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Research Report

When Good Management Shows: Creating Value in an Uncertain Economy

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Does it matter how executives manage for a recession? Without question! Organizations that manage well improve their performance relative to their competition. And the competitive advantage they get lasts for years. How do companies achieve this competitive advantage? The winners manage for value all the time and pull away from the pack when a downturn highlights their distinctiveness. Boom times float all boats; in a downturn, superior firms rise to the top. And winning firms make smart moves during the downturn itself, not to establish their strategic position, but to strengthen it.

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Does it matter how executives manage for a recession? Without question! Organizations that manage well improve their performance relative to their competition. And the competitive advantage they get lasts for years.

Although the past decade's record-setting economic growth temporarily obscured the importance of recessions for many executives, they are a fact of business life. The current business environment has reminded all of us that managing during times of economic turmoil is a critical business capability.

How do companies achieve this competitive advantage? The pundits tell us that the secret lies in taking the contrarian view that a recession is an opportunity, not a threat.¹ They assert that winners do the right things during the recession. They embrace customers rather than distancing them with cost cutting, and scoop up acquisitions at bargain prices as opposed to shutting down their capital programs.

Surprised? Probably not. The vast majority of executives—not just a few enlightened contrarians—think of a recession as an opportunity to improve business performance. Despite this resounding consensus, these companies' performances vary dramatically.

What, then, accounts for the gap? By interviewing senior executives who experienced the global recession of 1990-1991 and coupling it with our own analysis of the financial performance of 850 companies listed in the US, we conclude:

- **Savvy executives do change their company's competitive position and create value by managing downturns effectively.** Most executives recognize the potential opportunity, but most do not actually achieve the results they envision.
- **The winners manage for value all the time and pull away from the pack when a downturn highlights their distinctiveness.** Boom times float all boats; in a downturn, superior companies rise to the top.
- **Winning companies make smart moves during the downturn, not to establish their strategic position, but to strengthen it.** Following a cookbook of specific downturn tactics will not necessarily create success. Winning companies do not change course: they take advantage of the downturn to strengthen the initiatives they already had in mind.

What Is in a Recession?

To prove that managing for a downturn matters, we analyzed the financial results of 850 of the largest companies in the US.² Using return on invested capital (ROIC)³, we separated companies into three groups: the winners—those that outperformed others in their industry for the six years following the recession of 1990

to 1991; the losers—those that underperformed others in their industry; and those that ended up in the middle. On average, the winners were able to improve their competitive trajectory beginning in 1990, the start of the recession, and maintain their rate of improvement over the following couple of years. During the same time period, the losers lost ground (see Exhibit 1).

Our research

We analyzed the financial results of 850 of the largest companies in the US following the 1990 to 1991 recession using statistics from Value Line and Stern Stewart. To gauge performance, we analyzed a company's return on invested capital (ROIC) before, during, and after the recession compared to the average in its industry. We then conducted in-depth interviews with 40 senior executives from 35 companies with a range of performance characteristics to understand the actions they took to create the results they achieved.

A company's return on invested capital for the three-year period following this recession explains more than 60 percent of its return for the remainder of the decade.⁴ That is, companies that had the highest return coming out of the recession tended to maintain their lead despite other factors in the market. This correlation

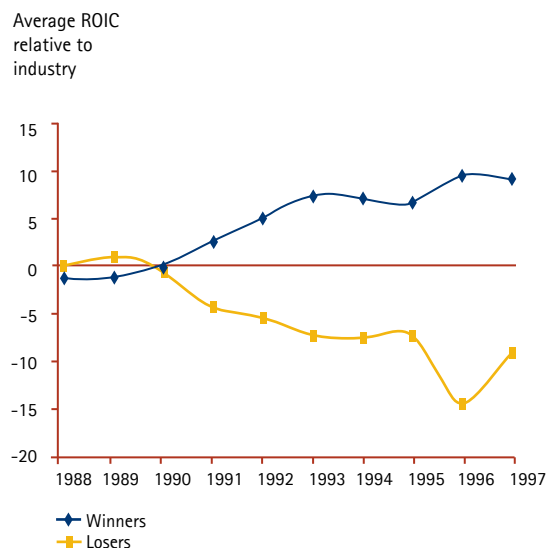


Exhibit 1: Winners pull away from losers after a recession

shows that companies that pull away from the competition during a downturn have lasting advantages, not just a fragile edge.

