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By Chris Zook and James Allen

On Managing in a Downturn

If you read nothing else on preparing for a tough economy and coming back stronger, read these definitive articles from **Harvard Business Review.**

Seize Advantage in a Downturn

by David Rhodes and Daniel Stelter

INACTION IS THE RISKIEST RESPONSE to the uncertainties of an economic crisis. But rash or scattershot action can be nearly as damaging. Rising anxiety (how much worse are things likely to get? how long is this going to last?) and the growing pressure to do *something* often produces a variety of uncoordinated moves that target the wrong problem or overshoot the right one. A disorganized response can also generate a sense of panic in an organization. And that will distract people from seeing something crucially important: the hidden but significant opportunities nestled among the bad economic news.

We offer here a rapid but measured approach—simultaneously defensive and offensive—to tackling the challenges posed by a downturn. Many companies are already engaged in some kind of exercise like this. Certainly every organization with an institutional pulse has held discussions focusing on what it should do about the current economic crisis. We hope this article will help you move from what may have been ad hoc conversations and initiatives to a carefully thought-out plan.

The merits of a comprehensive and aggressive approach are borne out in research by the Boston Consulting Group, which indicates that companies whose early responses to a downturn are tentative (for example, modest belt-tightening) typically overreact later on (say, cutting costs more than they ultimately need to). This results in an expensive recovery for the company when the economy rebounds.

Our approach has two main objectives, from which a series of action items devolves. First, stabilize your business, protecting it from downside risk and ensuring that it has the liquidity necessary to weather the crisis. Then, and only then, can you identify ways to capitalize on the downturn in the longer term, partly by exploiting the mistakes of less savvy rivals.

For some companies, the outcome of this process will be a program of immediate actions that represent a turbocharged version of business as usual. For others, it will be a painful realization that nothing short of an urgent corporate turnaround will suffice.

What Is Your Exposure?

The first step for a company to take in a challenging economic environment—especially one that could significantly worsen—is to assess in a systematic manner its own vulnerabilities, at the company level and by business unit.

Consider several scenarios

As an economic crisis evolves, sketch out at least three scenarios—a modest downturn, a more severe recession, and a full-blown depression, as defined by both duration and severity. Consider which scenario is most likely to unfold in your industry and your business, based on available data and analysis. There was evidence from the beginning, for example, that the current global downturn truly stands apart. Early on, banking losses had outstripped those of recent financial disasters, including the United States savings and loan crisis (1986–1995), the Japanese banking crisis (1990–1999), and the Asian financial crisis (1998–1999). Furthermore, as the economy first began to stall, the underlying problem of consumer and corporate indebtedness—in the United States, it totaled about 380% of GDP, nearly two and a half times the level at the beginning of the Great Depression—pointed to a prolonged period of economic pain.

Next, determine the ways in which each of the scenarios might affect your business. How would consumers' limited capacity to

Idea in Brief

Many companies fail to see the opportunities hidden in economic downturns.

To take advantage of opportunities, you first need to do a thorough but rapid assessment of your own vulnerabilities and then move decisively to minimize them.

This will position you to seize future sources of competitive advantage, whether from bold investments in product development or transformative acquisitions.

borrow reduce demand for your products? Will job insecurity and deflating asset prices make even the creditworthy increasingly reluctant to take on more debt? Will reduced demand affect your ability to secure short-term financing, or will weak stock markets make it difficult to raise equity? Even if you are able to tap the debt and equity markets, will higher borrowing costs and return requirements raise your cost of capital?

Quantify the impact on your business

Run simulations for each of these scenarios that generate financial outcomes on the basis of major variables, including sales volume, prices, and variable costs. Be sure to confront head on what you see as the worst case. For example, what effect would a 20% decline in sales volume and a 5% decline in prices have on your overall financial performance? You may be surprised to find out that, even in the case of a still-healthy company with operating margins (before interest and taxes) of around 10%, such a decline in volume and prices could turn current profits into huge losses and send cash flow deep into the red. Conduct a similar analysis for each business unit.

Next, quantify how your balance sheet might be affected under the different scenarios. For example, what will the impact be of asset price deflation? To what extent might lower cash flows and the higher cost of capital affect goodwill and require write-offs on past acquisitions? Will falling commodity prices cushion some of the detrimental effects?

Idea in Practice

Before trying to capitalize on the opportunities presented by a recession, you must assess and minimize your firm's vulnerabilities. The authors suggest setting up a recession checklist.

Financial Fundamentals

Liquidity is the key to surviving and thriving in tough times, when both cash to meet current obligations and capital for investing in the future are scarce. So you need to . . .

Monitor and maximize your cash position

- Calculate expected cash inflows and outflows
- Produce a rolling weekly or monthly cash report
- Centralize or pool cash across units

Tightly manage customer credit

- Segment customers based on their credit risk
- Offer financing only to credit-worthy or strategic customers
- Assess trade-offs between credit risks and marginal sales

Aggressively manage working capital

- Reduce inventories by monitoring production and sourcing
- Reduce receivables by actively managing customer credit

Optimize your financial structure

- Reduce debt and other liabilities
- Secure access to lines of credit
- Secure access to equity capital by tapping nonmarket sources such as sovereign wealth funds

Share Price

A strong market valuation relative to rivals is important in raising capital and acting on acquisition opportunities. So you need to . . .

