By Crawford Gillies and Patrick Manning

In a downturn, manage for the upturn

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Downturns don't last forever. In fact, the average recession in the UK since the 1950s has lasted only around 8 months. But when the markets rebound, many companies will find themselves hamstrung by rash decisions taken in gloomier times. The truth is, there's no better time to move your business prospects up. Leaders who swim against the tide and manage for the long-term will not only position themselves for the future, but will often do better in the downturn as well.

Consider Rentokil Initial. During the last UK recession in 1990 and 1991 it transformed itself from a modest pest control business into a world class supplier of office support services, growing turnover by 40% in the process. While the rest of the industry wrung its hands, Rentokil Initial invested heavily to build leadership around the globe, buying no less than 36 companies by the end of 1991. By then it was the market leader in the UK, US, Australia and New Zealand. Between 1990 and 1993, a period when the support services industry as a whole declined by 2%, Rentokil Initial's share price rose by 41% annually. Since 1993, operating profits have continued to grow at 17% per year.

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Rentokil Initial's achievement was all the more impressive in the context of a full-blown recession – something the UK will, hopefully, avoid this time around. Year-on-year GDP growth in the third quarter was a respectable 2.2%, and expectations for 2002 are 1.6%. Growth of below 1% is only foreseen in the event of a major catastrophe such as a UK-based terror attack.

But this is only half the story. Those impacted most directly by the September 11 attacks have already reported drastically reduced revenues. British Airways' reliance on transatlantic routes, for instance, has resulted in a 40% plummet in its market value. A second wave of UK companies – those with significant exposure to the US and Germany – have also started to suffer. Meanwhile, a number of sectors, including manufacturing, technology, media and telecoms and agribusiness, were in trouble long before September 11.

Add to this that most UK CEOs have limited experience managing in a downturn and it is hardly surprising that UK management teams are battening down the hatches. Only 10% of FTSE 100 CEOs or chairmen led their current companies during the last recession. Around one quarter of UK CEOs are now replaced every year, reflecting a much more assertive shareholder culture.

Evidence that many UK business leaders are responding to these testing times by putting revenue initiatives and strategic moves on hold is mounting. Acquisitions, buy-outs and other such deals have fallen sharply from the frenzied heights of 1999 and 2000. In the first three quarters of this year, deals were down 65% (or ~£300bn) year-on-year.

Understandable it may be, but a management "go slow" is the last thing companies need in testing times. Previous recessions show that periods of turbulence actually provide a unique opportunity to gain strategic advantage. Rentokil Initial is not unique. It is one of a subset of players – including Airtours, Tibbet & Britten and Abbey National – which significantly outperformed the market and their competitors during the last recession. Between 1990 and 1992, over 10% of companies achieved total shareholder return (TSR) greater than 30%, far outstripping the market average of 9% (see figure 1 overleaf).

What set the leaders of these companies apart from their less successful counterparts? Bain & Company has learnt that, far from ripping up their long-term strategies, these managers kept their nerve and resisted overreacting to events. Their approach boiled down to three key principles for managing in a downturn:

1. Act swiftly to make necessary adjustments, but avoid indiscriminate cost cutting
2. Strengthen the bonds of loyalty with employees, customers and other key partners
3. Accelerate the search for growth opportunities

Act swiftly, but avoid indiscriminate cost cutting

The first step in capturing the opportunities inherent in downturns is to be prepared to face facts and make difficult decisions quickly. Often, this will mean layoffs. Since the start of this year FTSE 100 companies alone have announced over 80,000 redundancies, with household names like BA, Rolls-Royce and BT among the biggest axe-wielders.

Though job cuts in themselves are no panacea for a company's ills, when redundancies are unavoidable it is best to start the programme straight away. Bain & Company research shows that the total shareholder return of UK companies which made layoffs early on in the last recession was as much as 20% greater than those which made them late.

But acting quickly does not mean acting precipitously.

Consider Merrill Lynch. Its response to the 1998 Russian financial crisis and near-collapse of giant hedge fund Long-Term Capital Management was to pare its international fixed income operations to the bone. 3,400 staff members, including many senior executives, were released, mostly through across-the-board cuts in the fixed income and emerging markets groups. At the time, the cuts were welcomed by investors who had grown tired of the volatile bond trading business. But the rebound came much faster than expected and an understaffed Merrill was unable to cash in, losing league table position to its competitors.

Merrill was right to cut costs, but wrong to make them in fixed income. Its leaders should have looked outside their core business to cut costs, rather than damage one of its best platforms for future growth.

