Heroes in a downturn:
strategies from the front lines

Offense is the best form of defense

By Sam Israelit, Chris Brahm and Dianne Ledingham

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Adversity always shuffles the deck in the tech industry—and the 2008–2009 downturn already shows signs of disruption that might create new winners in the future. Intel's introduction of the low-cost Atom microprocessor, Cisco's expansion into the datacenter business and Microsoft's push to make Xbox LIVE a platform for digital media distribution—these are just some of the potential game-changing moves this recession is ushering in. But the big churn is still around the corner. A recent Bain survey of leading tech companies reveals that most companies are still reacting defensively to the recession—and only a few are aggressively preparing to go on the offense or actively planning disruption (See Figure 1). It is these select leaders who will not just survive the downturn; they will race ahead of the competition as the economy improves.

To track the tectonic shifts that might already be underway in the tech industry, we interviewed CFOs and CEOs in 27 technology companies—hardware, semiconductors, software, services and Internet companies—with revenues ranging from $50 million to $50 billion. As expected, all tech executives reported that the downturn had a significant impact on their business in 2009. Most did not expect the recovery to start in earnest before mid-2010.

As we probed further, the difference in perspectives began to emerge. Many companies had not yet crafted the playbook to move from a recession to a recovery; these companies are most vulnerable to disruptive moves from the competition. A few have moved beyond the early shock waves and are actively using turbulence to get ahead of the competition; these companies are taking advantage of the current situation to execute new strategies that strengthen their position. Said a recovery-focused CFO, "A good downturn is a terrible thing to waste."

Figure 1: Pulling the right levers to win in this downturn

Strategy	Revenue	Operations	Organization
Identify leadership segments in portfolio	Focus on investments that reinforce customer loyalty	Reduce functional costs based on scenarios	Simplify the organization structure
Seek opportunities for disruptive innovation	Build sales effectiveness and target competitive share gain	Identify opportunities for restructuring the value chain	Focus on effective decision making and strengthen the organization's culture
Identify game-changing M&As	Price proactively to gain share or increase revenue	Reduce complexity and focus on structural cost reduction	Ensure the right talent is in place

Consider the widening chasm between potential winners and losers in the survey findings:

- Although 50 percent of executives claimed that revenues will be more severely hit in 2009 than they originally anticipated—and 30 percent felt unsure of meeting current revenue projections—most companies still hoped their initial actions for coping with the downturn were going to be sufficient. Only 20 percent had a backup plan in place to respond to the possibility of a continued recessionary environment or a slow, drawn out recovery.

- All the companies surveyed had taken some action to reduce costs. But less than 40 percent had undertaken initiatives to steal market share from competitors, build customer loyalty or improve the effectiveness of their salesforce.

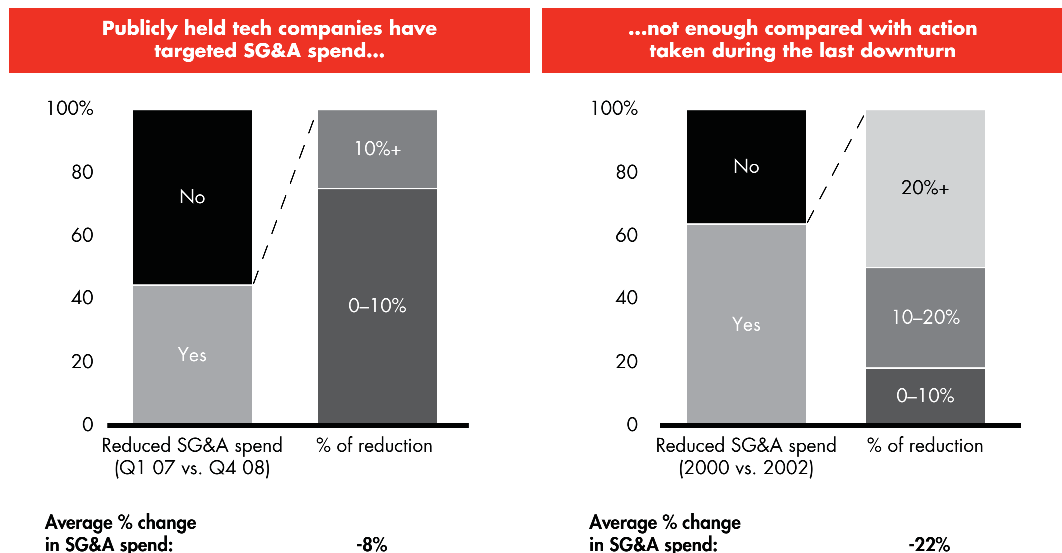
- The surveyed companies reduced SG&A expenses between the first quarter of 2007 and the last quarter of 2008 by an average 8 percent. While companies continue to focus on reducing costs in the future, many are grappling with how deep the cuts should be, especially in industry segments that are expected to decline by more than 10 percent. In the less severe 2000–2002 downturn for example, more than 60 percent of the tech companies lowered SG&A expenses by an average 22 percent (See Figure 2).