- Inform investors and analysts of your recession preparedness
- Consider opting for dividend payments rather than share buybacks

Assess rivals' vulnerabilities

Of course, none of this process should be carried out in a vacuum. Your industry and the locations of your operations around the world will help determine how your business will be affected. It's critical to understand your own strengths and weaknesses relative to those of your competitors. They will have different cost structures,

Current Business

Loosely run operations, sluggish unit sales, and an overextended enterprise leave you vulnerable to economic shocks. So you need to . . .

Reduce costs and increase efficiency

- Root out long-standing activities that add little business value
- Revive earlier efficiency initiatives too controversial to fully implement in better times
- Consolidate or centralize key functions
- Analyze current suppliers and procurement practices
- Reexamine the economics of offshoring

Aggressively manage the top line

- Revitalize customer retention initiatives
- Realign sales force utilization and incentives to generate additional short-term revenue
- Reallocate marketing spending toward immediate revenue generation
- Consider more-generous financial terms for customers in return for higher prices

Rethink your product mix and pricing strategies

- Offer lower-price versions of existing products
- Identify products for which customers are still willing to pay full price
- Consider creative strategies such as results-based or subscription pricing
- Unbundle services and adopt à la carte pricing

Rein in planned investments and sell assets

- Establish stringent capital allocation guidelines
- Shed unproductive assets that were difficult to dispose of in good times
- Divest noncore businesses

financial positions, sourcing strategies, product mixes, customer focuses, and so on. To emerge from the downturn in a lead position, you must calibrate the actions you plan to take in light of the actions that your competitors will most likely take. For example, assess potential acquisitions with a focus on vulnerable customer groups of weaker competitors.

This assessment of different scenarios and their effects on your company and its rivals, while just a first step, will help you identify particular areas where you're vulnerable and where action is most immediately needed. This analysis will also help you to communicate to the entire organization the justification and the motivation for actions you'll need to take in response to the crisis.

How Can You Reduce Your Exposure?

Once you understand how your business could be affected, you need to figure out the best way to survive and maximize your company's performance during the downturn. This requires achieving several broad objectives.

Protect the financial fundamentals

The aim here is to ensure that your company has adequate cash flow and access to capital. Not only does a lack of liquidity create immediate problems but it also is critically important to your ability to make smart investments in the future of the business.

Consequently, you need to *monitor and maximize your cash position*, by using a disciplined cash management system, by reducing or postponing spending, and by focusing on cash inflow. Produce a rolling report on your cash position (either weekly or monthly, depending on the volatility of your business) that details expected near-term payments and receipts. Also estimate how your cash position is likely to evolve in the midterm, calculating expected cash inflows and outflows. You may need to establish a centralized cash management system that provides companywide data and enables pooling of cash across business units.

How much spending you postpone depends on your assumptions about the severity of the downturn and to what degree such spending is discretionary. But you'll want to be just as aggressive in looking for ways to improve cash flow—if you were facing a worst-case-scenario liquidity crisis, for example, just how much cash would you be able to raise during the next quarter?

One way to improve cash flow is to more aggressively *manage customer credit risk*. Trade credit—financing your customers' purchases by letting them pay over time—should be reduced where possible. Given the economic environment, buyers will seek credit more frequently and your risk will increase. You'll need to segment your customers by assigning them each a credit rating. Avoid granting trade credit to higher-risk customers or to those whose business is less strategically important to you. Also, assess the trade-off between credit risks and the revenue potential of a marginal sale. This will require cooperation between people in sales and customer finance, as well as a review of those employees' incentives to make sure they're aligned with revised strategic goals for the downturn.

Another way to free up cash is to look for opportunities to *reduce working capital*. A surprisingly large number of companies are unaware of the benefits of aggressively managing their working capital—the difference between a company's current assets and liabilities—and thus make little effort to even monitor it. As a rule of thumb, most manufacturing companies can free up cash equivalent to approximately 10% of sales by optimizing their working capital. This involves reducing current assets, such as inventories (through more careful management of both production and sourcing processes) and receivables (through, in part, the active management of trade credit).

As you scrutinize your customers' debt profiles, you should review your own as well, in order to *optimize your financial structure and financing options*. The heyday of leverage, with constant pressure from the market to operate with relatively low levels of equity, is clearly over for now. You should be looking for ways to strengthen your balance sheet, reducing debt and other liabilities, such as operating leases or pension obligations, with the dual aim of reducing your financial risk and enhancing your risk profile in the eyes of investors.