The New Contrarians

The companies that created substantial value relative to their competition after the downturn of 1990–1991 practiced a new brand of "back to basics" contrarianism. They refused to pursue growth for its own sake, opting instead for profitable growth—growth where their return on capital exceeded the cost of that capital. They insisted on getting value from their investments— from acquisitions to internal infrastructure. And they built solid franchises with fundamental, value-based principles instead of financial engineering or Wall Street wizardry. These companies created the

foundation for their lead in the good times, and took advantage of it in the bad. A former vice president of a leading metals company explains his company's posture in the late 1980s, "The rest of the industry was living in an up cycle, putting their feet up and relaxing. But we were moving to another level to be ready for the next downturn."

Three factors distinguish these new contrarians from their rivals. These companies:

1. Focus on generating cash flow in the good times to give them flexibility and financial muscle in the bad.
2. Position themselves strategically in the good times to take advantage of the bad ones, not the reverse.

3. Execute differently from their peers—both in what they do, and in how they do it.

Focus on Generating Cash Flow

The new contrarians march to a different fiscal beat than most executives. Eighty-three percent describe their approach to financial management as conservative. In contrast, only 45 percent of the poorly performing companies take this stance. The winners build up war chests, limit debt and focus on cash flow in good times in order to remain flexible and unencumbered. This gives them greater degrees of freedom and positions them to take advantage of opportunities that come up during a downturn. Doug Rasor, vice president of strategic marketing for Texas

Instruments, says his company has the ability to be aggressive in a downturn because of its strong cash position. "I think we have an advantage in our ability to do more aggressive things than our competitors are able to do, and we believe this will turn to a competitive advantage when things turn around." A metals company executive adds, "With the cash generated by running lean in the good times, we are now shopping around aggressively for growth. We have a balance sheet that allows us to do that."

A strong cash position enables innovative companies to continue to invest in future growth. They fund research and development, sustain expansion programs and continue marketing initiatives. The chief financial officer of a successful semiconductor company emphasizes, "We let research and development spending float above the model percentage in a downturn. As a result we outgrow the industry by a factor of two on the up side and we lose only half as much on the down."

Clever companies hold performing, semi-liquid assets in lieu of cash to give themselves both financial returns and a downside cushion at the same time. For example, one major retailer owns stores rather than leasing or franchising them. These could be converted to cash if the company needed capital. The vice president of corporate strategy explains, "There are various theories on the best financial structure, but we always considered it a challenge to fund growth internally. Plus we have many company-owned stores which are a potential source of cash if we ever want to increase growth."

In contrast, Citibank was in a precarious situation in 1990 because it had pursued market share growth

at the expense of cash flow and profitability. In the words of one senior executive, "You're looking to grow so you lend aggressively. Credit control wasn't as good as it should have been, and we were emphasizing market share." To keep Citibank from teetering over the edge, the federal regulators stepped in for the next several years to supervise the company's return to financial health.

Position Strategically in the Good Times

The successful executives in our study did not win by predicting when the next downturn would hit. They assumed that their industry would have ups and downs and positioned their companies well in the good times. How did they pull this off? They forged resilient strategies and stuck with them; they focused on managing fewer businesses well; and they emphasized organic growth over acquisitions unless they were in a position to consolidate their industry.

They forged resilient strategies that worked in good times and bad, and stayed the course during the downturns. Successful companies crafted solid business models and good cost positions. In other words, leaders understood the differentiating value drivers for their companies and molded their strategies accordingly. In many cases, this involved taking a different track from competitors and withstanding criticism from Wall Street for their unconventional stance.

Across all the companies in this group, executives structured their companies to succeed in a recession before the recession arrived. "The strategy should be employed long before the downturn comes," emphasized a senior executive in the retail industry. "In the late 1970s, we chose a different strategy

from our competitors. We pursued that through the 1980s and kind of left them behind." His company managed to maintain a consistent ROIC during and after the recession of the early 1990s, while his closest competitors fell off the mark considerably over the same period. The executive continues, "It starts with good strategy planning on the front end, making sure your company's operating systems have robust detection tools and the right sort of levers to manage the business in the details" (see Exhibit 2).

