

■ Finance & Performance Management

Taking advantage of a downturn

By Brian F. McCarthy and Michael R. Sutcliff

Sometimes the most difficult economic circumstances provide the best opportunities. Just ask those companies that remained focused on shareholder value throughout the last slowdown.



During periods of sharp economic contraction, most companies react defensively—cutting marketing and R&D budgets, delaying new product launches or shelving acquisition plans (and sometimes all of the above). These kinds of slash-and-burn cost-reduction programs may have a positive short-term effect on earnings. But they could do serious long-term damage to shareholder value.

To be sure, there's nothing wrong with cutting fat. Companies that have let themselves become bloated must get leaner, particularly during economic hard times. But the obligation to create shareholder value doesn't end when a recession starts.

In fact, a recession can provide companies with a crucial opportunity to gain an advantage over competitors that are either weaker or distracted by major retrenchment or restructuring programs.

It can be much more difficult to gain a competitive advantage in a growing economy because practically everyone is expanding. Indeed, as companies compete aggressively for market share—and spend freely to support that effort—profits can be elusive, as many technology and Internet-based companies found in the late 1990s.

By contrast, during an economic downturn prices often drop, financing is generally cheaper, companies are less expensive to acquire and executive talent is easier to attract as others downsize—all of which makes it easier to pull ahead. Companies that make the right moves during a recession position themselves to outperform competitors once the economy improves.

In a recent study, Accenture looked at the performance of 848 companies

in the years following the 1990–91 recession. We found that only 33 of them had outperformed the S&P 500 for six consecutive years. This small, highly select group of companies was able to achieve this because they recognized the recession as an opportunity to focus on strategic leadership and establish a competitive advantage that carried well into the subsequent recovery.

Three companies—Dell Computer Corporation, Paychex and MBNA Corporation—stand out as having used the 1990–91 recession as a springboard for impressive expansion through the rest of the decade. Although the particulars of each situation were different, all three companies made bold strategic decisions that positioned them for growth and helped set them apart from their competitors. Beginning in 1992, Dell beat the S&P 500 for six consecutive years; Paychex and MBNA actually outperformed the S&P for seven consecutive years, from 1990 through 1996.

Meanwhile, a fourth company, ADC Telecommunications, seems to have made shrewd use of the recent economic downturn to position itself for what could be a sustained period of growth over the next several years.

Although differing in the details, the overall experiences of these four companies demonstrate that there are three essential actions your company should take during a recession.

- Review your strategy to determine whether it is still appropriate for the changed economic environment.
- Make sure that cost cutting will not threaten further growth.

- Communicate any changes in strategy or operations to your important constituencies, including employees and investors.

During a recession, it's important to reevaluate your company's strategy in light of the changed economic conditions. A game plan that assumed economic growth or an expanding market might need to be adjusted during a downturn. It's also important that the company understand the key value drivers in its business. Often these won't change during a recession, but their relative importance might shift.

For example, when a company is growing in a rapidly expanding market, it may decide that the importance of good service justifies a sizable investment in a number of regional customer service centers. But in a recession, when its pricing is under pressure, the same company may have to find ways of delivering a high level of service at a cheaper price. One option would be to use more temporary workers and shift to a more variable cost structure. Although service is still important, cost competitiveness has taken on greater importance than before.

Often the most crucial choice a company makes during a downturn concerns strategy—whether to persevere with the one that's already in place or head in a new strategic direction.

Take Dell, for example. Computer purchases normally drop in a recession, but during the economic downturn of 1990–91, the company strengthened its position in the market through a series of aggressive strategic moves. This approach set the stage for Dell's impressive financial performance in the following years.

As the US economy slowed down in the early 1990s, Dell invested heavily to expand its presence in Europe and South America. The company also continued to invest significantly in new product development, and in 1991 it introduced 22 new desktop and laptop personal computers.

Calculated risk

In 1990 Paychex, a Rochester, New York-based provider of payroll processing services to small and medium-sized companies in the United States, responded to the worsening economy by introducing a new product. This bold decision actually helped the company ride out the recession.

In the late 1980s Paychex had about 70,000 customers. Its largest competitor, Automatic Data Processing, had just come out with a new tax product. In addition to handling its customers' payrolls, ADP would also collect all the necessary local, state and federal taxes, hold them in escrow and then pay them at the appropriate time. It was clear that Paychex needed to come out with a competing product even though the economy was beginning to soften.

In the summer of 1989, B. Thomas Golisano, Paychex's chairman, president and chief executive officer, decided to develop the company's new Taxpay product. The decision carried a lot of risk. Taxpay took 12 months and \$1.5 million to create, and, as Golisano puts it, "Relative to our size, that was a fairly large sum of money." In fact, the investment was big enough that the company's earnings fell that year for the only time in its 19-year history.

