

# Moving Upward in a Downturn

by Darrell Rigby



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---

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**The Earnings Game: Everyone Plays,  
Nobody Wins**  
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---

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---

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---

**Moving Upward in a Downturn**  
Darrell Rigby R0106F

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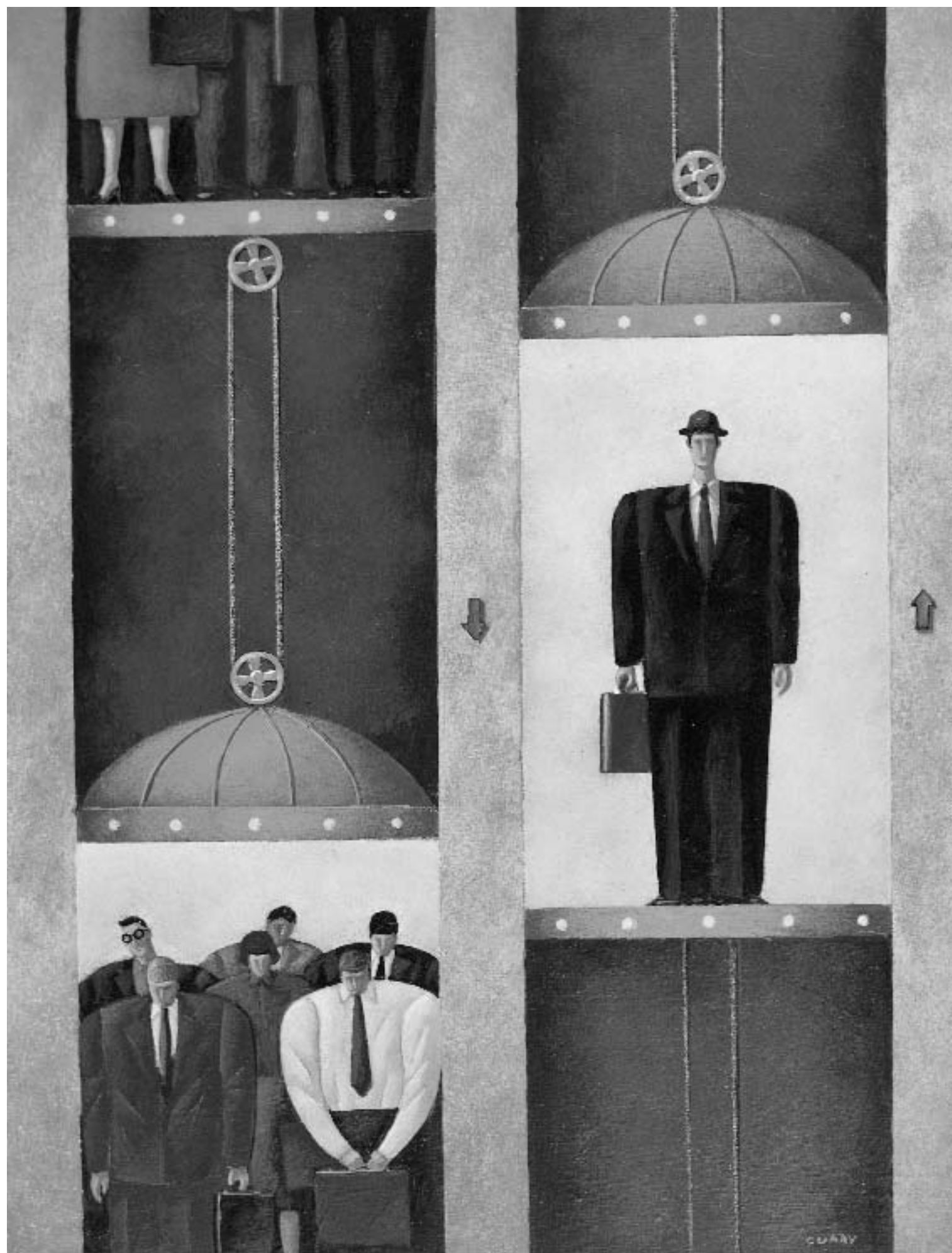
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---

