

## Bubbles pop, downturns stop

**Economic downturns are impossible to predict and sure as sunrise. Build resilience now, because when the sun comes up, you'd better be moving.**

*by Martin Hirt, Kevin Laczkowski, and Mihir Mysore*

**Waste no time** trying to predict the next economic cycle. The running joke is that “experts” correctly anticipated seven out of the last three macroeconomic events. Unfortunately, it is unlikely that the hit rate will be any better next time around.

Geopolitics, economic cycles, and many other forces that can have substantial effects on the fortunes of your business are inherently uncertain. Higher volatility in our business environment has become the “new normal” for many. And while scenario analysis is a worthwhile exercise to rationally assess some of the uncertainties you are facing, there is no guarantee for getting it right.

So if you are concerned about the economic outlook, and if you get challenging questions from your board about the resilience of your business performance, how do you best respond?

It turns out that in times of crisis and in times of economic slowdown, not everybody fares the same. When we traced the paths of more than 1,000 publicly traded companies, we found that during the last downturn, about 10 percent of those companies fared materially better than the rest. We called those companies “resilients”—and we were intrigued. What made them different? Was it sector related? Did they simply get lucky?

As we investigated more deeply, we found some noteworthy characteristics in how resilients weathered the storms: how they prepared for them, how they acted during tougher periods, and how they came out of them.

We will share some of the more specific findings with you below, but let's start with the core insight right here: Resilients moved early, ahead of the downturn. They entered ahead, they dipped less, and they came out of it with guns blazing.

In short, your business context is and will remain uncertain. But if you get moving now, you can ride the waves of uncertainty instead of being overpowered by them.

## How the resilienters performed

In our book, *Strategy Beyond the Hockey Stick* (Wiley, 2018), we researched more than 2,000 companies over two decades to show that corporate performance follows a power curve. A small number of companies capture the lion's share of global economic profit, while the vast majority return just slightly above their cost of capital. Moving up the power curve requires big moves: dynamic resource reallocation, disciplined M&A, and dramatic productivity improvement. Those findings held across economic cycles.

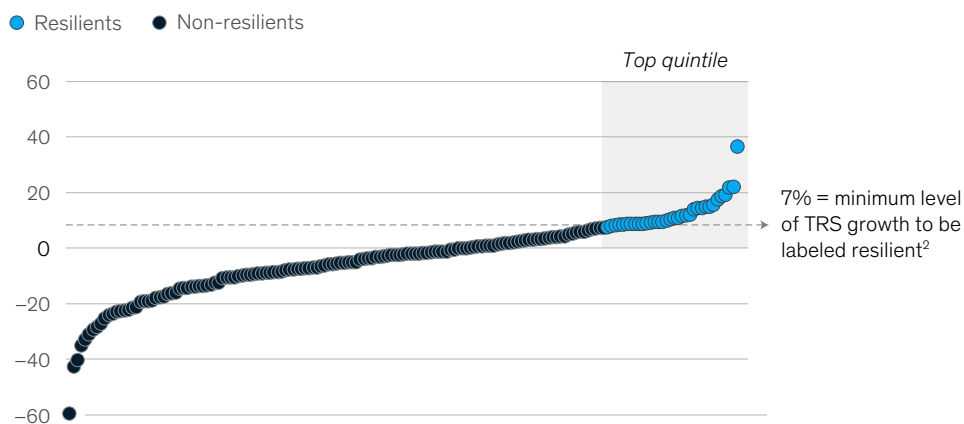
Our latest research focused squarely on what specifically helps companies thrive through downturns. The focal point of our analysis was a group of approximately 1,100 publicly traded companies, across a wide range of industries and geographies, with revenue exceeding \$1 billion. We found that between 2007 and 2011, in each of 12 economic sectors analyzed, there also was a power curve of corporate performance, measured in terms of total returns to shareholders (TRS) or excess TRS growth during that period, relative to the sector median. The top quintile of companies in each sector—the resilienters—delivered TRS growth that was structurally higher than the median in their sector (see Exhibit 1 for a representative analysis in the technology, media, and telecommunications sector).

