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Corporate (Re)financing and Restructuring Trends in Germany



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Corporate (Re)financing and Restructuring Trends in Germany

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AT A GLANCE

Germany's corporate-finance landscape has grown complicated, characterized by a period of historically low interest rates and a stagnant corporate credit business, among other changes. Businesses must craft new approaches to get needed financing; banks must remain relevant and better serve their business customers. This is particularly true for restructuring and refinancing situations.

INSIGHTS FROM GERMAN COMPANIES' EXPERIENCE

Many companies wait too long before generating fresh capital or refinancing during restructuring. To gain room to maneuver in these situations, companies must prepare adequately and initiate restructuring and refinancing processes early. They also need to have enough backup sources to bridge liquidity shortages, and should apply internal financing options before asking for fresh money.

NEXT STEPS FOR BUSINESSES AND BANKS

German companies facing a liquidity crisis—whether potential or realized—should cultivate close connections with select financing partners; be wary of high-risk alternative financing instruments; and establish fiscal reserves. Banks should help business customers understand the implications of complex refinancing situations and rigorously manage corporate loans that they do issue.

POWERFUL FORCES HAVE BEGUN to reshape Germany's corporate-finance landscape just as they have done in other Western nations. These forces include an increase in the issuance of corporate bonds, a rise in alternative sources of financing, and a decrease in the role of traditional banks in corporate financing—to name just a few. As these trends gain momentum in Germany, they are making corporate finance more complex than ever, especially in the realm of financial restructuring. Moreover, they are presenting businesses and banks alike with new opportunities and challenges, as well as raising questions about banking's long-time role in corporate finance.

To navigate successfully in this environment, corporate executives and traditional financial-services providers must understand how corporate finance is changing in Germany and what these shifts imply for their organizations. Then, executives need to devise new ways to get the financing that their enterprises require, whether for ongoing growth or for financial restructuring efforts. Traditional banks, for their part, have to craft strategies to remain relevant.

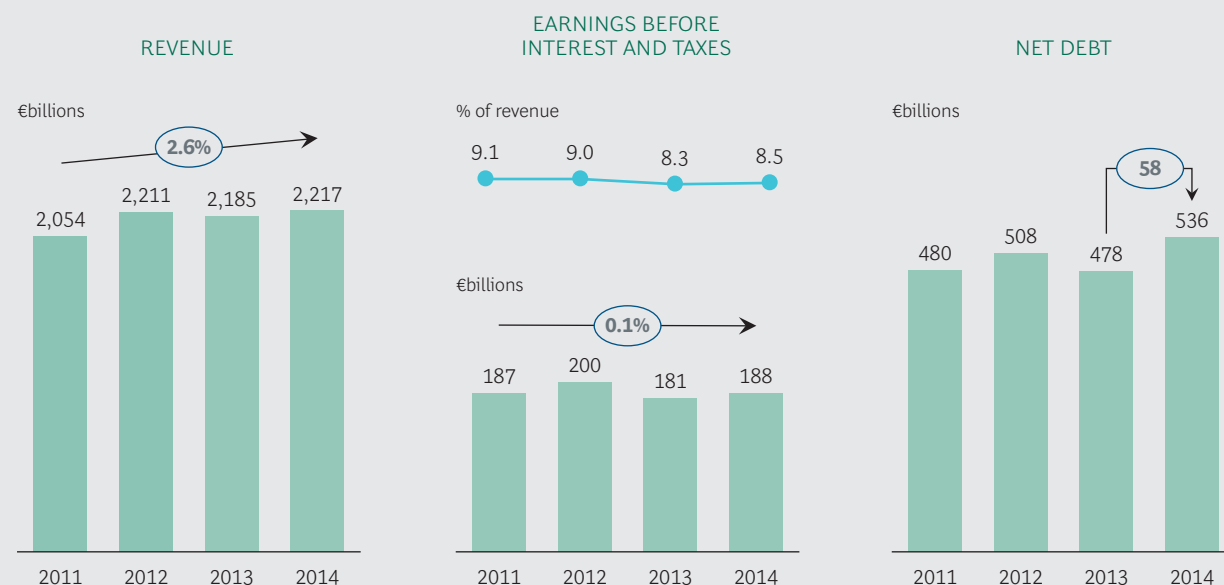
With these themes in mind, The Boston Consulting Group set out to analyze a number of companies that have undergone restructuring and refinancing. Our investigation of these companies' experiences generated insights that we believe will prove useful for other businesses facing similar scenarios as well as for traditional banks.

