RECESSION

Roaring Out of Recession

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Artwork: Felice Varini, **Drill Hall**, *2008, Singapore Biennale, Singapore*

Great leaders know that how they fight a war often decides whether they will win the peace. Yet as CEOs continue to combat the myriad challenges thrown up by the Great Recession of 2007, they are increasingly unsure about what strategic approaches to deploy. Many worry that the 27-month slowdown is far from over in the United States. Others feel that although a recovery may have begun, it could prove to be short-lived, and they would do well to brace for a double-dip recession. Almost all business leaders reluctantly admit that the current crisis also marks an inflection point: The world after it is unlikely to resemble the one before it. Their priority, when they get a moment's respite, must be to remake their organizations to cope with the "new normal." But CEOs, like generals in the heat of battle, are so busy tackling short-term priorities that the future is obscured by the fog of war.

Unfortunately, little research has been done on strategies that can help companies survive a recession, get ahead during a slow-growth recovery, and be ready to win when good times return. Folksy wisdom abounds (how many times have you read that Procter & Gamble, Chevy, and Camel flourished during the Great Depression because they advertised heavily?), but empirical studies are few. That's why we decided to mount a yearlong project to analyze strategy selection and corporate performance during the past three global recessions: the 1980 crisis (which lasted from 1980 to 1982), the 1990 slowdown (1990 to 1991), and the 2000 bust (2000 to 2002). We studied 4,700 public companies, breaking down the data into three periods: the three years before a recession, the three years after, and the recession years themselves. (See the sidebar "Analyzing Strategy Shifts.")

Analyzing Strategy Shifts

In December 2008 we started a project to identify the strategies that companies deploy during economic downturns and to evaluate their effectiveness. We studied corporate performance during the three recessionary periods prior to the current one: 1980 to 1982, 1990 to 1991, and 2000 to 2002.

We collected financial data on all the companies listed in Standard & Poor's Compustat database, analyzing 4,700 companies across the three recessions. Using data for the three years prior to each recession, the three years after it, and the recession itself, we analyzed strategy shifts during the recession years and developed hypotheses about how they had affected companies' postrecession performance.

Our findings are stark and startling. Seventeen percent of the companies in our study didn't survive a recession: They went bankrupt, were acquired, or became private. The survivors were painfully slow to recover from the battering. About 80% of them had not yet regained their prerecession growth rates for sales and profits three years after a recession; in fact, 40% of them hadn't even returned to their absolute prerecession sales and profits levels by the end of that time period. Only a small number of companies—approximately 9% of our sample—flourished after a slowdown, doing better on key financial parameters than they had before it and outperforming rivals in their industry by at least 10% in terms of sales and profits growth.

To identify strategy shifts, we calculated how companies' resource allocations had changed between the prerecession and the recession years, using six balance-sheet items: number of employees; cost of goods sold normalized by sales; R&D expenditures; sales, general, and administrative expenditures; capital expenditures; and plant, property, and equipment stock.

Only major allocation changes affect a company's performance, so we isolated those in two steps: first, we calculated changes from before to during each recession and adjusted them for the industry average; second, we calculated the percentile scores of those changes and assumed that only those in the top or bottom 33 percentile were significant increases or decreases.

We identified four groups on the basis of specific combinations of changes in resource allocation:

Prevention-focused companies, which had cut back further, relative to their competitors, on one or more of the six items, and hadn't increased expenditures on any of them more than their competitors had.

Promotion-focused companies, which had increased expenditure on at least one of the six and also not decreased expenditure on any of them by more than their rivals had.

These postrecession winners aren't the usual suspects. Firms that cut costs faster and deeper than rivals don't necessarily flourish. They have the lowest probability—21%—of pulling ahead of the competition when times get better, according to our study. Businesses that boldly invest more than their rivals during a recession don't always fare well either. They enjoy only a 26% chance of becoming leaders after a downturn. And companies that were growth leaders coming into a recession often can't retain their momentum; about 85% are toppled during bad times.