- About 60 percent of the companies indicated they were open to acquiring a distressed company. However, most had not planned the specific scenarios under which they would trigger such action, nor had they thought through how competitors might react.

What the past foretells

For some in the tech industry, these signs are familiar—and point to an impending shakeout. Bain's research shows that downturns create "heroes" and "casualties"—companies whose total shareholder return jumps or falls two or more quartiles among peers—and that this

Figure 2: Tech companies have reduced expenses, but most will need to cut more



Note: Prior downturn includes US public tech companies with all data available for last downturn analysis
Source: OneSource, Capital IQ, Bain Analysis

shuffling of the leader-board happens at *double* the rate in a downturn as in periods of growth (See Figure 3). In fact, our analysis of publicly listed technology, media, and telecom companies shows that despite the challenges of 2000–2002, 48 percent of the companies were "heroes" and gained ground substantially. That was twice as much disruption compared with other industries. In contrast, during the stable times of 2003–2005, only 24 percent of the companies could pull ahead of the pack.

The same holds true for the casualties. We found that companies experienced more dramatic loss in share during downturns than compared with growth periods. While 44 percent of the companies were "casualties" of the challenging 2000–2002 days, only 11 percent of the companies declined in performance during the relative calm of 2003–2005. Further, we found that the decline in casualties and the rise of heroes tended to continue even after the economy rebounded.

The implications for most tech companies are clear—companies proactively need to protect their turf and seek ways to use the downturn to their advantage and position their company for growth. Between 1989 and 2009, leading electronics manufacturing service (EMS) companies, for example, often tripped during turbulence. Sanmina-SCI lost leadership in the early 1990s recession, allowing Solectron to dominate the EMS market. Then Solectron was hit hard by the 2000–2002 downturn and ultimately merged with Flextronics. All the while, Taiwan-based Hon Hai steadily grew to become the world's largest electronics manufacturing services provider, successfully steering through business cycles over the last 10 years. Today, Hon Hai dominates the EMS profit pool.

Clearly, within a given industry, not every company suffers equally, even in severe downturns. Each company has its particular strengths and vulnerabilities, but each also faces a similar set of questions: What is our plan for most-likely and *worst-case scenarios*? What is required to retain our most important *customers and employees*? How can we fully take advantage of the downturn by "going on the offense" in *strategy, sales, operations*, and *organization*? What are our acquisition priorities and under what conditions should we initiate deals? How does our *business model* need to change for the long term? How will our industry *profit pool* change? How can we be a *catalyst* and benefit from change? In our experience, companies that face these questions squarely, that understand the relative strengths and weaknesses, and that identify the right levers to pull are the ones that successfully steer out of turbulence and gain competitive ground.

