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Preparing for **the next downturn**

In a buoyant economy, the next recession seems far off. But managers who prepare during good times can improve their companies' chances to endure—or thrive in—the eventual downturn.

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"Economists," Nobel laureate Paul Samuelson famously quipped, "have correctly predicted nine of the last five recessions." Impossible as it is to forecast the timing or depth of the next downturn, executives enjoying today's upbeat economy should also be preparing for the recession that will inevitably follow. Many weren't ready for the last one; by our reckoning, nearly 40 percent of leading US industrial companies toppled from the first quartile in their sectors during the 2000–01 recession, and a third of leading US banks met the same fate. At the same time, 15 percent of companies that had not been industry leaders prior to the last recession vaulted into those positions during it.

To understand how to make the most of a recessionary environment, we analyzed the performance before, during, and after the 2000–01 recession of some 1,300 US companies from a broad range of sectors[1] and identified which of these companies emerged from it having gained or maintained leadership status.[2] For these industry leaders, we analyzed which characteristics they exhibited before the recession that might help explain why they outperformed their peers. Although recessions strike different sectors in different ways and at different times, the postrecession leaders in most of the sectors we explored had characteristics in common. Entering the downturn, they typically maintained lower leverage on their balance sheets, controlled operating costs well, and diversified their product offerings and business geographies. Such fundamentals gave them a greater degree of strategic flexibility, which became even more valuable during the recession (Exhibit 1). And although previous recessions aren't necessarily a guide to future ones, we believe that flexibility can make a notable difference by allowing managers to take advantage of the opportunities that the next recession might provide.

Balance sheet flexibility

Whatever the position the companies had within their sectors before the downturn, many that emerged from it as leaders

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[1] In our past research, we analyzed what helps companies succeed during a recession, as well as in the expansion periods between recessions. See Richard F. Dobbs, Tomas Karakolev, and Francis Malige, "Learning to love recessions," *The McKinsey Quarterly*, 2002 special edition: Risk and resilience, pp. 6–9. In this article, we focus on the years immediately preceding a recession to identify how companies prepared for it. Although every one is different, we believe our research can be useful in helping managers and boards prepare when they conclude that a recession is imminent.

[2] For the pre- and postrecession periods (1998–99 and 2001–02, respectively), we define industry leaders as companies in the top quartile of their industries, measured by returns on invested capital (ROIC) and market-to-book ratios (M/B). For banks we used returns on equity (ROE) and M/B. Companies in the other three quartiles we refer to as challengers. Our sample included 1,024 US companies in 27 industrial sectors and 264 US banks. We investigated the financial performance of each company during the period from 1995 to 2005.

Exhibit 1

Prerecession approaches to increase flexibility

Top-quartile companies are better prepared.

Strategic lever	Industrial companies	Additional characteristics of banks
Balance sheet flexibility	Steady increases in capacity • Continue and increase capacity organically Reduction in inventories but also payables • Maintain lean inventories, continue to improve levels in prerecession years • Maintain ability to pay suppliers sooner to secure good contract terms Financing capacity for taking advantage of opportunities • Reduce leverage compared with industry • Boost ability to finance internally—higher cash balance, lower dividend payout	Financing capacity for taking advantage of opportunities • Control portfolio deterioration, use quality measure in investing • Improve capital adequacy ratio
Operating flexibility	Cost variability • Reduce selling, general, and administrative costs during recession, but not before • Build ability to quickly refocus, reduce spending • Maintain higher employee productivity • No across-the-board head count reduction at beginning of recession	Ability to preemptively cut costs • Improve interest spread • Reduce both personnel and nonpersonnel costs
Flexibility of product offering	Healthy diversification • By segment • By geography Value-based product innovation • Understand customer segments • Introduce innovations to increase volume without discounting prices • Continue focused advertising	Restructured product mix, innovative product offering • Offer products tailored to profitable customers • Identify, reduce exposure to unprofitable customers

expanded their businesses during the recession, both organically (through internal investment) and through inorganic activities such as M&A, alliances, and joint ventures. And although the leaders increased their asset bases through capital expenditures or acquisitions at the same pace as less successful companies did before the recession, the focus of their growth was different: the more successful companies spent less on M&A, on average, and focused more on organic growth. In 1999, for example, leading companies had, on average, capital expenditures that were 8 percent higher and growth through M&A that was 13 percent lower than their less successful counterparts did. During the recession itself, however, better performers leapfrogged the competition by continuing to invest and to grow inorganically: in 2000, companies that emerged in the top quartile spent 15 percent more on capital expenditures and conducted 7 percent more M&A—possibly buying cheaper assets from distressed sellers. In addition, they were able to pay their suppliers faster, probably in an effort to negotiate lower prices and better service.