Just who *are* the postrecession winners? What strategies do they deploy? Can other corporations emulate them? According to our research, companies that master the delicate balance between cutting costs to survive today and investing to grow tomorrow do well after a recession. Within this group, a subset that deploys a specific combination of defensive and offensive moves has the highest probability—37%—of breaking away from the pack. These companies reduce costs selectively by focusing more on operational efficiency than their rivals do, even as they invest relatively comprehensively in the future by spending on marketing, R&D, and new assets. Their multipronged strategy, which we will discuss in the following pages, is the best antidote to a recession.

Pragmatic companies, which had adopted both a prevention focus, by reducing COGS or employees more than their peers had, and a promotion focus, by increasing SG&A, R&D, CAPX, or PP&E more than their peers had.

Progressive companies, which had reduced COGS but hadn't cut employees more than their peers and had also allocated more resources, relative to their competitors, to market-related items such as SG&A and R&D and to asset-related items such as CAPX and PP&E.

We then calculated the three-year compound annual growth rates for net sales and earnings (EBITDA as a percentage of sales), adjusted for industry averages, to understand the top- and bottom-line performance generated by these strategies. Using growth rates allowed us to compare the performance of big and small companies; by adjusting for industry averages, we could compare performance across industries even if the recession had affected them differently.

We concluded that companies with both sales growth and profits growth 10% higher than those of competitors after a recession had achieved breakaway performance. (Our findings are valid, however, for a broad range of

Four Responses to a Slowdown

Companies, not surprisingly, don't all follow the same strategies during a recession. That could be because of differences in executives' cognitive orientation during a crisis. According to Tory Higgins, a Columbia University psychologist, human beings are hedonistic—we avoid pain and seek pleasure—but they differ in how they try to achieve those aims. There are two basic modes of self-regulation. Some people are driven most by goals, such as achievement, advancement, and growth. These promotion-focused individuals are motivated by ideals and aspirations that provide pleasure if realized and disappointment if not. Other people are prevention-focused—concerned mainly with safety, security, and responsibility. They strive to avoid bad outcomes, experiencing relief if they succeed and pain if they fail. Situations have a potent influence on cognitive orientation: A recession, for example, can trigger a response that overrides a person's usual orientation.

By applying this perspective to our empirical research, we were able to classify companies and their approaches to managing during a recession into four types:

definitions of breakaway performance: growth rates from 5% to 20% better than the industry average.)

Finally, we calculated the probability that companies in each of the four groups would achieve breakaway performance by dividing the number of winning companies that had used a certain strategy by the total number of companies using that strategy.

Prevention-focused companies, which make primarily defensive moves and are more concerned than their rivals with avoiding losses and minimizing downside risks.

Promotion-focused companies, which invest more in offensive moves that provide upside benefits than their peers do.

Pragmatic companies, which combine defensive and offensive moves.

Progressive companies, which deploy the optimal combination of defense and offense.

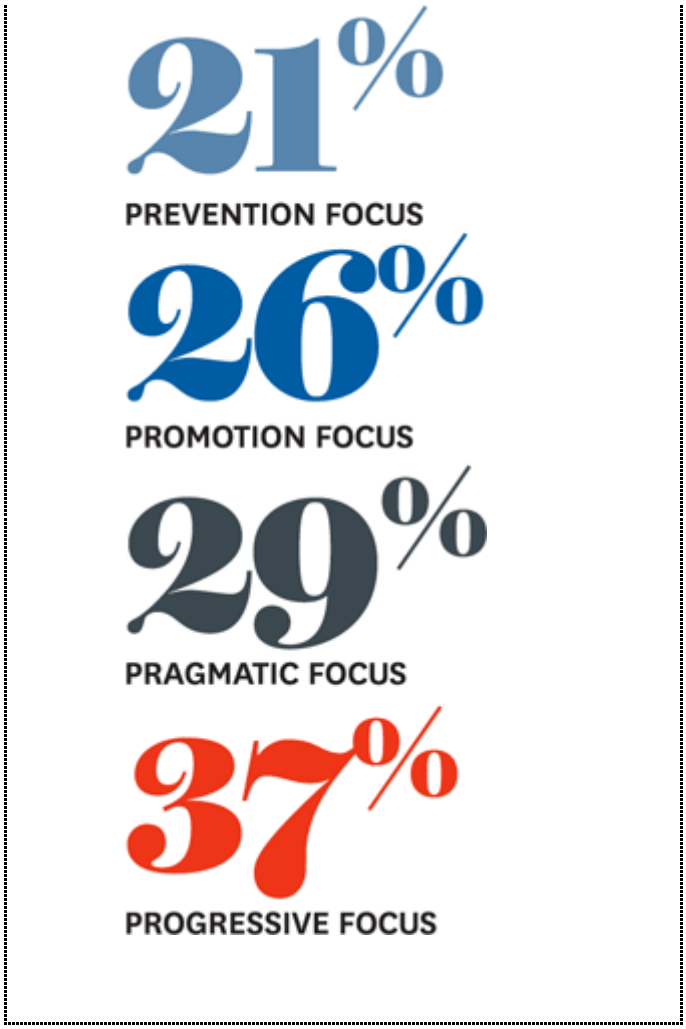
What Are the Odds...