A downturn can in fact be a good time to consider shedding non-core assets. This was the experience of Cattles, a niche credit services company, which entered the last UK recession highly diversified. When a new CEO, Eddie Cran, took over the business, he set about ridding Cattles of its non-core businesses including the textiles and curtains

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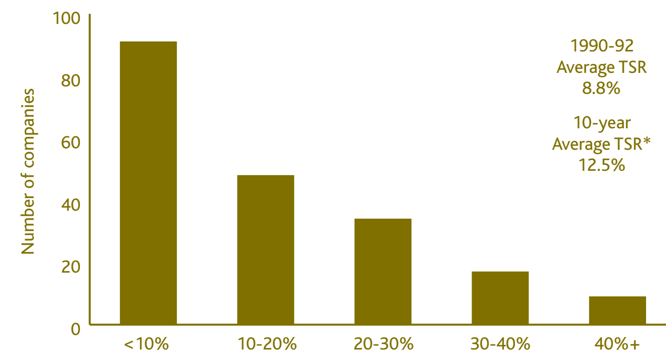
Figure 1

During the last downturn over 10% of companies achieved Total Shareholder Return greater than 30%



Total Shareholder Return is geometric average over period 1990-1992
*10 year average is from 1990 to 2000
Source: Bain analysis of 199 FTSE All-Share companies

business. Additionally, he made acquisitions to bolster the core credit services business and, by the end of 1992, had ensured that core business represented 84% of turnover, up from 69% just three years earlier. Since then, the company has consistently outperformed FTSE specialty finance companies.

Being able to adjust course and respond swiftly and proportionally to events means having contingency planning built into your company culture.

Hilton Hotels learnt this the hard way. The Gulf War, which precipitated the last recession, caused such a severe fall in occupancy rates that by early 1992 Hilton was barely earning enough to pay the interest on its debt. This prompted a further fall in its already damaged share price.

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But Hilton is not likely to find itself in such dire straits again, even if the current downturn gets worse. At a time when some of its competitors are again starting to feel the pinch of lower revenues, Hilton is better prepared for this downturn thanks to an ambitious sale and leaseback programme which strengthens finances. By the end of 2000, Hilton had sold and leased back 22% of its hotels. Today this figure is 50%, following the sale of 11 UK hotels to Royal Bank of Scotland for £312m in March of this year.

As well as easing its debt burden, the programme has freed up cash which may be used to fuel Hilton's best growth business: five-star hotels. Further, it still has £1.6bn of property so retains scope to raise more funds should it need them.

Good planning enables companies to withstand protracted downturns. It also enables them to act quickly to take advantage of changes in trading conditions or in the misfortunes of their competitors.

Package tour operator Airtours stands out as another example of effective scenario planning. In 1989 and 1990, when the rest of the leisure industry was heading south, Airtours grew strongly, doubling its market share and increasing turnover by over £100m. Airtours' increased financial strength helped it quickly capitalize on the 1991 collapse of ILG, a leading competitor.

"We knew from the moment Air Europe was grounded, ILG ... would be finished," said Harry Coe, Airtours finance director. "We had taken a close look at their holiday operations and had decided which resorts, which hotels – even which rooms in those hotels – we wanted to pick up from the ruins of their brochures."

Strengthen the bonds of loyalty

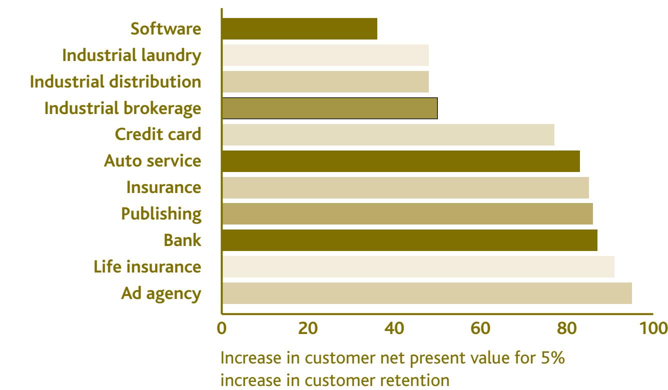
One contingency that often gets overlooked during difficult times is strengthening the bonds of loyalty with key customer groups and star employees.

This is probably not the first strategy that springs to mind when considering how best to navigate a downturn. But research at Bain & Company shows how customer loyalty directly results in dramatic increases in profitability. By holding on to your most attractive customers, you reduce your spending on acquiring new ones, your marketing initiatives become better targeted and you are often able to charge increased premiums and offer additional products and services. In some industries, such as financial services, a 5% increase in customer retention can translate into a more than 75% increase in operating profits (see figure 2).