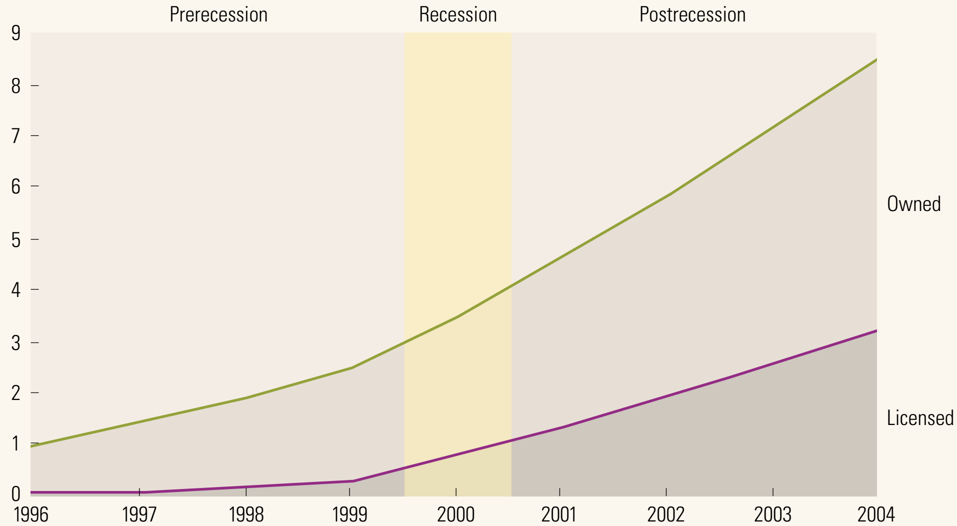
Arguably, winning companies leveraged the benefits of balance sheet flexibility that they had achieved before the recession. At industrial companies that ultimately emerged as sector leaders, for example, the average net debt-to-equity (D/E) ratio before the recession was roughly half that of their less successful competitors. What's more, the postrecession leaders also held

Exhibit 2

Starbucks—extreme flexibility

Starbucks accelerated its growth during the recession in part by increasing the number of licensed and owned locations.

Number of Starbucks outlets, thousands



CAGR[1] of outlets, %	39	34	32	40	35	25	23	19

[1] Compound annual growth rate.

Source: Starbucks; McKinsey analysis

more cash on their balance sheets prior to the recession than those that weathered it less successfully.

Starbucks was one company that used such tactics to good effect in holding on to its leader status before and after the recession. In 1996 it had a D/E ratio of 8 percent, compared with an average of 14 percent for the restaurant sector, and managers consistently reduced the company's leverage every year until 1999.[3] That year the D/E ratio of Starbucks dropped to only 2 percent, as the industry average hit a high of 31 percent. Managers achieved this target by expanding the proportion of licensed outlets from 7 percent in 1998 to 13 percent in 1999 and 23 percent in 2000. Licensing and international expansion through alliances allowed Starbucks to accelerate its growth during the recession (Exhibit 2). Currently, alliances contribute 14 percent of the company's revenues but account for 39 percent of its profits.

Executives can build flexibility into a company's balance sheet by reducing the capital intensity of the business model, for example, or by resisting the urge to use additional debt to finance dividend growth or share buybacks. In our study, as profits grew during the expansion, the companies that emerged as winners refrained from increasing their dividends: their dividend payout ratio gradually decreased from a peak of 40 percent in 1995 to 32 percent in 1999. Then they cut dividend payouts aggressively at the first signs of the recession,

[3] The D/E ratios of the companies in this analysis were not adjusted for the capitalized value of operating leases and retirement liabilities. Although such adjustments do affect the absolute degree of leverage, they do not significantly affect the relative ranking of companies.

reducing the payout ratio to 28 percent in 2000. In contrast, before the recession their less successful counterparts kept dividend payouts roughly stable—at 35 percent in 1995 and 33 percent in 1999—and even increased them to an average of 38 percent in 2000 as the recession began.

Operating flexibility

Many companies that emerged from the last recession as industry leaders also focused on reducing costs without damaging the long-term health of their businesses. Although selling, general, and administrative (SG&A) costs are typically difficult to cut in the short term, winning companies did so by making their overhead costs and operations more flexible before the recession. Consequently, they could redeploy their funds, assets, and personnel as conditions changed. When the recession began, they quickly adjusted their SG&A to the new environment, cutting these costs even further, to a level 3 percent below that of their less successful rivals,[4] in spite of having comparable starting levels.