that companies in the four groups will significantly outperform their rivals (by 10% or more) on both top- and bottom-line growth after a recession?

Let's now analyze these groups.

Don't Be Too Defensive

Confronted by a recession, many CEOs swing into crisis mode, believing that their sole responsibility is to prevent the company from getting badly hurt or going under. They quickly implement policies that will reduce operating costs, shrink discretionary expenditures, eliminate frills, rationalize business portfolios, lower head count, and preserve cash. They also postpone making fresh investments in R&D, developing new businesses, or buying assets such as plants and machinery. As a rule, prevention-focused leaders cut back on almost every item of cost and



investment and reduce expenditures significantly more than their competitors on at least one dimension.

Sony, which announced a cost-reduction target of $2.6 billion in December 2008, epitomizes the prevention-focused approach. It plans to close several factories and eliminate 16,000 jobs, and will delay investments—such as building a much-needed LCD television factory in Slovakia—in its core electronics business. This strategy resembles the approach Sony took during the 2000 downturn, when over a two-year period the Japanese giant cut its workforce by 11%, its R&D expenditures by 12%, and its capital expenditures by 23%. The cuts helped Sony increase its profit margin from 8% in 1999 to 12% in 2002, but growth in its sales tumbled from an average of 11% in the three years before the recession to 1% thereafter. In fact, Sony has struggled since then to regain momentum. It has invested in developing new products such as electronic book readers, gaming consoles, and organic light-emitting diode TV sets, but finds itself bested in those product categories by Amazon, Microsoft and Nintendo, and Samsung, respectively.

A focus solely on cost cutting causes several problems. One, executives and employees start approaching every decision through a loss-minimizing lens. A siege mentality leads the organization to aim low and keep both innovation and cost cutting incremental. Two, instead of learning to operate more efficiently, the organization tries to do more of the same with less. That often results in lower quality and therefore a drop in customer satisfaction. Three, cost-cutting decisions become centralized: The finance department makes across-the-board cuts, paying little attention to initiatives that may be the nuclei of postrecession growth. Four, pessimism permeates the

organization. Centralization, strict controls, and the constant threat of more cuts build a feeling of disempowerment. The focus becomes survival—both personal and organizational.

Few prevention-focused corporations do well after a recession, according to our study. They trail the other groups, with growth, on average, of 6% in sales and 4% in profits, compared with 13% and 12% for progressive companies. Whereas in the three years after the 2000 recession, sales for the 200 largest companies grew by an average of $12 billion over prerecession levels, the prevention-focused enterprises among them saw sales grow by an average of just $5 billion. Moreover, cost cutting didn't lead to above-average growth in earnings. Postrecession profits for prevention-focused enterprises typically rose by only $600 million, whereas for progressive companies they increased by an average of $6.6 billion.

Don't Be Too Aggressive

Some business leaders pursue opportunity even in the face of adversity. They use a recession as a pretext to push change through, get closer to customers who may be ignored by competitors, make strategic investments that have long-term payoffs, and act opportunistically to acquire talent, assets, or businesses that become available during the downturn. These strategies are designed to garner upside benefits.

