Situational strategies

A management tool for turbulent times

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Arrow Electronics will never forget May 1985. That was the month, as some say, when the last person who needed a computer and didn't have one bought one. June saw the start of a three-year downturn that nearly drove Arrow, the scrappy No. 2 player in the business of distributing electronic components, into the ground. Sales slumped 25 percent. At one point, Arrow was shouldering $3 of debt for every $1 of equity.

Instead of taking the conventional response – cutting back, battening down – until the storm passed, Arrow CEO Steve Kaufman took advantage of the turbulence. He bought a competitor with Arrow stock and money borrowed against inventory and receivables of the target. More acquisitions followed and, by 1992, Arrow had become the leading distributor of electronic components and computer products – a position it commands today.

A different kind of turbulence provided Emerson Electric with a huge opportunity to grow – and shed its image as an old-line, power equipment business. Emerson, best known for selling electric motors, refrigeration components and industrial tools, took advantage of market disruption in telecoms. In 1996, Emerson saw that the telecom business had become the biggest driver of growth. "We thought, 'we kind of like this business' and all the opportunity it represented," said Howard Lance, Emerson executive vice president. The company, with $4 billion available for acquisition, was ready to pounce. From 1998 to 2000, it spent $2.5 billion on the purchase of power companies to serve telecoms.

The move is paying off handsomely. The electronics and telecommunications division, growing a profitable 28 percent in fiscal 2000, now accounts for about a quarter of the firm's total sales, up from 12 percent in 1998. The division's pre-tax income in 1999 jumped 58 percent to $237 million. The aggressive move into telecoms had an added benefit: it helped to squash the criticism that Emerson's obsession with its more than 40-year history of unbroken profitability led it to be too conservative.

Both Arrow and Emerson show that, when the economy, technology, or another key condition of your business environment changes suddenly, not everyone loses. There are some winners. The trick is to correctly appraise the situation and quickly adopt a strategy adapted to its contours. With turbulence seemingly here to stay, the corporate capacity to develop and implement situational strategies is an increasingly critical capability.

Applying situational strategies is not easy. If it were, everyone would do it. First, you must be ready when the situation presents itself – expect the unexpected, as it were. Arrow and Emerson were ready because they were continuously taking stock of their strategic and financial positions, as well as the source and severity of industry turbulence. They also showed the discipline to turn away from strategy devised for calmer conditions. Staying a course and keeping sails up in a storm can capsize even the strongest corporate ship. Managers must be flexible and ready to act quickly without over-correcting as conditions change. To win in turbulence, senior executives must continually review three dimensions of their business context: their industry's source and level of turbulence, their own strategic position – or market share – within their sector, and their financial strength.

Our findings suggest that there is a significant opportunity to win in turbulence. For instance, in our analysis of the 377 *Fortune 500* companies that weathered the 1990-1991 recession, we compared each company's stock price performance with the industry norm before and after the recession. We found that 31 percent of these companies actually improved their relative performance during an economic downturn. The companies that were prepared for bad times captured a disproportionate share of industry growth and profits. Another finding was more ominous: companies caught unprepared can become paralyzed in their decision making. Sears, Roebuck & Co., for example, watched The Home Depot, with its low-cost and superior-service business model, sell hardware (the core of the Sears retail store) as it grew from one, to ten, to 200 stores. Only when The Home Depot had become a $10 billion company did Sears begin aggressively experimenting with alternative retail formats.

Designing situational strategies

Bain developed its notion of situational strategies by watching hundreds of firms weather turbulence, and through analyzing company financials and surveying senior executives. Our findings suggest that, when turbulence hits, senior executives need to shed the one-size-fits-all strategies that have been popular in less turbulent times. (Faced with the refrigerator, the ice industry responded with a 300 percent improvement in cutting, storing, and shipping ice.) Executives need to spend less time trying to create accurate models and predictions of the future and more time doing contingency planning for the whole range of possibilities.