How to win in this downturn

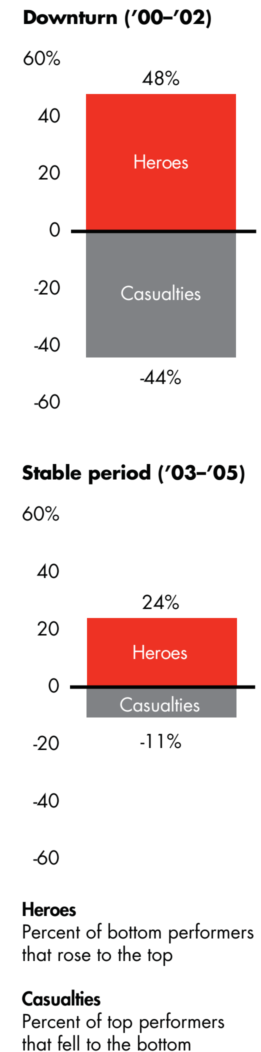
At times, fortunes in the tech industry seem to shift by chance. However, when we studied companies who were successful in grabbing the lead in a downturn and maintaining it on the upturn, we found that some consistent patterns emerge. Heroes strike the right balance between relentless focus on execution in their core business and aggressively investing in the future. Moreover, they were willing to take risk to disrupt and shape the future. Every time their market's "profit pools" shifted, they were right there in the new space ready for the next phase of growth. It didn't matter whether they were the catalyst of change or not, they speedily embraced the change either organically or through mergers and acquisitions. Operationally too, they were ahead of the game in how they managed cash and costs, R&D, pricing, and sales effectiveness.

Our research shows that companies that win over the long term capitalize on turbulence with the following five rules:

Rule 1: Execute Plan A—but prepare for Plan B

While most tech CFOs and CEOs foresee an uncertain future most were still not taking enough action to prepare for what might come. A systems company CFO remarked,

Figure 3: Companies make more dramatic gains—and losses—during downturns than in boom times



Note: Heroes are companies that performed significantly below average at the beginning of the period and significantly above at the end; similarly, casualties showed a significant decline in performance; compares relative performance (sales growth, profit margin, TSR) by industry category, for US tech, media and telecom companies
Source: Sustained Value Creator Database/Worldscope; Bain Analysis

"Cutting executive bonuses and furloughing workers is not a long-term cost reduction. We need to think about structural reductions."

More than two-thirds of the organizations surveyed had not developed any plan for additional structural cost reduction—and some were already wincing as a consequence. One hardware company's CFO admitted, "Initially, we thought we would be down by 5–10 percent, but within a month we had to revise it to 20 percent. It kept getting worse, and eventually, we were all-hands-on-deck to find more cash."

Some tech companies claimed they were conservative in their reductions because they didn't want to make the wrong decisions under pressure. In sharp contrast, a few forward-thinking companies mapped scenarios that clearly highlighted what circumstances would trigger what action—as well as the impact of those actions. Managers in these companies not only had a firm grip on costs but were equipped to make hard choices in worsening circumstances without panic. "We were very proactive in developing scenarios and contingency plans," said the CFO of a midsize enterprise software company. "We have a 'def-con' chart of various stages: business as usual, stormy seas, nuclear winter. That helped us to react quickly as events played out over the summer."

Such planning is important when the range of forecasts for IT spending vary so widely—from a depressing negative 12.0 percent to flat in 2009 and from negative 4.5 percent to 1.1 percent in 2010. While recent forecasts show signs of stabilization and some even suggest improvement in the second half of 2009, they also indicate wide divergence by sector—a clear signal that acting on "Plan B" might yet become necessary for companies in certain sectors or companies in a weak strategic and financial position. While it is impossible to predict the trajectory of the IT sector with any certainty over the next 12 to 24 months, the best prepared companies have already made plans to cover the full range of scenarios.

