Managing in a downturn – Seizing the Upside of a Downturn

By Donald Sull
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In a downturn, most managers fixate on the abundant bad news: demand is down, prices are falling, credit is scarce, and lay-offs are likely. Obsessing over threats obscures a surprising but crucial truth about downturns: the worst of times for the economy as a whole can be the best of times for individual firms to create value for the long term.

In past downturns, some companies, including Toyota, Nokia, Cisco, Samsung and Emirates, emerged from an economic crisis stronger than before. Like the mythological Libyan wrestler Antaeus who regained strength when thrown to the ground, these companies derived strength from economic hard times. Many of their competitors, in contrast, languished or failed. Part of the difference is down to having managers who understand how to create value during a downturn, as well as their effectiveness in acting on these insights.

Every downturn opens a window of opportunity to adjust the status quo, and astute managers push through necessary changes while the window is open. An economic crisis marks a sharp break with the past, and, observing the break, employees recognise that a firm cannot continue to do what it did in the past. The downturn lowers their resistance to change and cuts through complacency. A downturn often brings latent challenges to a head, and savvy managers can harness the resulting energy to infuse the organisation with a sense of urgency in fixing these problems.

A downturn provides a ready-made external rationale to justify painful decisions that would appear extreme in better times. Finally, an economic crisis provides managers with air cover to make decisions that incur short-term financial pain for long-term gain, such as pruning products, “firing” unprofitable customers or exiting money-losing businesses. Investors, boards and bosses are typically more forgiving of short-term dips in sales and earnings during a downturn, when all competitors are suffering, than they are during a boom, when everyone else is thriving.

Managers can harness a downturn to make any number of possible changes, but the following four actions in particular are likely to create long-term value.

Instil ongoing cost discipline

During the boom years, many managers thought their objective was to increase revenues through innovation. It is not. Companies exist to create economic value, which is the difference between revenues and the opportunity cost of all inputs (including capital). Good managers keep their hands on both levers at all times, looking for growth opportunities during downturns while maintaining cost discipline when the good times roll.

Unfortunately, best practice is not common practice. Many companies veer between periods of undisciplined growth and brutal cost cutting. During a boom, they press on the gas pedal to increase revenues. When the economic cycle turns, however, they slam on the brakes, abandon growth and focus on slashing expenses to free cash flow. Once the economy picks up again, they abandon their new-found cost discipline to pursue revenue growth.

This stop-go approach is a mistake. Golden opportunities to increase sales often emerge in downturns (see below). The best opportunities to cut costs often arise in good times. During a boom, managers tend to overlook the inefficiencies that sprout like weeds throughout the organisation, sapping resources from

more productive uses. During a downturn, good managers weed their overgrown gardens, but great ones also build processes to nip these costs in the bud as they crop up in the future.

Toyota overtook its Detroit rivals in large part through its "lean" production system, which continuously reduces costs by identifying and eliminating activities or materials that do not add value for end users. The carmaker pioneered these processes not in benign markets, but in 1950 during a deep downturn that depressed automobile demand and forced most Japanese automakers into the red.

Toyota managers did not ask what to cut, but addressed the more fundamental question of how to systematically identify and eliminate waste on an ongoing basis. Teams of managers benchmarked best practices within Toyota, and discovered an experimental process within the company's own machine shop, where successive work stations took only the parts or materials they needed at that point in time. This minimised inventories and quickly identified problems along the assembly line.

In instilling these processes, Toyota did several things well. First, managers looked outside the company for ideas without slavishly following the latest management fads. Second, they continued to refine their processes and added complementary practices including visual signals to pull more inventory and a system that allowed workers to stop the assembly line when they detected a problem.

Third, they used the downturn to negotiate changes in work practices. The Toyota system required workers to man more machines, provide constant suggestions for improvement and move among stations as work flow dictated. The downturn helped convince workers that these changes were necessary. Fourth, managers recognised that no company is an island, but is embedded in an ecosystem of suppliers and distributors, and they extended these practices to their suppliers. Finally, the company continued to use and improve these processes when the market picked up.

Managers can look for ways to build ongoing discipline into resource allocation processes. In many companies, the budgeting process takes the previous year's expenditures as given, and then incrementally augments or decreases them to calculate the next year's budget. Facing a deep recession in Brazil in 1983, retailer Lojas Americanas introduced zero-based budgeting that required managers to develop budgets from scratch and justify each item.