Be sure, as well, to secure financing—for example, draw on lines of credit as soon as possible to provide liquidity for day-to-day operations, holding onto any excess cash to avoid refinancing problems in the future. Meeting such needs may require some creativity in a tight credit market. For example, some companies, in renewing revolving credit facilities with banks, have agreed to forgo fixed interest rates on the funds they draw down under the facility. Instead, borrowers have agreed to link the rate to the trading price of their so-called credit default swaps. These financial instruments, which represent a form of insurance against a borrower defaulting, reflect the market's perception of a company's creditworthiness. By agreeing to initially high and variable interest rates for a line of credit, borrowing companies can secure access to funds at a time when skittish banks are reluctant to lend. To secure equity capital, companies need to look beyond the market to sources such as sovereign wealth funds, private equity firms, or cash-rich investors.

Protect the existing business

After ensuring that the company is on a firm financial footing, turn to protecting the viability of the business. You must be prepared to act quickly and decisively to improve core operations.

Begin with aggressive moves to *reduce costs and increase efficiency*. Although cost-cutting is the first thing most companies think about, their actions are often tentative and conservative. You need to work rapidly to implement measures, using the turbulent economic environment to catalyze action that is long overdue—or to revive earlier initiatives that proved too controversial to fully implement in good times. Keep in mind, though, that while speed is important so is a well-reasoned plan: You don't want to make cuts that in the long term will hurt more than they help by, for example, putting important future business opportunities at risk.

Some means of streamlining the organization and lowering break-even points are obvious: stripping out layers of the organizational hierarchy to reduce head count, consolidating or centralizing key functions, discontinuing long-standing but low-value-added activities. SG&A expenses—selling, general, and administrative costs, such as marketing—are also prime targets for cost-cutting. As such, they can highlight the risks of purely reactive action: Companies that injudiciously slash marketing spending often find that they later must spend far more than they saved in order to recover from their prolonged absence from the media landscape.

Opportunities to reduce materials and supply chain costs also arise in a downturn. Now is the time to pursue a comprehensive review of your current suppliers and procurement practices, which undoubtedly will prompt new initiatives—the adoption of a demand management system, say, or the standardization of components. In particular, consider how the downturn affects the economic equation of offshore manufacturing. Falling shipping costs could make offshoring more attractive, even for low-cost items; at the same time, a weakening domestic currency, trade barriers, and especially the cash tied up in the additional working capital required to source a product far from its market may offset any savings.

While looking for opportunities to reduce spending, you'll also want to *aggressively manage the top line*, cash being crucially important in a recession. Actively work both to protect existing revenue and identify ways to generate additional revenue from your current business. Customer retention initiatives become more valuable than ever. Consider tactical changes in sales force utilization and incentives. Reallocate marketing spending to bolster immediate revenue generation rather than longer-term brand building. While granting trade credit sparingly, also consider the possible benefits of offering customers more-generous financial terms while charging them higher prices—provided you've done your homework on your own financial structure.

As these initiatives suggest, you'll want to *rethink your product mix and pricing strategies* in response to shifting customer needs. Purchasing behavior changes dramatically in a recession. Consumers increasingly opt for lower-priced alternatives to their usual purchases, trading down to buy private label products or to shop at discount retailers. Although some consumers will continue to trade up, they'll do so in smaller numbers and in fewer categories. Consumer products companies should consider offering low-priced versions of popular products—think of the McDonald's Dollar Menu in the United States or Danone's Eco-Pack yogurt in France. Whatever your business, determine how the needs, preferences, and spending patterns of your customers, whether consumer or corporate, are affected by the economic climate. For example, careful segmentation may reveal products primarily purchased by people still willing to pay full price. Use that intelligence to inform product portfolio and investment choices.

Innovative pricing strategies may also alleviate downward pressure on revenue. These include: results-based pricing, a concept pioneered by consulting firms that links payment to measurable customer benefits resulting from use of a product or service; changes in the pricing basis that would allow a customer to, for example, rent equipment by the hour rather than by the day; subscription pricing, by which a customer purchases use of a product—say, a machine tool—rather than the product itself; and the unbundling of a service so that customers pay separately for different elements of what was previously an all-in-one package, as airlines have done with checked baggage and in-flight meals and entertainment. Offering consumers new and creative customer financing packages could tip the balance in favor of a sale. It was during the Great Depression, after all, that GE developed its innovative strategy of financing customers' refrigerator purchases.

You should definitely *rein in your investment program*. Most developed economies had excess capacity even before the downturn: Capacity utilization in the United States, for example, fell below 80% of potential output beginning in April 2008. In the current economy, there is even less need, in most industries, to invest in further capacity. You need to establish stringent capital allocation guidelines aligned with the current economic climate, if you haven't already. This may also be the time to shed unproductive assets, including manufacturing plants that have previously been difficult to shut down, selling them where possible to generate cash for the business.

Finally, take this opportunity to *divest noncore businesses*, selling off peripheral or poorly performing operations. Don't wait for better times, in the hope of getting a price that matches those of recent years, when the economy was buoyant and credit was plentiful. Those conditions aren't likely to return anytime soon, and if the

Avoiding the Snags of Implementation

ONE KEY TO THE SUCCESS of downturn-related initiatives is rapid implementation. A formal crisis management team to oversee your company's response to the recession can help the organization avoid these typical sources of failure.