The US cataloger and retailer Talbots, for example, increased the flexibility of its workforce in the years before the recession, adding part-time workers during the growth period of the 1990s at almost double the pace at which it added salaried workers. From 1998 to 2000, the company's hourly and part-time workforce grew by 14 and 16 percent a year, respectively, the salaried staff by only 9 percent. Then, as the recession took hold in 2000 and 2001, Talbots also radically shifted its advertising mix away from TV and catalog operations and toward focused activities targeting customer groups with the highest sales potential. Although this strategy somewhat reduced the company's ratio of advertising expenses to revenues (from 5.5 percent of revenues in 2000 to 4.3 percent in 2001), Talbots maintained advertising levels far above the sector in general: its ratio of advertising expenses to revenues was 120 percent higher than the sector average in 2000 and 80 percent higher than it in 2001. Such measures helped Talbots emerge from the recession as a leader in its sector, though it entered the recession as a challenger.

In contrast, less successful companies cut their R&D and advertising more deeply, putting them at a disadvantage for tapping the opportunities these expenditures might create. Before the recession, their productivity per employee was lower than that of the leaders, and so they had to lay off more employees during the downturn, perhaps damaging their ability to attract and retain talent in the future.

Product offerings

Companies that emerged from the recession as industry leaders generally had more diversified product offerings and a greater geographic presence before, during, and after the recession than did their less successful counterparts. This pattern was particularly true of companies that led their industries before the recession and retained this status after it: their sales were roughly twice as diversified by segment as those of companies that ceased to be leaders. By geography, the difference was smaller, but leaders that retained their status were about 20 percent more diverse in this respect.

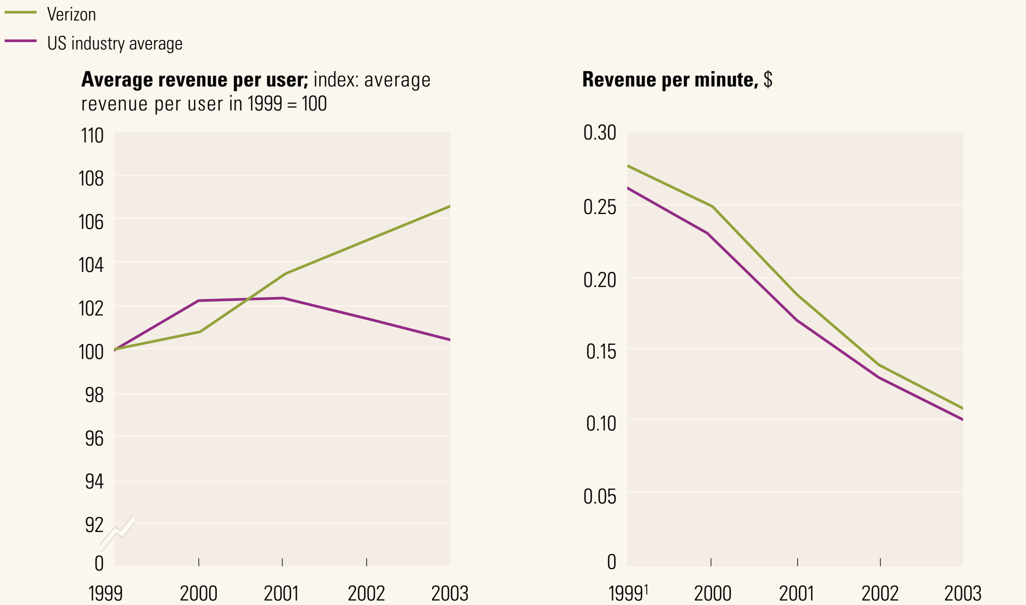
In addition, successful companies proactively managed their customer and product portfolios before the recession. Consider the US telecommunications company Verizon, which coupled an expanding customer base with increasing average revenues per user to offset falling call prices. Average revenues per user fell throughout the industry as per-minute revenues dropped

[4] Normalized for revenue.

Exhibit 3

Success in the face of decline

To offset falling call prices, Verizon combined an expanding customer base with increasing average revenues per user.



[1]For 4th quarter only.

Source: *Global Wireless Matrix 1Q04*, July 7, 2004, Merrill Lynch; McKinsey analysis

by nearly 20 percent annually from 2000 to 2003 (Exhibit 3). By altering its service mix toward broadband and value-added services, Verizon maintained its winning status through the recession.

Consider also the experience of Starbucks, which drove up sales during the late 1990s by boosting both prices and traffic; its comparable-store sales growth increased by 5 percent in 1997 and 1998 and by 7 percent in 1999. When the recession struck, Starbucks avoided massive discounts, instead adding innovative value-added services (including Wi-Fi Internet access in its stores), the Starbucks Card, and improved customer service. As a result, in 2002 the company again posted comparable-store sales growth of 6 percent, achieved through traffic growth of over 8 percent.

If past is prologue, managers and boards won't forecast with any precision the timing of the next recession. But they should be asking themselves today whether they are building the financial, operating, and product flexibility to make the most of the next downturn. **MoF**

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