At the height of the 2000 recession, for example, Hewlett-Packard drew up an ambitious change agenda even though sales and profits were falling. Carly Fiorina, then the CEO, asserted, "In blackjack, you double down when you have an increasing probability of winning. We're going to double down." HP embarked on a massive restructuring program, made the largest acquisition in its history by buying Compaq for $25 billion, and increased R&D expenditures by 9%. It also spent $200 million on a corporate branding campaign and $1 billion on expanding the availability of information technology in developing countries. These initiatives strained the organization and spread top management's attention too thin. When the recession ended, the company found it tough to match the profitability levels of IBM and Dell. By 2004 HP's earnings, at 8.4%, had slipped below IBM's 16.8% and Dell's 9.3%. (Throughout this article, "profits" and "earnings" refer to earnings before interest, taxes, depreciation, and amortization [EBITDA] as a percentage of sales.)

Organizations that focus purely on promotion develop a culture of optimism that leads them to deny the gravity of a crisis for a long time. They ignore early warning signs, such as customers' budget cuts, and are steadfast in the belief that as long as they innovate, their sales and profits will continue to rise. Even as customers clamor for lower prices and greater value for money, these companies add bells and whistles to their products. They simply don't notice that because the pie is shrinking, they must capture an even larger share from rivals to keep growing. Optimistic leaders attract employees who thrive in a forward-looking, growth-oriented environment. When positive groupthink permeates an organization, naysayers are marginalized and realities are overlooked. That's why promotion-focused organizations are often blindsided by poor financial results.

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Worse, when these companies are forced to tackle bloated cost structures, the changes they make often prove to be too little, too late. Because each function and business firmly believes that it contributes to corporate success, finger-pointing increases. Trade-offs are difficult to make and decision making becomes sclerotic.

Whereas prevention-oriented companies lower their cost-to-sales ratio by about three percentage points relative to peers over the course of a recession, promotion-focused enterprises are unable to reduce that ratio. Promotion-focused CEOs sometimes increase expenditures rather than cutting back, believing that this will push them ahead. If investments take longer than expected to generate paybacks, or innovations don't resonate with customers, these companies run headlong into trouble.

Despite a focus on growth, promotion-focused companies' postrecession sales and earnings rise by only 8% and 6% respectively, whereas those of progressive companies' shoot up by 13% and 12%. Among the 200 largest companies that tackled the 2000 recession, promotion-focused enterprises grew sales by $15 billion and profits by $1.5 billion, on average—far lower than progressive companies' average increases of $28 billion in sales and $6.6 billion in profits.

The Elusive Balance

The companies most likely to outperform their competitors after a recession are pragmatic as William James defined the term: "The attitude of looking away from first things, principles, 'categories,' supposed necessities; and of looking towards last things, fruits, consequences, facts." The CEOs of pragmatic companies recognize that cost cutting is necessary to survive a recession, that investment is equally essential to spur growth, and that they must manage both at the same time if their companies are to emerge as postrecession leaders.

A combination strategy sounds easy to develop: a little offense, a little defense, and voilà, you're a winner. If only it were that simple. Companies typically combine three defensive approaches—reducing the number of employees, improving operational efficiency, or both—with three offensive ones: developing new markets, investing in new assets, or both. This yields nine possible combinations, some of which are more effective than others. (See the exhibit "What's the Best Combination of Moves?")

What's the Best Combination of Moves?

Companies that focus simultaneously on increasing operational efficiency, developing new markets, and enlarging their asset bases show the strongest performance, on average, in sales and EBITDA growth after a recession. (Percentages, which are adjusted for industry averages, refer to the three-year compound annual growth rate.)

		PROMOTION-FOCUSED MOVES		
		MARKET DEVELOPMENT	ASSET INVESTMENT	BOTH
PREVENTION-FOCUSED MOVES	EMPLOYEE REDUCTION	GOOD SALES 4.6% EBITDA 6.6%	BAD SALES 3.9% EBITDA 3.3%	WORST SALES 3.3% EBITDA -5.2%
	OPERATIONAL EFFICIENCY	GOOD SALES 7.1% EBITDA 4.2%	GOOD SALES 8.4% EBITDA 8.4%	BEST SALES 13.0% EBITDA 12.2%
	BOTH	BAD SALES 5.2% EBITDA 2.1%	BAD SALES 5.2% EBITDA -0.5%	GOOD SALES 9.2% EBITDA 4.6%