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---

TOOL KIT  
**See Your Brands Through Your Customers' Eyes**  
Chris Lederer and Sam Hill R0106J



# Moving Upward in a Downturn

*During industry downturns, smart executives don't panic. Instead, they coolly place counterintuitive bets to outperform slumping competitors.*

**D**OWNTURNS ARE A RECURRING FACT OF LIFE in every industry. Sooner or later, demand for an industry's products or services declines—often dragging prices down along the way—regardless of the state of the economy as a whole. While it's true that many more industries suffer downturns during recessions, it's a mistake to think that any industry is safe during periods of normal economic growth. In the past two decades, at least 20% of all U.S. industries have battled a downturn in any given year but 1984, when GDP growth soared to more than double the norm.

Given these apparently gloomy facts, what should executives do to help their companies weather a slump? As in so many instances, there are conventional approaches that appear to make sense in the short term. For example, company leaders often approach impending trouble with overconfidence, denying that their industry faces any real danger. Then, when the downturn is an established fact, they make across-the-board cuts of everything from R&D spending to employee head count. Finally, when signs of recovery are everywhere, they

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turn on the spending spigot to rebuild morale. Although these approaches seem reasonable in the heat of the moment, they can eventually damage competitive positions and financial performance.

Better outcomes are possible, however, if a company's leaders exploit industry downturns to harness their unique opportunities for upward mobility, the same way *Apollo 13's* astronauts exploited the moon's gravitational pull to escape disaster. Both Arrow Electronics and Emerson (formerly Emerson Electric), for example, followed this path to emerge stronger following downturns. In the late 1980s, financially troubled Arrow launched a series of audacious but intelligent acquisitions during an industry downturn that allowed it to increase sales by more than 500%, turn operating losses into profits, and seize market leadership from a competitor that was once twice its size. Emerson, too, pressed ahead with an investment in a major air-conditioning-processor plant in Thailand during the Asian economic crisis of the late

1990s. While competitors mothballed projects, Emerson ramped up production, exported the plant's products, and secured a strong position for itself in the Asian market when the crisis ended.

To understand how successful companies combat declines in demand, Bain & Company analyzed 377 *Fortune* 500 companies that lived through industry slumps and economic recessions over the last two decades and interviewed nearly 200 of their senior executives. The research found that a downturn evolves through three separate phases. An examination of these phases reveals both the pitfalls that come from following conventional approaches and the rewards that can be reaped by exploiting contrarian opportunities.

Successful players in a downturn place counterintuitive bets in order to dramatically transform their market positions, but these bets are not lucky gambles that miraculously win big against the odds. Instead, they are rigorous and systematic moves that shift the odds in management's favor.

## The Gathering Storm

In phase one of a downturn, storm clouds are gathering on the horizon, but industry executives are still basking in memories of sunny years of profitable growth and public accolades. Confidence remains high. As the clouds roll in, however, analysts report that industry growth is slowing, and divisional presidents signal that they might miss their budgets—while still beating the competition, which is doing even worse. Our research found two conventional approaches to such news. Many executives take few if any precautions; they simply act as if the storm will blow over. Others run for cover, investing in new and often unrelated businesses to hedge their bets. But smart executives resist those extremes: they prepare for the worst while focusing their companies on what they do best.

**Preparing for the Worst.** As evidence gathers that a downturn is likely, executives often continue to radiate confidence—and even clairvoyance—about the future. They don't want to frighten the troops, which will only make matters worse. Our research shows that most executives are likely to be overly optimistic in the face of an approaching downturn. Some will contend that their industries are safe, period. Others believe that their own company's ability to weather a downturn is superior to that of competitors. As a result of these misguided views, few companies have contingency plans in place that are ready for implementation.

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*Darrell Rigby is a director of Bain & Company in Boston.*

One common concern is that contingency planning will signal a lack of confidence in the company's ability to grow and will thus dampen the organization's morale. Managers also worry that the process will be a waste of time that involves conjuring doomsday scenarios that may never materialize. But these concerns are shortsighted. Failing to plan for the worst is a much bigger mistake than upsetting the troops in the short term, because once an industry is in the middle of a downturn, it is almost impossible for companies to come up with inventive solutions.