High technology winners concentrated on finding sweet spots in their industry that were more stable than commodity hardware. One semiconductor industry executive explains, "The memory and processor segments were volatile. We were well situated in signal processing, the most stable part of the industry, which is really important when you get into challenging economic times." A software supplier to the automotive industry dealt with cyclical by building a base of recurring revenue. Comments the vice president of marketing, "We structured our revenue model so we would see 40 to 50 percent of the price of the initial systems contract for each of the next five years. Our clients, the automobile dealerships, had done the same thing by focusing on service instead of sales. We were both more resilient to downturns as a result."

Companies that repositioned in good times did better than those that waited for a downturn to rally the will for strategic change. For example, Northrop Grumman, a defense contractor, began its transition from airplanes to electronics and systems in the early 1990s—an up cycle as the Gulf War boosted revenues for its annuity B-2 aircraft line (see Exhibit 3). The company had done its homework in the previous downturn with a far-reaching study on the

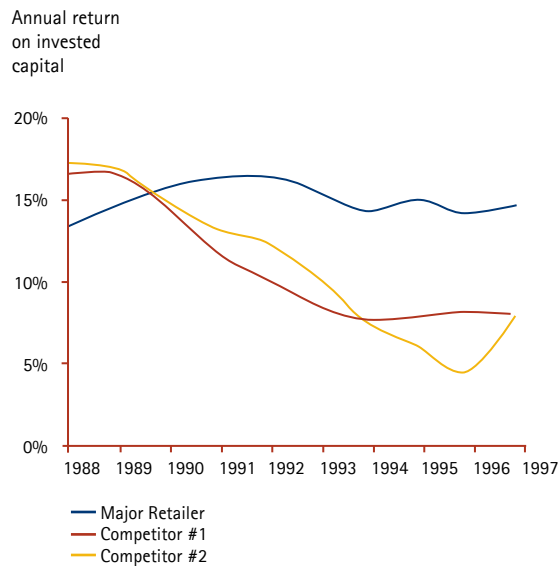


Exhibit 2: A major retailer sustains excellent performance while competitors fall off

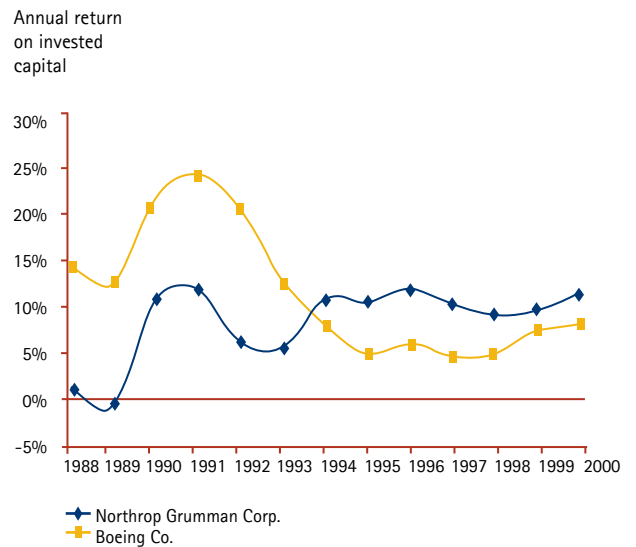


Exhibit 3: Northrop Grumman repositions itself strategically to improve ROIC

future of war. "We concluded that it is human nature, and war will continue," remarks one executive, "but the value will shift from the airplanes themselves to the electronics systems that are stuffed in them." The market upturn gave it the operating runway to begin to move in the direction its strategists had outlined.

In the recent downturn, Harrah's "outperformed the industry by a mile," according to chief operating officer Gary Loveman. The company came under criticism from analysts in the mid 1990s when it focused casino investments in places like Tunica, Mississippi, instead of Las Vegas and targeted individual customers rather than large groups. Despite analysts' complaints, Harrah's stayed with its plan to build a resilient business model that caters to individual gamblers rather than conventioners. It uses

a database of 25 million individuals to create demand a few people at a time. Loveman continues, "To drive growth, we committed to a strategy that is robust through a wide range of situations. Our competitors are much more dependent on large groups that come and go en masse."