To instil ongoing cost discipline, managers should ask themselves a few questions. What processes do we have in place to systematically identify and eliminate waste? Could we improve these procedures? Are there promising best practices in parts of our organisation that we could disseminate more widely?

Force hard choices

Good times produce ample resources that blunt the need to make hard trade-offs. During a boom, managers tend to spread resources evenly to preserve a sense of fairness and minimise conflict. Even in the best of times, this means that promising opportunities receive fewer resources than they require while others get more than they deserve.

In the worst of times, it is even more harmful, dissipating scarce cash. Many managers, for example, try to spread the pain of downsizing evenly, demanding an identical percentage reduction in headcount or expenditure across all units regardless of their merits.

A downturn provides the ideal opportunity to force hard choices. Consider Nokia. After the Soviet Union crumbled in the early 1990s, Finland suffered one of the worst recessions in its history, and Nokia, then a diversified conglomerate, faced financial distress. Rather than spreading cuts evenly, Nokia's executives made the hard call to focus on the fledgling telecommunications business while exiting other businesses that then accounted for nearly 90 per cent of revenues.

This example illustrates important points about making hard choices during a downturn. First, managers must be willing to reverse their previous decisions. During the 1980s, Nokia executives invested heavily in consumer electronics, but when that bet failed to pay off, the top team was willing to cut their losses and focus on the much smaller mobile phone business. Second, Nokia's executives recognised that betting on telecommunications reduced the group's diversification and exposed the focused firm to greater risk. They offset this with other risk management tools, including diversification within telecommunications (for example, handsets and infrastructure), spreading across geographic markets and achieving economies of scale.

A downturn provides an occasion to make hard choices not only in the C-suite, but throughout the organisation. After the dotcom bubble burst in 2001, Cisco suffered a sharp decline in sales. The company's leadership responded by forcing hard choices at every level, including consolidating suppliers from 1,300 to 420, halving the number of channel partners, culling the bottom third of products, streamlining research and development projects and sharply reducing acquisitions.

During the boom, Cisco middle managers enjoyed wide latitude to acquire start-ups – the company snapped up two dozen in 2000 alone. During the downturn, Cisco tightened up the process by creating an investment review board that met monthly to vet acquisition targets. Managers proposing acquisitions were required to draw up detailed integration plans and personally commit to hitting sales and earnings targets for the new business.

Companies can also harness a downturn to prioritise which corporate initiatives really matter. Corporate "priorities" tend to proliferate during a boom. Middle managers in one European engineering group counted more than 50 so-called "strategic priorities" that had rained down on them from headquarters during the preceding two years. This excess of objectives consumes not only cash, but also diverts managerial attention from what truly matters.

In a downturn, senior executives should consolidate their major initiatives into a single list and select a handful that are truly critical. To ensure everyone gets the message, they should communicate the key priorities throughout the entire organisation, including a list of initiatives that are no longer objectives. Senior executives can give these priorities teeth by eliminating key performance indicators linked to less critical initiatives and link the bonuses of managers to corporate objectives.

To force hard choices, managers can ask themselves a series of questions. What initiatives, businesses, products, markets and so on, have a call on our scarce resources? Can we rank order them in terms of value creation potential? Where should we draw the line that marks the truly critical from the nice to have?

Accelerate fundamental changes

Prior to the current downturn, many organisations embarked upon large-scale change programmes. Common examples include shifting from selling products to services, fostering greater collaboration across organisational silos, or building a more entrepreneurial culture. Major change efforts are difficult in the best of times, and many executives worry that a downturn will halt future progress or reverse any gains made to date. Indeed, in a downturn, managers too often scurry from fighting one fire to the next and thereby lose sight of the longer transformation effort.

Large-scale change initiatives typically require eight to 10 years to complete and often run out of steam along the way. Downturns provide an ideal opportunity to re-invigorate an ongoing transformation. Managers can harness a downturn to renew a sense of urgency, justify unpopular decisions and overcome complacency or resistance to change.