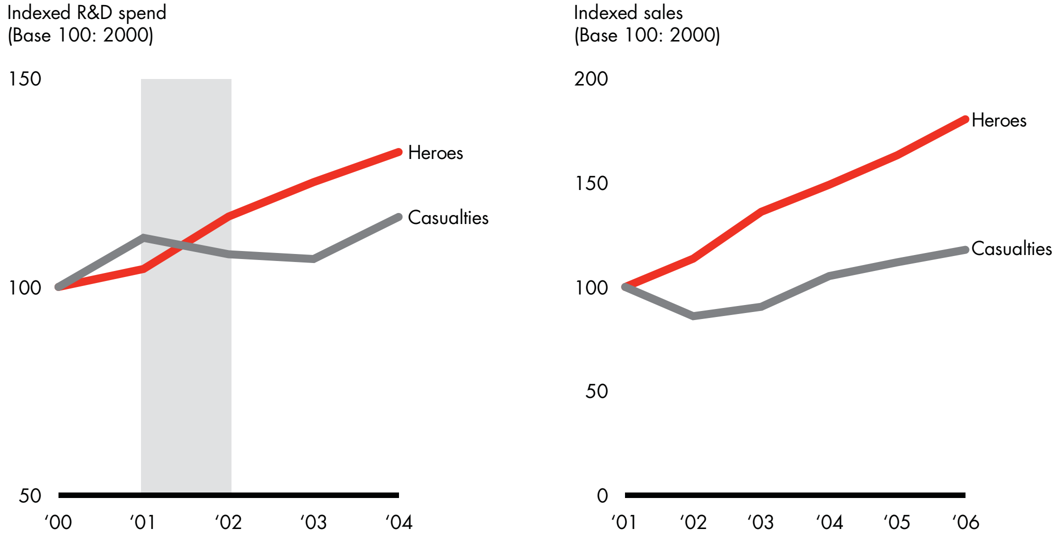
Rule 2: Selectively invest to grow

Managers usually take serious defensive actions—cutting costs, reducing working capital, shrinking headcount, reducing overhead, and more recently, off shoring and outsourcing—to respond to downturns. But Bain research shows that tech companies that became heroes did not just cut costs in the last downturn—they generated cash, which they then invested to spur growth. Some increased R&D investments by an average 9 percent—even as they cut elsewhere. When the economy picked up, so did their revenues. These companies grew, on average, 30 percent faster than the tech industry's overall growth. Others that used the cash for strategic M&A were also rewarded: returns on tech acquisitions made during the last downturn were double the returns for tech acquisitions done before or after the downturn (See Figure 4).

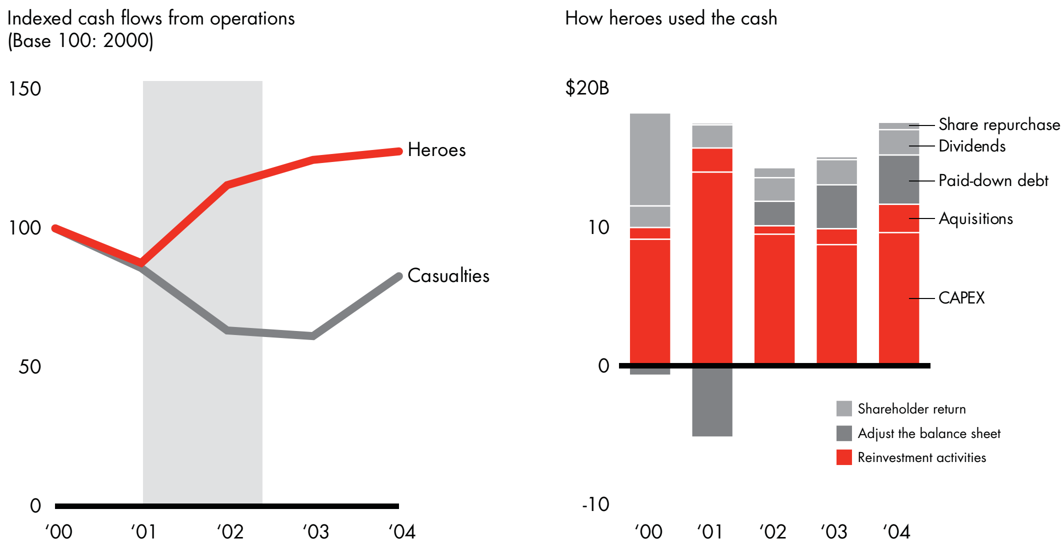
Our Bain survey for this downturn indicates that tech companies are taking five times as many actions related to reducing cost compared with those increasing revenue and share (See Figure 5). One services company CFO said, "We have no visibility into revenue right now. If it comes, it comes. In this environment, we feel we have to get ahead on costs."

