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To Survive or Thrive?

Gaining Competitive Advantage in an Economic Downturn

by Don deCamara

Everyone knows the proverb about finding opportunity in chaotic times. But what about lean times? In the traditional view, an economic downturn is something your business hopes to survive: hunker down, dial back on spending and hiring, and wait for the uptick that signals a return to business as usual.

But surviving isn't good enough, in lean times or anytime. Every business wants to grow and thrive. And by turning to a set of common-sense strategies now, you can position your company to thrive during a downturn by taking market share away from competitors, and be poised for breakthrough growth when the economy rebounds.

Chances are, the structure you're currently running is built on a set of circumstances that are already starting to erode. If you wait too long, your ability to make changes may become limited.

There are many signs that point to an approaching downturn. The subprime mortgage crunch has undercut a housing market that was already in trouble, and it has significantly reduced available credit needed to fuel other parts of the economy. The automotive industry continues to suffer; in 2007 U.S. auto sales dipped 3 percent across the industry. The housing industry continues a multi-year slide. Oil prices are on the rise, while consumer confidence—and non-government payrolls—are on the decline. Many analysts aren't talking about whether a recession is coming in 2008. They're talking about how severe it will or won't be.

Good times can mask deep-seated problems

When the economy is strong, businesses typically chase revenue growth with little to no focus on fine-tuning their operations. They may also deliberately approach human resources, product line diversification, inventory and other areas in ways that are calculated to make the most of the situation – to gather revenues while the gathering is good. But when the economy slows, these approaches can become liabilities.

While it never met the official definition of a recession (two consecutive quarters of negative growth), the downturn that affected the U.S. economy from 2000 to 2002 holds lessons for the way good times can mask inefficiencies in a business—and how some businesses can not only survive a downturn, but prosper during it.

During that period, the manufacturing sector lost significant value. External factors such as reduced orders and rising energy costs got the headlines, but these companies also suffered from factors well within their own control. The number of customers and products proliferated. Structural costs were high, and back-office costs weren't set up in a way that allowed them to vary with demand. Acquisitions and emerging-market investments created far-flung, poorly integrated operations. The common denominator? Companies were riding the policies of a boom into the realities of a bust, and their inefficiencies were coming unmasked.

What to hope for

It's easy to define "thriving" in ordinary or prosperous times. But what does it look like in a downturn?

- Sustained profitability
- Increased pricing leverage over competitors
- Increased market share
- Improved customer service
- Continued capital investment
- Minimal workforce disruption
- Surpassing investor expectations

Achieving these goals isn't a fantasy. In 2000-2002, a number of manufacturing companies, including Terex Corp., 3M, United Technologies and Danaher, outperformed the Dow Jones Industrial Average despite a tightening economy. United Technologies streamlined supply chain management and made cost-consciousness a company-wide initiative [1]. 3M used global sourcing to smooth out raw material cost changes [2]. Terex focused on product lines that were less exposed to price competition and used outsourcing to reduce fixed costs by 20 to 25 percent [3]. And Danaher invested in smart product development and used web-based tools to improve material procurement [4].

It can be done. Here are key strategies to consider.

- Grow smart
- Simplify your business model
- "Lean out" operations
- Shift fixed costs to variable costs
- Manage talent proactively
- Bolster planning discipline

Grow smart

One redeeming factor in a potential economic downturn is the lack of uniformity in the current global economy. Not every industry or market follows the general trend up or down. While demand in the United States may be declining, chances are that demand in Asia may be strengthening due to the weak dollar and the consumer strength from emerging markets. This gives smart businesses an opportunity to hedge against recession by investing in counter-cyclical areas – ones that experience increased demand when everything else is headed down.

Smart growth in a downturn also means focusing on products and services that are less price-elastic and subject to consistent demand. They will continue to provide market share and revenue, and in comparison to foundering competitors this may add up to a net gain. And it's never a bad time to innovate: offering a superior customer experience will shore up price realization and give clients new reasons to be loyal at a time when these relationships are tested the most.

Simplify your business model

When the economy is strong, a business can afford complexity: there's revenue to be earned, and adding product lines and customer channels can help bring it in. The work of identifying underperforming lines, structural inefficiencies and less profitable customers can wait until later. But later is now.