New Complexities for German Corporate Finance

The need for financing among German companies has intensified, thanks to an uptick in growth among many European corporations, which has been fueled by overall economic recovery in the region since 2011. In a 2015 study of roughly 600 companies across 22 industries (most of them in Germany but some in Austria and Switzerland), BCG found that revenues rose by more than 2.6% per year from 2011 through 2014. In that same time frame, earnings before interest and taxes declined slightly. Meanwhile, net debt increased from €480 billion in 2011 to €536 billion in 2014, with the most pronounced rise from 2013 through 2014. (See Exhibit 1.) An increase in net working capital was the primary driver of the €58 million jump in net debt over those two years, accounting for €39 million of the total (67%). Trade receivables rose from €411 billion to €444 billion; inventory, from €236 billion to €256 billion. Meanwhile, trade payables went from €225 billion to €239 billion. Overall, working-capital days went from 71 to 77 from 2013 to 2014 for the companies in our study. These numbers suggest that additional financing was needed for increased working capital as a result of growth. However, eroded working-capital efficiency also led to increased financing, as the statistics about working-capital days imply.

Powerful forces are making corporate finance in Germany more complex than ever.

EXHIBIT 1 | Corporate Growth Has Intensified the Need for Financing



Source: BCG analysis.

Note: Based on a 2015 BCG industry study of approximately 600 companies in 22 industries in Germany, Austria, and Switzerland.

Thankfully, central banks have continued to provide the markets with low-interest financing. Indeed, from 2007 to 2015, the European Central Bank's assets soared by more than 122%, while its main refinancing rate declined by 3.45 percentage points. There seems little sign of an imminent turnaround in interest rates. The euro inter-bank offered rate has remained close to zero since 2012, down from 1.6% in the third quarter of 2011. In addition, the forward-swap curve suggests that we won't see a dramatic increase in interest rates leading up to 2020.

The anticipated ongoing low rates should represent good news for finance-hungry businesses in Germany. But the developments that have begun complicating Germany's corporate-finance picture are presenting new challenges for companies as well as banks and other players in the restructuring community. Below, we examine the most significant among these developments.

Stagnant Corporate Credit. Despite positive developments in the European economy, the corporate credit business in Germany remained stagnant in the first few years following the global financial crisis. From 2010 through 2014, credit volume in German companies declined slightly, from €894 billion to €891 billion, even as indexed GDP for Germany rose from 100 to 106. This minimal participation in financing by traditional banks stems in part from their increased capital requirements and their reservation of capital in 2013 for the European Banking Authority stress test and asset quality review. This effect intensified with creditors' participation in the bailouts of European banks. To keep their credit rating, German banks had to maintain a capital ratio even higher than that required by Basel III. All of this has led to stagnation in corporate credit volumes provided by banks, despite businesses' increased need for financing to fuel growth.

Intensifying Private Equity Action. The number of transactions in which PE firms (both domestic and international) took over German target companies rose from 231 to 310 from 2010 through 2015, demonstrating heightened M&A activity and bullishness among investors to acquire and finance such companies. Moreover, EBITDA multiples of PE transactions with German target companies increased from 8.1 to 10.5 during that period. This indicates that PE firms are feeling pressured (thanks to low interest rates and scarce alternative investment opportunities for financiers) to invest their expanding funds in a limited number of available targets. The result has been stepped-up corporate buyouts on PEs' part.

At the same time, hedge funds have been on a renewed course of growth since the financial-market crisis, including financing in the distressed segment of the market. Assets under management in hedge funds worldwide jumped from slightly under \$474 billion in 2000 to slightly over \$3 trillion in 2014. The percentage of investment channeled into the distressed market rose from 2.5% to 3.0% from 2013 to 2014. For corporate financing in Germany, these trends imply that professional, and sometimes activist, investors have entered the arena to finance both performing and nonperforming companies.

The Heightened Role of Capital Market Instruments. In Germany, capital market instruments are playing an increasingly important role in corporate finance. Corporate bond holdings increased 7% per year from 2011 to 2015. From 2011 to 2014, proceeds from initial public offerings more than doubled—jumping from €1.5 billion to €3.3 billion. Meanwhile, proceeds from capital increases have risen from a historically low level of €12 billion in 2012 to €34 billion in 2014. The stronger role of capital market instruments partly compensates for the stagnation in banks' corporate financing and offers an alternative to heightened involvement in financing by PEs.

