The board has been heavily involved in strategy formulation with me, and we have a better strategy because of it.”
—Bill Nuti, chairman, president, and CEO of NCR

The way CEOs work with their boards has changed fundamentally during the past year. In tough times, difficult decisions must be made quickly, so it’s not surprising that many CEOs find themselves communicating more regularly with the board to keep it abreast of developments. Full board meetings have been supplemented by letters, e-mails, intranet postings, informal discussions, and conference calls. At Cardinal Health, “board updates”—conference calls held as frequently as every two weeks—address questions from

Who’s who

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<tr>
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<th>Company</th>
<th>Industry</th>
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2008 employees:

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Leadership lessons for hard times

board members. “They weren’t board meetings. There were no minutes. No one was obliged to attend. But it was very helpful,” says Clark, who sees the updates as an efficient way to address individual concerns and increase confidence in the management team.

Many CEOs have already accepted the need for frequent and open communication with their boards, a practice they say proves its worth when difficult decisions must be made. If directors are up to speed, they are better placed to offer both support and advice. What has changed markedly is the content of board discussions. In particular, discussions about strategy are no longer the preserve of a once-a-year off-site meeting. The pace of change—crisis or no crisis—makes that model unworkable.

Today, at many companies, strategy is on the agenda of every board meeting. “The world moves at a pace that requires strategy to be front and center all of the time,” says NCR’s Bill Nuti. “There are too many variables that come into play in a normal cycle, let alone this one, that can rapidly change the course of your company, so I bring strategy up at every single meeting.” Eric Foss, of Pepsi Bottling, decided to integrate strategy into every board meeting at the beginning of 2008, before the crisis. It was a fortunate decision, according to Foss, considering the board’s contribution. He, like others, is happy to communicate more frequently with a talented board not just to build its trust but also to benefit from its experience. Several CEOs said that working to get the right people with the right experience onto their boards had been
a priority, over the course of several years, for that very reason.

Nuti credits his board with helping him understand the potential magnitude of the current downturn very quickly. “You get great research when you can pull information from board members who all sit on 2 or 3 boards. You’re getting the perspective of 18 different boards. I was looking for commonality in their feedback and, fortunately—or unfortunately, in the light of circumstances—there was a lot of commonality.”

Be transparent with employees
“The only way to address uncertainty is to communicate and communicate. And when you think you’ve just about got to everybody, then communicate some more.”
—Terry Lundgren, chairman, president, and CEO of Macy’s

One legacy of the current downturn will be a reinforced belief in the value of frequent, transparent communication with employees, and not just the CEO’s direct reports. The CEOs we interviewed could not overemphasize the power of openness at all levels.

“At Cardinal, we work hard on internal communications,” says Clark. “We do a lot of town hall meetings, for example. We used to just do them around earnings time, but now we do them to discuss any major initiative that’s under way.” Clark also notes that investor relations (IR) and internal communications work hand in hand, so that any information that goes to the investor community is reworked for employees. “We do a very good job of making sure information doesn’t get in front of one group without getting in front of the other.”

Being open about what is happening in a company is partly a question of integrity: employees deserve honesty. Openness also builds respect, trust, and solidarity, all of which in turn help employees stay focused on the task of running the business at a time when financial rewards might be limited and the future uncertain. Openness helps build morale as well. A CEO cannot mislead people and certainly shouldn’t panic them, but explaining problems and the actions being taken to deal with them builds confidence in the quality of the CEO’s leadership. “People will take any hill, walk into the worst situation, if they have faith in your leadership and know what your strategy and objectives are,” says Tyco’s Breen.

3M’s George Buckley emphasizes, in addition, the need to assure employees that the CEO has faith in them and that they will not be blamed for things beyond their control—such as the state of the economy. “When they’re battling the marketplace, they need to know you will support them,” he says.

Finally, openness helps ensure that everyone in an organization understands how to make a difference. When the CEO explains “the current situation,” says Ingersoll Rand’s Henkel, “people understand why we need cash both to pay off debt and to be able to continue making investments. That, for example, makes them think twice about ordering something just to be on the safe side.”