In the three boom years before 2007, the resilienters actually underdelivered slightly on TRS. However, they opened up a slight TRS lead relative to their sector peers during the downturn and extended this lead through the recession (Exhibit 2). By 2017, the cumulative TRS lead of the typical resilienter had grown to more than 150 percentage

Exhibit 1

### While the last downturn was severe, some companies flourished.

Compound annual TRS growth rate for companies in technology, media, and telecom sector,<sup>1</sup> 2007–11, %



<sup>1</sup>TRS = total returns to shareholders; n = 171; results are representative of analyses done for 11 other sectors, for a total of 1,144 companies.

<sup>2</sup>That is, 7% more compound annual TRS growth from 2007 to 2011.

Source: S&P Capital IQ; McKinsey analysis

points over the non-resilients. This lead was tough to reverse: nearly 70 percent of the resilients remained top-quintile performers in their sector, with just a small fraction of the non-resilients joining them.

When the economy started heading south, what distinguished the resilients was earnings, not revenue. Barring a few sectors that were exceptions, resilients lost nearly as much revenue as industry peers during the early stages of the slowdown. However, by the time the downturn reached its trough in 2009, the earnings, measured as earnings before interest, taxes, depreciation, and amortization (EBITDA), of resilients had risen by 10 percent, while industry peers had lost nearly 15 percent.

## What the resilients did

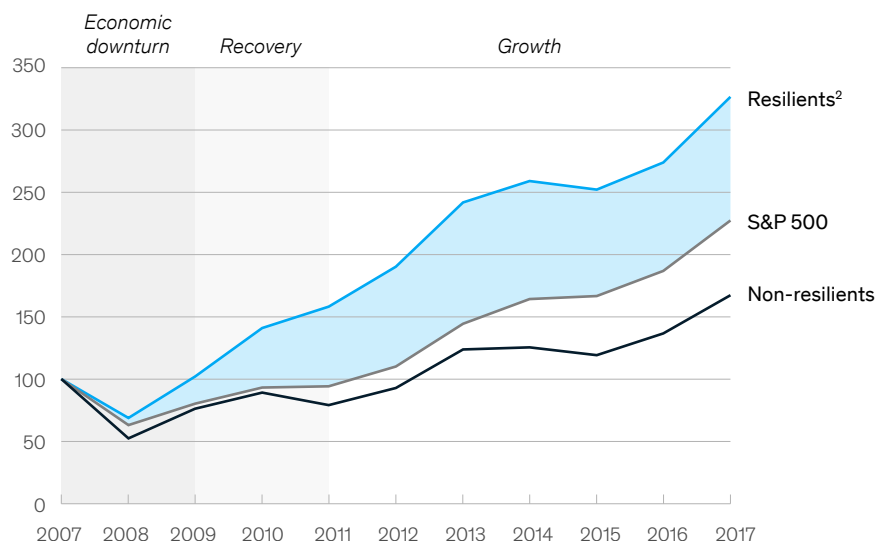
Resilients did three things to create this earnings advantage:

**1. Resilients created flexibility—a safety buffer.** They did this by cleaning up their balance sheets before the trough, which helped them be more acquisitive afterward. In particular, resilients were deleveraging during 2007: they reduced their debt by more than \$1 for every dollar of total capital on their balance sheet, while peers added more than \$3 of debt. They accomplished this partly by divesting underperforming businesses 10 percent faster than their peers. The upshot was that resilients entered the trough with more financial flexibility. At the first sign of economic recovery, the resilients shifted to M&A, using their superior cash levels to acquire assets that their peers were dumping in order to survive. Overall, the resilients were about 10 percent more acquisitive early in the recovery. They accelerated when the economy was stuck in low gear.