But bonds come with their own potential peril: the risk of a spike in defaults. Indeed, during 2014, a considerable number of bonds for small and midsize (SME) German businesses defaulted. Meanwhile, the number of bonds that will mature through 2018 has risen sharply, suggesting the possibility of further defaults and the need for financial restructuring. Bonds are sometimes used to generate easy last-resort financing via the capital markets. What's more, they offer forms of repayment (such as lump sum) and interest (such as payment-in-kind) that can be favorable for unprofitable businesses. But if companies haven't addressed their cash problems in the meantime, their coffers may be empty when their bonds mature. Companies with bond financing that face this situation are also more complex to refinance because of the many small bondholders that are hard to control. These companies are thus at greater risk of bankruptcy.

Capital market instruments are playing an increasingly important role in corporate finance.

Financing Alternatives. Alternative sources of capital (such as mezzanine lending and promissory notes) are not expected to play a large role in Germany's corporate-finance environment in the near future. Most of these programs have proven to be unsuccessful because of high default rates and downgrades and are not expected to be renewed because of their declining popularity. But online-only financial-technology players—the so-called fintechs—are entering the financing business elsewhere around the world, especially in the US and Europe but also in Asia. These companies support a range of finance-related activities, such as payment services, invest-

ment advice, and crowd or peer-to-peer lending. A vast number of such players are now doing business, and crowd investment in Germany—essentially nonexistent in 2011—was expected to reach €164 million by the end of 2015 (extrapolated from data for the first quarter of that year). We expect fintechs to also venture into the corporate-finance realm, given their considerable success to date in providing other finance-related services. Though fintech activity is increasing in Germany, the trend is still nascent. Thus, it's difficult to know how it may evolve in the long term and what impact it may have on Germany's corporate-finance landscape.

Traditional banks' declining role in corporate financing—combined with the rising use of PE and hedge funds, corporate bonds, and fintech services—underscores the new levels of complexity in the German corporate-finance arena. Raising capital for a corporation, as well as implementing a financial-restructuring effort, now constitutes a mix of measures—a situation that contrasts sharply with the bank-dominated model that had long prevailed. This scenario presents both opportunities and challenges for all members of Germany's restructuring community, whether they're workout bankers, PE investors, corporate lawyers, or businesses that are either seeking financing to support growth or facing a financial or other kind of restructuring scenario. German SMEs, in particular, will find the new environment most challenging, given trends such as investor activism and the complexities that come with restructuring capital market financing as opposed to obtaining bank loans.

Insights from German Companies' Experience

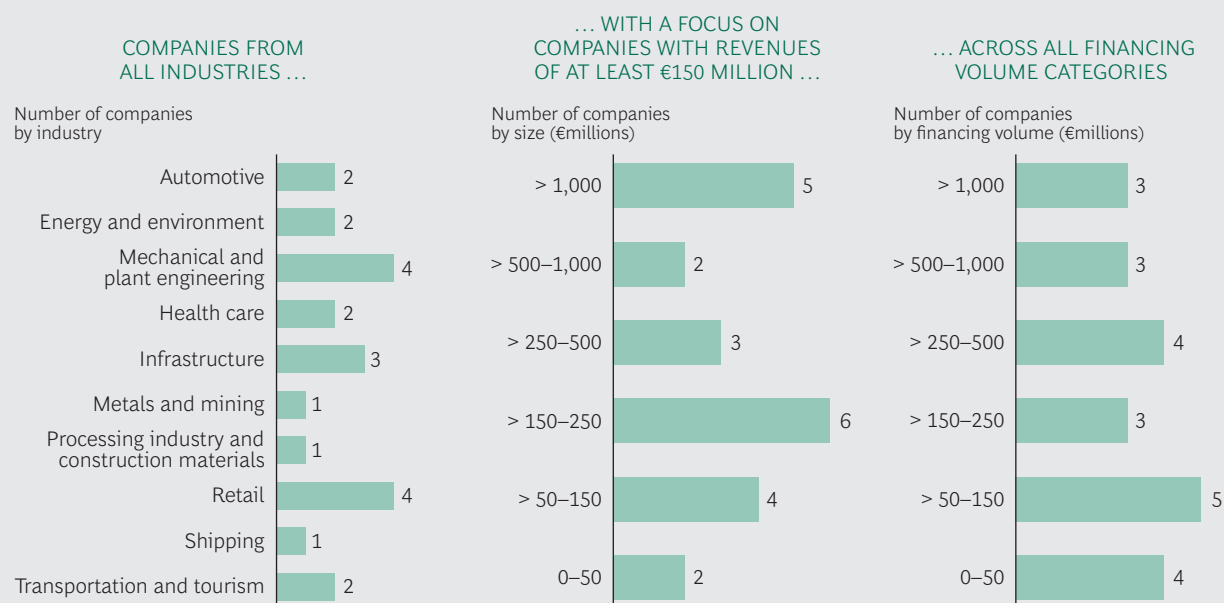
With the unique situation of German SMEs in mind, BCG analyzed 22 such companies that had undergone restructuring and refinancing at some point between 2012 and 2015. The intent was to identify practices that led to successful restructuring and refinancing efforts, which were defined as those that avoided insolvency proceedings. Most of the companies were based in Germany, though some were based in Austria or Switzerland, and all had engaged BCG to support the refinancing efforts they were undergoing—for instance, to help them define a restructuring concept, compile a going-concern prognosis, conduct refinancing negotiations, or implement a restructuring concept. Of these companies, 82% were aiming for an out-of-court solution, with the goal of avoiding having to file for insolvency. And within that group, 83% achieved the goal.