But the 1990 launch of Taxpay paid off. Paychex quickly recruited thousands of clients, producing a

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revenue boost that helped pull the company through the recession. Half of that revenue came from funds held in escrow and invested in high-grade municipal bonds prior to disbursement. Today Paychex boasts approximately 375,000 customers.

Staying the course

Unlike Dell and Paychex, credit-card issuer MBNA successfully weathered the downturn of the early 1990s by maintaining its strategic direction. Ironically, MBNA started life as an independent company in the middle of the last recession. The company, a former subsidiary of the now-defunct MNC Financial Corporation, was spun off to shareholders in 1991 when the parent company got into trouble.

MBNA has pursued the same strategy throughout its 20-year history. Using an affinity-marketing approach, MBNA aggressively targets members of large organizations, like colleges and professional associations. But in the middle of this recession, MBNA changed its sales tactics, switching to a person-to-person marketing approach in which company sales representatives attend annual conventions of the organizations whose members it is targeting.

Given the unfortunate timing of its 1991 initial public offering and without a track record as an independent company, it would have been understandable if MBNA had trimmed its operating costs by finding cheaper ways of doing business. But the company stayed with the strategy it knew would work, the tactical change in its approach to sales notwithstanding.

MBNA had another opportunity to pull back from its core strategy in 1997, when the credit-card industry hit a rough spot and losses spiked. But as most of its competitors

retreated—a not-uncommon occurrence in the cyclical credit-card business—MBNA intensified its marketing to solidify its position as the second largest credit-card issuer in the United States, behind Citigroup.

“We tend to stay out of that cycle and maintain consistency in all types of credit environments,” says Brian Dalphon, director of investor relations. The strategy has paid off: Since 1997 MBNA has outpaced all of its competitors in total shareholder return.

Cutting costs often becomes necessary when revenue plummets during a recession. But it’s vital that companies don’t retrench in a way that places their long-term growth at risk. The conventional approach to cost management is to reduce costs across the board. But since many costs are fixed, companies end up cutting spending on such discretionary items as research and development, marketing and investments in technology—the very things that, when managed properly, help create shareholder value.

Instead, companies should take a more strategic approach and categorize their costs as either value-added or non-value-added. Value-added costs, including marketing, customer service and product development, directly support present or future revenue growth. Non-value-added costs relate to a variety of administrative functions, including human resources, finance and facilities services.

It’s also important that companies convert as many of their fixed costs to variable costs as possible. One example would be to outsource those back-office operations that do not support present or future revenue growth but relate to non-value-added functions.

During the 1990–91 recession, Dell focused on cutting costs that did not provide value to the customer. For example, it started buying used office furniture for its executives, and during travel they were required to fly coach class and stay in budget hotels.

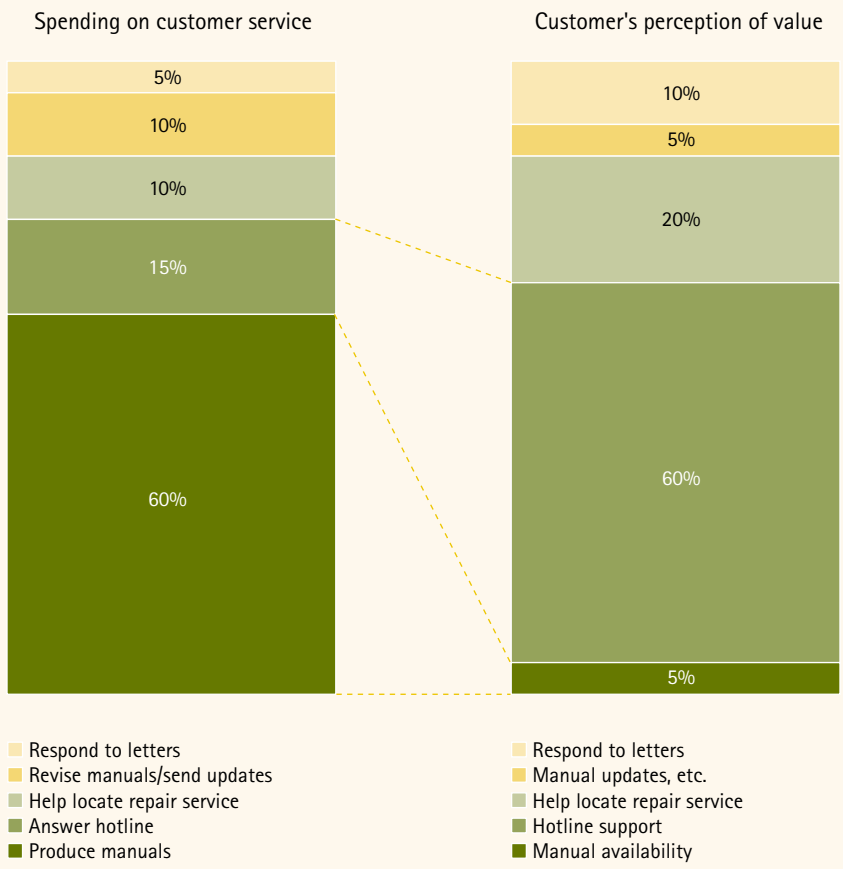
Once a company has adjusted its strategy, cost structure or both for a recession, it's important to communicate these changes to employees and institutional investors alike. Employees need to