Yet although the importance of good internal communication is widely understood, it can slip from the priority list in a crisis. “In hard times, we ask employees to work harder than ever,” comments P&G’s A. G. Lafley. “But in hard times,
you get caught up with investors, analysts, the media, suppliers, and retailers. It’s all too easy to overlook your employees at precisely the time you should be communicating more with them.”

**Be open with investors**

“Our policy is: ‘If in doubt, communicate.’ We always want to conduct our business with integrity and forthrightness.”

—Ron Sugar, chairman and CEO of Northrop Grumman

Most CEOs we interviewed have noticed that the amount of time they spend communicating with investors has risen exponentially of late. Here too they strive to be as open as possible. “If I’ve learned anything in the last 18 months, it’s that transparency in troubled times really matters,” says Travelers’ Jay Fishman. Yet he believes the crisis has revealed that transparency still goes against the grain for many people. “If asked to describe this or that exposure, the advice from many IR departments is to use some formulation that basically says don’t worry. I’ve tried to resist that. Now is not the time to tell people not to worry. If you’re in the financial-services industry, you ought to be able to quantify. I try to be specific, and we’ve gained credibility as a result.” Pepsi’s Foss too recommends transparency with investors: “we’re facing up to our issues” and in this way “demonstrating that we have a management team that knows what it’s doing.”

But there are caveats. In times of crisis, there can be a tendency to focus entirely on short-term results—a tendency CEOs should counter. While acknowledging current difficulties, it is just as important to emphasize what is being done to build a company’s longer-term health. Fishman, like others, has spent much time talking about his company’s mid- and long-term strategy, its efforts to improve productivity, and his willingness to sacrifice some short-term performance to create longer-term value.

There is also a feeling among CEOs that not all investors are equal. While chief executives are acutely aware of disclosure requirements, some say that their companies would gain very little if they spent more time with short-term investors. CEOs count themselves lucky when they feel strategically aligned with long-term investors who have large holdings. That makes these CEOs believe they have some breathing space in a crisis, and as a result they may not have to spend a great deal more time with their investors. But they note how hard they worked to recruit those investors.

When Jackson took over at AutoNation, for instance, he knew that to succeed he would have to attract a new shareholder base prepared to sacrifice some short-term profit for longer-term gain. “The investors I have now understand the business model, and that’s been a huge plus. But it didn’t happen by itself,” he points out.

**Build and protect the culture**

“Stay focused on culture, people, and values: it’s the area most likely to get compromised in this environment.”

—Eric Foss, chairman and CEO of Pepsi Bottling Group

A healthy company enjoys not only strong financials but also a culture and values that bind it together. Much of what our interviewees describe as important is driven by corporate culture—
open communication or a focus on a company’s long-term health, for example. Several CEOs chose to highlight how a strong culture had helped them in hard times and how important it is not to sacrifice that culture when a company comes under pressure.

Jackson says that the most critical battle he waged when he arrived at AutoNation was destroying the “growth at any cost” culture. “We wanted entrepreneurialism, but we also wanted the highest standards of integrity,” he says. Over the next three years, he worked hard to nurture and recruit the right people for the company’s top 350 positions and to purge the “high-performing money makers whose risk profile would keep you awake at night.” This amounted, he says, to a cultural revolution that has delivered a sustainable competitive advantage—and one that he isn’t about to jeopardize by shedding his best talent.

Lafley too feels that the culture he worked hard to build at the beginning of the decade at P&G has paid off. Concerned that the company had become too inward looking, he flipped that around. “Take trust. We only ever talked about it in relation to employees. But what matters most now is that consumers trust our brand, that shareholders trust our stock, that customers trust us to be the best supplier, and that suppliers trust us to be their best customer.”

At Travelers, Fishman is proud of the culture he has nurtured, which rewards returns on capital rather than revenue and has offered some protection during the financial crisis. “We never criticize anyone for a transaction not done, not ever—not ever,” he says.