Exhibit 2

## Resilient companies did better at the outset of the downturn and after.

Cumulative TRS performance<sup>1</sup>



<sup>1</sup>TRS = total returns to shareholders; calculated as average of subsectors' median performance within resilient and non-resilient categories; n = 1,140 companies; excludes financial companies and real-estate investment trusts.

<sup>2</sup>Resilient companies defined as top quintile in TRS performance by sector.

Source: S&P Capital IQ; McKinsey analysis

**2. Resilients cut costs ahead of the curve.** There is little evidence to suggest that the resilientists were better at timing the market. However, it is quite clear that they prepared earlier, moved faster, and cut deeper when recessionary signs were emerging. One such warning came in the summer of 2007, when the global financial markets briefly seized up before settling back down. By the first quarter of 2008, the resilientists already had cut operating costs by 1 percent compared with the year before, even as their peers' year-on-year costs were growing by a similar amount. The resilientists maintained and expanded their cost lead as the recession moved toward its trough, improving their operating edge in seven out of the eight quarters during 2008 and 2009. In doing so, the resilientists appear to have focused primarily on operational effectiveness, reducing their cost of goods sold, while maintaining selling, general, and administrative costs roughly in line with sales.

**3. Resilientists in countercyclical sectors focused on growth, even if it meant incurring costs.** There were three sectors in the last recession that behaved very differently to the rules above, primarily because they saw little impact to their revenues and only slightly slower growth as an industry. Oil and gas was in the middle of a commodity supercycle in the early part of the recession, with prices reaching as high as \$120 per barrel. Meanwhile, demand for healthcare and pharmaceuticals proved relatively inelastic. For these growth sectors, the rule book was quite different. Their resilientists actually overdelivered significantly on revenue, while taking on higher costs.

## **What's different now**

Invaluable as the lessons of history are, we also must be cognizant of changes in the external environment. Consider first costs: reducing them, faster and deeper, in the way that the resilientists did during 2008–09, is likely to be difficult. That's partly because competition in global markets, and the relentless pressure of activist shareholders, have left businesses with less fat to trim than in previous cycles. We recently asked a group of CEOs at the World Economic Forum in Davos, as well as at a similar forum in New York, whether their companies had a lot of potential for large cost cuts. Two-thirds of them were dubious.

Although, when push comes to shove, it starts seeming more feasible to realize challenging savings—these days, across-the-board cost cuts can create more problems than they solve. For starters, there's the risk of undercutting digitization efforts by underinvesting in mission-critical talent. There are also the wider social costs of layoffs, which companies are starting to feel in the form of backlash from communities, customers, politicians, and workers.

Digital and analytics-driven productivity improvements may be an important alternative to conventional cost cuts or cross-border labor-cost arbitrage. Our work with major manufacturing businesses across a range of sectors over the past two years suggests that for many companies, cost-reduction opportunities using “traditional” levers amount to only about 2 percent of costs, whereas those applying digital and analytics tools can reduce costs by a further 5 percent. In general, accelerating digitization has widened the gap in capabilities and performance between digital leaders and laggards—a gap that is likely to grow during any downturn.

## A robust resilience playbook

These environmental differences don't mean you should forget about costs in the next recession; the ability of the resilient to drive earnings growth despite top-line challenges was a critical differentiator. But it does point toward a resilience playbook (Exhibit 3) emphasizing more balanced performance interventions, as well as faster decision making enabled by a resilience "nerve center" and a well-prepared organization.