Insufficient understanding and appreciation of the evolving crisis

The crisis management team can help create and maintain a sense of urgency within the organization, in part by creating a transparent, consistent, and fact-based process for carrying out the necessary initiatives. The team should also continually monitor the economic situation and, if needed, move from, say, a modest downturn scenario to a worst-case action plan.

Senior leaders' lack of preparation and commitment

By promoting a close working relationship with the sponsor of the company's recession response (often the CEO), the team can keep the company's senior executives informed of progress and direct them to where their participation is needed.

Failure to see how individual initiatives are part of a comprehensive plan

By establishing the priority and timing of initiatives, the team can help ensure that the individual measures reinforce one another. The team should continually evaluate initiatives both individually and collectively, with the aim of suspending, accelerating, or combining existing efforts—or initiating new ones.

Lack of attention to the human element

To earn employees' commitment to the initiatives, the team must articulate the threats facing the organization, explain why change is needed and what it will entail, and clearly communicate to individuals how they will be affected.

business isn't critical to your activities and increases your vulnerability to the downturn, divest it now.

Research by our firm shows a strongly positive market reaction to the right divestitures in recessionary times. And shedding noncore operations ideally will end up energizing your core business. In 2003, in the middle of a particularly acute economic downturn in Germany, MG Technologies, a €6.4 billion engineering and chemicals company, decided to focus on its specialty mechanical engineering business. It sold its noncore chemical and plant engineering businesses and emerged as the renamed GEA Group, a slimmed down but successful specialty process engineering and equipment company, better positioned to pursue growth opportunities in its core areas.

Maximize your valuation relative to rivals

Your company's share price, like that of most firms, will take a beating during a downturn. While you may not be able to prevent it from dropping in absolute terms, you want it to remain strong compared with others in your industry. Much of what you've done to protect the financial fundamentals of your business will serve you well. In a downturn, our data shows that markets typically reward a strong balance sheet with low debt levels and secured access to capital. Instead of being punished by activist investors and becoming a takeover target for hedge funds, a company sitting on a pile of cash is viewed positively by investors as a stable investment with lower perceived risk. For that to happen, you need to *create a compelling investor communications strategy* that highlights such drivers of relative valuation. This will also be important as you try to capitalize on the competitive opportunities that a recession offers, such as seeking attractive mergers and acquisitions.

You can further enhance your relative value if you *reassess your dividend policy and share buyback plans*. A Boston Consulting Group study of U.S. public companies found that, on average, investors favor dividends because they represent a much stronger financial commitment to investors than buybacks, which can be stopped at any time without serious consequences. On average, sustained dividend increases of 25% or more overwhelmingly resulted in higher relative valuation multiples in the two quarters following their announcement. By contrast, buybacks had almost no impact on the relative valuation multiple in the two quarters following the transaction. For example, TJX Companies, a U.S. discount retailer, announced a dividend increase of 33% in June 2002, when the country was in a recession—and then enjoyed a price-to-earnings multiple 42% higher than the average of S&P 500 companies over the two quarters following the announcement. These are exceptional times, though, and we recommend that companies analyze their particular situation as well as investor preferences before taking a specific measure.

How Can You Gain Long-Term Advantage?

The best companies do more than survive a downturn. They position themselves to thrive during the subsequent upturn, guided again by a number of broad objectives.

Invest for the future

Investments made today in areas such as product development and information or production technology will, in many cases, bear fruit only after the recession is past. Waiting to move forward with such investments may compromise your ability to capitalize on opportunities when the economy rebounds. And the cost of these investments will be lower now, as competition for resources slackens.

Given current financial constraints, you won't be able to do everything, of course, or even most things. But that shouldn't keep you from making some big bets. Prioritize the different options, protecting investments likely to have a major impact on the long-term health of the company, delaying ones with less-certain positive outcomes, and ditching those projects that would be nice to have but aren't crucial to future success.

Sanofi-Synthélabo, the French pharmaceutical company, entered the economic recession that began in 2001 with a solid product portfolio. Throughout the downturn, the company maintained, and in some cases increased, its R&D spending in order to keep its product pipeline robust. Sanofi increased its absolute R&D expenditure from €950 million in 2000 to €1.3 billion in 2003. Because of its strong business and financial performance, the company gained market share and outperformed peers in the stock market. The company was thus well positioned to acquire Aventis, a much larger Franco-German pharmaceutical company, after a takeover battle, in the economic upswing of 2004.

Or look at Apple Computer. The company wasn't in particularly good shape as it headed into the 2001–2003 recession. For one thing, revenue fell 33% in 2001 over the previous year. Nonetheless, Apple increased its R&D expenditures by 13% in 2001—to roughly 8% of sales from less than 5% in 2000—and maintained that level in the following two years. The result: Apple introduced the iTunes music store and software in 2003 and the iPod Mini and the iPod Photo in 2004, setting off a period of rapid growth for the company.

A downturn is also a good time to invest in people—for example, to upgrade the quality of your management teams. Competition for top people will be less fierce, availability higher, and the cost correspondingly lower.

