

MEMO TO THE CEO

Winning in Turbulence

Pull the Right Levers for Your Situation

BY

Darrell Rigby

Bain & Company, Inc.

PREVIEWS THE FORTHCOMING BOOK

Winning in Turbulence

Harvard Business Press
Boston, Massachusetts

ISBN-13: 978-1-4221-3908-0
3909BC

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THIS PLANNING SEASON is shaping up as the most challenging in memory for a generation of managers. As executives try to build contingencies into their strategic plans and budgets for next year, it's becoming clear that this downturn will test companies to their fullest, and some will not survive.

What does the downturn mean for your business, and what should your company be doing to navigate through it?

This article and subsequent installments are designed to provide you with the practical tools you need both to survive the storm and to improve your competitive position. Survival, of course, is primary and must be every company's top priority. But downturns present strategic opportunities as well as risks, with many more companies recording dramatic gains than in normal times. About 24 percent more firms moved from the bottom of the pack to the top in the 2001 recession compared with the subsequent period of economic growth, according to an eight-year study by Bain & Company that analyzed the net profit margins and sales growth of more than twenty-five

hundred companies. This downturn may well be longer, steeper, and deeper than any recession in decades, and already it's affecting companies operating in most markets around the globe. That's likely to mean even more turnover in the ranks of industry leaders as some companies move up and others fall back or disappear altogether.

Subsequent installments in the series will help you end up on the right side of that ledger. They will show how you can build flexibility in the short term by tightening cost management and improving cash flow. They will describe practical methods of boosting revenues and margins to keep the business moving forward. And they will help pinpoint the right long-term investments to make during this downturn to endure the hurricane and prepare to power up when the global economy begins its eventual recovery. Before deciding on the right tools, though, you need to know exactly where you stand.

Weathering Turbulence: Three Critical Dimensions

A tropical storm viewed from a weather satellite looks more or less uniform, as if it were affecting every area it touches with equal force. On the ground, the picture is different. One home loses its roof while others on the street come through intact. One community is devastated while its neighbor a mile away escapes unscathed.

So it is with business storms: even a sharp downturn affects everyone differently. Each company has particular strengths and vulnerabilities. Each will have different answers to three critical questions: How is the slowdown affecting the *industry* I compete in? What is my company's *strategic position* within that industry? What level of *financial resources* can my company draw on to weather the storm?

Your most powerful moves in a downturn depend on where you stand on these three dimensions. If your company has a strong financial position, for example, you may be able to out-invest competitors in marketing to increase customer loyalty. You may be able to attack or even acquire weaker competitors. If financial resources are scarce, you face a different set of possibilities. Depending on your strategic position and your industry's volatility, your best options may be to divest noncore assets and restructure the balance sheet, or to accelerate decisions around reducing cost and debt. You may need to seek alliances or merger partners and dispose of anything that is not essential to survival.

Let's look more closely at the three dimensions and at the opportunities each situation presents.

Industry Impact

Recessions hit some industries harder than others, so staying alert matters. The variations get amplified in a globalizing, interdependent economy. That adds both opportunity and complexity. The opportunity for executives is to shift a company's focus to economically healthier regions. The complexity arises from having to make long-term investments in global operations with less certainty than ever about where you will be exposed when the next downturn hits.

The U.S. economy provides a compelling example of the way boom and bust cycles affect industries differently. From 1987 to 2007, the U.S. experienced two recessions.¹ But look at what happened to specific industries in that same twenty-year period. The apparel industry weathered negative growth in thirteen out of twenty years, while the petroleum and coal industry had negative growth in ten of those years. Insurance carriers also suffered ten years of negative growth, compared with eight years for automobile manufacturers, but real estate survived the period without any down years through 2007.

When recessions do hit, recovery times vary dramatically. Following the 2001 recession, the S&P 500 stock index for construction staples bounced back to positive growth in only three months, while the computer index took nine months and the telecom stock index required almost three years return to positive growth. Another indicator of differential impact is the gap between an industry's ten-year average growth rate and its growth during a recession year. For computers and electronics, the disparity in the 2001 recession was 25 percentage points. For broadcasting and telecommunications, the difference was only 1 point.