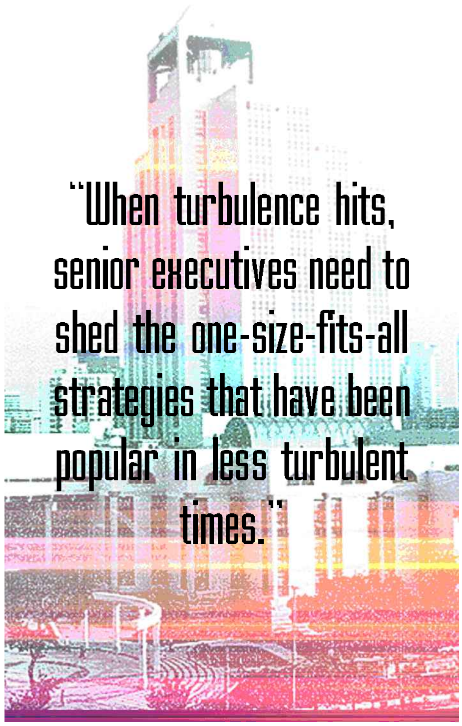
The fact is that a company's culture, or even top managers' psychology, may stand in the way of quick action. Most executives find it hard to approve some kinds of spending that can be part of a shift in strategy – like spending on capital, research and development, hiring increases, and advertising. Only a fifth of our survey respondents listed contingency planning as a critical tool for taking advantage of turbulence, whereas almost half listed cost management. What is more, some managers freeze in the clutch: their perceptions become distorted and they find decision making more difficult; they obsess on the insignificant and ignore the important; and they stall, trying to prove that their mistaken hypotheses were right all along.

Turbulence planning must be institutionalized. In Emerson's annual planning conferences each division must demonstrate how it will achieve profits, regardless of economic or industry conditions. Managers must devise a Plan A budget for the most likely scenario. They also must come up with a Plan B budget and a Plan C budget to cope with a downturn. If the economy slows, the planning enables the company to move fast to protect profits.

At Arrow, says Kaufman, turbulence strategy is created by "the top two to three people with an intimate knowledge of the business" who "lift their eyes out of the business and scan the horizon." Once you detect signs of turbulence, you must act quickly to determine the right situational strategy. You will need to identify the severity of turbulence and then analyze your financial and strategic situation.

Ask yourself: What is the source – Economic? Technological? Competitive? Sources of turbulence vary widely by industry. While banking is affected strongly by macroeconomic factors, utilities must worry about regulatory factors, and, for computers, technology looms large. The consumer film industry is seemingly subject to irrational attacks and price warring. The frequency of downturns varies as well. In the last two decades, the US economy has suffered three recessions. Over that period, some industries like natural resources and heavy manufacturing, which are highly sensitive to macroeconomic factors, have experienced more than triple that number.

The next question managers must ask is: How quickly does your industry recover from a recession? Hotels require 30 months. Airlines take almost four years. The electronics industry typically goes through a cycle of about three years of good times, followed by two quarters of no growth, followed by a downturn that lasts four to six quarters. In the 1990s, though, both the up and the down of the cycle lasted longer. The good times lasted from 1992 to 1996, while the downturn dragged on from 1996 to 1999.



Companies in industries that are highly vulnerable to turbulence must be prepared to change directions more frequently and sharply. They should be willing to pay more for options that will hedge against unpredictable market events. Their business models require greater flexibility – factories with quicker changeover times, cost structures that are less fixed and more variable, technologies that have a wider range of applications. These companies should be geared for faster turns, even if they have to give up a little speed on the straightaways.

The second factor to consider in setting up situational strategies is your strategic position. A Bain study of 240 companies that sustained profitable growth from 1988 to 1998 found that 96 percent of them had developed strategic positions that allowed them to dominate a business segment, geography or channel. Companies with strong strategic positions have more options and a higher probability of success in times of turmoil. This is true because the returns of market leaders are not only higher than those of market followers, they are also more stable.

Consider the effects of even a mild price war. Those companies with market share positions less than 3 percent of the size of the industry leader will see their negative returns expand by 50 percent and will immediately be forced into Draconian cost reductions. Companies in the middle will see marginal profits turn to losses, which may precipitate changes in the management team and strategic direction. Market leaders, meanwhile, will experience slightly lower returns, but their profitability will remain far above the cost of capital. They will have the flexibility to maintain or increase spending on R&D, advertising, capacity expansion, or acquisitions.

The final factor to consider when devising strategies for turbulence is a company's financial position. How much debt capacity does it have? What is its interest coverage? How much cash is on the balance-sheet? What happens to margins when industry sales slow? These and other questions can help companies determine their options once turbulence hits. Emerson, for instance, was in a powerful position to pounce: it was the only triple-A-rated manufacturing company in the USA.

Analyzing the situation

Depending on analysis of your strategic and financial position and the severity of the storm, you could find yourself in one of four positions at a time of high turbulence. Included below are examples of companies that weathered high turbulence in different combinations of strategic and financial situations.

