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Resilience in TMT: Winning in downturns

Economic downturns hold substantial opportunities for companies in the technology, media, and telecommunications (TMT) sector. By starting now to build an action plan and execute no-regret moves, companies can put themselves on a path to emerge resilient through the next slowdown.

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The technology, media, and telecommunications (TMT) sector has enjoyed unprecedented growth over the past decade. Seven of the ten largest companies by market value are TMT companies. Incumbents such as Apple, Disney, and Verizon have been joined by a quickly scaling group of disruptive players such as Alibaba Group, Alphabet, Amazon, Facebook, Netflix, and Salesforce, all of which have been buoyed by consumers' and businesses' growing appetite for technology products and services.

Yet the current growth outlook is uncertain. Business investment in the United States contracted in the second quarter of 2019, as did the GDPs of Germany and the United Kingdom, two of the largest economies in the world. Although we cannot predict when a downturn will occur—and there is no way to know how damaging it will be—most people agree we are closer to the next one than we are to the previous one.[1]

How the next downturn will affect individual TMT companies is also impossible to predict, but one thing is certain: the top tier of them, which we call "resilients," will outperform the rest of the sector by a significant margin, according to our research examining the most recent two recessions. The research shows that how you manage through a slowdown largely determines how you come out the other side, not just in immediate recovery but for several years after. First and foremost, winning is about more than cost cutting. Resilients bested the majority of their competitors not only by battening down the hatches but by taking several key strategic actions, some of which were counterintuitive, and no-regret moves. These included increasing the productivity and amount of their sales and marketing investments, continuing to invest in their core product engine, creating capacity by reducing leverage going into the slowdown, and remaining active in M&A and divestments.

Of course, every downturn is different, and each company will play the next one differently. Any upcoming slowdown will be a significant opportunity for a company to set itself up on a long-term trajectory of outperformance. Well-capitalized disruptors will likely go on the offense, using the slowdown as an opportunity to strengthen their long-term strategic positions. Incumbents—many of whom have been using much of their cash flows to drive returns to shareholders through share buybacks and dividend increases—will need to start making some hard choices on where to keep investing and put more emphasis on new digital and analytics tools to drive the next leg of efficiencies.

Regardless of their starting position, leaders of TMT companies need to start planning—and taking action. Execution of strategic preparations will take time, as will securing critical buy-ins from management teams, boards, and shareholders. Successful strategic plans will need to take a long-term view and not give in to short-term impulses and pressures. In order to succeed, companies cannot afford to wait for the onset of a downturn to make no-regret moves.

Lessons in resilience from recent downturns

To understand how executives should approach the next downturn, we analyzed around 3,000 companies in TMT over the past 20 years across nine subsectors. What we learned is that how you operate heading into and during a slowdown matters greatly. In recent downturns, only about 20 percent of companies in TMT "got it right" and accelerated their performance relative to peers. Amazingly, the enhanced performance of these resilients during the downturn accelerated coming out of the downturn and led to significant additional gains in the years following (Exhibit 1).