In sharp contrast, one CEO explained that as soon as his enterprise software company got a grip on costs by consolidating sites, reducing headcount, and slashing expenses—it set itself a growth challenge. Despite the downturn, what can the company do to *increase* earnings by 5 percent compared with the previous year? First, the company hiked its marketing budget to fund a new campaign in the spring to differentiate itself from the competition. Then it pumped up the pace of product development to target new customers over the next few quarters. Finally, it raised incentives to motivate the salesforce. Today, the company's earnings are 12–18 percent ahead of last year. "We realized we're not going to

Figure 4: In the last downturn, winning tech companies invested in R&D, increased revenues...

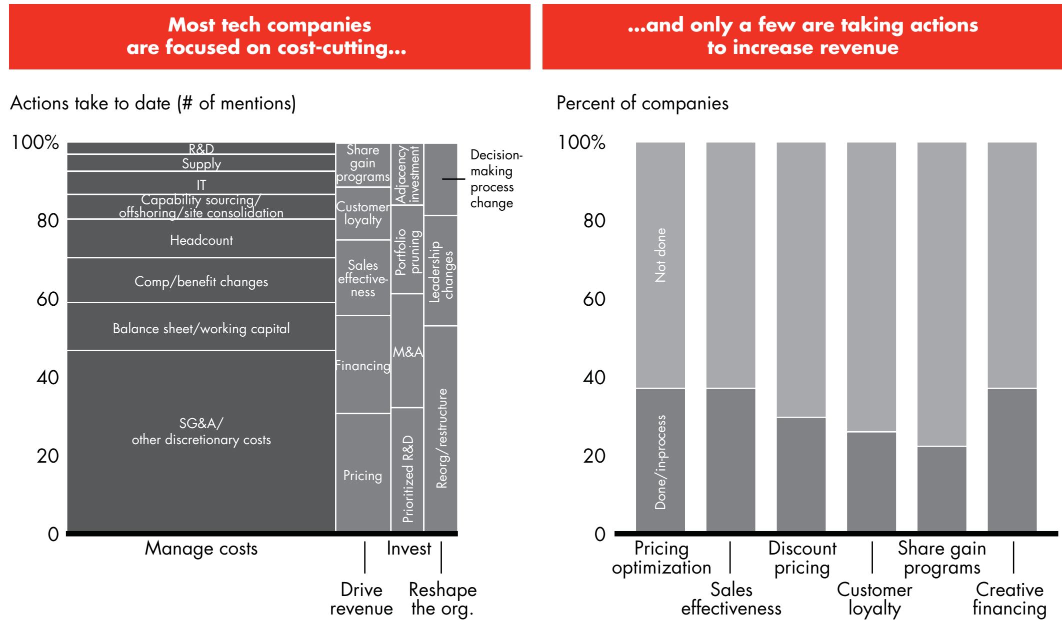


...and generated cash to reinvest in the business



Note: Heroes are companies that performed significantly below average at the beginning of the period and significantly above at the end; similarly, casualties showed a significant decline in performance; compares relative performance (sales growth, profit margin, TSR), for US tech companies
Source: Sustained Value Creator Database/Worldscope; OneSource; Bain Analysis

Figure 5: Winners cut costs—but also focus on revenue growth



Source: Bain interviews of tech industry CFOs & CEOs

solve our problems by just watching costs anymore. We're going to have to drive revenue," says a company executive. "What excites me now is that when the economy improves, our earnings will go through the roof!"