The current downturn, too, is affecting industries differently, both in the United States and around the world. Financial services firms have been struggling throughout 2008, especially in the United States and Europe, and entered an acute slowdown with the collapse of Lehman Brothers in September. Home construction in some countries has come to a near-standstill. Retailing activity in the United States and elsewhere declined dramatically in the fourth quarter of 2008. Most healthcare-related industries, by contrast, have continued to grow, albeit at a slower pace. One indicator of the difference: between 2007 and late 2008, the S&P pharmaceutical index sank 28 percent, while financials dropped by 65 percent and the telecommunications index declined by 42 percent during the same period.

Strategic Position

Within a given industry, not every company suffers equally. A company's prospects depend heavily on its strategic position.

Consider, for instance, the difference between industry leaders and followers. The returns of market leaders on average are both larger and more stable than those of followers. Many studies have borne out this relationship. *Fortune* magazine, for example, regularly compares the ten-year return of leaders in several markets with the returns of a close follower. The magazine's 2007 chart showed leaders generating total shareholder return of 267 percent over a decade, the followers only 68 percent.²

Leaders are better positioned to deal with the effects of a downturn. Say that prices decline an average of 5 percent. Followers are likely to see profits turn to losses and may be forced into draconian cost-reduction programs. Leaders may record somewhat lower returns, but their profitability will usually remain above the cost of capital. They will have more flexibility to maintain or even increase spending on R&D, advertising, capacity expansion, or acquisitions.

Financial Strength

Financial resources provide the fuel for navigating through a downturn. If the fuel tank is low, the trip will be a short one. If it's full, you have options that aren't available to others. "There are enormous opportunities in recessions," Virgin Group founder Sir Richard Branson recently commented in *Fortune* magazine. "And we've got financial resources. Some of our companies will tighten their belts and not do a lot right now. Others will expand in this recession." Virgin is considering setting up airlines in Brazil and Russia, for instance. "It's a good time to get brand-new planes at reasonable prices," said Branson.³

So you need accurate assessments of the resources available to you. What is your company's financial leverage? How much debt does it carry? What are its cash reserves? How do these numbers compare with those of your competitors? An important step for any company in a downturn this deep is to run a series of short-term and long-term downside scenarios to determine the resources required for survival. Will you be able to refinance your debt? At what cost? Only by assessing all the potential risks can you gauge the "surplus" resources you have available for investment.

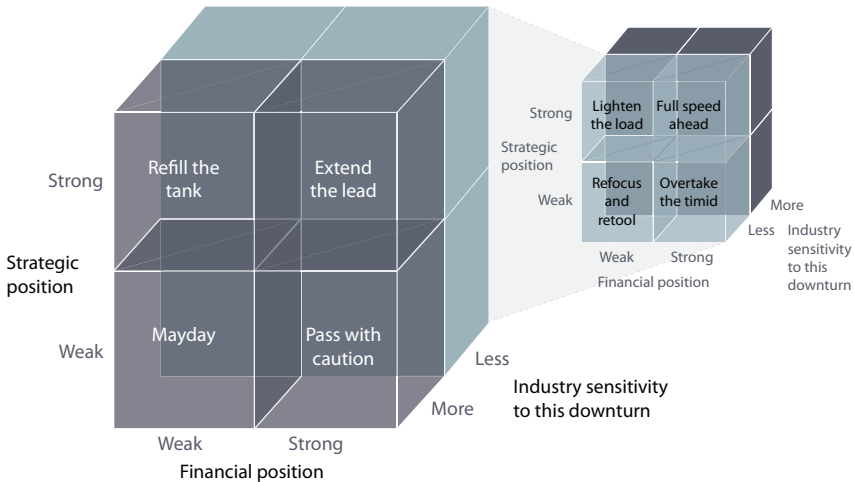
Guidelines for an Action Plan

These three dimensions—the downturn’s impact on your industry, your company’s strategic position, and its financial strength— can provide guidelines for an action plan calibrated to the specifics of your situation. It helps to think of a cube representing all three dimensions (figure 1-1). By locating your company on the cube, you can focus on which actions are likely to be most effective for your situation.

Say you’re in a business that is less affected even by a severe downturn. Your strategic position is weak but your financial position is strong, so you’re in the lower right-hand quadrant of this grid. In that situation, investing in your core business is a top priority. You may want to acquire companies that can help build that core business and strengthen your strategic position. That’s how LabCorp became the number-two provider of diagnostic medical testing in the United States. Taking advantage of the last downturn, it acquired three competitors in 2001 and 2002. LabCorp combined these acquisitions with its lower cost structure to underprice smaller competitors and gain additional market share.