Pursue opportunistic and transformative M&A

The recession will change several of the long-standing rules of the game in many industries. Exploit your competitors' vulnerabilities to redefine your industry through consolidation. History shows that the best deals are made in downturns. According to research by our firm, downturn mergers generate about 15% more value, as measured by total shareholder return, than boom-time mergers, which on average exhibit negative TSR.

To capitalize on opportunities, closely monitor the financial and operational health of your competitors. Companies lacking the financial cushion to benefit from the recession—or even to stay afloat—may even welcome your advances.

In late 2001, only weeks after the 9/11 terrorist attacks had brought vacation travel to a near standstill, Carnival, the world's largest cruise ship operator, interceded in the planned friendly merger of Royal Caribbean and P&O Princess Cruises, then the second and third largest cruise operations respectively. Its own bid to acquire P&O Princess required persistence—it was 15 months before P&O Princess shareholders finally accepted Carnival's offer—but the deal turned out to be a smart strategic move for the company, whose total shareholder returns far surpassed those of the S&P 500 in the years following the announcement and then the completion of the acquisition.

Of course, you'll have to ride out the recession carrying the baggage of any company you acquire, so due diligence—particularly concerning a potential target's current and future cash positions—takes on even more importance during a downturn. This knowledge will help you to limit the particular risks arising from an acquisition made during a recession, as well as to convince your management teams and supervisory boards that a bold move during a period of caution makes sense.

Rethink your business models

Downturns can be a time of wrenching transformation for companies and industries. The economics of the business may change because of increased competition, changing input costs, government intervention, or new trade policies. New competitors and business models may emerge as companies seek to increase revenue through expansion into adjacent product categories or horizontal integration. Successful companies will anticipate these changes to the industry landscape and adapt their business models ahead of the competition to protect the existing business and to gain advantage.

Consider IBM. During the U.S. recession of the early 1990s, the company under Lou Gerstner faced its first decline in revenue since 1940 and endured successive years of record losses. In this context, it began to rethink its business model. Struggling with sluggish economic growth, particularly in Europe and Japan, as well as increased price competition, IBM was forced to confront head on the inevitable decline of its traditional business, mainframe computers. Realizing that the company's markets were shifting, Gerstner redefined the company's business model, transforming IBM from a hardware producer into a computer services and solutions provider.

Where Do You Take Action?

The process we have laid out should yield a list of promising initiatives—undoubtedly more of them than you'll have the capacity to launch and manage all at once. So you'll need to prioritize, carefully assessing each initiative based on several criteria—most notably, urgency, overall financial impact, barriers to implementation, and risks that the initiative might pose for the business. The result will be a portfolio of actions with the right blend of short-term and long-term focus.

Who is going to carry out the recession plan? We recommend that you form a dedicated crisis management team to manage your organization's response to the recession. The team will develop different economic scenarios and determine how they might affect the business; identify recession-related risks and opportunities; and prioritize initiatives designed to mitigate the risks and capitalize on the opportunities. It will then oversee implementation of the initiatives, monitoring their progress and continually reevaluating them in the light of changes in the economic landscape. (For a summary of how the crisis management team can help ensure a recession plan's success, see the sidebar "Avoiding the Snags of Implementation.")

Companies adopting the comprehensive approach we have laid out will be not only better placed to weather the current storm but also primed to seize the opportunities emerging from the turbulence and to get a head start on the competition as the dark clouds begin to disperse.

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How to Survive a Recession and Thrive Afterward

A Research Roundup. *by Walter Frick*

IN EARLY 2000, A FIVE-YEAR-OLD online bookseller called Amazon.com sold $672 million in convertible bonds to shore up its financial position. One month later, the dot-com bubble burst. More than half of all digital startups went out of business over the next few years—including lots of Amazon's then-rivals in e-commerce. Had the bubble burst just a few weeks earlier, one of the most successful companies ever might have fallen victim to that recession.

Recessions—defined as two consecutive quarters of negative economic growth—can be caused by economic shocks (such as a spike in oil prices), financial panics (like the one that preceded the Great Recession), rapid changes in economic expectations (the so-called "animal spirits" described by John Maynard Keynes; this is what caused the dot-com bubble to burst), or some combination of the three. Most firms suffer during a recession, primarily because demand (and revenue) falls and uncertainty about the future increases. But research shows that there are ways to mitigate the damage.

In their 2010 HBR article "Roaring Out of Recession," Ranjay Gulati, Nitin Nohria, and Franz Wohlgezogen found that during the recessions of 1980, 1990, and 2000, 17% of the 4,700 public companies they studied fared particularly badly: They went bankrupt, went private, or were acquired. But just as striking, 9% of the companies didn't simply recover in the three years after a recession—they flourished, outperforming competitors by at least 10% in sales and profits growth. A more recent analysis by Bain using data from the Great Recession reinforced that finding. The top 10% of companies in Bain's analysis saw their earnings climb steadily throughout the period and continue to rise afterward. A third study, by McKinsey, found similar results.

