How the robust and audacious thrive through business cycle swings

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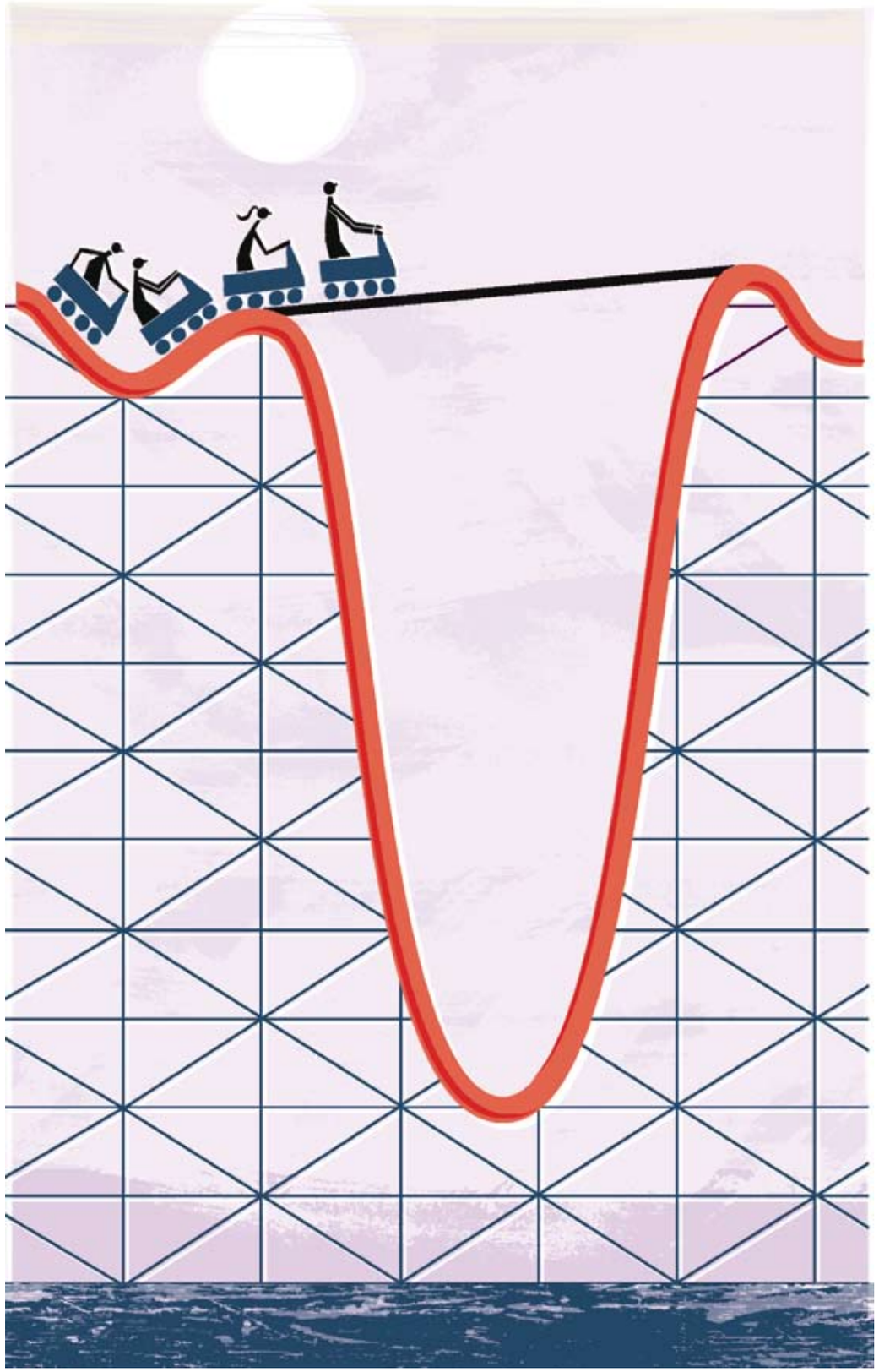

Among many companies, the knee-jerk reaction to a downturn is to pull back. Capital spending is cut, acquisitions are scaled down and marketing expenditure is slashed in a desperate effort to survive the bad times. But smart companies apply a more controlled response to difficult conditions. Instead of simply cutting back wherever possible, they take precisely targeted steps to ensure that they come out of the bad times a step ahead. This article shows how any company can go beyond the reflex reaction and take advantage of the downturn to emerge stronger than the competition.