Traditional banks' declining role in corporate financing underscores the new levels of complexity.

The average revenue for the selected sample was €765 million; the average number of employees, roughly 4,100. Participating firms represented ten different industries: automotive, energy and environment, mechanical and plant engineering, health care, infrastructure, metals and mining, processing industry and construction materials, retail, shipping, and transportation and tourism. The majority of the companies in our sample had revenues of at least €150 million. Though average financing volume was €464 million, there was considerable diversity in volume size. For example, the companies were spread fairly evenly across six financing-volume categories, the smallest being €0-50 million; the largest, greater than €1 billion. (See Exhibit 2.)

To conduct the study, we asked the BCG project leaders who had worked with the selected companies on restructuring to complete a survey. Comprising more than 40 questions, the survey focused on topics such as the client companies' previous fi-

EXHIBIT 2 | A Closer Look at the Study Sample



Source: BCG analysis.

financing structure, the financial-restructuring measures initiated, and the refinancing process those businesses experienced.

Analysis of the survey responses showed that almost all of the companies in our study were facing a liquidity crisis and needed financing to fund restructuring measures or to bridge short-term working capital or liquidity needs. These findings suggest that companies tend to take action to generate fresh capital and apply restructuring measures only *after* crisis strikes. This approach contrasts sharply with one focused on establishing disciplined crisis-prevention practices, such as initiating restructuring measures at an early stage.

Moreover, while most of the companies we examined still had a good equity ratio, their gearing ratio (defined as the proportion of net debt to EBITDA) was in poor shape from the beginning of the restructuring efforts we supported. Indeed, all but two of the businesses were subinvestment grade, with a gearing of 3.5 or above. In such cases, debt level is said to be no longer sustainable, indicating that a company has waited too long to take action and may be unable to make full interest payments and repayments on debts in the future. Compared with gearing, equity ratio offers little insight into a company's financing problems and its future ability to repay its debt.

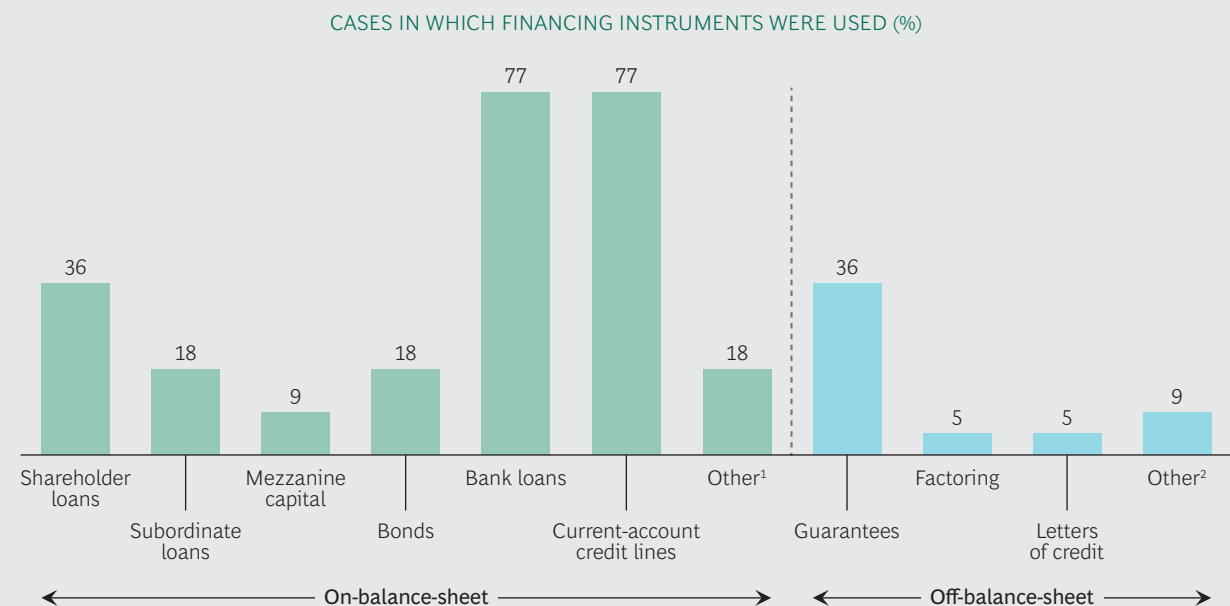
We also found that at the beginning of restructuring, many of the companies involved still had limited free funds available. Indeed, as much as 14% of total available financing volume consisted of free liquidity. But the companies needed additional financing to survive the subsequent one to three years and to apply the measures laid out in their restructuring concept. In fact, on average, the new financ-