The difference maker was preparation. Among the companies that stagnated in the aftermath of the Great Recession, "few made contingency plans or thought through alternative scenarios," according to the Bain report. "When the downturn hit, they switched to survival mode, making deep cuts and reacting defensively." Many of the companies that merely limp through a recession are slower to recover and never really catch up.

How should a company prepare in advance of a recession and what moves should it make when one hits? Research and case studies examining the Great Recession shed light on those questions. In some cases, they cement conventional wisdom; in others, they challenge it. Some of the most interesting findings deal with four areas: debt, decision making, workforce management, and digital transformation. The underlying message across all areas is that recessions are a high-pressure exercise in change management, and to navigate one successfully, a company needs to be flexible and ready to adjust.

Deleverage Before a Downturn

Rebecca Henderson (of Harvard Business School) likes to remind her students, "Rule one is: Don't crash the company." That means, first and foremost, don't run out of money. Because a recession usually brings lower sales and therefore less cash to fund operations, surviving a downturn requires deft financial management. If Amazon hadn't raised all that money prior to the dot-com bust, its options would have been much more limited. Instead, it was able to absorb losses in its investments in other startups and also launch Amazon Marketplace, its platform for third-party sellers, later that year. It further expanded during and after the recession into new segments (kitchens, travel, and apparel) and markets (Canada).

Companies with high levels of debt are especially vulnerable during a recession, studies show. In a 2017 study, Xavier Giroud (of MIT's Sloan School of Management) and Holger Mueller (of NYU's Stern School of Business) looked at the relationship between business closures and associated unemployment and falling housing prices in various U.S. counties. Overall, the more housing prices declined, the more consumer demand fell, driving increased business closures and higher unemployment. But the researchers found that this effect was most pronounced among companies with the highest levels of debt. They divided up companies on the basis of whether they became more or less leveraged in the run-up to the recession, as measured by the change in their debt-to-assets ratio. The vast majority of businesses that shuttered because of falling demand were highly leveraged.

"The more debt you have, the more cash you need to make your interest and principal payment," Mueller explains. When a recession hits and less cash is coming in the door, "it puts you at risk of defaulting." To keep up with payments, companies with more debt are forced to cut costs more aggressively, often through layoffs. These deep cuts can impair their productivity and ability to fund new investments. Leverage effectively limits companies' options, forcing their hand and leaving them little room to act opportunistically.

The extent to which high levels of debt pose a risk during a recession depends on various factors. Shai Bernstein (of the Stanford Graduate School of Business), Josh Lerner (of Harvard Business School), and Filippo Mezzanotti (of Northwestern University's Kellogg School of Management) have found that companies owned by private equity firms—which often require the companies they finance to take on debt—fared better during the Great Recession than similarly leveraged non-PE-owned firms. Companies with lots of debt struggle in part because access to capital slows to a trickle during a downturn. PE-backed firms emerged in better shape, the study suggests, because their owners were able to help them raise capital when they needed it. Issuing equity is another way companies

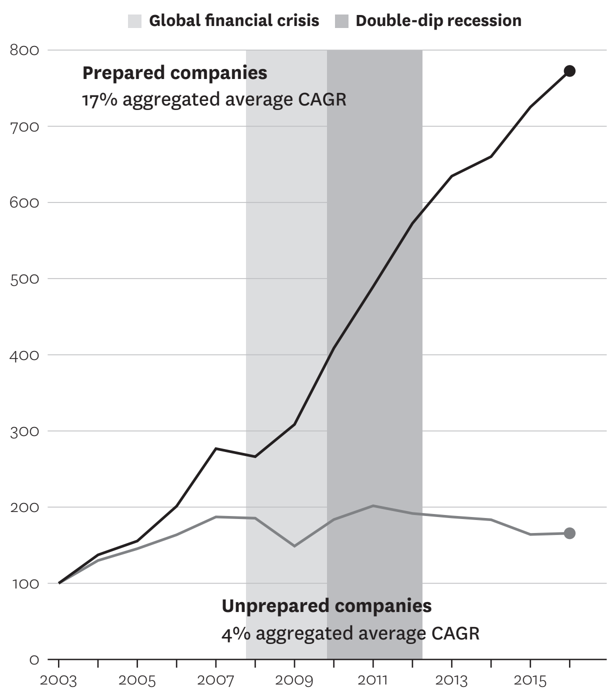
Companies That Prepare for a Recession Pull Ahead During and After It

by Mark Kovac and Jamie Cleghorn

RECESSIONS CATCH MANY COMPANIES by surprise, with predictable results. In the 2001 recession, total sales for the S&P 500 declined by 9% from its prerecession peak to its trough 18 months later—almost a year after

Companies that prepare for a recession pull ahead during and after it

Aggregated average EBIT indexed to 2003



Source: Bain analysis of Capital IQ data. Includes 388 prepared companies and 3,113 unprepared companies worldwide.
Note: A double-dip recession is when GDP becomes negative after at least a quarter of positive growth. EBIT and CAGR are not adjusted for inflation.

the recession officially ended. But these periods also present opportunities for well-prepared companies to take advantage of the turmoil and gain share.