Situation 1: Seat Pagine Gialle

- Financial position – strong.
- Strategic position – strong.
- Turbulence – High.

Strategy: lead consolidation:

- acquire weaker players;
- sustain investment;
- protect cost leadership.

In October 1997, shortly after being taken private, Seat Pagine Gialle faced the gigantic market disruption caused by the arrival of the Internet. Seat PG was the organizational unit that managed the *Yellow Pages* business in Italy for government-owned Telecom Italia. It was profitable, but not efficient. Seat PG had a strong strategic position: it controlled 89 percent of Italy's advertising collection and distribution of the *Yellow Pages*.

Yet the company's CEO, Lorenzo Pellicioli, saw the Internet on the horizon and wanted to be part of it. He says that he never changed the company's mission: to own and organize the market square. As Zook and Allen (2001) write in *Profit from the Core: Growth Strategy in an Era of Turbulence*, Pellicioli's first step was to make sure that the company was ready for the changes ahead. He built a new management team, developed a leaner corporate structure, and reduced costs to double cash generation.

With the core stabilized, the company dived into six new adjacent businesses, including, most significantly, the Internet. The Internet campaign began with the acquisition of three firms. In addition, the core *Yellow Pages* franchise was brought online. "We're the market organizer, enabling both businesses and consumers to interact, inform, investigate and decide," said Pellicioli. "We neither buy nor sell products, just provide the space for the buying and selling process . . . We also have our own shops on the [cyber] square . . . In the middle of the square we have our content aggregation system, and we're pursuing more content to expand it. We exploit all the synergies between all these activities."

The result is impressive: Seat's stock price increased by 12 times in three years, and the company has effectively become the AOL of Italy.

Situation 2: Emerson Electric

- Financial position – strong.
- Strategic position – weak.
- Turbulence – high.

Strategy: concentrate strength:

- dominate niches;
- acquire selectively.

In 1998, Emerson spotted turbulence in the telecom sector, both from incredible growth in demand and from major new demands for system reliability. Emerson was in a strong financial position. The company's earnings per share had risen every year for over 40 years for a compound annual growth rate of 11.5 percent. Yet the growth in sales of the base company was slowing – from 8.3 percent in 1995, to 5.4 percent in 1996, 4.4 percent in 1997, 4.7 percent in 1998, and 1.5 percent in 1999. In the electronics business, the company made power and climate systems for data facilities as well as embedded power conversion solutions for smaller equipment. Although these units were leaders in their fields, Emerson was not a big player in the telecom power market. It saw an opportunity to offer a full solution in something the fast-growing telecommunications world desperately needed – impeccable reliability.

So Emerson repositioned itself by investing aggressively in the telecom sector. Emerson made its first telecom acquisition in 1998 when it bought Nortel Advanced Power Systems. After five more deals in 20 months, Emerson had invested $2.5 billion in the sector. Its market share jumped from less than 5 percent in 1996 to 15 percent in 2000, giving it a powerful position at 1.5 times larger than the No. 2 player in the field.

Situation 3: IBM

- Financial position – weak.
- Strategic position – strong.
- Turbulence – high.

Strategy: refill the tank:

- focus on core competencies;
- divest non-core assets to raise cash;
- rebuild the balance-sheet.

When Louis Gerstner Jr took charge of IBM in 1993, the company was ailing. It had regained its top position in personal computer sales, but it had lost money for the previous three quarters, and the stock price was 75 percent off its peak in 1987.

Gross margins had fallen to 40 percent from 55 percent in 1990. Cheap silicon chips, which paved the way to powerful and inexpensive personal computers, had changed the game. IBM, weighed down by bureaucracy, had taken too long to adapt and now faced competition from upstarts making PCs that cost a lot less and ran just as well.

Gerstner's predecessor proposed to decentralize operations to turn IBM into a series of free-standing companies, Baby Blues, but Wall Street was unimpressed. So Gerstner kick-started IBM's turnround by slashing costs and non-strategic divisions, cutting the workforce, shaking up entrenched management, and dumping the plans to decentralize. Size, he figured, could be an asset. Those moves produced quick results. In 1994, Big Blue had its first profit in four years. Three years later, in 1998, Gerstner made his move to divest a big chunk of IBM's non-core business to raise cash. He sold Global Net, the world's largest high-speed voice and data network dedicated to network-centric computing, to AT&T for $5 billion. It was a move that let IBM focus on its core business of hardware, software, and computer service. As part of the deal, AT&T hired IBM for processing and data center management operations. That ten-year agreement is valued at $4 billion.