In tight times, it pays to recalibrate overall cost burden based on an effective customer-product mix. In some cases, up to 30 percent of a company's customers or products are actually not profitable. Remedying this would require improving the "front office" (customer-product segments) followed by aligning "back office" support to achieve higher profitability.. It may also be wise to turn away from an evenly spread – or "peanut butter" – approach to SG&A costs, instead rationalizing the SG&A footprint based on true "cost to serve" each business unit/product segment. For example, commodity businesses within the portfolio would receive a more "affordable" level of service.

Back in 1998-99, Procter & Gamble was faced with increasing business complexity – a large array of product lines aimed at a disparate customer base. The company reorganized itself, splitting business units and restructuring along product segments to drive focus on customers and markets. As a result of this strategy, P&G was better positioned to take advantage of the subsequent upturn (2003-04) and deliver strong financial performance in a rather competitive retail environment [5].

Companies that have recently been through mergers may find more potential adjustments in their pre-recession toolboxes. If an unfinished integration

process has left redundancies in place or economies of scale unrealized, this is a good time to find those performance leaks and seal them up.

"Lean out" operations

Are your reporting structures, PPE footprints and supply chains aligned with the brisk business you've been doing, or with the economic reality that lies ahead? How will expected changes in structural costs like regulatory compliance, employee benefits and energy affect the cost of doing business? Are you reaping all the benefits of renewed competition among your vendors?

There are almost as many ways to lean out a business as there are businesses. But as with the other strategies described here, the process starts with a decision to look forward, not backward.

Physically, a business is better poised to thrive in a downturn if the size and location of its facilities is rationalized to suit forecasted demand. Recent growth in emerging markets may have some companies spread thin in this area, which puts a strain on both the supply chain and the work of managing the operation. Real estate footprint can shrink if a mobile workforce is allowed more flexibility in when and where it works.

There are similar opportunities in a business's organization structure: aggressive hiring, internal promotions or acquisitions – or all three – may have created a tangle of organizational layers and one-on-one reporting relationships. A flatter organization may function more efficiently. M&A activity may also have increased the number and complexity of a company's legal entities, which can lead to increases in the finance and tax workload. In addition, previous acquisitions may not have been fully integrated, leaving synergies on the table. Conversely, past divestitures may have left the company with stranded costs.

When it comes to sourcing, remember that vendors are also fighting to remain competitive as the economy threatens to stall. There may be savings available through revisiting these relationships, choosing new partners and strategies, or tightening the screws on compliance by existing vendors.

By the end of 1998, Danaher improved operational efficiencies (through lean principles) and trimmed capacity to prepare for uncertain economic times. The expectation was to reduce salaried employment by 7% and also shed redundant capacity from recent acquisitions before the onset of a downturn. This helped create a leaner cost structure in response to a potential slowdown in top-line growth [6].

Shift fixed costs to variable costs

Every business has a number of costs that don't decline as volume falls. Certain support functions are what they are, no matter how intensive the demand or how efficiently it's met. Full-time employees earn salaries that don't change with performance, and they drive health care costs that grow without any relationship to revenue. The pool of retirees isn't going anywhere, and their pensions and health care plans aren't either.

There are ways to convert some of these constants to variables. New approaches can break some of these cost logjams.

Shared support functions such as Finance, IT and HR don't have to be viewed as fixed monoliths. They, along with their business unit customers, can be incented to manage the demand for services by encouraging business units to adopt efficient operating practices. In return, the business units can be charged for services they actually use.

Employee compensation packages can be reframed to include more variable pay based on performance assessments, and less base pay that changes hands no matter what. Health care costs can also be unlocked through a combination of consumer-driven health plans and workplace wellness initiatives. For both current and retired employees, Voluntary Employee Beneficiary Association (VEBA) trusts are one way to take health care costs off the company books and cap exposure.

It's also helpful to examine a company's mix of permanent and contractual employees. Shifting the mix toward more contract workforce for non-core/support functions can provide flexibility in the cost structure.