Rule 3: Retain old customers—and acquire new ones

At the best of times, companies ignore customers at their peril; in a downturn, the danger doubles. A company must now worry about retaining current customers, as well as increasing market share, all with limited resources. In the last downturn, Yahoo and Google gained ground by redefining the value they brought to their customers, while AOL struggled because it lost its focus on finding new ways to offer customers value.

In this down cycle, many tech companies are yet to turn their attention to customer loyalty. Though 85 percent of the companies surveyed were taking at least one action to drive revenue in the short term, few companies mentioned "the customer" as a critical priority without being prompted. Less than 40 percent of the survey respondents admitted to using pricing strategies to boost demand—and most price reductions were reactive rather than to gain market share.

One software company in the survey stood out: It was actively using every tool at its disposal to focus on customers. Its sales force was out aggressively promoting new modules, with flexibility in offering discounts such as an extended warranty. The frontline was working with customers helping them figure out how the government's stimulus plan can benefit them. Said the CEO, "We have a competitive attack plan." Another CFO shared the plans to beat their competitor in the next 12 months. "We have identified 20 key accounts we are going to take from them and have assigned teams to go after each one. We have customized plans for each of them and a majority of our bonus is based on winning them over."

Rule 4: Be the disruption

Recessions offer tremendous opportunities for disrupting the status quo. Two kinds of disruptions stand out for how they reshape industries: new value propositions and industry consolidation. In downturns, customers are more willing to take risk in search of more value—so new, discontinuous value propositions are a real and present danger. One CFO remarked, “A couple of years ago we would have considered a cloud-based email solution just too risky. Now we have no choice. We have to consider alternatives that reduce costs for the customer.”

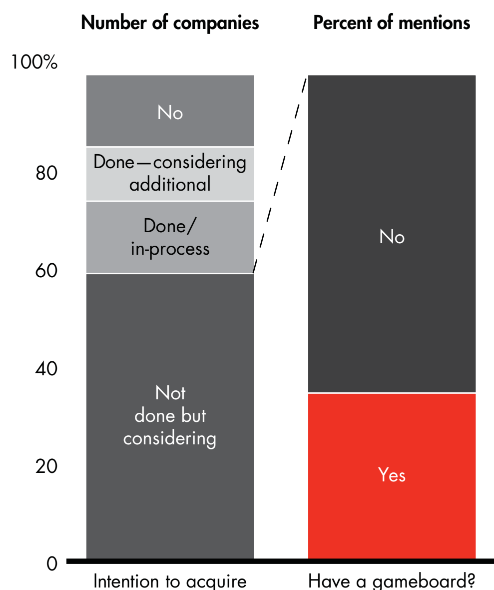
Sometimes these disruptions are business-model-driven; sometimes they are technology-driven. For example, Indian systems integrators gained market-share in both the last recession and this one, by simply offering lower prices based on their significant cost advantage. Similarly, the TV industry shifted to LCD and plasma technology in the last recession, reshaping the competitive dynamics. In the current recession, already there is a growing list of possible technology disruptors. To name just a few: behavioral advertising, smart phones and mobile internet devices, cloud-computing, internet video, location-based services, eBooks, solid state storage, low-cost camera modules, smart grid and low-cost outsourced design services.

While all the CFOs surveyed could name a number of the possible disruptors for the markets they compete in, most admitted they had not adequately planned to deal with their impact on their industry. Said one software CFO, “We can see how many of these technology and business model disruptions could impact our business. But we do not yet have a clear strategy to take advantage of them.”

In addition, there are mergers and acquisitions, which can substantially redraw the competitive landscape. Our research shows that in 2001, “heroes” saved more than $15 billion in cash, of which nearly 80 percent was used for capital investments, dividends and buybacks—and acquisitions. Some of the bigger deals: Google acquired YouTube to build a leadership position in video, eBay bought PayPal to enhance the functionality of its marketplaces, and HP purchased Compaq to broaden its product offerings for consumer PCs and low-end servers. While the ultimate value created by some of these deals is subject to debate, it is undeniable that consolidation follows in the wake of a downturn.