The case of Samsung illustrates this. After succeeding his father as Samsung Group chairman in 1987, Lee Kun-hee launched a programme to transform the conglomerate from a good Korean competitor to a great global group. Fifteen years later, Samsung Electronics, the group's flagship business, had largely achieved this ambition, leading in technological innovation, market share of key products, brand awareness, and financial returns. A careful analysis of Samsung's transformation reveals that most of the critical decisions that propelled the group were concentrated during two downturns.

After a promising start in the mid-1980s, Samsung's transformation was running out of steam. Mr Lee used the global recession during the early 1990s to force through a series of difficult changes in short order. He divested businesses, such as sugar and paper processing, that had a profitable and long-standing place in the group's portfolio, because they could not achieve leadership in global markets.

Mr Lee concentrated research and development and advertising expenditures on a handful of businesses deemed capable of competing globally while curtailing expenditures in others. He insisted that subsidiaries measure performance against global leaders, rather than benchmark other Korean companies, and instituted manufacturing processes to produce world-class quality. Finally, Mr Lee bucked the Korean tradition of basing promotions strictly on seniority to advance a large number of young executives based on their performance and global outlook.

By the mid-1990s, Mr Lee was concerned that the transformation was losing traction. While other Korean executives bemoaned the Asian Economic crisis beginning in 1997, Mr Lee saw it as another opportunity to re-invigorate Samsung's transformation. He divested additional units and led a further round of headcount reductions. He also increased the autonomy of the remaining businesses by eliminating cross-business subsidies, loan guarantees and below-market transfer prices. These changes, which marked a sharp break from traditional Korean business practices, freed Samsung to compete more effectively in global markets.

As they enter the fray of short-term retrenchment, managers should ask themselves these questions to keep sight of long-term transformation. Which large-scale changes did we start prior to the downturn? Which do we still consider critical to our long-term success? What changes would we have to make even if this crisis had never occurred? How can we harness the crisis to accelerate these changes?

Seize golden opportunities

Golden opportunities refer to occasions when a company can create value significantly in excess of the cost of the resources required to seize the opportunity. Examples include acquisitions at bargain prices (think Santander's acquisition of Alliance & Leicester and Bradford & Bingley); innovative products, such as Apple's iPod, that dominate a new sector; expanding in emerging markets; or acquiring valuable resources cheaply.

Most managers look for golden opportunities when the good times are rolling. This is a mistake. The best opportunities often arise during downturns when distressed sellers are forced to offload valuable assets at bargain prices – recall how ING Direct snapped up the deposits unloaded by failing Icelandic banks. To conserve cash, companies may be forced to retreat from attractive propositions, thereby creating an opportunity for rivals. In the face of the current recession, Adobe Systems may scale back its ambitions in web-design software, creating an opening for a deep-pocket competitor such as Microsoft.

Competitors may have to pass on new opportunities to conserve cash. Airbus launched its A380 into the industry downturn following the terrorist attacks of September 11 2001 when few airlines had the wherewithal to buy the new aircraft despite its greater range, size and fuel efficiency. Emirates, in contrast, pounced.

Sometimes, seizing the opportunity requires a creative deal to help ease another company's pain. When the South Korean won collapsed during the Asian crisis in the late 1990s, Korean producers flooded the European market with cheap microwave ovens, driving European appliance makers near bankruptcy. The Chinese company Guangdong Galanz negotiated a novel agreement with European white goods companies. The Europeans moved their state-of-the-art production lines to China, where Galanz manufactured microwaves for half the cost, and secured the right to use the spare manufacturing capacity to make its microwaves for sale in Asia. Galanz thereby secured cutting-edge manufacturing technology, economies of scale, and exposure to leading companies' product design, which allowed it to quickly emerge as the world's largest producer of microwaves.

In a downturn, it is easy for managers to focus exclusively on managing threats, and thereby lose sight of golden opportunities. To counterbalance this, they should ask themselves the following questions. Are competitors retreating from opportunities that we can seize? Should we double down in growth markets, such as Bric economies, rather than retrenching to our core? Does our customers' or competitors' pain create an opportunity for us? Can we snap up key resources at bargain prices?

All the economic bad news can eclipse the crucial reality that every downturn has an upside. To make the most of that upside, managers must recognise opportunities during hard times and muster the courage to seize them.

Donald Sull is professor of management practice in strategic and international management and faculty director of executive education at London Business School.