The best time to undertake major changes that will strengthen a company during recession is before it hits. Prior to the past recession, both eventual winners and eventual losers in a group of 3,500 companies worldwide experienced double-digit growth rates. Once the recession struck, however, performance began to diverge sharply—the winners continued to grow while losers stalled out. The performance gap widened during the recovery. What did the winners do that losers didn't? They pursued a variety of tactics *before* the recession that were designed to fortify the firm when the downturn hit.

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can avoid the burden of debt obligations. "If you issue equity in the run-up to a recession," Mueller says, "the problem of defaulting will be less pronounced."

The reality, of course, is that many companies have some level of debt going into a recession. Mueller's study found that the average debt-to-assets ratio among firms that had increased debt levels in the run-up to the Great Recession was 38.3%. Among the group that had deleveraged, it was 19.5%. Although there's no magic number, modest levels of debt aren't necessarily a problem, research shows. Nonetheless, Mueller suggests that if a company thinks a recession is coming, it should consider deleveraging. McKinsey's recent recession research supports this: Firms that emerged in better shape from the Great Recession had reduced their leverage more dramatically from 2007 to 2011 than had less successful ones.

When it comes to deleveraging, it helps to start early, says McKinsey's Mihir Mysore. That means reducing debt levels before it's clear the economy is in recession. "You need to take a hard look at your portfolio," Mysore advises, because shedding assets can be a way to reduce leverage without necessarily cutting core aspects of operations.

Focus on Decision Making

A company's performance during and after a recession depends not just on the decisions it makes but also on who makes them. In a 2017 study, Raffaella Sadun (of Harvard Business School), Philippe Aghion (of Collège de France), Nicholas Bloom and Brian Lucking (of Stanford), and John Van Reenen (of MIT) examined how organizational structure affects a company's ability to navigate downturns. On the one hand, "the need to make tough decisions may favor centralized firms," the researchers write, because they have a better picture of the organization as a whole and their incentives are typically more closely aligned with company performance. On the other hand, decentralized firms may be better positioned to weather macro shocks "because the value of local information increases."

The researchers relied on data from the World Management Survey of manufacturers, which includes questions on how much autonomy a plant manager has to make investments, introduce new products, make sales and marketing decisions, and hire employees. Companies in which plant managers had little discretion were considered highly centralized; those in which they had a lot of discretion were scored as less so. The researchers also examined results from a similar survey run by the U.S. Census and matched them with company reports of sales, employment levels, profits, and other performance measures. And they gathered data on which industries were hardest hit by the Great Recession. "Decentralization was associated with relatively better performance for firms or establishments facing the toughest environment during the crisis," the researchers report. They also found that the benefits of decentralization faded as economic conditions improved—a sign that delegation has particular value during uncertain times.

Why did decentralization help? "The recession introduced a lot of uncertainty and turbulence," says Sadun. Because decentralized firms delegated decision making further down the hierarchy, they were better able to adapt to changing conditions. For example, they were more aggressive in adjusting their product offerings in response to changes in demand. "One [piece of] advice would be [to] really think carefully about your organizational structure because that's one way you cope with uncertainty," says Sadun.

Of course, organizational structure isn't easy to adjust quickly in preparation for a recession, but that doesn't mean companies can't learn from these findings. "What decentralization does," says Sadun, "is match decisions with expertise." She says companies can fall into the trap of hoarding decision rights during a downturn. But the uncertainty of a recession necessitates experimentation, which requires that decisions be made throughout the organization. Even if companies decide not to decentralize, they can try to do a better job of gathering input from employees at all levels when making key decisions. "Recessions offer opportunities for change," notes Sadun.

Look Beyond Layoffs

Some layoffs are inevitable in a downturn; during the Great Recession, 2.1 million Americans were laid off in 2009 alone. However, the companies that emerged from the crisis in the strongest shape relied less on layoffs to cut costs and leaned more on operational improvements, Ranjay Gulati and his colleagues found in their study of public companies.

That's because layoffs aren't just harmful to workers; they're costly for companies, too. Hiring and training are expensive, so companies prefer not to have to rehire when the economy picks back up, particularly if they think the downturn will be brief. Layoffs can also hurt morale, dampening productivity at a time when companies can ill afford it.

Fortunately, layoffs aren't the only way to cut labor costs. Companies should consider hour reductions, furloughs, and performance pay. After the stock market crash in 2000, Honeywell laid off nearly 20% of its workforce and then struggled to recover in the downturn that followed. So when the Great Recession hit, in 2008, the company took a different approach, as Sandra J. Sucher and Shalene Gupta describe in their 2018 HBR article, “Layoffs That Don’t Break Your Company.” “Honeywell furloughed employees for one to five weeks, providing unpaid or partially compensated leaves, depending on local labor regulations,” Sucher and Gupta wrote. That saved an estimated 20,000 jobs. Honeywell emerged from the Great Recession in better shape than it did from the 2000 recession in terms of sales, net income, and cash flow, despite the fact that the 2008 downturn was much more severe.