Research shows that executives close their minds to new ideas when they are under stress. They tend to reach for the same levers they have pulled in the past, even if those levers don't work in the new conditions. The time to get a range of options out in the open, where they can be broadly and creatively debated, is before a downturn. Managers who are able to successfully negotiate a downturn build contingency planning into the culture of their strategic planning and budgeting processes.

Emerson has been one of the most consistent performers in the *Fortune* 500—it has seen 43 consecutive years of earnings growth—and its performance is the direct result of sophisticated planning systems. Former CEO Charles Knight and his senior managers spent at least half their time planning, and David Farr, who replaced Knight in the fall of 2000, has continued to build on Knight's foundation.

At Emerson, each unit must create a monthly report that reforecasts the remaining quarters of the current year as well as the first quarter of the next fiscal year. The monthly reports have been in place for 25 years but are continually refined. Each report includes a five-column table that lists growth projections and results. The first column displays current expected revenue and profits for the year and by the quarter. The second column shows expected revenues and profits from the previous month's report. The third shows the annual budget, and the fourth indicates actual revenue and profits for the previous year. The fifth column shows the expected percentage increase or decrease over last year's figures. "When I was a division president, I spent one day a month figuring out what would go into that report," says Farr. "The whole organization works that way—everyone who provides input to a division head spends one day per month focused on the future of the business. So if anyone sees a weakness, a plan to deal with it is immediately created."

Farr combines information from the monthly reports with that gathered during monthly one-on-one conversations with company business leaders at St. Louis headquarters. Emerson also holds annual planning conferences, during which each division must demonstrate how it will achieve sales and profit growth, regardless of con-

# Navigating a Downturn

	The Conventional Approach	The Contrarian Approach	Success Stories
1. <i>Storm Clouds on the Horizon</i>	<p>Express confidence that <i>your</i> industry (or <i>your</i> company) is safe from harm.</p> <p>Hedge your bets: diversify in the hope that your winners will offset your losers.</p>	<p>Build contingency planning into your culture and you'll be prepared for anything.</p> <p>Play to win where you are strongest: reinforce your core.</p>	<p><i>Emerson, which reforecasts major financial drivers every month.</i></p> <p><i>Borden in the early 1980s, which beat competitors by going on a strict corporate diet. (Like so many dieters, Borden put the weight back on in the late 1980s, and its performance suffered.)</i></p>
2. <i>Battling the Elements</i>	<p>Cut costs like there's no tomorrow.</p> <p>On the line in the budget for acquisitions, write "\$0."</p>	<p>Treat your stakeholders like fellow combatants who happen to be stuck in the same foxhole.</p> <p>Scoop up bargains that bolster the core business.</p>	<p><i>Solectron, which actually increased its focus on quality—its source of competitive advantage—during the recession of the early 1990s.</i></p> <p><i>Arrow Electronics, which has followed a "buy in bad times" strategy to become number one in its industry.</i></p>
3. <i>Here Comes the Sun</i>	<p>Spend your way back into the good graces of employees and customers.</p>	<p>Don't overstress the engine: shift smoothly into higher levels of growth.</p>	<p><i>Emerson, which handled phases one and two deftly during the recession of the early 1990s, steadily added people, R&amp;D dollars, and capacity to maintain growth.</i></p> <p><i>American Express, meanwhile, stumbled badly during the early 1990s. But it used the more forgiving post-recession climate to completely retool its business.</i></p>

ditions in the global economy or the industry. If the economy slows, Emerson's planning process allows the company to react quickly to protect sales and profits. As a result of all this planning, managers know far in advance of turbulence that if their business environment changes, they have a well-developed plan to deal with it. In the late 1990s, Emerson was able to sustain investment in next-generation process automation—the software and devices that regulate refineries, paper mills, and other industrial plants—while competitors focused on weathering the downturn. So when industry capital spending rebounded, Emerson emerged a stronger player, with sales and profits recovering several quarters ahead of the competition.