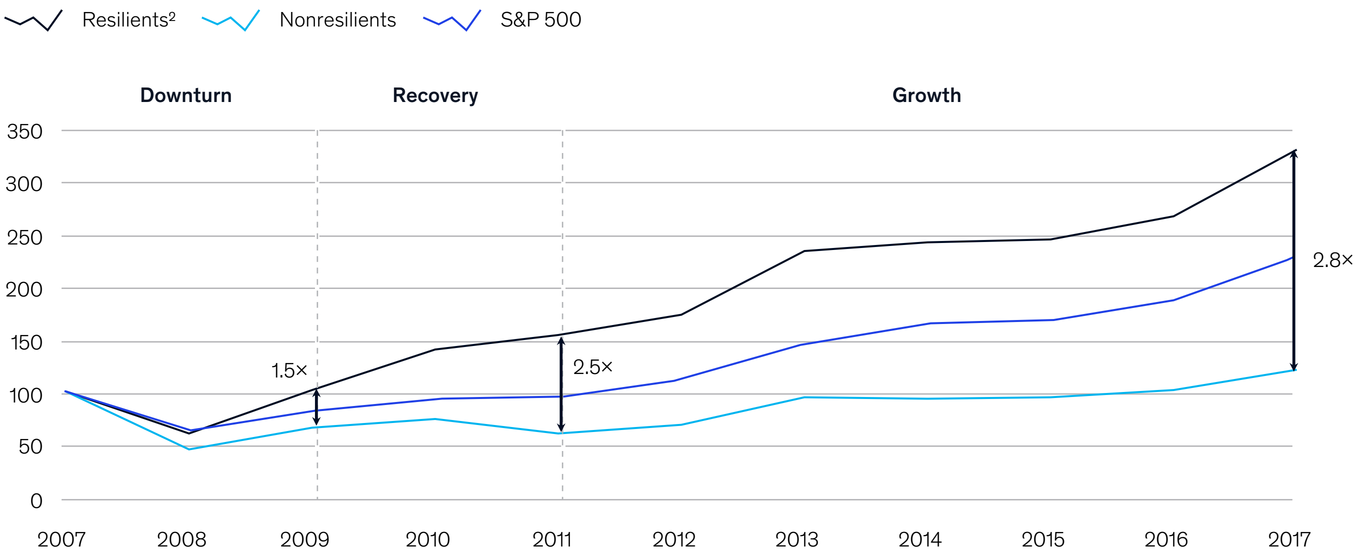
TMT as a sector has outperformed most other sectors in economic profit across the most recent two downturns, reflecting its overall strength and suggesting its companies may enjoy a relative tailwind compared with those in other parts of the economy. At a subsector level, the research revealed that *how* you play is critically important, in addition to *where* you play—particularly in slow times. For example, during the 2007–11 recession and recovery, resilient companies outperformed nonresilients in their respective subsectors by

[1] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly,* May 2019, McKinsey.com.

Exhibit 1

Resilients started separating themselves during the downturn and outperformance expanded during subsequent recovery and growth.

Total shareholder return (TSR) performance in TMT, indexed to 100[1]



Note: The analysis includes non–financial services companies on Canadian, European, and US stock exchanges with revenue $100 million in 2000 and 2007.
[1] Calculated as average of subsector median performance of 444 resilient and nonresilient companies across the TMT sector.
[2] Resilient companies are defined as those in the top quintile of their sector by TSR.
Source: CPAnalytics; McKinsey analysis

significant margins—up to 46 percentage point outperformance in total shareholder returns growth and up to 67 percentage point outperformance in economic profit growth (Exhibit 2).

According to our research, the outperformance of resilients in past recessions was driven by four key actions.

Increasing productivity while also increasing sales and marketing investments

Increasing the productivity of sales and marketing investments includes boosting investments alongside revenue growth, but always at higher productivity. For example, during the 2008 downcycle, resilients in software, such as Ansys, Citrix, and Salesforce, increased sales and marketing productivity by three percentage points—from about 34 percent of revenue at the start of the recession to about 31 percent by 2011—while growing their revenues.[2] From 2007 to 2011, Ansys improved sales and marketing productivity by four percentage points while also raising dollar sales and marketing spending by 54 percent. Salesforce saw productivity gains of five percentage points while tripling the dollar spend.

Continuing investing in the core product engine

Resilients increased median R&D investments up to three times faster than nonresilients during and after the recession. For example, from 2007 to 2011 software resilient Salesforce increased R&D as a share of revenue to 11 percent, up from 9 percent, to continue upgrading existing products and expanding into new ones, such as AppExchange.

[2] Unless otherwise noted, all company data is based on McKinsey analysis of Capital IQ data.

Exhibit 2

Across sectors and subsectors, resilients outperformed nonresilients in terms of economic-profit growth and total shareholder returns (TSR) during the most recent downturn and recovery.