Customer loyalty relies to a large extent on employee loyalty. In his recent book on the subject, Bain partner Frederick Reichheld drives

Figure 2

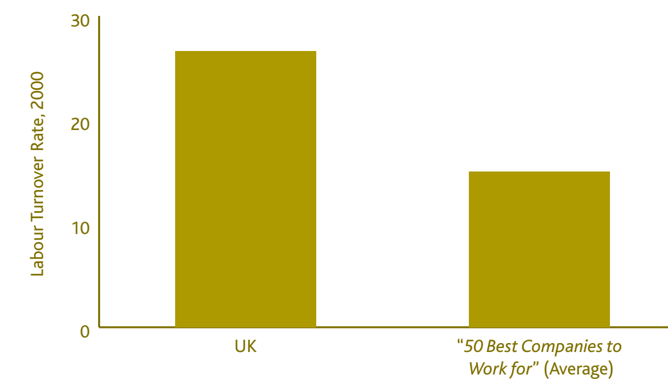
A 5% increase in customer retention can increase profitability by 40% to 95%



Source: "The Loyalty Effect" by Frederick Reichheld

Figure 3

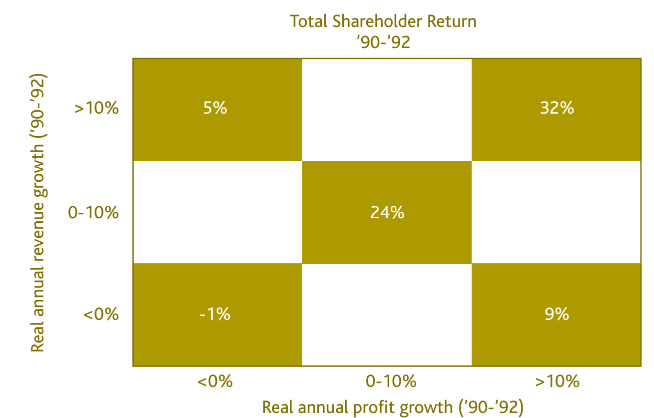
Average labour turnover rate of the "*50 Best Companies to Work for*" is just over half the UK average



Source: Labour Turnover Survey Report, Chartered Institute of Personnel Development, October 2001; The Sunday Times "*50 Best Companies to Work for, 2001*"

Figure 4

Key to driving Total Shareholder Return during the downturn is maintaining focus on the top and bottom line



Profit growth is net profit
Total Shareholder Return is geometric average over period 1990-1992
Source: Bain analysis of 199 FTSE All-Share companies

home the link between fostering loyalty among employees and developing loyal customers. Indeed, he shows that successful long-term growth can only be achieved by showing your leadership is founded on principles worthy of loyalty. These principles must cultivate partner growth and prosperity, not simply your own profits or the prospects of your shareholders. For each partner to prosper in the long-term, each business relationship – with employees, dealers, vendors and investors – must have as its primary aim the creation of value for customers.

Employee loyalty also drives costs down. Last year more than a quarter of all UK employees switched jobs and the cost of replacement has risen to an average of nearly £4,000 – much higher than that for managers and professionals. The best companies to work for (as ranked by the *Sunday Times*) turn out to have an employee turnover rate of a little more than half the national average (see figure 3).

UK food retailer Morrison is a good example of how increasing the bonds of loyalty saves money. Although the supermarket sector proved largely immune to the last downturn, the company took no chances and invested heavily in developing employee, supplier and customer relations. For instance, instead of chasing profit margins, it improved the customer value proposition by lowering prices.

When sales in the industry did start to slow, Morrison managed to increase turnover and volume sales while spending less on advertising per pound of sales than key competitors. It was able to do this partly because loyal, existing shoppers recruited new ones by personally recommending the store.

As well as attracting a higher spend per customer than its competitors, Morrison ramped up its profit-sharing scheme, paying out a company record in 1991 of £2.3m to reward its 7,000 employees. The result? Morrison's total shareholder return during the period 1990 to 1992 was 46%, substantially higher than even its nearest competitor, Sainsbury's, which showed which achieved TSR of 32%.

Loyalty has also played a large part in Harley Davidson's success. Its decision to build mutually beneficial relationships with staff, customers and dealers was key to its recovery from near-bankruptcy in the 1980s and its managers have been high-profile exponents of this philosophy ever since.

The onslaught of Japanese competition during the mid-1980s and the motorcycles' poor reputation for quality and reliability would have sunk the firm were it not for a hard core of loyal Harley owners. Under the leadership of Rich Teerlink, Harley Davidson recognised that these customers were the bedrock of the business and set about rebuilding the company based on customer loyalty, and the employee loyalty that earns customer loyalty. During the next few years, Teerlink encouraged dealers to organise associations of riders in order to get closer to its customers. At the same time, Harley's leaders won the loyalty of workers and broke new ground in effective union relations. It also transformed its bikes into state-of-the-art products.