**Focusing on the Core.** Here's another piece of conventional wisdom for surviving a downturn: hedge your bets. Pursue growth through diversification. Although this approach works well for individual investors, it makes little sense for corporations.

Contrary to conventional wisdom, downturn winners avoid diversification—and wisely so, because during downturns, typical diversification (the type that enters new businesses with low odds of achieving market leadership) is worse than worthless. It dilutes the company's average market share and therefore subjects it to more earnings volatility, not less. What does make sense is focus, creating ballast by reinforcing the core business. Successful downturn managers avoid diversification and concentrate as many resources as possible on playing to win on their main field of competition.

The example of Borden illustrates the pitfalls of diversification and the wisdom of focusing on core strengths. As the economy started to turn sour in 1980, CEO Eugene Sullivan put Borden, a sprawling \$5 billion conglomerate at the time, on a strict diet. He divested the company of high-fat holdings unrelated to the core dairy business, including women's clothing operations, a phosphate rock

mine, and a perfume company. Between 1980 and 1985, Sullivan also led the acquisition of 28 companies that were directly related to Borden's core business. As a result of these initiatives, the company's average annual net income was significantly higher than that of competitors throughout this period.

Unfortunately, Sullivan's successor, Romeo Ventres, reversed course: he acquired 90 grocery product companies, which distracted Borden away from its core dairy business. Borden became a jumble of consumer businesses that were spread much too thin across too many lackluster segments, and it was eventually scooped up by RJR Nabisco for \$2 billion in stock.

Just as most people on the road assume that they're above-average drivers, most executives feel that their company will do better than competitors when faced with a decline in demand.

But without proper planning, that's unlikely. When the weather starts to turn nasty, you can't wait until the last minute to buy batteries and water—by then, the shelves will be empty. Far better to plan ahead and stay focused on what you know you can do, not on what you hope to do better than established players in other markets.

## Eye of the Hurricane

At a certain point, questions about an industry downturn become moot. No one can ignore the high winds or copious precipitation falling from the sky. Several smaller competitors are visibly on the brink of ruin. Investor dollars, management talent, and public attention are all seeking higher ground in industries with brighter prospects. Analysts aren't sure how long the downturn will last but express their fears that the industry will never be the same again. Companies think first and foremost about survival. Conventional wisdom urges quick and drastic action and cautions against acquisitions spending. Clearly, this is a time when costs must be reined in—but prudently. Smart companies look beyond the storm and even find ways to grow while it rages around them.

**Seeing Beyond the Bad Times.** When an industry's news is universally bad, managers tend to want to apply quick fixes. To cut costs quickly and spread the pain as fairly as possible, they slash budgets and staff across the board. They slice sales and earnings targets. They also reduce capital expenditures, drop services that competitors don't offer, and push suppliers to cut prices. In other words, their focus becomes short-term survival.

This is not unreasonable. Aggressive cost management is extremely important during a downturn, just as it is

during an upturn. The problem is, many executives overreact to disturbing economic reports. Layoffs, for example, are often implemented as a way of holding down costs, but do they really make financial sense? Consider that voluntary employee turnover averages 15% to 20% per year in the United States, that sales volume was depressed by less than 10% in 85% of all industry downturns from 1977 to 1999, and that the average recession during that period lasted only 11 months. Given those facts, you

have to wonder why there is such a scramble to fire—and then rehire and retrain—so many employees.

Squeezing suppliers is another short-term fix that can do more harm than good. Consider the tale of two Chryslers. During the recession of 1990 and 1991, Chrysler's approach was brilliant. Rather than forcing suppliers to share the pain, the company developed closer

relations with them, outsourcing more components, reducing inventory, and slashing cycle times. If suppliers suggested ways to cut costs by 10%, they got half the savings. Chrysler used improved cash flows to invest in new product development, introducing cross-functional platform teams to improve quality and speed. Partly as a result of its work with suppliers—as well as judicious cost cutting—Chrysler was the only Big Three automaker to turn a profit in 1992.