In some parts of the world, policy makers encourage shorter hours as an alternative to layoffs. Many countries and more than half the states in the U.S. have some sort of “short-time” compensation program, whereby workers whose hours are reduced receive partial unemployment compensation. In France, 4% of workers and 1% of firms took advantage of short-time work programs in 2009, and the program paid off for both workers and companies. In a 2018 discussion paper for the European think tank Centre for Economic Policy Research, Pierre Cahuc, Francis Kramarz, and Sandra Nevoux found that companies that took advantage of the short-time work program laid off fewer workers and were more likely to survive during the Great Recession. The effect was most significant among the companies most severely hit by the recession and those with the highest levels of debt. According to the researchers, the short-time work approach allowed vulnerable companies to hold on to more of their workforce. Absent the subsidies, they most likely would have had to lay off more employees, making it more difficult to recover after the recession or causing them to go out of business altogether. The researchers estimate that for every five workers on short-time work, one job was saved. And they estimate that the cost per job saved was less than that of comparable programs; since the alternative was paying unemployment, the program actually saved the French government money.

One appealing thing about both furloughs and short-time work is that, as with layoffs, companies have discretion over which workers are affected. By contrast, across-the-board pay cuts or hiring freezes that fail to consider employee productivity can backfire, damaging morale and driving away the most productive employees. Similarly, hiring freezes affect every department indiscriminately, without weighing the value of various potential hires.

Performance pay—compensation based on some measure of productivity or business outcome—is another way to control labor costs without hurting productivity. There is a long-running debate about performance pay, for executives and frontline workers, and plenty of evidence for and against the management tool on both sides. But a recent study by Christos Makridis (of the White House Council of Economic Advisers) and Maury Gittleman (of the U.S. Bureau of Labor Statistics) documents an important fact. Using responses to the National Compensation Survey from 2004 to 2014, the study shows that U.S. companies rely on performance pay more frequently during economic downturns. Although they can't say whether this strategy works out for companies, they show that a given job is more likely to come with performance pay when times are tough. They hypothesize that this is because performance pay makes companies more flexible by aligning workers' incentives with changing conditions.

Invest in Technology

It's tempting to think of a recession as a time to batten down the hatches and play it safe. However, downturns actually appear to encourage the adoption of new technologies. In a 2018 paper, Brad Hershbein (of the Upjohn Institute for Employment Research) and Lisa B. Kahn (of the University of Rochester) compared more than 100 million online job listings posted from 2007 to 2015 with economic data to see how the Great Recession affected the types of skills employers were looking for. They found that the U.S. cities hardest hit by the recession saw a greater demand for higher-order skills—including computer-related skills. The boost in demand was partly due to employers' taking advantage of high unemployment to be choosier, as suggested by Alicia Sasser Modestino (of Northeastern), Daniel Shoag (of Harvard Kennedy School and Case Western Reserve), and Joshua Ballance (of the New England Public Policy

Center). Their study found that the demand for tech skills returns to more normal levels once the labor market improves.

But companies weren't only being choosier, Hershbein and Kahn found; they were becoming more digital, too. In those hard-hit areas of the United States, companies also increased their investment in information technology, driving the surge in IT skill requirements in their job postings.

Why do companies invest in technology during a recession when money is tight? Economists theorize that it's because their opportunity cost is lower than it would be in good times. When the economy is in great shape, a company has every incentive to produce as much as it can; if it diverts resources to invest in new technologies, it may be leaving money on the table. But when fewer people are willing to buy what you're selling, operations need not be kept humming at maximum capacity, which frees up operating budget to fund IT initiatives without dampening sales. For that reason, adopting technology costs less, in a sense, during a recession.

That's fine in theory, but other reasons may make more practical sense to managers. Technology can make your business more transparent, more flexible, and more efficient. According to Katy George, a senior partner at McKinsey, the first reason to prioritize digital transformation ahead of or during a downturn is that improved analytics can help management better understand the business, how the recession is affecting it, and where there's potential for operational improvements.

The second reason is that digital technology can help cut costs. Companies should prioritize "self-funding" transformation projects that pay off quickly, George says, such as automating tasks or adopting data-driven decision making. The third reason is that IT investments make companies more agile and therefore better able to handle the uncertainty and rapid change that come with a recession. In manufacturing, "we are finally seeing uptake now in the adoption of digital and advanced analytics," she says. It used to be that a manufacturer could be the cheapest in the market or could stay nimble—but not both. Flexibility came with serious costs. However, digital technologies "create much more flexibility around product changes, volume changes, etc., as well as around movement of your supply chain around the world."

That, in George's view, is one way the next recession might be different from past ones. Companies that have already made an investment in digital technology, analytics, and agile business practices may be better able to understand the threat they face and respond more quickly. As we've seen, recessions can create wide and longstanding performance gaps between companies. Research has found that digital technology can do the same. Companies that have neglected digital transformation may find that the next recession makes those gaps insurmountable.

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