Diverse companies narrowed their portfolio of businesses, shedding even profitable operations that did not contribute to a clear, advantaged position. Instead of counting on portfolio diversification to smooth out business cycle ups and downs, these companies took another tack. They concentrated their assets and efforts in areas in which they held a leadership position. Texas Instruments' Rasor recalls, "We sold off \$4 billion in profitable business when our total sales were \$12 billion. By selling these divisions in the good times, though,

we generated massive cash flows. We can now use that for research and development to solidify our position in digital signal processing." Robert Krebs, retired chairman of Burlington Northern Santa Fe Railroad, tells a similar story about his company. At the time he took over, the company was a conglomerate, including a railroad, a mining company, a leasing company, gas and oil pipelines, and a real estate development company. Krebs sold and swapped assets until he had pared the operating company back to its railroad core. Then he shrunk the railroad and drove costs down to position the Santa Fe as the least cost producer.

Winning companies drove internal growth rather than acquiring, except when they were in a position to consolidate operations expertly. Despite the chance to pick up bargain assets, for example, one

Annual return on invested capital

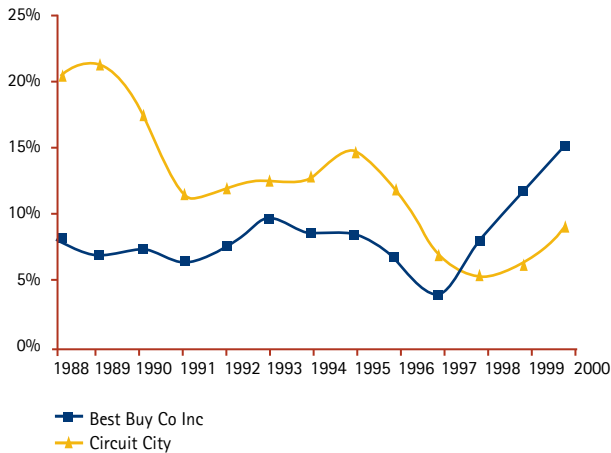


Exhibit 4: Over time, Best Buy closed the performance gap with Circuit City

Annual return on invested capital

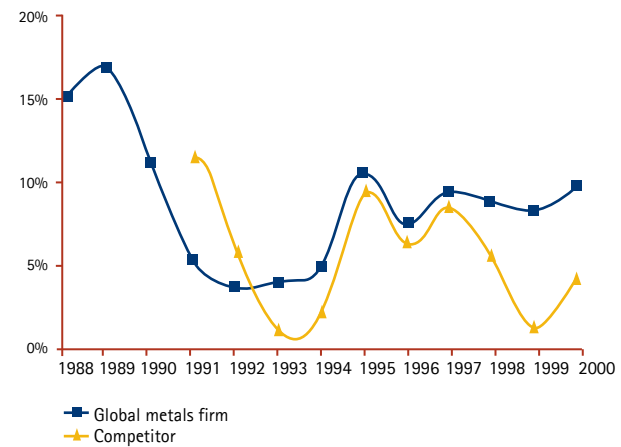


Exhibit 5: A global metals firm drove performance improvement even in good times

high-performing energy company moved prudently. The chief financial officer at the time explains, "A lot of companies in our industry were making acquisitions in the downturn, but we had core assets which we could develop and grow at better returns than we saw in the M&A arena. It certainly helped that our founder and majority owner kept saying, "Is this going to make me money?" Only 8 percent of the winning companies ramped up acquisition programs in the downturn of 1990-1991, in contrast to 45 percent of the losers. The winners clearly understood what would drive the most value for their companies and acted accordingly.

Best Buy took on the giants of consumer electronics stores in the late 1980s and focused on internal growth. The company grew 40 percent in 1991, increasing its number of stores by 30

percent. While the recession affected its bottom line—profits only grew 1 percent in that year—the company has recently overtaken Circuit City in profitability (see Exhibit 4). Al Lenzmeier, Best Buy's president and chief operating officer, explains, "In 1989, we were not in a position to compete with the leaders in our industry; we just did not have the volume. The company conducted focus groups and found out that customers wanted a non-pressure sales environment. We developed a self-service format that focused on efficiency, speed and low price. Then we continued to grow aggressively to amass market share, which allowed us to have the lowest SG&A expense in the universe. Then we kept our foot on the pedal. When Federated went out of business, we picked up their stores—otherwise all our growth has been organic."