**Keep faith with the future**

“*If you don’t invest in the future and don’t plan for the future, there won’t be one.*”

—George Buckley, chairman, president, and CEO of 3M

CEOs and their leadership teams need to remain forward looking despite the near-term pressures their businesses might be facing. There are opportunities in a crisis, even though that notion is too lightly bandied around when companies and their employees come under real stress. Many of the CEOs we interviewed were determined to ensure that their companies emerge from this recession with a competitive advantage by setting the course for higher productivity, acquiring a footprint in a new market, or not squandering a company’s talent or reputation in pursuit of lower costs.

Likewise, at P&G, Lafley continues to look for growth opportunities through alliances and acquisitions and is increasing the company’s investment in R&D and innovation. His efforts require resolve. “We’re keeping the pedal to the metal on innovation, for example, but it’s not always easy when people are complaining about your short-term profit performance. You have to get the balance right between the present and the future, but we want to come out of this recession stronger than when we went in,” he declares.

‘My challenge has been to keep driving the transformation of the company while still adapting to the realities of the present; you can’t cut the things that will impact your ability to reach your vision’
Nuti too acknowledges the difficulty of looking to the future while concentrating on a challenging present. When he arrived at NCR, in 2005, he was concerned that although the company was rightly focused on cost cutting to regain profitability, it had no plan for the future. “My challenge, up to and including the last six to eight months, has been to keep driving the transformation of the company while still adapting to the realities of the present. You can’t cut the things that will impact your ability to reach your vision.” Nuti suggests using a scalpel rather than an ax. The ax will make the biggest dent on costs and make you look smart for a while. But the more precise scalpel can protect a company’s future, even if there are fewer short-term gains.

None of the CEOs we interviewed claimed to have attempted anything revolutionary. What was evident, however, was their resolve in pursuing the principles they thought were right, often in the face of opposition. Leadership becomes increasingly important in tough times, when so much is at risk—but it can be even harder to exercise. The leadership “musts” described in this article have made the greatest difference for these CEOs on the front line.
Long a major force in India, the Tata Group is quickly establishing a global presence. With a combined market capitalization of more than $32 billion and operations in every major international market, Tata owns companies in businesses as diverse as consumer products, energy, engineering, information systems, communications, services, and materials.

The group's largest business, Tata Steel, was established in India in 1907 and retains its headquarters in Mumbai. In recent years, the company has expanded both within Asia (by acquiring Thailand's Millennium Steel, now called Tata Steel Thailand, and Singapore's NatSteel Asia) and outside it (through the 2007 acquisition of the UK company Corus, as well as a host of smaller acquisitions, joint ventures, and associations). These now place Tata among the world's top ten steel manufacturers, and one with a unique perspective on integrating new acquisitions. According to the group CFO of Tata Steel, Koushik Chatterjee, the company sends only a few people, not planeloads of employees, to do the job—an aspect of what he describes as a sincere effort to create a partnership that jointly develops a vision for the combined company.

Recently, Chatterjee discussed this approach with McKinsey partners Richard Dobbs and Rajat Gupta. During the conversation, he explained the impetus behind the group's acquisitions abroad,
the effects of the global financial crisis on the steel industry and Tata Steel, and the company’s efforts to improve the efficiency of its operations. The crisis, Chatterjee notes, makes opportunities more apparent—and restructuring more critical for the company’s long-term health.

**McKinsey on Finance: Last year was the first in which Asian and Indian companies acquired more businesses outside of Asia than European or US multinationals acquired within it. What’s behind the Tata Group’s move to go global?**

**Koushik Chatterjee:** India is clearly a very large country with a significant population and a big market, and the Tata Group’s companies in a number of sectors have a pretty significant market share. India remains the main base for future growth for Tata Steel Group, and we have substantial investment plans in India, which are currently being pursued. But meeting our growth goals through organic means in India, unfortunately, is not the fastest approach, especially for large capital projects, due to significant delays on various fronts. Nor are there many opportunities for growth through acquisitions in India, particularly in sectors like steel, where the value to be captured is limited—for example, in terms of technology, product profiles, the product mix, and good management. India actually needs a faster pace of increased organic capacity in steel in the near future to meet its growing demand.