Growth, 2007–11, %

Sectors and subsectors	Resilients'[1] performance: Economic profit,[2]	Resilients'[1] performance: TSR,[3]	Nonresilients' performance: Economic profit,[2]	Nonresilients' performance: TSR,[3]
Total TMT	28	15	2	–5
Technology	29	24	3	–6
• Devices	65	36	–2	–10
• Infrastructure	2	4	–7	–13
• Software	16	19	13	–1
• IT services	12	15	N/A	–5
• E-commerce	25	37	10	–2
• Tech distributors	73	5	8	–3
Media	41	10	21	–4
Telecommunications	13	8	–12	–2

Note: The analysis includes non–financial services companies on Canadian, European, and US stock exchanges with revenue ≥$100 million in 2000 and 2007.
[1] Resilient companies are defined as those in the top quintile of their sector by TSR.
[2] Compound annual growth rate of sector's economic profit for the period.
[3] Percent change in TSR for the period weighted by market capitalization.
Source: Capital IQ

For telcos, consistent capital-expenditure investment focused on strategic growth areas through the cycle was a particularly important factor of success.[3] Sector resilients such as Bell Canada, TELUS, and Verizon increased capital investment dollars by 63 percent, whereas nonresilients reduced capital investment dollars by 16 percent from 2007 to 2011.

Creating capacity by reducing leverage

Across most sectors, resilients had significantly lower leverage heading into a downcycle or deleveraged much faster at the onset of the cycle, creating room to invest. For example, ADTRAN made a conscious decision in 2006 to start early repayments of outstanding debt, which provided the company much more flexibility later during the crisis. Going into the downcycle, nonresilients had a debt/EBITDA ratio of up to 2.5 times higher than resilients, and during the downcycle that gap expanded to up to 9.0 times.

Remaining active in mergers and acquisitions and divestments

Illustrating the gap in activity for resilients and nonresilients, divestitures for resilients doubled year-over-year in 2007 while nonresilients stayed flat. Likewise, resilients decreased the number of deals by 16 percent from 2007 to 2008 and then picked up the pace from 2008 to 2009, growing M&A deal activity by 16 percent. By contrast, during the downturn, nonresilients decreased the number of M&A deals per company by 33 percent from 2007 to 2008 and by 23 percent from 2008 to 2009, at the bottom of the cycle.

[3] For more on telecom operator resilience, see Miguel Fonseca, Olivier Gorter, Eric Kutcher, Philipp Nattermann, and Benedict Vanderspar, "Telecom operators: Surviving and thriving through the next downturn," September 2019, McKinsey.com.

For example, Disney acquired Marvel for more than $4 billion in 2009. Since the company released its first Marvel movie, *The Avengers,* in 2012, the studio has generated more than $18.2 billion at the global box office for Disney.[4]

Plan for next downturn, not the previous one

While TMT companies can learn from the previous downturns, we see three areas of fundamental difference to consider.

First, the market environment has changed significantly. Several key subsectors, such as software, IT services, and telecom services, are growing significantly slower than they were heading into the last cycle. E-commerce now makes up about 24 percent of the TMT sector's revenues (versus 7 percent in the last cycle). Trade and geopolitical risks are creating significant uncertainty for global supply chains. And leading industry disruptors (for example, Amazon Web Services, Facebook, Netflix, Salesforce) have achieved scale, while emerging disruptors (such as Airbnb and Uber) have raised a huge amount of capital.

Second, several financial factors have altered the landscape. Debt/EBITDA ratios are up across almost all subsectors (except e-commerce and media), while coverage ratios (EBITDA-to-interest expense) are stable or have deteriorated. The proliferation of subscription models (for example, software as a service) increases variability risk in revenue and it is unclear how that will play out during a slowdown. And shareholder activism in TMT is at all-time highs, with activists sitting on a large amount of capital to deploy.

Finally, productivity improvements have become more difficult to achieve, as simple cost-cutting measures are no longer sufficient. Instead, such gains require investments in digital, automation, and analytics, which will be difficult to make in a resource-constrained environment such as a downturn.

What companies need to do now: Build a resilience action plan and start executing

Companies tend to put off preparing for slowdowns as they focus on the day-to-day tasks of increasing revenue and total shareholder returns. Continuing to wait, or wallowing in analysis paralysis, will be considered an egregious mistake in retrospect. Leaders must adopt a bias toward action and a steadfast mind-set that looks beyond any potential downturn and envisions the company's path through the economic cycle toward sustained, stable growth regardless of market conditions.