A global metals company did not focus on internal growth; it scooped up its competition instead. But it aggressively consolidated its acquisitions and applied its own efficient processes across the expanding domain (see Exhibit 5). Because the company drove itself to achieve superior process performance all the time—not just in a downturn—it was able to achieve significant operating savings as it brought acquired companies under its management. One senior executive explains, "We drove to have top quadrant performance in every process and practice in our company. And we compared ourselves to the best companies in the world, not just in our industry. As we got thinner, leaner, and meaner we were able to acquire our competitors and immediately do to them what we had done to ourselves." In contrast, a large agricultural

chemicals company also merged with its competition, but the resulting company did not rush to exploit the operating synergies it created. According to one executive, "Egos got in the way, so it took us a long time to pull the companies together." This company's results lagged those of others in its industry.

3. Execute Distinctively

Winners and losers make some of the same moves during the downturn itself; they also do some things differently. Let us first look at the most visible tactics—the ones that do not separate the good from the poor performers:

- No executive we interviewed recommends hunkering down. Counsels Robert Krebs, "The biggest mistake you can make is trying to ride out a recession. Maybe prosperity will come back if you hide your head, but you just missed a huge opportunity to create change."
- Eighty-five percent of the executives we interviewed took steps in the downturn to reduce costs, conserve cash and eliminate or delay unnecessary spending. Executives told us employees' resistance to internal efficiency improvements drops in a downturn, so executives can take some unpopular moves that would destroy morale in other circumstances. This allows companies to cut expenses and even butcher sacred cows. And some are savvy enough to apply cost cutting unevenly. They preserve the critical people and activities and allow the ax to fall disproportionately on functions and processes that do not pay off.
- Twenty-four percent shop for bargain assets to fuel their

company's expansion. The chairman of an information technology service company remarks, "We made our first major acquisition in the early 1990s. Then the economy turned up and we could not do any more acquiring until now." Mary Atkin, CIO of AG Edwards, points out that her company's management applies the same logic to scarce talent, saying, "We recruit the highest number of financial consultants from the competition during downturns. In good times, other companies pay 'upfront money' to get brokers to move. We never do that, so we wait for the downturn to get to a level playing field and attract brokers based on cultural fit."

- Every company we interviewed, save one, actively communicated with Wall Street to adjust expectations of future cash flows. These companies did not, however, increase their effort or emphasis on investor communications. They said it was part of their normal practice.

These recession tactics are important, but they are not the drivers of competitive value; they do not separate the winners from the losers. However, winning companies do take some actions that losers do not. These strengthen their strategic position. High performing organizations:

Act decisively when trouble is at hand:

Executives in more poorly performing companies may accept that their industries are slowing down but hold their breath in the hope that things will get better before any hard actions are necessary. A railroad chief financial officer speaks from the experience of the early 1990s, "We waited to respond to the downturn until we saw the impact on the operating line. By then it was just too

late." The best performers watch for downturns and take action quickly.

Explaining how they dealt with Best Buy's profitability nosedive in 1997, chief operating officer Lenzmeier says, "PC prices dropped, and we were caught with a lot of product. This exposed our weaknesses in systems and processes. It was the wake-up call that told us we had to change how we operated internally. We stopped our growth, got some external help, and redesigned our organization and our business processes. That was the first time we ever went outside for expertise, but we needed it."

Set priorities based on a detailed knowledge of how the company creates value:

Companies do not just cut costs, they cut the right costs. And they divert resources to activities that actually create value. How did these companies make the right calls? Unlike most executives, the leaders and everyone else in these companies knows explicitly how they make money.⁵ They know how their products and services stack up against those of the competition, why customers prefer doing business with them, and exactly what they have to do to turn a profit. Susan Kaminski, a former executive in the semiconductor industry, emphasizes, "It's not just the finance people who must understand the financial and operational measures. Anyone in the company, from human resources to research and development, should be able to talk you through the details."