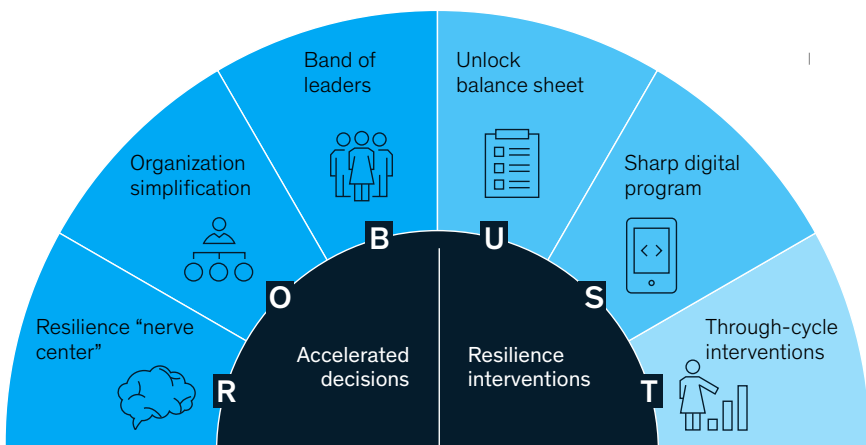
### Balanced performance interventions

Getting past the limitations of traditional performance approaches oriented around head count and cost will require fresh thinking about boosting productivity. A large electrical-equipment manufacturer, for example, found that adopting robotic-arc welding led to a 30 percent decrease in manufacturing costs, a 50 percent improvement in production time, higher quality, and better process control. Production costs fell to levels similar to those in China, and the manufacturer decided against further offshoring, expanding manufacturing in the United States instead. This example shows that the economic logic of advanced technologies and automation cuts in multiple directions, with robots creating and saving some jobs even as they displace others. Working through this nuance, and communicating it to relevant stakeholders, will be an important part of leaders' roles moving forward.

Although the resilient's earnings edge rested primarily on cost savings, they were also better at locking in post-cycle growth, partly through the use of emerging tools that enabled them to better serve higher-value customer segments. A specialized cargo airline, for instance, developed a new system for categorizing customers in its micromarkets based on demand, flight availability, and capacity per flight. It then rewarded customers that contributed most to its tough-to-fill routes and negotiated price with large customers based on their route-by-route volume. This increased the carrier's share of wallet as high as 20 percent with key customers.

Exhibit 3

## A new resilience playbook is emerging.



These performance interventions need to be balanced with creating flexibility—either operational or financial. Financial flexibility is achieved partly by unlocking your balance sheet, or by divesting noncore assets early, before the fire sales start. Operational flexibility may be created through variable contracts and more diverse supply sources and platforms that share components across product lines and parts, among other levers, as new McKinsey Global Institute research shows. Toyota has been on such a journey, investing billions to ensure its factories can shift seamlessly between different body styles and power trains.

### **Sharp digital discipline**

As advanced technologies and analytics create performance opportunities, they're reshaping competitive dynamics in far-reaching ways. Our colleagues have shown in separate research that those further along the digital journey are realizing 7-plus percent more revenue growth than industry peers, and nearly 6 percent more EBITDA growth. This digital divide, combined with the tendency for downturns to drive a sustained wedge in performance, could mean a long-lasting bifurcation among digital “haves” and digital “have-nots.” The digital haves will connect better with loyal customers; provide a frictionless, private customer experience; serve them at a lower cost; absorb price hits; and avoid expensive IT upgrades at a vulnerable time. Digital have-nots, on the other hand, may feel a need to retrench, making catch-up elusive, even when economic conditions improve.

Future resilientists will likely have a clear view of which critical processes should be digitized to drive near-term value and which initiatives (such as creating new offerings or investing to extend customer reach) are critical to remaining competitive. An auto insurer, for example, might safeguard an initiative aimed at using analytics and machine learning to create claims estimates without sending an inspector to look at a damaged car, because of its transformational potential. It might also stay the course with the development of a new pricing system that has significant near-term potential. On the other hand, a process-redesign effort whose full potential will be difficult and time-consuming to capture as a result of regulatory and reporting differences across geographies might get moved off the priority list.

