Keeping Pace With Change

Management consulting firm Booz & Company addresses strategies for navigating 2009's uncertain economic tides.

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After an extraordinarily eventful year, we at Booz & Company would like to step back to offer some reflections on 2008 and provide insights into the key forces that we believe will shape the industrial sector in 2009.

The past year has, of course, been exceptionally volatile and destabilizing, featuring geopolitical drama, wild fluctuations in commodity prices and exchange rates, and a credit and financial system crunch of a magnitude unknown to the current generation of business leaders. Fearing another Great Depression, governments around the world have taken virtually unprecedented steps to intervene in the financial markets. We now face the prospect of the most prolonged downturn since at least the early 1980s, and many industrial firms will face a structurally different world at the end of this economic cataclysm.

Although there are no pat answers that apply to all companies, we can put forth some guiding principles for these troubled times. The key to managing through hard times is to drive dual strategies simultaneously: One is geared toward today, the other focused on tomorrow.

Strategies For Today

The companies hit hardest by recession are those without liquidity. One approach is to seek out one-time sources of cash from a mix of "quick hits" and near-term operational changes, with close scrutiny of selling, general, and administrative expenses. We have seen many companies focus on working capital and achieve significant improvements through strict inventory management and improved operating procedures.

We believe the most valuable components of any portfolio are those businesses that promise the biggest difference between their market value today and their value in the future once they have been improved.

The Danaher Corporation offers an example of a company with a strong strategy. Using the Danaher Business System, or DBS, it has made a steady stream of acquisitions and developed an infrastructure for integrating new businesses. DBS is a set of values—quality, delivery, customer focus, and innovation—and a series of associated processes that bring discipline in the form of kaizen. More important, Danaher has been consistent in focusing on high-growth sectors of the economy where the players are fragmented and it can create value by consolidating assets. Along the way, Danaher has systematically divested businesses in order to keep focusing on the high-growth, active sectors of its portfolio. The strategy has paid off in the form of 20 percent compound annual growth in sales and earnings per share for much of the last decade.

At the same time, companies must protect their basic business in hard times and avoid the temptation to initiate significant cuts in the core value proposition to customers, such as service.

Strategies For Tomorrow

Downturns don't last forever. Successful companies look beyond knee-jerk reactions to tough economic times and keep an eye out for opportunities to create value that will persist into the future. Unfortunately, managers usually devote an inordinate amount of attention to the immediate crisis. Now is the time to get past recessionary cost cutting and make efforts to increase top-line revenue and improve the company's long-term strategic position. Across-the-board job cuts are seldom effective in the long term anyway, because the most valued employees are the ones who can always find new jobs and leave.

Assuming a company has a sound capital structure, a recession can allow it to pick up previously overpriced acquisition targets. Typically, companies hit hardest in a downturn carry the highest growth multiples. This means there is a window of opportunity to buy companies that can fuel growth over the long haul.

Many companies do just the opposite: They divest businesses during downturns, and buy when times are good and prices are high. Booz & Company research shows that this approach is exactly wrong. Consolidation taking place in soft markets is five times as likely to be successful, with 84 percent of deals succeeding. For consolidation that occurs during hot markets, 65 percent of the transactions result in significant value destruction. If a company has the balance sheet to support it, the time to acquire is now, rather than during the eventual recovery.

When it comes to making decisions about which businesses to go after or abandon, too many firms make the mistake of using measures that focus on performance, not value. Value is more difficult to measure, as it lacks clear-cut, external benchmarks, but is also a better indicator since it incorporates current and expected future performance. Companies also tend to fail to acknowledge the cost of forgone opportunities. To avoid this error, managers must go beyond looking at portfolio synergies to search for more valuable ways to use company resources such as people, capital, and time.

Hard times can free companies to fundamentally rethink business models and move from the middle of the pack into a leadership position. Consider whether this might be a good time to take a restructuring charge. Share prices are down so low already that the market reaction will be muted. The downturn will also diminish resistance to change from entrenched interests, such as employees, unions, or politicians. In fact, for some companies, a prolonged downturn may be the only time when transformative change in the business is possible. The trick is to use the spirit of crisis to create a new vision for the firm, instead of reverting to indiscriminate and incremental cost cutting.

Consider ArcelorMittal and the value it has created over the last decade by rolling up steel assets at a time when the rest of the world viewed the industry as toxic. The company helped transform a perpetually underperforming sector of the economy into the envy of most other industrial sectors. Today, ArcelorMittal is able to adjust to shifts in the economic outlook with quick changes in capacity—a feature of the industry that was missing prior to its acquisition spree. To capture opportunities in a downturn and emerge stronger, companies need a clear sense of the capabilities they want to enhance or build. In this time of crisis, companies must focus on building their truly essential capabilities while lowering their overall break-even point in order to come out of the downturn stronger.

Companies also tend to build their internal capabilities, such as new systems or human resources, while under pressure. A true capabilities-driven strategy is outward-looking and starts and ends with customers.

Management In These Times

In this time of unprecedented turmoil, we have a generation of American managers who have little experience managing through any major downturn, let alone one this severe. In the coming years, many executives in the industrial sector will confront decisions they have never faced before. Crisis management is a unique skill, and managers who were successful in the past eight years of growth may be ill suited for the current environment. Winston Churchill was highly regarded as a leader during wartime, but was at a loss when the artillery went silent.

Companies may want to complement their current management teams with seasoned warriors, or make changes at the top that suit the harsh new business environment. The winners in the next up cycle will be those who take bold and decisive actions during 2009.