ing required by our study respondents was 20% greater than their available financing in terms of volume. The good news is that, in more than half of the cases we analyzed, the companies still had uncollateralized assets that could be used to generate the needed additional financing—giving them room to maneuver during crises. The lesson here is that companies can gain some advantages by retaining a reasonable degree of backup sources, even during flush times.

As for the financing instruments used in the initial restructuring situations we examined, traditional financial sources dominated, in the form of bank loans and current-account credit lines. But we also saw some use of other on-balance-sheet instruments, such as shareholder loans, mezzanine capital lending, bonds, leasing, and swaps. In terms of off-balance-sheet instruments, many of the companies used guarantee facilities (such as bank guarantees), while a few used factoring, letters of credit, reverse factoring, or sale-and-lease-back lines. (See Exhibit 3.) Bank financing still made up a noticeable portion of the financing-instrument picture for these companies. But we expect that it will recede in response to the above-mentioned trends, particularly the increased use of capital market instruments and PE firms' or hedge funds' involvement in refinancing programs.

When it came to types of measures taken for the restructuring and refinancing situations (such as equity, debt, liquidity, and government funding), debt measures dominated. (See Exhibit 4.) In addition, for many of the companies we studied, fresh money came in only by way of shareholders, through either capital increases or shareholder loans, suggesting that the financiers involved sought to reduce their

EXHIBIT 3 | Companies in the Study Used a Mix of On- and Off-Balance-Sheet Financing Instruments