When a physician strikes the tendon below your knee-cap, your lower leg suddenly jerks forward. This automatic reflex is known as the knee-jerk reaction. Companies hit by a downturn often show a similar automatic response: they postpone capital expenditures, scale back acquisitions, slash marketing expenditures and the like. Past downturns have demonstrated that such knee-jerk reactions may not be the most effective. In fact, the smartest companies use the downturn to act in a much more controlled way and, as a result, come out stronger than their competitors when the downturn has ended. For example, during the 1997-1998 financial crisis in Asia, Coca-Cola increased marketing spend by 50 per cent and got three times the coverage due to lower media space costs. Sales grew by 18 per cent during the period and boosted market share substantially.

In this article, we will show what you can do to come out of a downturn stronger than your competitors. We will group the measures you can take into two categories:

- Measures to reduce your company's intrinsic vulnerability, i.e. its own exposure to the ill effects of the downturn;
- Measures to take advantage of your competitors' weakened position as they are hit by the ill effects of the downturn.

We will illustrate these measures with examples of companies that have managed past downturns successfully. We will also point to some examples emerging from the current downturn.

Reduce your company's intrinsic vulnerability

Clearly the best way to weather a downturn is to enter it well prepared. And the best preparation takes place when times are good. Even so, several of the measures we explain below can still be taken when the downturn starts

to hit. None of these taken separately is spectacular, but together they make for a robust arrangement (see Table 1 for an overview).

We distinguish four sets of measures:

a. Make the aggregate of your activities less cyclical;

b. Make your fixed costs variable;

c. Secure the revenues from your customers;

d. Reduce the risk of owning unproductive current assets.

Table 1 **How to reduce your company's intrinsic vulnerability**

Make the aggregate of your activities less cyclical

- **Add less cyclical businesses or activities**
- **Add out-of-phase businesses, markets or product lines**

Make your fixed costs variable

- **Deploy flexibility elements in your HR strategy**
- **Have a fexible production set-up for fast ramp-up/down**
- **Outsource high fixed-cost activities**

Secure the revenues from your customers

- **Lock in your customers**
- **Pass on cost to your customers**

Reduce the risk of owning unproductive current assets

- **Keep asset levels in line with anticipated demand**
- **Cut down on asset classes whose risk increases with a downturn**

Source: Arthur D. Little analysis

a. Make the aggregate of your activities less cyclical

The most obvious way to reduce your company's overall exposure to business cycles is to add less cyclical businesses or activities. For example, if you are selling capital equipment, you can expand the consumables or parts business to generate recurring revenues from your installed base. Swedish truck manufacturer Scania, for example, derives approximately 20 per cent of its sales from parts and services. During the past 10 years, volatility of truck sales has been 36 per cent higher than services sales. Truck

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sales declined in the 2001-2002 downturn, while services and parts sales continued to grow.

Even more drastically, you can add service activities to your product portfolio. Global telecoms company Ericsson is a successful example. As technology was becoming more complex and telecom operators decided that managing networks was no longer their core business, Ericsson saw a strategic opportunity to enter a new area. Today, Ericsson's Professional Services represents 24 per cent of total group sales, one third of which are of a recurring nature. The outlook for 2009 looks promising, as fourth-quarter results for 2008 increased by an impressive 34 per cent compared to the same quarter for 2007.

Another way of reducing your company's overall exposure to business cycles is to add businesses, markets or product lines that move out of phase with one another. Freight services company FedEx, for example, reduced its exposure to swings in the business cycle by acquiring ground transportation services company Caliber Technologies in 1997. Air freight and ground freight to a large extent are contra-cyclical businesses. As a result of its reduced exposure towards air transportation, FedEx emerged less battered from the aftermath of September 11 than it otherwise would have been.

b. Make your fixed costs variable

The second set of measures is about turning otherwise fixed operational costs, such as labour, plant and equipment, into variable costs, i.e. having them go down with your revenues. This positive effect on the bottom line is called operational leverage.

Steel manufacturer Nucor, for example, succeeds in accommodating much of the price and volume variations that occur in the highly cyclical steel industry. It does so thanks to a business model with flexible wages and working hours, and by sharing profits and losses across all employee levels. As a result of this flexibility, Nucor's share price and operating margins have been less volatile than those of US Steel. In a similar vein, automotive manufacturer Daimler purposefully makes use of temporary staff. When times

are good and demand increases, the need for extra labour is covered by agreements with temporary employment agencies. Vice versa, temporary in-sourcing under certain circumstances can soften the blow of declining sales.