So to pursue our overall growth strategy, we needed to go beyond India. And as the first step, we looked at the ASEAN\(^1\) rim for our initial acquisitions, due to the nearness of the markets. When we acquired NatSteel Asia, headquartered out of Singapore, in 2004, it gave us immediate access to six markets in the region, including Malaysia, the Philippines, and Vietnam. They may not be very big now, but these countries have meaningful populations and are on a trajectory for growth over the longer term, making them very attractive for the future. And by the way, these first regional acquisitions also let us test the waters of M&A and taught us how to run a transnational business, to understand the cultural issues, and to integrate larger organizations.

**McKinsey on Finance: How do you think about the synergies of those smaller acquisitions compared with larger ones, such as the recent Corus deal?**

**Koushik Chatterjee:** Obviously, the synergies are larger for larger acquisitions and smaller for smaller acquisitions. At Corus, for example, one part of the company had very efficient operations, and the other part had lots of potential for improvement. Tata Steel itself went through a phase, in the 1990s, when it transformed itself into the most globally competitive company in its sector from a not-so-competitive one. We feel that there is a similar transformational journey ahead for Corus. That’s the work we’ve been doing since the acquisition.

The size of the overall improvement is obviously pretty significant in Europe. The aggregate performance-improvement gains have been nearly £400 million since the acquisition, up to September 2008, on a base EBITDA\(^2\) of around £700 million for 2006, the year before the acquisition.

The present slowdown or reversal in the economic environment obviously affects that journey, due to the severe contraction of demand in Europe, but we have reworked our short-term strategy at the same time as we continue to work on longer-term structural issues for our European operations.

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\(^1\) The Association of South East Asian Nations: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

\(^2\) Earnings before interest, taxes, depreciation, and amortization.
McKinsey on Finance: In your approach to acquisitions, what kinds of things do you do differently from other companies?

Koushik Chatterjee: If you look at the literature about how to acquire and integrate a company, it typically says that you put in your own people, who understand your objectives, and have them drive the new company, aligning the acquired company's people, processes, and systems with those of the acquirer. We haven't been doing that with the conventional rigidity of an acquirer. From a mind-set perspective, we quite genuinely tend to look at an acquisition as a partnership rather than an acquisition. If a company is listed in the public markets, in form it will obviously be an acquisition, but in substance it could be a very good partnership if we align the objectives across the organizations. We don't send planeloads of people into a new company. Instead, we only send in a few integrators. That's been the key interface.

We also tend to cocreate a vision for the enlarged organization rather than just imposing our own. For example, after we closed the transaction for Corus, on April 2, 2007, we worked together for the next six months on cocreating a vision for the enlarged enterprise. And in that vision we asked questions. What are our objectives? What are our strengths and our weaknesses? How do we leverage those strengths—such as people, R&D, access to new markets, and our organic-growth pipeline—to achieve the vision? If the vision exercise isn't shared or if the process isn't participative, then the acquired organization's willingness to be part of the future action plans and the consequent accountability will be much lower.

McKinsey on Finance: Do you see any risks in this approach?

Koushik Chatterjee: The risk is that if the approach is more for show rather than a concrete action plan, then it will just fall by the wayside. So we need to ensure that the building blocks are in place, that we are all aligned in creating a shared vision, and that we follow the action plan. This approach requires a lot of maturity from the senior leadership on all sides, as it depends on a great deal of adaptability to new situations, cultures, and sensitivities. It's not easy to do.

We don't have a prescriptive integration manual, but we attempt to engage at various levels. The risk is that it takes time to positively influence a large organization or even to establish trust in the sincerity of the shared vision. But I believe that when we eventually establish that trust, things move faster; you don't have to go around reassuring people. This was demonstrated by our European colleagues, who reacted very fast to the global economic crisis last year, when we realized Europe would be significantly affected. A short-term program, “weathering the storm,” was launched, which gave us very significant value—over £700 million—in the six months between October 2008 and March 2009. The program continues even today, with significant savings forecast for this year too, and we think some of the savings will remain, due to better practices adopted in the past ten months. This program demonstrates the organization's keenness and motivation to react to this unprecedented crisis.