Alcatel, the French communications company, took to creating a more flexible and lean business model to react to business cyclicality. It shed plants and workers in several countries in 2000, embracing a business strategy that included little if any in-house manufacturing. The companies that bought the factories hired the existing workforces and got preferential treatment in supplying Alcatel with their products. Meanwhile, Alcatel hired more engineers and made product development, which was more core to its business compared to manufacturing. Manufacturing became a variable cost – placing, amending or cancelling orders – instead of a fixed cost that involved maintaining, retooling or shuttering company-owned plants [7].

Manage talent proactively

If you're going to thrive in tough times, it's going to be because your highest- performing people are by your side. This is also a good opportunity to transition under-performing employees. Initiate a process now to identify the employees you can't afford to lose, and start working on non-disruptive ways to "out-counsel" people who are underperforming.

Those are important steps, but only the simplest ones in a comprehensive talent management strategy. Once you know whom you want to keep – and whom you want to attract – it's important to make sure compensation, other incentives, and the company's culture are aligned to make them happy to stay.

Compensation models at many companies use a "satisfy many, disappoint few" approach. If your aim is to retain your highest-performing people heading into a downturn, look at ways to focus the "satisfy" part more squarely on these performers. What performance assessment tools are you using? What do these employees expect, and how do your rewards stack up?

One way to strengthen an employee's ties to the company is through non-monetary incentives. Giving people training and development opportunities at company expense is likely to make them feel valued in ways that money alone doesn't – and will send a signal that you'd like them to remain part of the team. Another option is to secure their commitment to the business through promotion or, if it's not practical at the moment, a succession plan that makes their future importance clear.

Channels of communication can help improve morale, recruitment and retention. Unionized workforces may be skeptical of management's plans and intentions. High-profile cases of what some consider to be inappropriate executive pay packages can erode employees' confidence in the company's real priorities. These fears can be allayed if the company is open about its financial performance and goals – and the ways in which employees can directly affect the outcome.

GE's well-publicized commitment to talent management, performance assessment and succession planning stands out as an example to many. From recruiting strategies to staff development to retention, GE's HR practices have significantly contributed to talent retention at all stages of the business cycle [8].

Bolster planning discipline

No business can plan for a downturn if it is blind to its external environment. And while it may not be hard to read news of the general economy's likelihood to turn south – in this article, for example, among many other sources – one company's recession is another's speed bump. Every industry reacts differently to the economic climate, and every company has to know what indicators spell boom or bust for its own outlook.

Spend time now identifying the macroeconomic factors that matter to your business, and create a system for monitoring them – a "dashboard" that puts your part of the larger economy in constant perspective. Then, map out the scenarios you might face, which indicators will serve as warnings, and how you'll react when those bells go off. Know what your capacities are, how much of them you're currently using, and where you want to be as things slow down.

Remember, the idea in a downturn is to do well, not merely to get by. Even if that's been the focus of your planning, people in your organization may revert to survival mode when the crisis actually hits. Now is a good time to identify top capital planning goals, make sure everyone knows what they are, and make sure that when hard times hit, capital investment gets smarter instead of simply grinding to a halt.

When the economy was flying high, expansion and acquisitions may have added debt to the company balance sheet. One aspect of smart pre-downturn planning is to reduce your leverage by generating liquidity or issuing stock.

Heavy equipment manufacturer Terex's strategy in the mid to late 1990s had been marked by growth through acquisition – which meant taking on significant new debt. The company had the planning discipline to recognize when its growth objectives had been met, and changed gears to focus on increasing cash flow and paying down obligations. As a result, it entered the 2000-2002 downturn with a significantly de-leveraged balance sheet [9].

Contrary to conventional wisdom, a downturn can be an opportunity to gain competitive advantage, not a threat. Management that employs proactive strategies can position themselves to gain market share over its competition, sustain profitability during the slowdown, and exceed investor expectations.

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[1] Deutsche Bank, 22 May 2000

[2] 3M Annual Report, 1999/2000

[3] Salomon Smith Barney, 6 Feb 2001

[4] Bear Stearns, 14 August 2000

[5] Credit Suisse, Report on Procter & Gamble Company, 28 Nov 2007

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[7] "Which Manufacturing companies will thrive in next five years", ExpansionManagement.com, 15 January 2002

[8] Harvard Business School Case, "GE's talent Machine", 3 Nov 2006

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