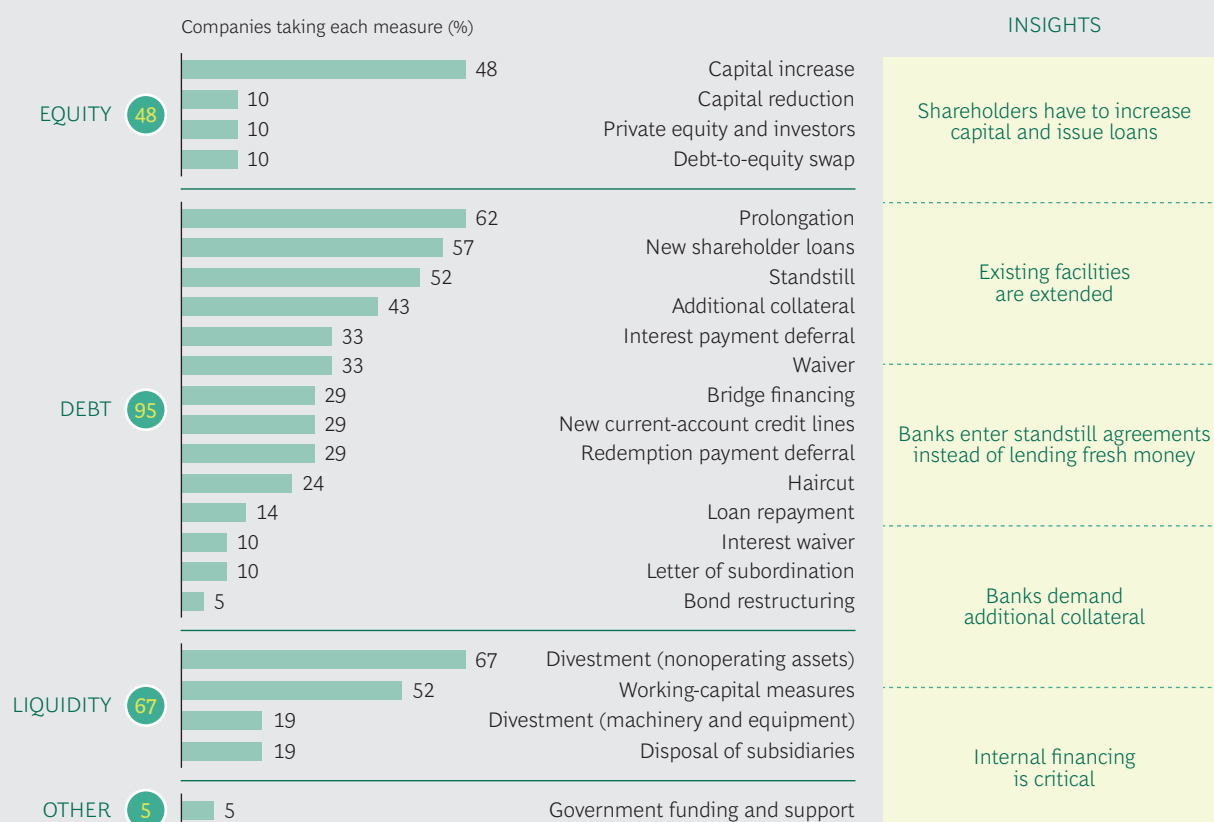


Source: BCG analysis.

¹This category was made up of 75% leasing and 25% swaps.

²This category was made up of 50% reverse factoring and 50% sale-and-lease-back lines.

EXHIBIT 4 | Measures Taken by Companies When Refinancing in Restructuring Projects



Source: BCG analysis.

risk positions. Indeed, 57% of the companies cited issuance of new shareholder loans as a debt measure taken, and 48% cited fresh capital coming from capital increases. Sixty-two percent chose to prolong existing external debt, while 52% signed standstill agreements. In 43% of the companies, financing parties demanded additional collateral, whereas only 29% took on additional external debt or deferred repayments. This suggests that financiers demanded additional collateralization, whether to extend financing or to just stay on board. On the other hand, extensive liquidity measures often had to be taken, particularly if fresh money was requested. Divestment of nonoperating assets topped this list (67%), followed closely by working-capital measures (52%), which suggests that internal financing continues to be relevant in restructuring situations.

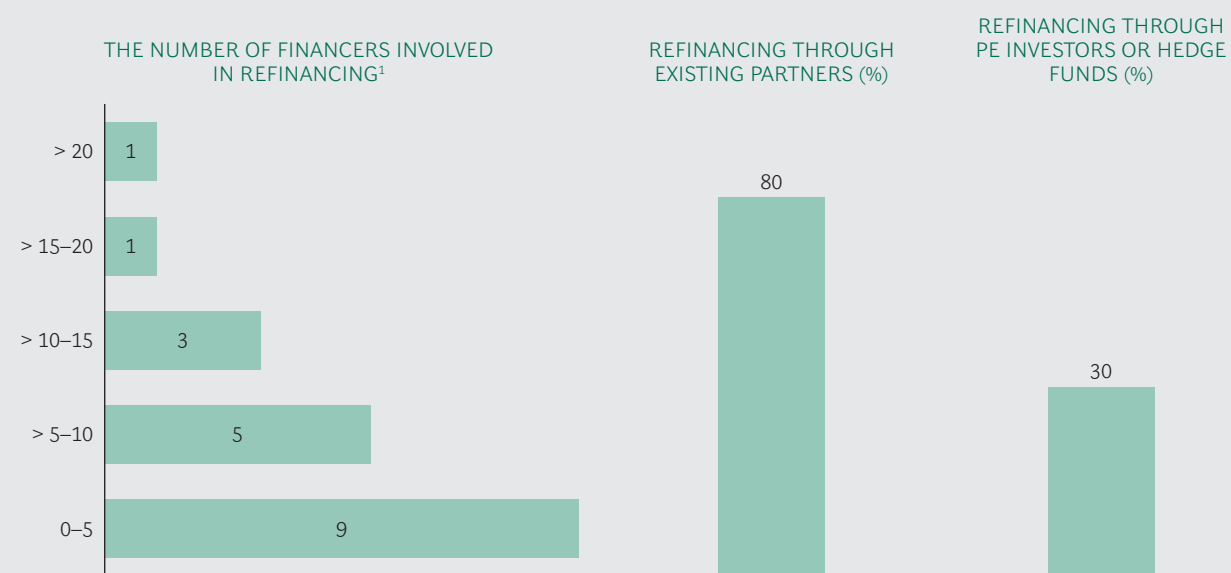
The upshot? Caution is clearly the watchword for banks involved in restructuring situations. Shareholders must give everything they have in terms of available financing before banks consider providing fresh loans. Indeed, banks want to see companies applying other options first, such as prolongation, standstills, debt-covenant waivers, and exhaustion of available collateral. In short, before lending money, banks require that a company exhaust all its internal sources of financing, including net working capital and asset optimization.