We also share and adopt good practices across the organization through performance-improvement teams, lending credibility to the concept of shared change. This gives employees in the acquired organization a sense of confidence that they too have good things that the parent company is absorbing. This approach builds trust in the partnership and in the whole target-setting
process. But it is much, much harder than the structured route, which would typically say, “We do these five things, and therefore these five things must be done by everyone.”

McKinsey on Finance: What cultural barriers do Indian companies face when acquiring a European company?

Koushik Chatterjee: First, we have to accept that there will be differences in cultures; one cannot make a single-culture organization. But it is critical to build a uniform performance culture. By that, I mean how we think as one enterprise and set targets for the larger organization, how we go about realizing the group vision—including how we benchmark performance and identify sources of value—and how we measure less tangible actions and behavior. These things are especially relevant now because there are no standard operating procedures for overcoming a global financial crisis.

So how can you build a culture that does not fear failure and tends to break barriers—and that goes right down into the organization? And as an
Indian company, how do you welcome new family members and make them comfortable? The Indian mind-set is generally not rigid and has significant empathy. We are generally enthusiastic about welcoming people from different geographies, with different languages, and are proud to be a truly global organization. The inclusiveness of the Indian mind-set helps in building a global business, especially when that mind-set is reinforced by a structured emphasis on profit and value creation for the stakeholders. At the same time, an inclusive-partnership approach doesn’t mean that we are shy about making the tough decisions if they are in the long-term interest of the organization.

McKinsey on Finance: What has the financial crisis meant for Tata Steel?

Koushik Chatterjee: It’s actually been different across our three hubs—Southeast Asia, India, and Europe. Europe has been affected the worst, as the size and impact of the contraction has been severe. Southeast Asia is kind of a mixed bag. Thailand, for example, had been affected by the crisis much earlier than elsewhere in the region because of the political and general economic situation there.

Singapore is a different story because when we acquired NatSteel, in 2004, it had around 60 to 65 percent of the Singapore construction market, which at that time was around 15 billion to 17 billion Singapore dollars. By 2007, that market had increased to around 30 billion Singapore dollars. With the help of government-supported construction during this crisis, it could still be 22 billion to 24 billion going forward. And while that’s worse than 2007 or 2008, it’s still much higher than 2004. For the entire Southeast Asian business, we are focusing more on cost competitiveness through improved operating practices and tight working-capital management and also ensuring that we improve our market share in the region.

In India, we are actually increasing our production base for steel, even as the rest of the world is contracting. We’ve commissioned a 1.8 million-ton-capacity expansion, for a total of 6.8 million tons, and we are going to produce and sell 20 percent more in the financial year ending in March 2010. And we continue to work on the continuous improvement of our operating practices and to raise the bar on cost competitiveness. We are also enhancing our capacity further, by around 30 percent, over the next two years.

In Europe, we have been able to maintain supply discipline to match the demand contraction. At Tata Steel Europe, the production cuts have
been significant, matched by a very strict focus on the management of spending and a contraction of the cost base, as mentioned earlier, through the weathering-the-storm program. For the longer term, we’ve launched a program to reconfigure or realign some of the production facilities in Europe, especially in the United Kingdom, and to make them more competitive.

**McKinsey on Finance: Has the weak economy affected your restructuring plans?**

**Koushik Chatterjee:** What we have planned and announced is a long-term restructuring of our European operations. The scope and extent of the restructuring depend on the opportunity to fundamentally alter the competitive position of the business. During a cyclical upturn, some of the opportunities remain hidden, as the businesses actually keep generating cash flow and earnings by riding the cycle rather than being fundamentally strong. The problem a company faces is to figure out how much of its performance is cyclical and how much is fundamental—and to find the right time to do this exercise.