FIGURE 1-1

Winners in a downturn redefine their strategies using three dimensions of performance



Source: Bain analysis

Now flip the cube around and imagine that you're in an industry that is greatly affected by the downturn, as so many industries will be this time around. If your financial and strategic positions are both strong—that is, if you're in the upper right-hand quadrant—you have some options to take advantage of competitors' weaknesses. In the last downturn, Intel Corporation effectively pulled away from Advanced Micro Devices Inc. (AMD), its scrappy rival in the chip business. Heading into the 2001 recession, AMD's earlier investment in product design was paying off and its revenues were growing three times faster than Intel's. Then the recession hit, catching the entire industry with too much capacity. As AMD's lack of profitability prevented it from investing in new production facilities, Intel seized the advantage. It invested in new facilities with state-of-the-art production capability and spent heavily to advertise its P4 processors. In the ensuing years, Intel's relative cost position improved dramatically, and AMD had to slash 15 percent of its workforce. The momentum AMD had built quickly evaporated, and a reenergized Intel remained the industry leader.

Tesco, the leading retailer in the United Kingdom, was in the same position as Intel when the 2001 recession hit: strategically and financially strong. The company had missed some opportunities during the downturn of the early 1990s, but this time it was prepared. It quickly moved its advertising focus from its "Finest" line of products to "Value" products. Then it began to invest. It expanded its sales area by 10 percent annually from 2000 to 2002, triple the expansion rate of a leading competitor. It deepened its talent pool. Thanks to strategic acquisitions, it was able to roll out a new express-store format quickly. These moves enabled Tesco to avoid massive cost-reduction plans and helped it double its market-share lead over its closest rival.

Korea First Bank was in a different position—the lower right-hand corner of the cube, where companies that are strategically weak but relatively strong financially need to move with great caution. Driven into bankruptcy by the Asian financial crisis of the 1990s, Korea First was acquired by a foreign investment firm. Having lost its status as Korea's top corporate bank, its strategic position was weak. But thanks to the acquirer's deep pockets, its financial position was strong. Korea First used its resources to transform itself from a corporate bank into a retail bank. It shifted its branch structure to serve retail clients, built customer-service and back-office support capabilities, and remade its sales force to focus on customer service. By reducing complexity and investing selectively to focus on customers, Korea First cut loan approval time by 75 percent and reignited the bank's growth as the economy improved.

Companies in the lower left of either matrix, with weak strategic and financial positions, face serious challenges. Chances are they need complete restructuring, alliances, or merger partners. They are racing time to find and sustain a viable core business. In the upper right of both quadrants the situation is reversed: companies are strong both strategically and financially. As long as they invest to protect their leadership position, they may have opportunities to gain share organically, acquire weaker competitors, or both.

The Toolkit: An Overview

You'll need a set of specific tools to implement any action plan, and the key is to pick the right ones for the job. The tools you are likely to draw on reflect four broad imperatives:

- **Reduce costs and investments.** Most companies can improve their performance significantly by *reducing complexity, streamlining back-office and other G&A functions, and optimizing their supply chain*. Long experience has shown that these are the most powerful cost-management levers you can pull in the short term. They'll help you gain the flexibility you need to weather a sharp downturn and invest for the future. *A receipts-and-disbursements-based cash flow tool* can help with the tight monitoring and forecasting required to ensure liquidity and meet short-term financing requirements, while *downside scenarios* that look ahead two or even three years will be important to plan effectively given the likely depth and scope of this downturn.
- **Increase revenue and margins.** Is your salesforce as productive as it could be? Many companies have shored up declining sales and even increased revenue quickly by *restructuring and refocusing their sales reps*. A series of data-driven tools help reps concentrate on the right targets, manage their pipeline effectively, and maximize customer face time—all essential in the current market. To maintain margin, you need to *price for margin or share gains*. Pricing has a greater effect on profits than any other managerial tool, yet pricing capabilities remain underdeveloped at many companies.
- **Shift resources to core business activities.** Winners in a downturn typically *invest to gain share in their core business*. The investments create or strengthen a leading position in critical market niches and give

them the benefit of leadership economics. These companies also *strengthen relationships with their core customers*, building loyalty and increasing their share of wallet. Investments in *strengthening the organization* help winning companies avoid decision paralysis and focus on the decisions that matter most, then make and execute those decisions well and quickly. Some companies may opt to free up cash and management time by *divesting noncore assets*; others will choose to wait and sell those assets when market conditions improve. Either way, companies need to determine which course is right for them, and prepare assets for an effective sale.