Over time, Chrysler's hard-won cost advantage slipped, and now a different story appears to be in the making. The cornerstone of the current turnaround attempts is a supplier squeeze. Since January 1, 2001, all suppliers have been required to tear up existing contracts, reduce prices by 5%, and figure out how to cut an additional 10% from prices by 2003. Some suppliers are suggesting that they may withhold parts, and others have said they no longer have any incentive to bring Chrysler their best technologies. As a result of its tough stance, Chrysler may end up paying much more than it saves.

Costs do have to be carefully managed, but the key is consistency. A company shouldn't act one way in good times and another way in bad times. Otherwise, employees, suppliers, and other business partners will lose confidence in the company, and morale, cooperation, and productivity will all decline.

Now look to the contrarians. They know that downturns don't last forever and, in effect, they make friends with others who are trapped in the same foxhole—employees, vendors, business partners, and customers. They know that forcing a relatively small price cut (which will be remembered when the tables are turned) on suppliers is typically far less valuable than working with them to

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eliminate duplicate operations, improve forecasts, reduce inventories, and improve cycle times. They understand that although employee layoffs will reduce costs in the short term, the combination of severance expenses, loss of knowledge and trust, and subsequent hiring, training, and retention costs can quickly overwhelm expected savings. Companies such as Southwest Airlines, Harley-Davidson, and FedEx have no-layoff policies. As a result, their employees dig in during tough times rather than shop for new jobs.

Some companies have used downturns to build loyalty with other stakeholders. For example, electronic components manufacturer Solectron used the recession of the early 1990s to build customer loyalty. It did so by maintaining an unwavering focus on quality, the driving force behind its ability to attract and retain such customers as IBM, Hewlett-Packard, and Sun Microsystems. When demand fell in 1991, it increased its focus on quality and customer retention by interviewing customers weekly to check satisfaction. The company also added low-cost capacity in Malaysia that year to gain market share. These efforts during a downturn paid off handsomely: in 1991, Solectron won a Baldrige Quality Award, increased revenues by more than 50%, and replaced SCI Systems as the market leader. By focusing on the long term, Solectron has outperformed its competitors for more than a decade. Even as the industry slumps again this year, analysts predict that the company will grow 70% faster than SCI Systems between 2000 and 2002.

**Shopping for Bargains.** Conventional wisdom says that acquisitions are too risky to undertake during a downturn. According to this way of thinking, companies that appear ripe for the picking are likely to be deeply troubled and could drag down an already fragile business. Moreover, a company thinking about acquisitions may find that its cash is limited, that debt is unavailable, and that its stock price is depressed and thus not valuable as acquisition currency. Given these dismal conditions, the last thing a company should do is double down existing bets with acquisitions.

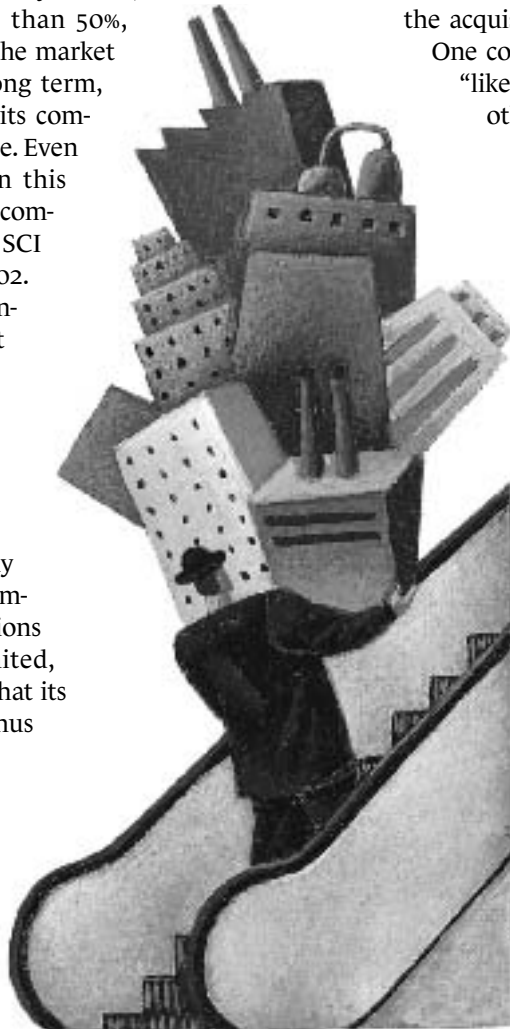
In keeping with this logic, only 20% of executives in our survey said

they would be likely to make acquisitions during a future downturn, while 50% said they would be unlikely to do so (the rest were undecided). But clear winners in a downturn don't lock their purses; they spend on bargains, as the following example demonstrates.