The crisis causes the opportunity to become more apparent—questions about performance inevitably rise to the surface—and then it becomes imperative to make the hard decisions. I believe stakeholders understand why it’s necessary. It also costs money to restructure, and one has to balance the priorities: to retain liquidity and yet undertake fundamental restructuring to create long-term value.

Economically, the cost of restructuring marginal activities is higher in good times because they are making money—the problem is that you don’t want to restructure them when they’re making money, even though you know that you’ll have to do it eventually. So the question is when to actually do it.

**McKinsey on Finance: What has the crisis meant for how you, as a CFO, spend your time?**

**Koushik Chatterjee:** Since the Corus acquisition, we have become a large, diverse organization in a very short time, adding significant complexity to the business, which means I spend a lot of time focusing on performance management, capital allocation, and liquidity management. But we’d been building a liquidity cushion and buffers long before the crisis. I think the best time to raise capital is when you don’t need it immediately but have a long-term deployment strategy in place. That gives you the leeway to get the best out of negotiations with the providers of capital, because you’re not under duress. These last six months have reaffirmed my view on that point, and our buffers are in long-term capital—three, five, or seven years—that won’t need refinancing in the short term. We have also raised equity recently, which will be deployed in some very attractive capital projects, especially the growth projects in India. Given the volatility and uncertainty of the global environment, it is important to keep an adequate liquidity buffer.

Furthermore, I’m extremely focused on generating cash savings in the broader organization. There has to be enough tightness to make business units go on pushing operating improvements to ensure further reductions in working capital and spending management. The best people to identify and reduce costs or spending are the people in the business. I also firmly believe improving working capital is primarily a role for operating functions, not the finance function. But the finance function can be a very effective partner in improving working capital, and my colleagues in the finance
function and I find that a large part of our time goes into looking at how that can happen, both on the revenue side and the spending side. We also have a pipeline of capital projects—especially the Indian expansion projects and the mining projects, which are value creating under any economic conditions—and therefore have to prioritize their capital needs.

Finally, the global financial markets may undergo a structural change in the near future. At the very least, we have entered an era of capital scarcity. Therefore we need to look at the capital structure and ensure that the balance sheet of the company has the right mix of debt and equity and that the liquidity from these sources is deployed in the most effective manner. Also, the source of capital is fundamentally debt or equity, and each has its own risk–reward servicing implications. The structured-finance approach, which had developed very significantly through hybrid instruments in recent times, possibly went too far and did not help the investor and the issuers. Instead, it tried to hide the true risks and drove a return profile that was artificial. Therefore, a key part of my engagement is devoted to developing the blueprint of a sustainable and value-creating financial architecture for the company—covering several aspects, including capital structure, future financing, cost of capital, liquidity management, and effective capital allocation principles.

**McKinsey on Finance:** How do you keep the organization aligned with such a complex agenda?

**Koushik Chatterjee:** Communication plays an important part in ensuring that the organization is geared up to the challenges. The key is to make finance, which is often remote, understandable to people in the business. To do this, we use the five Cs: costs, contribution, capital expenditure, capital preservation, and cash flows. While not rocket science, this simplifies finance into the five levers that the organization should focus on.

To illustrate, when knowledge of the crisis broke, last October, my CEO asked me to make a presentation to the union leadership in India to make them aware of the global financial crisis as it was unfolding. “In the language they are familiar with and the form in which they understand easily” was his brief. This presentation was intended to alert them to the forthcoming challenges, so that they could in turn communicate the same to the wider workforce. At the end of the meeting, there were many people from the union who asked what they should do to ensure Tata Steel emerges stronger from this crisis. That approach from the wider organization is our strength to counter any downturn—the element of self-belief and can-do spirit is quite extraordinary.  

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As the global financial crisis ebbs, discussion among corporate, government, and opinion leaders everywhere reflects deep uncertainty about the postdownturn “new normal” of the world economy. Which nations will become its growth engines? Where will new business opportunities arise? How will global trade and savings imbalances evolve?