Another form of operational leverage relates to the flexibility of the production set-up, i.e. the ability to ramp production volume up and down rapidly in response to anticipated sales volumes. Truck manufacturer Paccar has implemented a culture enabling it to ramp production up or down at the first sign of recovery or recession. To that purpose, it follows key industrial indicators such as freight tonnage closely. Its European affiliate DAF Trucks has been a pioneer in build-to-order production systems. Paccar has been profitable in a highly cyclical industry for more than 60 consecutive years.

The third set of measures is about increasing the stickiness between your business and that of your customers. What exactly you can do depends on the nature of your business and your bargaining power toward your customers.

The third form of operational leverage is the outsourcing of high fixed-cost activities. Xilinx pioneered the concept of the fabless semiconductor supplier. It does not own any fabrication facility – which cost well above $1 billion a piece – but relies on semiconductor foundries that specialise in the latest process technologies. Xilinx itself focuses on designing and bringing advanced semiconductor products to market.

c. Secure the revenues from your customers

The third set of measures is about increasing the stickiness between your business and that of your customers. What exactly you can do depends on the nature of your business and your bargaining power toward your customers.

One way to increase stickiness is to lock in your customers, i.e. make it harder for them to drop you than to drop your competitor when their demand weakens. An example of a lock-in mechanism is to establish long-term contracts from which your customer will not want to walk away. Packaging company Tetra Pak has secured its revenue position by leasing its filling machines. Having locked up beverage companies on long-term machine leases, Tetra Pak enters into contracts with customers to supply them with packaging materials. The materials have been custom-designed for Tetra Pak machines, giving the organisation an advantage in providing raw materials to the filling machines. Once familiar with Tetra Pak machines and with employees trained to operate them, beverage companies have little incentive to switch to other suppliers. Tetra Pak also offers them protection from technological obsolescence. Competition law may, of course, put a limit on how far you can go with customer lock-in, as Tetra Pak has found out.

Another form of stickiness is the possibility of passing on costs to your customers. Multi-year supply contracts can include automatic price increases linked to an inflation index, which is quite customary, for example, with insurance products.

Another example is to establish a strong linkage between your product and the related consumables sold. Nespresso, the luxury coffee subsidiary of Nestlé, does this lucratively. The business model is based on selling coffee machines at a discount but the portioned coffee capsules required to make the coffee are charged at a premium. Being the sole supplier of the machines and the capsules, Nespresso basically controls the entire process. Once customers have bought a Nespresso machine they are, hopefully, in for a very long time.

"Smart linkages" can also be made in other ways. Consider the numerous companies selling customised software packages. In essence, they are increasing the complexity of their offering and, as a consequence, their customers' technical dependence on them. Once the software is in your system, it is hard to find anybody other than the clever people who designed it to maintain it at reasonable cost.

Another form of stickiness is the possibility of passing on costs to your customers. Multi-year supply contracts can include automatic price increases linked to an inflation index, which is quite customary, for example, with insurance products. Alloy surcharges are commonly used in the metals industry: stainless steel producers add a surcharge to the base price of stainless steel that fluctuates with the market price of nickel, a key ingredient of stainless steel.

If you have long-term supply contracts with your customers, say for services, you could try to make your supply periodic instead of fluctuating with your customer's own business volume. For example, if you are selling maintenance services linked to your product (e.g. materials handling equipment), it would be better in a downturn to have a periodic maintenance schedule (e.g. once a quarter) than a maintenance frequency that is based on your customer's actual usage of your product (e.g. equipment mileage).

d. Reduce the risk of owning unproductive current assets

The fourth set of measures is about cutting down on assets on which the return is likely to go down during a downturn or, even worse, assets that may have to be written off. The most obvious example is to reduce inventory renewal in anticipation of declining demand. Likewise, one can intensify the collection of receivables or be more selective in selling to customers with a higher risk of default in a downturn to come.

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Real estate management company Arden Realty is an example of a company that took defensive actions toward the end of the booming real estate market in 2000. It foresaw the downturn and selected tenants only after careful consideration. It accepted only those who were able to sign long-term contracts and had good credit ratings. It also launched an initiative to collect outstanding receivables. When the downturn came, it was well prepared compared to most of its competitors (see also side text about ways to forecast a business cycle).