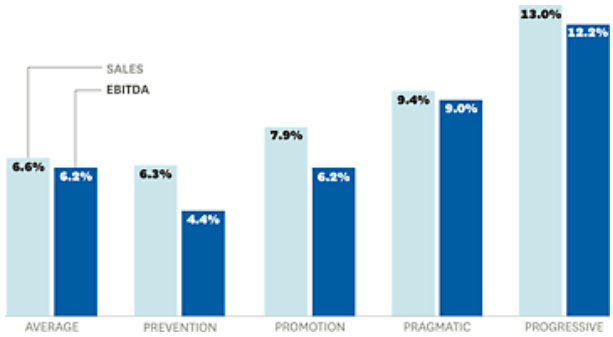
One combination has the greatest likelihood of producing postrecession winners: the one pursued by progressive enterprises. These companies' defensive moves are selective. They cut costs mainly by improving operational efficiency rather than by slashing the number of employees relative to peers. However, their offensive moves are comprehensive. They develop new business opportunities by making significantly greater investments than their rivals do in R&D and marketing, and they invest in assets such as plants and machinery. Their postrecession growth in sales and earnings is the best among the groups in our study. It's important to

Click here for a larger image of the graphic.

understand why the companies that use this combination do so well after a recession.

Postrecession Leaders in Sales and Profits Growth

After a recession, progressive companies outperform pragmatic companies by almost four percentage points in sales and more than three percentage points in earnings before interest, taxes, depreciation, and amortization (EBITDA)—and do about twice as well as companies in general. (Percentages, which are adjusted for industry averages, refer to the three-year compound annual growth rate.)



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Operational efficiency.

Most enterprises implement aggressive cost-reduction plans to survive a recession. But companies that attend to improving operational efficiency fare better than those that focus on reducing the number of employees. Don't get us wrong: Progressive companies also lay off employees, but they rely on that approach much less than their peers do. Only 23% of progressive enterprises cut staff—whereas 56% of prevention-focused companies do—and they lay off far fewer people.

Companies that rely solely on cutting the workforce have only an 11% probability of achieving breakaway performance after a downturn. There may be several reasons for this. In our experience, morale is usually better at companies that stress operational efficiency. Employees at these companies appreciate top management's commitment to them, and they are more creative in reducing costs as a result. They don't spend their time worrying about job security—as do people at companies that rely on deep staff cuts. And although layoffs may reduce costs quickly, they make recovery more difficult. Companies run the risk of scaling up too late, especially if hiring is more difficult than they anticipated. People are loath to work for organizations that reduce head count in difficult times. Moreover, as these companies rehire, costs shoot up.

In contrast, companies that respond to a slowdown by reexamining every aspect of their business models—from how they have configured supply chains to how they are organized and structured—reduce their operating costs on a permanent basis. When demand returns, costs will stay low, allowing their profits to grow faster than those of competitors.

During the 2000 recession, Office Depot and Staples took differing approaches to cost management. Office Depot cut 6% of its workforce, but it couldn't reduce operating costs significantly. Although the company created an incentive plan to boost sales, its sales growth fell from 19% before the recession to 8% after—five percentage points below Staples' postrecession sales growth rate.

By contrast, Staples closed down some underperforming facilities but increased its workforce by 10% during the recession, mainly to support the high-end product categories and services it introduced. At the same time, the company contained its operating costs and came out of the recession stronger, bigger, and more profitable than it had been in 1999. Its sales doubled, from $7.1 billion in 1997 to $14.6 billion in 2003, while Office Depot's rose by about 50%, from $8.7 billion to $13.4 billion. On average, Staples was about 30% more profitable than its archrival in the three years after that recession.

Staples closed down some underperforming facilities but increased its workforce by 10% during the 2000 recession.

Investment in both existing and new businesses.
During recessions, progressive companies develop new markets and invest to enlarge their asset bases. They take advantage of depressed prices to buy property, plants, and equipment. This helps them both during the recession and afterward, when they can respond faster than rivals to a rise in demand. Because their asset costs are lower than their noninvesting competitors', their earnings can be relatively higher.

Progressive companies stay closely connected to customer needs—a powerful filter through which to make investment decisions.