Much depends on the future of consumer spending—now nearly 60 percent of world GDP. Many companies that formerly counted on the United States and Europe as key growth markets are bracing for lower growth. Consumers in these advanced economies will eventually start spending again. Nonetheless, the aging of the baby boomers, coupled with depleted retirement savings and the likelihood of a rising long-term tax burden, means that consumption will probably expand less rapidly than it did before the crisis.

The new middle class in China and other emerging markets could play a key part in picking up the slack. McKinsey research estimates that by 2015, these countries will add a billion or so middle-class consumers, with extraordinary spending potential in the aggregate. How quickly this new army of customers can muster and how aggressively its members spend will be critical factors in the post-crisis world’s trajectory.

CEOs and CFOs planning for recovery and growth should take note, particularly of the possibility that 

A more consumer-centric Chinese economy would generate more jobs, spread the benefits of growth more equitably, and even grow more rapidly. Global companies should take note.
China could become a global driver of consumption, in addition to its current role as a manufacturing center. While that country may have suffered its first export decline in seven years during 2008, its economy is still projected to grow by 8 percent this year. Moreover, China’s leaders have already announced plans to increase consumption as part of a long-range attempt to rebalance the sources of economic growth away from government-led investment. These and other initiatives could greatly boost Chinese consumption.¹

**A boom in consumption?**
When private consumption in China hit $890 billion in 2007, it was already the world’s fifth-largest consumer market, behind only the United States, Japan, the United Kingdom, and Germany. But relative to China’s huge population and stage of development, the country’s consumers still punched far below their weight. As a share of GDP, consumption stood at only 36 percent—half and two-thirds that of the United States and of Europe and Japan, respectively. Indeed, China’s consumption-to-GDP ratio is still the lowest of the world’s major economies, and it has fallen by nearly 15 percent since 1990, despite robust GDP growth. The speed and magnitude of this decline are unprecedented in modern history; even during the full-scale industrialization of the US economy during World War II, consumption never dropped below 50 percent.

Of course, there is no optimal consumption-to-GDP ratio, and some might argue that consumption’s 70 percent share of the US and UK GDP is just as unbalanced as China’s 36 percent. But something closer to 50 percent would bring China into line with its peers in Asia today. Raising China’s consumption to that level will be difficult, but even if the government does nothing at all, China is already on track to become the world’s third-largest consumer market by 2025 in terms of purchasing-power parity. Although consumption would rise only modestly, to 39 percent of GDP, China’s middle class would still grow to around 288 million households, about four times the number of America’s middle-class households today (65 million).

If Beijing acts only on policies it has already outlined—such as stimulating consumption directly, extending social provisions for health and education, and undertaking structural reforms that boost household incomes—consumption could rise to 45 percent of GDP. That would increase the country’s total GDP by around 6.5 trillion renminbi ($952 billion; 8 percent higher than it would be if the government did nothing to increase consumption) and private consumption by 8.0 trillion renminbi (26 percent higher). Still more aggressive policies to extend social protections and reform the economy’s structure could raise consumption to more than 50 percent of GDP, increasing the gross domestic product by around 11.9 trillion renminbi above the trend line, or some 3 percent of today’s global GDP at current exchange rates.

**Reluctant consumers**
Getting the Chinese consumer to spend more freely won’t be easy. Households in China currently save an extraordinarily high 25 percent of their discretionary income, about six and three times the savings rates in the United States and Japan, respectively. China’s rate is even 15 percent higher than Asia’s GDP-weighted average. The conventional explanation is that ordinary Chinese are naturally thrifty, as well as reluctant to spend money in view of the country’s inadequate health care and pension systems. Stitching together a safety net comprehensive enough to ease these anxieties will take time and require greater government spending. That spending...
Unleashing the Chinese consumer

will, of course, provide new business opportunities for health care providers and insurers. Yet it will also increase the share of state spending within the economy and therefore probably boost the consumption-to-GDP ratio by only 0.2 to 1.1 percent before 2025.