Take advantage of your competitors' weakened position

The measures described so far relate to actions you can take within your own company, ideally before the downturn hits so that you enter it well prepared and in robust shape. Below we describe measures to take advantage, once the downturn has hit, of competitors who are less well prepared than you are (see Table 2 for an overview).

We distinguish three sets of measures:

a. Acquire companies previously too expensive or inaccessible;

b. Exhaust your competitors;

c. Keep the war for talent going.

Table 2 How to leverage competitors' weaknesses

Acquire companies previously too expensive or inaccessible

Exhaust your competitors

- **Make investments they cannot follow**
- **Make expenditures they cannot match, with more bang for the bucks**

Keep the war for talent going

- **Keep talent productively on board**
- **Hire exceptional talent**

Source: Arthur D. Little analysis

a. Acquire companies previously too expensive or inaccessible

During a downturn, prices of acquisition targets tend to be lower, as both stock market prices and price premiums decline. Distressed owners may have to resort to a fire sale of part of their activities. You may have access to targets that otherwise were inaccessible. Often there are fewer (private equity) bidders for any given target.

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Chemicals manufacturer DuPont launched a major strategic initiative to cut capital expenditure in early 2000 at the peak of the business cycle. During the downturn that followed, it made seven strategic acquisitions, financed with the cash reserves it had built up. DuPont maintained its profits during all but one quarter until late 2003 when separation costs related to the divestment of Invista hurt its results.

IT solutions provider IBM acquired PricewaterhouseCoopers' consulting arm for $3.5 billion in the 2002 downturn, further expanding its professional services capability with 30,000 professionals. In November 2000, HP had offered $18 billion for the same business but had had to withdraw its bid further to a bad quarterly report and a stock price decrease of 15 per cent.

Aviation group Lufthansa continues to drive forward the consolidation of the European airline industry in the current downturn. In the second half of 2008, it acquired Austrian Airlines and a strategic equity stake in Brussels Airlines, all subject to regulatory approval. It is said to be in takeover

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talks with SAS and Alitalia/AirOne. In the aftermath of the previous downturn it had already acquired Swiss.

Another ongoing case is the "forced disposal" by Ford Motor of several of its premium passenger car activities. It sold its Jaguar and Land Rover units to Tata Motors in early 2008. In late 2008 it started talking with bidders for its Volvo Cars unit.

Software developer Oracle has stated recently that it will keep up its 12-company-a-year buying habit, using its enormous cash reserve ($11 billion on November 30, 2008). We can expect to see a similar acquisition spree from other technology companies.

b. Exhaust your competitors

The second set of measures is about using the muscle you built up during the good times to force your weaker competitors to hurt themselves or let go. Either way they lose terrain. It is the equivalent of the marathon runner putting in that hurtful little acceleration whenever he spots a moment of weakness in his opponents.

If you have built up muscle, you can make pre-emptive investments in innovation, production facilities or distribution that your competitors cannot follow. Such investments tend to be cheaper and faster than during boom times. Foreseeing the business cycle peak in 2000, builders merchant Lowe's expected new home sales to plummet soon and demand for home improvement materials to grow. Therefore it embarked on a strategy of opening almost 300 new stores in two years. As a consequence it took a large share of the market from competitor Home Depot.

Semiconductor company Intel has announced that it will maintain its focus on manufacturing leadership, drive innovation, develop new markets and implement operational efficiencies despite a 23 per cent decrease in revenues in the fourth quarter of 2008 compared to the same period in 2007. During the 2001 downturn, Intel outmaneuvered AMD through well timed investments in new processor and manufacturing technologies. In 2002, Intel's sales increased and profit margin went back up to historical levels, despite the recession. AMD, which was about 15 per cent the size of Intel, did not have the financial resources to match Intel's investments, recorded a sharp decline in sales and took heavy losses.

Clothes retailer H&M has announced that it will open 225 new stores during 2009 (an increase of 13 per cent), despite the recent decrease in like-for-like sales. In the previous downturn in 2001-2003, the number of stores increased by 9 to 13 per cent annually.

A downturn is heaven for companies that can afford to safeguard past investments in talent or even to make further investments. Rather than firing and re-hiring people, they keep talent productively on board.