In May 1985, the electronic components industry had hit a wall. It marked the beginning of a three-year slump that nearly drove Arrow Electronics into the ground. "We had \$30 million worth of interest due that year and no operating income," CEO Steve Kaufman tells us. "We were losing big chunks of cash." Sales were collapsing, dropping from \$730 million in 1984 to \$550 million in 1987. Kaufman had already disposed of the company's sideline businesses in lead smelting and electrical distribution. Although Arrow was number two in the industry, it was about half the size of the leader in the field.

Rather than cut back in the hope of surviving, Kaufman took advantage of the turbulence. "We made our greatest strategic moves during the period of greatest financial weakness," he says. He decided to get out of the hole through acquisitions. In 1987, Arrow bought the number three player. It funded the purchase with one-third Arrow stock and two-thirds cash that was borrowed against the acquisition target's receivables and inventory.

One competitor snickered that the deal looked "like two men who can't swim grabbing each other in the deep end of the pool." But it worked. In the first full year after the acquisition, Arrow registered a modest net profit of \$10 million. In 1991, Kaufman bought the new number three company, which was suffering during what turned out to be a little blip of an industry downturn. The deal was an exact replica of the 1987 acquisition. After several more acquisitions in



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Europe, Arrow swept past Avnet, the industry leader, to take the top position in the field. Kaufman looks upon the inevitable downturns in the electronic components business as an opportunity: "We acquire in bad times," he says. The surprising insight is that—assuming the core business is worth holding and growing—focused acquisitions during downturns should reduce risk, not increase it.



As the Arrow example demonstrates, consolidating acquisitions diminishes business risk by strengthening the core and reducing earnings volatility.

## Clear Skies on the Horizon

In the final phase of a downturn, portents of economic renewal emerge. Industry analysts begin to predict a turnaround, although they may be vague about the timing. Competitors start to take advantage of lowered interest rates to expand capacity and boost inventories in anticipation of rising sales. New orders start to flow in, and hitting next year's budget figures seems realistic. Conventional wisdom says that companies should make an abrupt about-face and shift into high-spending mode. But again, this is flawed advice. Companies that have successfully managed the first two phases of a downturn won't need to put the pedal to the floor. Those that remain beleaguered should consider completely overhauling the way they do business.

**Accelerating Smoothly.** Preparing to exit a downturn is either the easiest or the hardest stage of management. Companies that properly managed the first two phases of a downturn seldom need much advice in the third. They have mapped out and implemented contingency plans to deftly sidestep unexpected hazards. They have pruned share-diluting businesses and strengthened their core. They have bolstered vital relationships with employees, vendors, business partners, and customers. They have made share-boosting acquisitions at attractive prices. As a result of these moves, they have captured a disproportionate share of industry growth and profits. Now they are prepared to accelerate gradually and reap the rewards.

As the recession of 1990 and 1991 wound down, Emerson smoothly ramped up from a sales decline of 2% in 1991 to growth rates of 4% in 1992 and on to 16% by 1995. CEO Knight has steadily added people, R&D dollars, and capacity to maintain the company's return on assets at between 9% and 11% every year since 1990.

But Emerson's success is uncommon. In fact, more businesses fail after a downturn than during one. Part of the reason is that it takes a while for downturn-diseased companies to die. But a bigger part of the reason is that actions taken during the exit phase are inadequate to position the company for renewed growth.