understand why the changes—which might entail business closures and layoffs—are necessary to improve the company's short-term performance while ensuring its long-term survival. They need to be brought into the process as partners through honest communication.

Of course, investors, too, need to understand how the company intends to manage its businesses in an economic downturn. Simply stated, it's crucial that management teams set realistic earnings targets

The cost-value gap

As the economic environment changes, customer preferences tend to change as well. Take the major electronics company depicted below. There was a big gap between what services customers valued and what the company was spending money on to serve them. In periods of economic downturn, companies need to pay special attention to changing customer needs and tailor their spending cuts and investments accordingly.



SOURCE: ACCENTURE ANALYSIS

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and then meet them; their credibility with investors will clearly have a major impact on their company's stock price.

Paychex's strong performance in the 1990–91 recession was still paying dividends at the end of the decade. Last fall an analyst's report on the company stated, "When we consider how they performed in the recession of 1990–91, we believe multiple expansion and relative out-performance is more likely during and coming out of a recession."

A thorough redesign

Like many telecom companies, ADC was hit hard in 2001. Founded in 1935, the company, which is based in Eden Prairie, Minnesota, is a global provider of broadband network equipment, fiber optics, software and systems-integration services to broadband networks.

That market all but collapsed last year when a variety of factors combined to form what Robert Switz, the company's executive vice president and chief financial officer, calls "the perfect storm." These included the bursting of the dot-com bubble, the recession and excessive capacity, all of which greatly reduced demand for network equipment. ADC's sales fell from \$3.3 billion in 2000 to \$2.4 billion in 2001.

The company's first reaction was to review its entire cost structure to see where it could rationalize its operations without putting future growth at risk. This was not a slash-and-burn endeavor but a thorough redesign of the company.

ADC grew rapidly during the Internet boom of the late 1990s by acquiring many businesses, which it maintained as separate entities

and rarely, if ever, consolidated. Since then it has achieved significant savings by centralizing a variety of administrative and operational functions—finance, human resources, information technology and manufacturing.

The company also decided to focus on a smaller number of core activities, prompting it to close down or sell several of its businesses. "The industry conditions have given ADC a unique opportunity to refocus the company in a manner that will allow us to be more competitive going forward," says Switz.

The company has hardly withdrawn from the fray, however. "We're still in an offensive mode, but a different one," says Switz.

ADC has carefully selected those markets where it feels it can be especially competitive, and then has pushed aggressively for growth. Switz says it has gained market share in IP cable and fiber optics at the expense of such companies as Cisco Systems, Nortel Networks Corporation and Lucent Technologies. Despite the difficult revenue environment, ADC also invested in and completed a branding campaign—it had never had a unified brand with its customers—which it saw as essential to its long-term growth.

These dramatic changes in strategy and organizational structure have been communicated to employees and investors alike. ADC's senior management wanted its employees to understand why it was taking such strong action—especially because it had reacted to the changed environment in the telecommunications industry in advance of most other companies. The company used a variety of approaches, including internal newsletters and town hall

meetings, to keep its employees informed. "There was a very good level of candor in our communications," Switz says.

Last year ADC told its investors it intended to take a number of strong measures that it hoped would lead to growth in 2002. The company was explicit about the steps it was taking to preserve long-term shareholder value, and Switz believes that ADC's successful follow-through has improved the company's credibility on Wall Street. "Everything we said we would do we did in the time frame we said we would do it," he says.

As of early May 2002, ADC's stock price had yet to respond positively to the company's strong medicine, probably reflecting the overall continued downturn in the telecom industry. And perhaps investors still had some concerns about the company's long-term performance. But by refocusing its strategy and intelligently managing its costs, and by then effectively communicating those changes to employees and the market, ADC reacted positively to the recession of 2001-02. If the company goes on to outperform the S&P 500, this will be a big reason why.

Increasing shareholder value needs to remain the top priority of management, regardless of the economic conditions. And sometimes the most difficult circumstances provide the best opportunities. ■

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