In addition to looking at restructuring measures taken, we analyzed typical participation in refinancing scenarios for companies in distress. Most of the restructuring situations in our study involved 10 to 15 financiers, with a few entailing as many as 50. Just over half included foreign financiers and involved banking syndicates. But in most of the cases we examined, only a few financiers were also actively involved in the refinancing process. In nine of our cases, fewer than five financiers were engaged in the refinancing process and provided financing to the firms. In 80% of the cases, refinancing was done primarily through existing partners, while only 30% of the cases entailed the participation of PE investors or hedge funds. (See Exhibit 5.)

These findings have two implications. First, companies need to approach their existing financiers early, through open and trusting conversation. This can involve bilateral discussions as well as talks with a group comprising the most important parties. Second, companies need to take a dual-track approach, initiating an early search for new financiers (such as PE firms) and reaching out to existing financiers. This helps companies leverage the full potential of investors hunting for adequate targets—an especially important financing source in the distressed segment.

Among our study participants, restructuring concepts required an average of three months to develop. Refinancing negotiations took an average of six months to conduct because of the more time-consuming nature of the negotiation process and the need for legal documentation of contractual restructuring and refinancing agreements. The lengthiest negotiations were characterized by the participation of PE investors or hedge funds, likely because searching for potential investors and conducting due diligence require considerable time, and companies must start the process early in a restructuring case. Such deals in our study took, on average, one

EXHIBIT 5 | Companies in the Study Refinanced Primarily Through Existing Partners



Source: BCG analysis.

¹Shareholders are generally counted as one partner, even if there are several; this category is not applicable in three cases.

and a half months longer to complete than deals that did not involve investors. Negotiations involving the use of corporate bonds as a financing instrument also took more time, because of the legal complexities involved in bond restructuring. In our analysis, such cases dragged on for up to three months longer, on average, than those that did not involve bonds.

The majority of the refinancing negotiations in our study were conducted by management or by external restructuring advisors. For some of these companies, additional external parties included investment banks, M&A advisors, financial advisors, legal advisors, and auditors. Equally interesting, in nearly half of the cases in our research, the refinancing effort involved a change in management (for instance, resignation or replacement of the CFO or CEO) and the hiring of a temporary chief restructuring officer (CRO). Engaging advisors and CROs makes sense, because it improves the odds of a successful restructuring. These experts are familiar with restructuring situations and have an objective view of each situation at hand. They are specialists who use proven tools and methods and bring significant restructuring expertise and experience to the table. They also have credibility in the eyes of financiers, often because they have cultivated long-lasting relationships with them during the resolution of former cases.

Interestingly, in 41% of the cases in our sample, insolvency proceedings were calculated and planned in parallel with out-of-court solutions by the acting persons, most likely supported by legal advisors specializing in insolvency law. However, only 9% of the cases ultimately ended up in court. A clear-eyed, objective evaluation of alternative potential courses of action, such as possible insolvency, helps a company prepare for multiple paths. Financiers also value this approach, because it helps them to understand the expected proceeds and insolvency quotas and to gauge the likelihood of recovering their exposure in a court scenario. Such transparency can also lead to more constructive negotiations and discussions in the course of a refinancing.

Next Steps for Businesses and Banks

Drawing on insights from our analysis of the companies in our study, we have identified specific actions that German businesses can take to improve the likelihood of a successful restructuring or refinancing effort in today's increasingly complicated corporate-finance arena. We have also identified steps that banks can take to more effectively manage the refinancing arrangements they decide to participate in and to serve as more valuable partners to their business customers in this challenging environment.

Businesses. For any German SME on a growth path, the ideal situation is to avoid getting into a liquidity crisis triggered by, for example, a sharp increase in the need for working-capital financing or capital expenditure financing, or a period of unprofitable growth. One way to avoid such crises is to enhance working-capital efficiency as the enterprise grows.

But for companies that nevertheless experience a liquidity crisis, regardless of catalyst, executives can boost the likelihood of not just surviving the crisis but emerging

A clear-eyed, objective evaluation of alternative potential courses of action helps a company prepare for multiple paths.

from it in a stronger financial position. One conclusion we have drawn from our analysis is that the earlier a company initiates the restructuring and refinancing process, the better its chances of survival. This is because the business is more likely to invest sufficient time in developing a restructuring concept that will prove sound. A comprehensive concept also calls for tapping all possible internal sources of financing (such as working-capital reduction and disposal of nonoperating assets) before approaching external sources.