**Completely Retooling.** After a painful time, executives often hope they can mend the damage by flipping on the spending switch. Their rationale is simple: since draconian cuts have seriously damaged the loyalty and morale of beleaguered employees, generous spending is now essential to regain their affections. In addition, heavy marketing, promotion, and service investments are

needed to win back customers who defected when they grew exasperated with quality reductions and service cut-backs. Unfortunately, as companies in the motor vehicle and oil and gas industries have discovered, spending increases in this situation often outpace growth, forcing companies to make drastic cuts again when the next downturn hits.

Companies that fell behind in the first two phases require serious rehabilitation in this last phase if they hope to survive another downturn. Rather than try to spend their way out of their misery, troubled companies should consider retooling altogether. Such retooling may require a mix of the approaches outlined earlier but on a greater scale, from jettisoning noncore businesses to slashing costs. The difference is the warmer business climate: as industry conditions improve for what could be several years of growth, down-and-out companies have a better chance of successfully reinventing themselves.

American Express followed this path after emerging from the recession of the early 1990s in very poor shape. Strong new competition had led to a 1.6 million decline in the number of AmEx cards in circulation, and those who kept their cards were using them less and less. In 1991, about 100 restaurants in Boston threatened to boycott AmEx in protest over unreasonable transaction fees. Compounding these problems, the company had to write off \$265 million in bad loans made to customers of American Express's credit card offering, Optima.

In 1993, the AmEx board ousted chief executive James D. Robinson III. Robinson's successor, Harvey Golub, set about rehabilitating and reshaping the company to take advantage of the expected upswing in consumer spending and prepare it for future slowdowns. He began by divesting noncore businesses like Shearson, a brokerage firm. Then he attacked costs, seeing the advantage of making the company lean in good economic times. By 1994, he had cut \$3 billion in costs, along

with 15,800 jobs. Although such pruning was painful, it prepared the company to grow as it recovered from the troubles of the early 1990s. If such drastic measures had been taken during a downturn, they would have hampered the company's ability to return to profitability. They might have destroyed the confidence of AmEx's organization and shareholders, eventually requiring even more dramatic actions and leading the company on a downward spiral.

Golub's third campaign was to refocus AmEx on its core business—charge and credit cards. For example, he successfully challenged the elitist attitude in the company that opposed allowing customers to use AmEx cards at gas stations. He also broadened the pool of retailing partners, signing up Kmart in 1993 and Wal-Mart in 1995.

*Failure to strengthen a company during a downturn can leave it in a much tougher position afterward.*


As a result of these forceful measures, the company came back strong during good economic times. In 1994, the number of cards in circulation began to increase, rising from about 25 million to more than 29 million by 1996. The company introduced many new products, building its market share from 17% in 1994 to almost 21% in 1998. Its stock outperformed the S&P index by three-and-a-half times between December 1991 and the end of the decade.

As the story of American Express demonstrates, failure to strengthen the company during a downturn can leave it in a much tougher position afterward. At that point, dramatic changes will likely be required. The company may need to refocus on its core, prune its portfolio, and bring in new management, not only to bring fresh energy and breakthrough perspectives, but also to convince key stakeholders (especially employees) that the reinvention is for real. The new team needs to establish a core set of values and make it clear that the company will adhere to them in good times and in bad. To avoid wild spending swings, it has to establish cost structures that can be sustained through a downturn.

And then, after several years of profitable growth and public accolades for the management team, economic storm clouds will enter the scene...again. But the company will be much better positioned this time to handle the bad weather.

## Look to the Lighthouse

Making it through the three phases of a downturn isn't easy, and there's no guaranteed path to success. Nevertheless, our research findings may provide a beam of light to help companies see their way through a storm. Companies that successfully navigate huge waves tend to look bad news in the eye and institutionalize an approach to detecting storms. Rather than hedge their bets through diversification, they place a big bet on their core businesses and spend to gain market share. They manage costs relentlessly during good times and bad. They maintain a long-term view and strive to earn the loyalty of employees, suppliers, and customers. Coming out of the downturn, they maintain momentum in their businesses to stay ahead of the competition they've already surpassed.

As the recent bursting of the dot-com bubble has shown, business is still subject to cyclical change. Every industry will face periodic downturns of varying severity. Executives with the vision, ingenuity, and courage to go against the grain of convention can buoy their companies to new heights while competitors are sinking. 

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