In contrast, a vice president at one financial services company explained that the company did not put much stake in extensive business measures. He asserted that the organization outperformed the competition because it had the best operating margins in the industry. When we looked, we

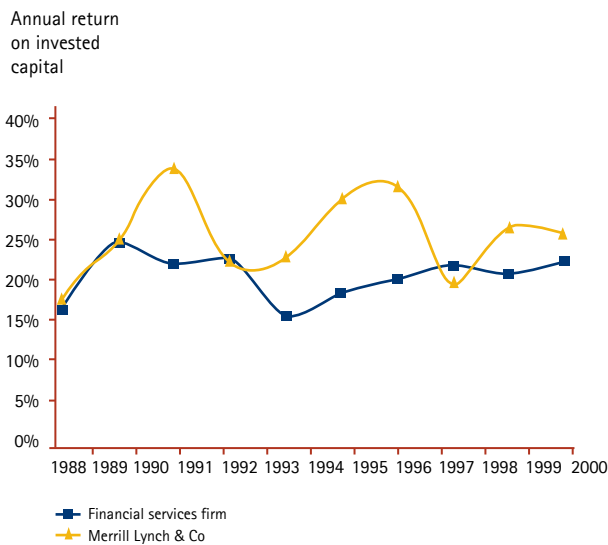


Exhibit 6: Financial services firm underperforms its competition

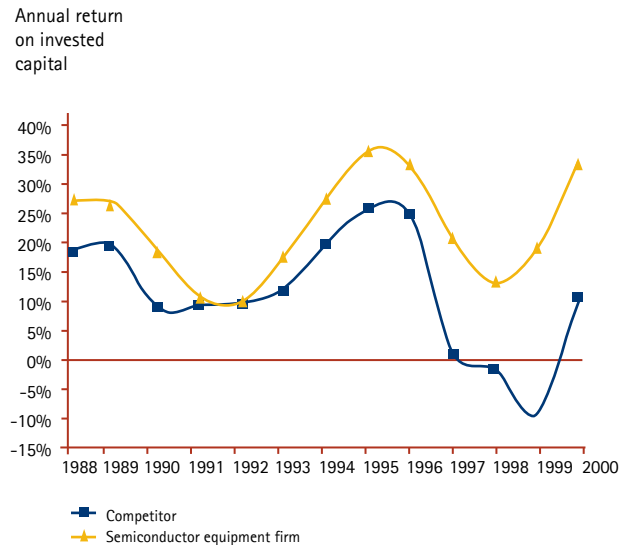


Exhibit 7: Semiconductor equipment firm learned to outpace competition in the ups and the downs

found that the company's overall performance actually lagged that of others in its industry (see Exhibit 6). The implication? The executives in this company did not really know whether or not they were creating value relative to the competition.

Leverage unique information systems:

The high performing companies invest in information systems designed to give them the ability to manage their key value drivers, and, more importantly, they use the output. The poorly performing companies do not have the same responsive systems. Bank of Montreal's vice president of strategic planning, David McVay, along with his counterpart at a major retailer both point to computer-based modeling systems that give their companies an edge—the former for risk management and the latter for

real estate site selection. The retail executive explains, "Before we decided to develop our own models, we and everyone else in the industry used data provided by supermarket developers to locate new stores. Now we independently prospect for new sites based on numerical trading potential. It's been very important for us."

In describing his process for turning around a transportation company, its former chairman points out, "Even though I was afraid we could not afford it, we spent \$150 million for the best information system in the industry. Every morning, we knew how we did the day before and how we were set up for the day ahead." A global metals company executive says they also managed successfully through downturns because of the wealth of actionable information available to them. "We had every

one of the numbers in front of us constantly. We knew where every fraction of a body was in the company." Competitors were not so well equipped. This executive talks about inviting a competitor into his plant for a tour: "They were a family company—not lean and ruthless enough—and the tour convinced them that their plants could never match our efficiency. That's how they decided to get out of the business."

Collaborate with customers to improve value propositions:

The winners reach out to customers to better understand the pressures they are facing. This allows them to provide new products and services that meet customers' needs and cement relationships. Companies that took this approach improved performance in both good times and bad. Kaminski agrees: "Downturns are a great time

to be involved with your customers, to work with them and find ways to reduce your costs as well as theirs." Through a collaborative relationship with customers, good companies are able to maintain quality and innovation in their products during a downturn (see Exhibit 7). "Some of the best products and services evolve out of downturns," says Kaminski. Bank of Montreal's McVay adds, "We elevated our role from a source of credit to a personal advisor to our clients during the recession. We helped them understand how to cut down on inventory and use their debt so they would emerge stronger."

Some organizations do not just tweak their value propositions, they design new offerings that appeal specifically to customers who want to save money in the recession. The founder and former CEO of a health insurance company saw the 1990-1991 recession as a huge opportunity for growth. "We knew people were going to be more price sensitive than ever," he explains, "so we designed the first managed care health plan to help them tighten their belts. Over the next five years, the company grew at an enormous rate and went from break-even to highly profitable in the process."