While almost all the survey respondents said they would be open to acquisitions—and some have even created war-chests—less than a third had analyzed which companies they would acquire, and under what circumstances (See Figure 6). One hardware company stood out for the thorough job it had done to identify potential acquisitions. Said the CFO: “We have a pipeline of targets in businesses adjacent to our business. We update this on a regular basis and currently, there are two areas we are monitoring closely.” Another semiconductor com-

Figure 6: Many tech companies are considering acquisitions, but few have a plan of action



Source: Bain interviews of tech industry CFOs

pany is watching a clutch of related companies with balance sheet problems—and will strike when the price is right. Says the CFO: "These companies don't have the ability to access capital. Our balance sheet is strong, we have the advantage."

Rule 5: Build a winning team

As might be expected, more than 75 percent of all publicly held tech companies laid off employees between February 2008 and April 2009. According to the Bain survey, about 25 percent of firms cut their workforce by 10 percent or more. In general, within the industry, hardware companies made the deepest cuts, followed by media companies and then software. The survey revealed they share a common concern about the impact of layoffs on company morale. Says the CFO of a semiconductor equipment company: "We are really concerned about losing the hearts and minds of our employees. This recession has been brutal for our organization. Our biggest challenge is getting ready for the recovery. We need to maintain a strong talent pool, reduce employee turnover, and get our people excited despite the continued uncertainty."

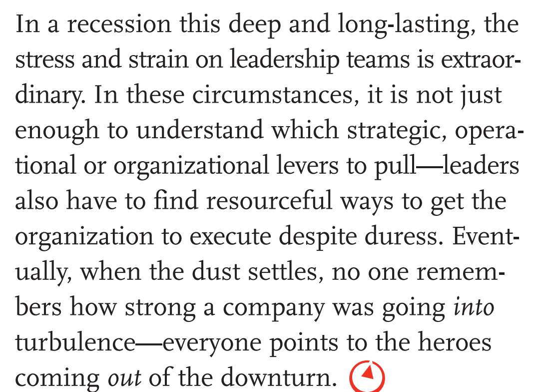
A leading hardware company CFO described the company's plans to build the organization over the next 12 months: Keep people motivated, and make sure the best performers are engaged. The top management is dramatically increasing the amount of "walking the halls." It is engaging employees through small group work sessions, soliciting open feedback and involving them in solving the challenges of the business. The company is aggressively reviewing its talent pipeline and doubling down on investment in its top performers.

Other surveyed companies mentioned that they are using employee forums and online tools to engage employees and address critical issues. One company is using the downturn to provide development opportunities for its key employees. It is assigning special projects—such as economic impact assessments, new product brainstorming and process redesign—to engage key individuals to help address specific challenges.

At a few companies, leaders are capitalizing on a market flush with talent—particularly competitors' employees facing uncertainty—to upgrade capability. "We are replacing the underperforming with the performing," said the CFO of a large software company, adding: "We are hiring at many levels of the organization, even the most senior. We want to fill the skills and competencies we don't have, especially in businesses where we may be weak." Whatever the approach, the best companies are taking nothing for granted and investing aggressively in their people to ensure their organization is stronger coming out of the downturn than going into it.

The will to win

None of these strategies is easy, especially in the tech industry, where even in boom times the competitive pressure can be intense. Western Digital came out of the last downturn a hero, partly because it quickly moved to a lower-cost business model as the hard-drive market matured. The lower overhead and faster development times quickly translated into market share and higher margins in the growth years. On the other hand, Sun Microsystems exited the last downturn a hero, but its slow pace in evolving its proprietary hardware-based business model left it vulnerable to a takeover in this downturn.



In a recession this deep and long-lasting, the stress and strain on leadership teams is extraordinary. In these circumstances, it is not just enough to understand which strategic, operational or organizational levers to pull—leaders also have to find resourceful ways to get the organization to execute despite duress. Eventually, when the dust settles, no one remembers how strong a company was going *into* turbulence—everyone points to the heroes coming *out* of the downturn.

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