A still more important reason for the extraordinarily high savings rate is that, beyond China’s largest cities, there simply aren’t many attractive products and retail outlets, nor secondhand markets and e-commerce, and prices are relatively high. (Even in rural China, almost 70 percent of the people say they would prefer to shop at modern, Western-style malls, so there is probably huge unmet demand, as well as a major opportunity for international retailers eyeing the Chinese market.) Moreover, spending in China is also constrained by its people’s tendency to save for expensive big-ticket items. Encouraging the responsible use of credit cards—a promising area for financial-services firms—could raise China’s consumption-to-GDP ratio significantly by 2025. Enhancements to China’s consumer infrastructure could raise it 1.3 percentage points by 2015 and maintain this level through 2025.

**Structural reforms**

Changes in consumer spending and savings behavior are only part of the solution. Even if consumer-oriented policies halved China’s savings rate by 2025, this would increase the consumption-to-GDP ratio by only 2 to 5 percent. Structural reform of the economy is at least as important. China’s consumers have found themselves capturing an ever-smaller slice of a fast-growing pie: as the corporate share of the national income has risen, household income’s share has fallen from a peak of 72 percent of GDP in the early 1990s to less than 55 percent by 2007 (compared with more than 60 percent in Europe and more than 70 percent in the United States). By prioritizing investment and industrialization, China has crowded out consumers.

Breaking this cycle is a difficult long-term challenge requiring sustained and sweeping reforms—to the financial system, industrial policy, and international trade—that together could boost private consumption by 10 to 20 percent and China’s GDP by 1.8 to 2.9 percent. One key priority is a shift toward services. Heavy industry produces new jobs more slowly than the service sector does, so income rises more sluggishly. And in China, state-owned enterprises, which tend to dominate heavy industry, aren’t obliged to distribute profits through dividends and generally no longer give their employees the “iron rice bowl” of comprehensive social benefits.

The government’s 11th five-year plan (2005) targeted a 3-percentage-point increase in the share of services in GDP by 2010. If the government extended this goal by aiming to achieve such an increase every five years after 2010, services would reach 49 percent of GDP by 2025. Should China hit this target, in that year average household incomes would be 9 to 10 percentage points higher than they would on current projections, but the consumption-to-GDP ratio

China’s consumption-to-GDP ratio is still the lowest of the world’s major economies, and it has fallen by nearly 15 percent since 1990, despite robust GDP growth
would rise by only 2.8 percentage points, since huge investments in human capital and technology would be needed.

That’s why China should also improve the flow of income to households from investments, including mutual funds and other financial products, which currently account for less than 2 percent of average household income. Even in the short term, giving households access to a greater array of financial products and services would be effective. For every additional percentage point of income from investment-related sources by 2025, the consumption-to-GDP ratio should rise about 0.3 to 0.4 percent. As an illustration, it would go up by 1.2 percentage points if investment-related sources of income rose to 5.1 percent of total income.

**Prognosis: Good**
The country can probably make genuine progress, even within five years, in all three areas of reform—the direct stimulation of consumption, extended social protections, and structural economic reforms—because in China, the government has significant powers that help it orchestrate and implement policy initiatives quite rapidly. Beijing started to raise fiscal spending aggressively, for instance, during the same quarter when it announced the stimulus package, in November 2008. Other governments needed many months to prime the pump.

If China can boost its consumption-to-GDP ratio to between 45 and 50 percent of GDP by 2025, its GDP would rise by 8 to 15 percent a year. In addition, the economy would create 10 million to 50 million more jobs, and average household incomes would increase by 10 to 20 percent. The global implications of such changes are immense. China’s trading ties with the rest of the world would be less fraught with conflict, because its trade surplus would shrink by up to 40 percent. The country would account for more than one-quarter of all new consumption in the world over the next 15 years, raise the increase in global consumer demand by more than 10 percent from what it would otherwise be, and add $1.9 trillion a year to net new global consumption. That would make China’s consumption-to-GDP ratio equal to 40 percent of America’s in 2025, up from just 12 percent today—a new normal, indeed.

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