Cultivating close connections with a few financing partners before a crisis strikes—for instance, by regularly engaging major partners on a bilateral basis—can further enhance a company's survival odds. That's because involving the right financing stakeholders early and openly can lead to constructive dialogue. Moreover, it strengthens financiers' trust in the company's management, which can erode if a business doesn't behave in an open, transparent manner.

Executives should also be wary of alternative financing instruments. As noted earlier, bonds, in particular, pose risks because they're more complex to refinance and because the lack of regular repayment schedules makes a company more vulnerable to default. In the case of bond financing, companies should work with a set of specialized advisors early on to determine ways to restructure the debt. Furthermore, companies should consider whether bonds are the right instrument for generating additional financing, particularly in restructuring situations. If the company cannot raise additional funds through other means, then it should seek help and initiate a restructuring program. Raising bonds without addressing the root causes of the liquidity crisis is just a stopgap measure.

What's more, companies need to accept that they probably won't find a traditional bank willing to support the resolution of a crisis without significant contributions by the company or its shareholders. With this reality in mind, forward-thinking executives will establish fiscal reserves in forms such as free collateral or options for shareholder contributions, take a dual-track approach in their search for new investors, and fully tap internal sources of financing before reaching out for third-party assistance.

The earlier a company initiates the restructuring and refinancing process, the better its chances of survival.

Finally, during a liquidity crisis, companies can also benefit by receiving help from individuals with the right expertise, knowledge, and skills, such as restructuring advisors, temporary CROs, and other types of experts. To select external advisors who can deliver the greatest value for the company and accommodate its unique situation, executives should look for individuals who have established strong networks with financiers (especially workout divisions in banks), legal experts specializing in restructuring and refinancing, and CROs who have lengthy experience in implementing restructuring concepts and initiating transformative change in distressed enterprises. Additional credentials include deep expertise in, and familiarity with, the industry a company operates in; detailed knowledge of the relevant regulatory environment; and considerable experience in managing corporate finance functions.

Banks. Given their changing role in Germany's corporate-finance environment, traditional banks should also consider how best to interact with business customers seeking to raise funds through this lending model. For one thing, bankers need to

help their business customers understand the factors that can accompany a complex financing situation that was developed to deal with a liquidity crisis. Contact persons at the bank may change, for instance, and customers may have to deal with more demanding experts on the bank's side. In addition, banks can work with customers to identify fiscal problems that could emerge in the future and help them proactively design solutions, even if a company is currently enjoying brisk growth. By providing such assistance, a traditional bank can become a trusted partner to business customers.

Banks should set up the right conditions for successful restructuring and refinancing.

For banks that do issue loans to business customers, it's vital to explain to these clients early on what the consequences will be for a company that misses targets on KPIs, such as the gearing ratio or interest coverage ratio. To safeguard their own financial health, banks will then need to follow through with those consequences if targets are indeed missed. Early in the process of considering whether to issue a loan to a company facing a liquidity crisis, banks must also clearly define what's required of the customer to seal the deal. Examples include shareholder contributions and management support by a qualified CRO.

Finally, when working with a business customer in crisis, banks should set up the right conditions for successful restructuring and refinancing, such as allocating sufficient time to develop a sound restructuring concept. These concepts address a range of critical questions, such as how the company's operations will be stabilized, what its financing needs are, and what strategic vision the restructuring is meant to realize. Banks can also help clarify roles and responsibilities for the refinancing process. For example, who might best serve as CRO, and what tasks and activities should he or she focus on? Who will lead implementation of restructuring measures, including defining and tracking progress toward operational and strategic goals? Like their corporate customers, banks considering bringing in outside expertise should carefully assess their options to ensure that the people they select have the right knowledge and skills.

POTENT FORCES HAVE begun transforming Germany's corporate-finance landscape, and that transformation will only gain further momentum in the coming years. As these changes raise the level of complexity in the realm of corporate financing, members of the restructuring community will encounter not only new opportunities but also fresh challenges, depending on the role they fill in that community. By adopting the best practices we've gleaned from our analysis of successful restructuring cases, German businesses can improve their chances of avoiding a liquidity crisis in the first place—and of emerging intact from such a crisis if avoidance proves impossible. Banks, meanwhile, can help customers in distress arrive at a productive solution by providing more valuable advice and by infusing discipline into their management of the corporate loans that they decide to issue.

Navigating through this increasingly complex landscape will not be easy. But companies and members of the restructuring community in Germany can take steps now to set the stage for effective restructuring and refinancing later. That upfront investment could pay big dividends for the players that prove willing and able to make it.

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