Situation 4: Arrow

- Financial position – weak.
- Strategic position – weak.
- turbulence – high.

Strategy: find friends fast:

- dispose of anything that is not essential to survival;
- seek alliances and merger partners.

At Arrow, "we made our greatest strategic moves during the period of greatest financial weakness," said Steve Kaufman. The 1985-1987 recession in the industry was brutal. Arrow lost between $10 million and $20 million each year for the three years. The company had $150 million of debt, and the borrowing cost averaged 12 percent. Arrow had no operating income at the time – just some one-time gains from real-estate sales. Sales were collapsing. Kaufman had already disposed of sideline businesses in lead smelting (for the cash flow) and electrical distribution.

Kaufman looked to acquisitions. In the first full year after its 1987 acquisition of a rival company, Arrow registered a modest net profit of $10 million. In 1991, Kaufman bought the No. 3 company that was suffering during what turned out to be a blip of an industry downturn. After several more acquisitions in Europe, Arrow swept past Avnet Inc., the industry leader, to sit atop the field. In 1994, Arrow's electronic sales were $4.6 billion, compared with Avnet's $3.4 billion. So the inevitable downturns in this cyclical business are an opportunity: "We acquire in bad times," explains Kaufman.

Profiting from turbulence

Our survey shows that CEOs want to take advantage of turbulence. More than half of the 90 senior executives queried said that their companies – if not fully prepared for a slow-down – were at least "actively involved in turbulence planning." Yet our survey suggests that a lot of executives are not as prepared as they may think. We asked the executives whether they agree or disagree with the statement: "During turbulent times is it more important to protect market share than profit margins?" The largest group of respondents, more than 30 percent, neither agreed nor disagreed. They want a clear strategy but still have not addressed the trade-offs that a successful strategy demands. It is not clear that they are aware of this problem: 79 percent claimed that their company was better positioned to handle economic turbulence than other companies in their industry, but only 34 percent of their companies actually outperformed their industries in the last recession.

There are, of course, many ways to profit from turbulence via routes that depend on some of the factors we have described. Yet all of the companies we have studied that have profited in turbulent times share four characteristics:

(1) *They act quickly without over-correcting*. Emerson, for example, acted quickly by moving into the telecom market, but it did not ditch the core business of supplying air-conditioning and power supplies to large computer rooms, or small-scale power supplies for devices like cell phones.

(2) *They focus on the core*. The best compass in turbulent times is a strong set of core values that consistently guides choices among trade-offs. Is revenue growth more important than cost reduction? Is market share more valuable than profit margins? Is the loyalty of employees and customers more consequential than quarterly earnings targets? At Arrow, for instance, Kaufman believes, "We're in a cyclical business driven by people." So when the downturn hits, the company doesn't lay off masses of people. "You suck it up. You look the shareholder in the eye and say sorry, we're in a cyclical business." And then you look around for competitors to buy. According to Bain's survey of 240 "sustained value creators," nearly 80 percent had one or, at most, two dominant core businesses. Only 7 percent of the winners were highly diversified companies.

(3) *They chart alternate courses while the going is good*. Only 16 percent of the executives we interviewed strongly agreed that "if a slow-down hits our economy, we are well prepared to quickly implement appropriate contingency plans." Yet planning alternate courses in calm seas was a characteristic of many companies that performed well through the 1990-1991 recession.

(4) *They stay on deck once the storm hits*. In rough seas, you should continuously survey conditions outside your company. CEO Kaufman makes it standard procedure to look outside the company and traditional markets in the worst of times. He still feels that looking outside the company in a storm is one reason why Arrow overtook the market leader.

There are no guarantees, of course, but a pattern is emerging among companies that have dealt with turbulence successfully. These companies tend to have institutionalized an approach to detecting turbulence on the horizon and effecting situational strategies to catch the updrafts. They inculcate their executives with the managerial traits of succeeding in stormy times, educate them on when and how to ask the right questions to determine action, and they reward quick reflexes.

Look at Emerson, now gearing up for its next bout with turbulence. "We're now looking at the next five years, and we're seeing a price/cost squeeze," says Lance. So lowering costs is a key concern. He adds: "These initiatives aren't fun; they take a lot of work. But we like to make sure that we're looking ahead and putting pressure on ourselves."

Reference

Zook, C. and Allen, J. (2001), *Profit from the Core: Growth Strategy in an Era of Turbulence*, Harvard Business School Press, Boston, MA.