- **Prepare for bold moves.** Because so many companies are struggling, a downturn brings the possibility of *game-changing acquisitions and partnerships*. If you have a strong financial position, you can make use of the downturn to consolidate or expand your market position and acquire capabilities at bargain prices. Even companies that were once unapproachable may welcome partnerships they spurned in better times.

FIGURE I-2

Winning in this downturn: Pull the right levers for your situation

	Industry sensitivity		Less				More			
	Strategic position		Strong	Strong	Weak	Weak	Strong	Strong	Weak	Weak
	Financial position		Strong	Weak	Strong	Weak	Strong	Weak	Strong	Weak
			Full speed ahead	Lighten the load	Overtake the timid	Refocus & retool	Extend the lead	Refill the tank	Pass with caution	Mayday
Reduce costs and investments										
1 Drive performance improvement			●	●	●	●	●	●	●	●
2 Tightly manage cash and liquidity			●	●	●	●	●	●	●	●
Increase revenue and margins										
3 Turbocharge sales			●	●	●	●	●	●	●	●
4 Price for margin or share gains			●	●	●	●	●	●	●	●
Shift resources to core business activities										
5 Clarify strategy: choose where and how to win			●	●	●	●	●	●	●	●
6 Improve loyalty of core customers			●	●	●	●	●	●	●	●
7 Strengthen the organization			●	●	●	●	●	●	●	●
8 Divest non-core assets			●	●	●	●	●	●	●	●
Prepare for bold moves										
9 Pursue game-changing M&A and partnerships			●	●	●	●	●	●	●	●

Source: Bain analysis

Testing Your Firm's Readiness

To perform effectively in a downturn, you need an action plan grounded in your company's specific situation and the right management tools to carry it out. You also need a strong set of core values that consistently guides the necessary trade-offs. To test your firm's readiness, try asking your management team the four questions below:

What are our objectives, priorities, and values? A turbulent environment forces leaders to know what they value most and act accordingly. Is revenue growth more important than cost reduction? Is market share more valuable than profit margins? How important is the continuing loyalty of employees and customers—as compared, for example, with hitting quarterly earnings targets?

What are the most important decisions we will make? Long before making a decision, the best companies discuss what will need to be decided. Research shows that executives under stress typically reach for the same levers they have pulled in the past. It's better to make sure you're reaching for the right levers before you start pulling anything at all.

What changing conditions could we encounter? Today's downturn is testing companies and their executive teams as they have rarely been tested before, and nobody has a crystal ball. As you plan, make a point of encouraging “company Cassandras”—people who will generate plausible worst-case scenarios. These scenarios will help you understand what will be required for survival.

What conditions would trigger a change in course? Every company needs a well-grounded understanding of when to begin implementing its contingency plans. Decide right now what environmental and marketplace changes you will monitor. Then determine what level of change in either direction would dictate a shift to “Plan B” (further measures to protect your strategic position and profitability) or “Plan A+” (moves to help you accelerate out of the downturn).

Each of these tools will be described in more detail in future installments in this series. Some tools will be more relevant and effective than others, depending on your company's situation (figure 1-2). As you read future installments, you can check to see whether each tool described is practical and effective for your company.

The next year or two are likely to present companies with substantial long-term challenges. Some firms won't rise to the occasion. They'll fall back in the pack, be acquired, or face bankruptcy. But downturns create opportunities as well as risks. With a practical action plan that reflects a firm's unique position and puts the right tools to work immediately, companies can emerge from the storm stronger than ever.

1. A recession is usually defined in the press as two consecutive quarters of decline in real gross domestic product. The actual definition used by the National Bureau of Economic Research (NBER), the Cambridge-based organization that determines the beginning and end of recessions, is both more comprehensive and more complex. That needn't concern us here, except to note that the NBER typically announces the beginning or end of a recession many months after the relevant date has passed.
2. Statistics taken from "The Fortune 500" list, *Fortune*, April 30, 2007.
3. Barney Gimbel, "Sir Richard Branson," *Fortune*, November 10, 2008.