If you have built up muscle, you can also make marketing expenditures that your competitors cannot match – and with more bang for the bucks, as prices of marketing services tend to come down and your share of voice is likely to be higher. Coca-Cola is spending 8-11 per cent of sales on advertising every year. In 2001 and 2002 it increased spending compared to 1999 and 2000. Consumer products company Procter & Gamble maintained its advertising spend during the 2001-2002 downturn and then increased it during 2003. For these companies, counter-cyclical initiatives are just another way to expand their industry leadership.

c. Keep the war for talent going

A downturn is heaven for companies that can afford to safeguard past investments in talent or even to make further investments. Rather than firing and re-hiring people, they keep talent productively on board. Truck manufacturer Scania is currently offering training programmes to its workforce instead of laying people off, despite the downturn's brutal impact on the transport equipment sector.

By the same token, this is the time to hire exceptional talent more easily than during a boom. Non-life insurance company Progressive used the soft employment market in 2001 to hire and train more than 3,000 college graduates whom it otherwise would have had difficulties attracting. Today it has more than 28,000 employees.

In this article we have described measures to reduce your intrinsic vulnerability to a downturn and to take advantage of your competitors' weakened position during a downturn. When taken together, they will make you more robust and audacious at the same time.

There is one more condition, though, needed for the robust and audacious to prosper over an extended period of time: calories. Indeed, no time is more appropriate for recounting Aesop's fable of the ant and the cricket than a downturn. Many of the measures described above can be taken only if you are in a strong financial position. A strong financial position means a positive net cash position, a low debt/equity ratio and/or positive cash flow from operations.

Cash is king – always. Remarkably, we only seem to know what our king is worth when times are bad.

If you are in a weak financial starting position, your first priority is survival. In many cases this will imply financial re-engineering, such as the sale of crown jewels, even if all your businesses have a strategically strong position. The troubles surrounding Dow Chemical's planned acquisition of Rohm and Haas or the merger of Lyondell and Basell are telling examples from the chemical industry.

Insights for the executive

Business cycle management is about maintaining the strategic and financial health of the company across an entire economic cycle, from expansion through downturn. It means building assets and capabilities and creating and exploiting opportunities when times are good. But it also means, when times are good, taking the measures required to reduce your company's intrinsic vulnerability to the ill effects of the downturn that eventually will strike. And when times are bad, it means having the audacity to take advantage of your competitors' weakened position. When you combine all these measures, you will be able to come out of the downturn stronger than your competitors.

The measures to reduce your intrinsic vulnerability fall into four groups:

- Make the aggregate of your activities less cyclical;
- Make your fixed costs variable;
- Secure the revenues from your customers;
- Reduce the risk of owning unproductive current assets.

The measures to take advantage of your competitors' weakened position fall into three groups:

- Acquire companies previously too expensive or inaccessible;
- Exhaust your competitors;
- Keep the war for talent going.

Of course, many of the measures described above can be taken only if you have hoarded enough financial means in times of abundance. Cash is king – always. Remarkably, we only seem to know what our king is worth when times are bad.

Forecasting the turns in the business cycle

Anticipating the inflection point in the business cycle is essential for being able to beat competitors during the downturn. It is impossible, however, to forecast exactly its timing, its amplitude and the specific sectors, industries and segments that it will affect most. Fortunately, there are tools for improving transparency.

One commonly used group of forecasting tools is forecasting models. Forecasting models are normally based on historical patterns and the assumption that these patterns will hold during the forecasting period. The forecasting model data are usually adjusted for structural changes and other factors that have been identified. Economists' projections of GDP and unemployment, and analysts' projections of stock market earnings development are examples of output from forecasting models.

The weakness of forecasting models is that historical patterns do not always repeat themselves, and that it is very difficult to forecast the inflection point of the business cycle accurately. One tool for handling this type uncertainty is to use scenario planning. In scenario planning, a number of future scenarios are used as the starting point, and then important parameters are backcasted to today.

Another group of tools for predicting the downturn is leading indicators. Leading indicators are figures, key ratios and other measures indicating the direction of the business cycle in advance. Macro-economic indicators indicate where the economy is heading. Yield-curve, stock and oil prices, confidence indicators and the OECD Composite Leading Indicators are examples of leading macro-economic indicators. Business-related indicators indicate where a specific industry or sector is heading. In the pulp and paper sector, for instance, pulp future prices, paper prices, utilisation rates and inventory levels are examples of business indicators.

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