These companies also judiciously increase spending on R&D and marketing, which may produce only modest benefits during the recession, but adds substantially to sales and profits afterward. The resources freed up by improving operational efficiency finance much of this expenditure. In turbulent times, it's tough for companies to know where to place their bets for both the immediate term and the long run. Progressive companies stay closely connected to customer needs—a powerful filter through which to make investment decisions.

Getting It Right

Pursuing a Janus-faced strategy isn't easy. Cutting budgets in one area while expanding them in another means explaining to those who are being asked to bear the burden of the former why the company is spending where no immediate benefits are apparent. It's easier to exhort everyone to sacrifice and share the pain or to show courage and invest for gain. To pull off a combination of cutbacks and strategic investments, CEOs have to exercise cost discipline and financial prudence and detect opportunities that offer reliable returns in reasonable payback periods.

Let's look at how one company has managed this difficult balancing act. During the 2000 recession, Target increased its marketing and sales expenditures by 20% and its capital expenditures by 50% over prerecession levels. It increased the number of stores it operated from 947 to 1,107 and added 88 SuperTarget stores to the 30 it had already set up. It expanded into several new merchandise segments, ramped up investment in credit-card programs, and grew its internet business. The company made several smart choices along the way. Instead of trying to go it alone online, Target partnered with

Amazon to sell its products. It also teamed up with well-known designers such as Michael Graves, Philippe Starck, and Todd Oldham to cement its reputation for cheap chic, thereby differentiating its products.

Meanwhile, Target relentlessly tried to reduce costs, improve productivity, and enhance the efficiency of its supply chain operations. For instance, in 2000 it was one of the 12 retailers that founded the WorldWide Retail Exchange, a global business-to-business electronic marketplace, to facilitate trading between retailers and vendors. In January 2001 Target consolidated its Dayton's and Hudson's stores under Marshall Field's to take advantage of the well-known brand name. These moves helped the company grow sales by 40% and profits by 50% over the course of the recession. Its profit margin increased from 9% in the three years before the recession to 10% after it.

These strategies contrast sharply with those of other retailers, which focus primarily on growing store networks. For example, the discount retailer TJX Companies, which operates T.J. Maxx and Marshalls, added 300 stores to its network of 1,350 from 2000 to 2002, increasing its retail square footage by almost 25% and nearly doubling its capital expenditures. TJX's competitors were scaling back growth plans, so real estate options were more plentiful and prices were lower. Although the increase in retail floor space fueled some healthy medium-term sales growth—four percentage points above peers' growth in the postrecession period—it didn't improve the bottom line. That's because TJX did little to change its business model; it just scaled up its centralized buying and flexible distribution of merchandise. This more-of-the-same approach put TJX's bottom-line growth, which had been on a par with rivals' before the recession, at 9% lower three years afterward.

Many CEOs find investing in bargain-basement assets a tempting offensive move in a downturn. But the revenues and profits from opportunistic investments can take a long time to materialize, leaving a company saddled with an asset base that doesn't significantly boost returns. As TJX found, focusing purely on assets also keeps companies from looking for more-imaginative ways to build new businesses that will drive growth when the recession is over.

Target hasn't faced this problem. During the current recession, the retailer initially saw a decline in same-store sales, in part because Wal-Mart's message of everyday low prices went down well with customers. Realizing that spending on "wants" was decreasing sharply, Target strengthened its position in a key "needs" segment: food. It launched a new store format that doubles the amount of floor space devoted to food; extended the range of its food brands, Market Pantry and Archer Farms; and overhauled its operations to support the emphasis on food. The retailer also increased media spending and reaffirmed its positioning with the slogan "Expect more, pay less"—with an emphasis on the second half. These are early days, but the results appear promising: By 2008 Market Pantry's sales had increased by 30% and Archer Farms' by 13%. And food has become a $1.8 billion business for Target.

Few progressive business leaders have a master plan when they enter a recession. They encourage their organizations to discover what works and combine those findings in a portfolio of initiatives that improve efficiency along with market and asset development. This agility, even as leaders hold the course toward long-term growth and profitability, serves organizations well during a recession. An analysis of the stock market performance of companies that use progressive strategies reveals that they can also ride the momentum after a recession is over. Their approach doesn't just combat a downturn; it can lay the foundation for continued success once the downturn ends.

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Can you please clarify numbers here? 9% flourish, 17% disappear and 80% survive = 106%

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