Jeff Bleustein, Harley Davidson's current CEO, carried on the tradition of maintaining loyalty when he integrated the Internet into its operations in a manner that strengthened, rather than alienated, its relationship with dealers. Customers searching Harley's central Web site for a product are directed towards their local dealer's site. The result is win/win. Customers win because they have Web access to a wide range of merchandise. Dealers win because they earn the retailing profits from all Web sales and the company wins because it has expanded marketing and sales via the Internet and strengthened dealer relations.

Between 1995 and 2000, the company enjoyed revenue growth of 17% versus negative industry growth of 31%. Income growth between 1997 and 2000 was 26% versus negative industry growth of 32%.

Accelerate search for growth opportunities

Finally, savvy management teams look beyond cost cutting and seek out opportunities to grow the top line and improve their strategic position, often by making acquisitions at a time when target companies are more likely to sell. Companies that achieved superior top **and** bottom line growth in the UK during the last recession on average generated 20-25% higher

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returns to their shareholders than those which achieved only one or the other (see figure 4).

Companies best placed to improve their strategic position are those, like Dell and HSBC, that were well-managed in the upturn and have a strong market position, strong relative share price, and/or strong balance sheet going into the downturn.

Dell is a great example of a company in the process of leveraging its strong market position to achieve organic growth. During boom times it's well established that the high-cost producer sets the price, and most competitors make money. But in a downturn, the low-cost producer sets the price, eroding the margins of higher-cost competitors.

Dell owes its low cost position largely to its direct sales model, which achieves large supply chain and distribution savings. This year, Dell has used its cost position to take market share from competitors. In February, Dell cut the cost of some of its portable PCs by 26% in Western Europe. This has meant that, at a time when PC sales in the region have fallen an overall 11%, Dell actually grew 5.6%. Meanwhile, Compaq, the market leader in Europe, declined by nearly 19% during the same period, shrinking its market share lead to 3 percentage points.

Another route to growth is acquisitions. Consider HSBC's acquisition of Midland Bank during the last UK recession.

Midland was the most vulnerable of the UK clearing banks and struggling to maintain a steady flow of profits. The bank had been particularly hard hit by bad loans and had been forced to reduce its dividend in the 1991/1992 financial year.

HSBC, in contrast, performed strongly going into the recession and cast around for the right target. It had developed a strong network of operations throughout Asia, North America and the Middle East, but lacked a significant corporate or retail banking operation in Continental Europe. HSBC had some UK presence through a 15% share of Midland Bank. Convinced that the UK clearer would be a perfect match, in March 1992, HSBC made an offer for the remaining share capital of Midland. Midland shareholders accepted HSBC's final offer in June of that year.

The relative strength of HSBC shares throughout this period enabled it to continually improve its offer until Midland accepted the bid. HSBC's strong performance also enabled it to issue equity soon after the takeover in order to repay the expensive bridge facilities it had taken on to buy Midland. It moved wisely. By November of that same year, HSBC had doubled its share price.

Germany's so-called 'Super 21' companies provide an example of companies who in the current downturn are leveraging their strong balance sheets to make strategic acquisitions. This group of large, privately-held engineering businesses, all conservatively-managed, resisted making pricey acquisitions during the recent boom in M&A activity and are now taking advantage of more reasonable price tags.

These companies, which include Robert Bosch, Miele, Trumpf and Stihl, have undertaken much of this activity away from the limelight, but some examples have come to public attention. In April of this year, Mahle, a piston maker, bought Japan's top parts maker Tennex. A couple of months before that, Vaillant, a boiler-maker, acquired the UK heating and building products company Hepworth for £692m. And in October of this year, vehicle components maker INA took over FAG Kugelfischer, the country's biggest producer of industrial bearings and a public company, for £457M.

Conclusion

Even if the UK skirts a full-blown recession, there is no doubt that the current environment is proving tricky to navigate. As the sands shift, it's difficult to predict who will come out ahead. Will British Airways, with its huge cash pile, weather the storm and gobble up market share as its European competitors start to flounder? Or will the nimbler, lower-cost airlines like Ryanair, which have pressed home their advantage in the downturn, continue to woo customers from costlier carriers?

So far, it is unclear. But we can be certain that the winners-in-waiting are doggedly managing for the long-term, perhaps in the face of shareholder calls for cost-cutting and retrenchment. Like the crop of CEOs that bucked the trend during the last UK recession, today's smart leaders will resist indiscriminate cost-cutting but be prepared to take hard decisions when necessary. They will also be resolute in their belief that strengthening the bonds of loyalty with all stakeholders is a necessity, not a luxury. And finally, they will prove there is no better time to build their business through investing in the core and acquisitions.

One of the key principles for managing in a downturn is to strengthen the bonds of loyalty with employees, customers and other key partners.