The most critical aspect of such a proactive approach is building a formal resilience plan and gaining top leadership commitment to it. For each company, this plan needs to be grounded in an understanding of the impact a slowdown will have not only on the company but also on its ecosystem—including customers, competitors, and suppliers. For example, IT hardware companies need to understand the stresses in their supply chain that may get introduced in certain scenarios. Software companies need to understand which customer segments are more likely to pull back and which ones are likely to stay stable or grow. Given the unique nature of TMT, in which players continuously make moves into new adjacencies, companies need to understand their competitive landscape and how it may evolve as new and existing players take actions in a slowdown. In addition, the plan must include a thorough assessment of the company's own strengths and weaknesses (operational, organizational, and strategic) and a financial plan that incorporates scenarios based on these elements.

Resilience action plans will look different from company to company, but there are some broad, common elements they will have, depending largely on whether the organization is a disruptor or an incumbent.

[4] Sarah Whitten, "Disney bought Marvel for $4 billion in 2009, a decade later it's made more than $18 billion at the global box office," CNBC, July 21, 2019, cnbc.com.

Disruptors

Disruptors, if they are well capitalized, are likely to go on the offense, looking to establish a sustainable competitive advantage. This would involve both inorganic (external to the company, such as M&A) and organic (internal operational) moves. Those disruptors with clean balance sheets should be buying strategic assets at more attractive valuations. Building an M&A blueprint that ties to strategic aspirations, together with a strong process for integrating new assets into the overall business, is critical to succeed in programmatic M&A.

Being on the offense also means focusing the company's resources on the most important parts of its operations in the face of slowing top-line growth. These include the most critical revenue drivers (for example, encouraging renewals and expanding the company's footprint by building a superior customer experience); margin drivers (for example, pricing discipline and value-based pricing); cost drivers for sales (for example, salesforce productivity, marketing ROI improvements); and R&D (for example, using machine learning and artificial intelligence to drive R&D productivity, implementing agile and DevOps through the organization). Disruptors can spend incrementally higher amounts on operations, but each investment needs to be significantly more productive.

Incumbents

On the other side, incumbents need to make several decisions on how they position themselves for the downturn. Downturns may well cause revenue drops in mature or legacy markets, and incumbents need to plan for that possibility. First, incumbents' inorganic growth paths need to be determined by choosing where to divest and where to acquire. A comprehensive mergers, acquisitions, and divesture blueprint starts with a portfolio review that asks whether the company is still the "best owner" of each asset, meaning determining if the company still creates the most value with that asset.[5] Any divestments must be quickly undertaken given current relatively higher values in the markets and potentially drawn-out disentanglement timelines. Potential acquisitions need to be studied and preparations made to maximize value upside for shareholders.

Operationally, incumbents need to decide where to cut and where to invest. Foundational investment in digital and analytics may be required to compete effectively against digital native companies. R&D investments need to be lined up with strategic portfolio priorities and adjusted to take advantage of high-growth products, even if they're not yet major revenue sources. R&D productivity must be maximized through people and process optimization, including adoption of agile, DevOps, and lean, all aided by machine learning and artificial intelligence. Analytics-driven sales productivity improvements, across the customer life cycle (for example, sales, customer success, renewals, pricing), can help provide the next significant step forward in reducing sales and marketing costs, while maintaining or improving the revenue trajectory. Overall, operating expenditures must be aligned to adjust for potential major reductions in revenue.

Historically, slowdowns have represented periods of immense opportunity in TMT from which the next generation of leaders have emerged. It cannot be overstated how important it is to get started not only planning but also taking action before any downturn has actually begun. Companies must build their resilience action plans and align them across the management team, board, and shareholders, without delay. Early action on no-regret moves pays significant benefits before, during, and well after a downturn.

[5] Richard Dobbs, Bill Huyett, and Tim Koller, "Are you still the best owner of your assets?" *McKinsey Quarterly,* November 2009, McKinsey.com.

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