Price for profitability:

Winners work themselves into an advantaged cost position during good times, then use their pricing flexibility to pick up market share in a downturn. Says one transportation executive, "We lowered our prices to gain market share. We took some business from the truckers and some from the railroads. We won it on price." A veteran executive from Motorola added, "Our competition is smaller companies that do not have our scale or manufacturing flexibility. We pick up market share by booking four or five year contracts at prices they can not match." However, in the downturn,

winning companies walk away from bad business, and losers do not. The companies that perform poorly accept unprofitable sales in an attempt to hold onto market share. An insurance company executive lamented, "We had conflicting goals. We wanted to grow, but we had to meet the competition in price. As a result we put business on the books that was under-priced." A high performing bank took the opposite road. Says a senior executive, "We aim for consistent growth, not spectacular growth. That means, for some risky opportunities, we just decline to participate."

The Reckoning

By cultivating financial flexibility, making smart strategic moves, and developing an intimate understanding of the real drivers of value and executing accordingly, companies can and do shape recessions into opportunities. They gain market share, forge new customer relations, and strengthen product and service positions to provide them with a platform for profitable growth into the next expansion.

However, making the most of a downturn is as much about what a company does in the good times as the tactics it takes when recession hits. What matters most is managing for value consistently, relentlessly, and continually. Successful executives infuse their companies with an innate sense of urgency that compels action even without the stimulus of a foundering economy. "That is the toughest challenge, to maintain the discipline necessary to be prepared for a downturn during the good times," says former PepsiCo Division President Lloyd Ward.

Companies that wait for the downturn to worry about the fundamentals

are often too late. Especially in challenging industries, they choke on the excesses of the previous up cycle—undigested acquisitions made possible through encumbering debt, distracting diversifications that do not strengthen the company's position, and loose decision processes that allow investments without returns that pay the cost of capital. Tightening up costs and reining in decentralized decision making surely helps performance. It just does not create advantage.

What does create advantage? The superior strategic positions, operating capabilities and superb execution of well-managed companies. Good companies exhibit these traits in good times as well as bad, but prosperity masks performance. In an expansion, even astute observers can not easily tell the difference between a business model that creates value and one that destroys it.⁶ But things change in a downturn. Companies with poor fundamentals falter and the consequences show up quickly in their results. Economic downturns, then, shine a spotlight on able leadership.

What should companies do in the current uncertain economy? Companies that are not well positioned can still turn the downturn to their advantage. During a downturn companies can get unvarnished answers to vital questions. Executives have the chance to learn what is important to customers, what is essential for delivering value, and what actually distinguishes their company from its competition. Companies can ask these questions any time, but the pressure of a difficult economic environment puts a much finer point on the responses. Organizations that seek and apply these answers can ready themselves to take advantage of the next inflection point.

About the Authors

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Notes

¹ Darrell Rigby, "Moving Upward in a Downturn," Harvard Business Review, June 2001: 99-105.

² We identified high- and low-performing companies by first comparing each company's average ROIC from 1992-1997 with its industry average ROIC. We also compared each company's percentage point increase in average ROIC from 1988-1991 to 1992-1997 to its industry's average increase over the same two time periods. A company was tagged as a winner or a loser if it fell more than +/- 0.431 standard deviations respectively away from its industry average, which would put it in the top or bottom 33 percent probability for each comparison. We then calculated the difference in each company's ROIC from its industry ROIC for each year from 1988-1997. Finally, the average of all winners and the average of all

losers were calculated, and these data were plotted year by year.

³ We define ROIC as annual earnings from total operations divided by the company's invested capital at the end of the year. Invested capital is the sum of long-term debt and shareholders' equity.

⁴ We calculated average ROIC for each of the 850 companies we analyzed for the periods 1992-1994 and 1995-2000. The correlation of the two sets of ROIC produced an r-square of 0.61.

⁵ Jane Linder and Susan Cantrell, "Working Models," Accenture Institute for Strategic Change Research Note, January 2000.

⁶ We define a business model as the way a company makes money. Its strategy is its plan for evolving that

model as business conditions change. See also Jane Linder and Susan Cantrell, "It's All in Your Mind(set)," Across the Board, May/June 2002.

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