Most advanced technology efforts require engaging people in multiple parts of the organization—analytics experts, customer-experience specialists, operators skilled at robotic process automation, lean-operations gurus, and the like. Breaking down organizational silos to engage all these people often requires special attention. Australian insurer IAG, for example, created an “accelerator” that, according to Chief Digital Officer Mark Drasutis, looks “across all the activities to understand and direct priorities, [and bring] together expertise across the business . . .”<sup>1</sup> The challenge during a downturn is that near-term cost pressures and traditional organizational reporting lines sometimes yield efforts to “lean things out” function by function, with each executive or manager told to “make cuts in what’s in your control.” This approach becomes outmoded fast in the horizontal, cross-functional world of digital innovation and execution. Instead, companies should get important digital work done through agile operating units, deployed flexibly against value-creation opportunities.

---

<sup>1</sup> See “Scaling and accelerating a digital transformation,” February 2019, McKinsey.com.

### **The resilience nerve center**

A resilience nerve center aims to do three things well:

- *monitor* a small number of material risks and use stress tests to orient the company, early, toward downturn-related economic impacts
- *decide* how the organization will manage these impacts faster
- *execute* by organizing teams into agile, cross-functional units that drive toward clear outcomes, create forums for faster executive decision making, and monitor the results through value-based initiative tracking

The art of effective resilience monitoring starts with a recognition that any effort to identify an economic scenario precisely will inevitably miss something that turns out to be important, while creating a deafening cacophony of risks that leaves leaders overwhelmed and unable to act. It is far better, in our experience, to agree on a small number of representative major threats and for each to define a clear leading indicator, as well as triggers for escalating the threat to decision makers. Thinking this through ahead of time is great preparation for tackling unexpected threats when they emerge.

The next step is to incorporate these material threats into a map, like the one devised by an oil and gas company we know, that focuses on the potential timing, sequencing, magnitude (confirmed by stress-test modeling of financial impact under different scenarios), and second-order effects associated with various hazards. This map becomes the basis for big strategic moves. If a particular idea will not help neutralize one of the issues spelled out in the threat map, it may not be bold enough to make the company resilient.

All of this work ends up being a theoretical exercise unless it leads to quick decisions and then action—which in our experience starts with forming cross-functional, highly autonomous teams with well-defined objectives.

### **Preparing your organization, your leaders—and yourself**

The fast-moving teams that support nerve-center activities, and also are intertwined with many digitization and operational-improvement efforts, may sound a lot like agile squads. That's no accident, because more and more organizations are embracing agile approaches.

Leaders should certainly use resilience planning to build on those initiatives, but as part of a much wider effort to simplify the organization and prepare for uncertainty. A full-scale reorganization is tough to pull off anytime, and particularly so in the throes of a major downturn, so a reclustering of activities may help. This is best done in the flow of ongoing strategic dialogue about portfolio priorities, particularly divestiture and acquisition opportunities whose urgency could rise with swings in the macroeconomy. The reclustering can be dramatic, approaching a zero-based “clean sheet” approach, or something more incremental.

Simultaneously, you can identify, using an analytical approach, the skills and people needed to carry the business through turbulence. Most companies shed people during a recession, but resilient players are just as conscious of investing in the skills needed to win in the recovery. Know your key roles. Then look at how your top talent is arrayed against them and what you need to do about any mismatches (which might include, for example, retaining or acquiring digital skills, or rethinking the outsourcing of IT talent).

All this will require a leadership team that is itself agile and resilient, able to make effective decisions quickly in an atmosphere of uncertainty and stress. Many superstars imploded under pressure during the last recession, and most of their equivalents today have not been tested in the cauldron of a serious downturn. Resilient executives will likely display a more comfortable relationship with uncertainty that allows them to spot opportunities and threats and rise to the occasion with equanimity. Now is also the time to develop a plan spelling out who will be involved, and how often, in making and communicating key decisions, ideally empowering those employees closest to the work. Particular attention should be focused on a process to ensure that “big bet” strategic decisions—those like divestments and acquisitions—are the outcome of a healthy and well-informed debate rather than made on the fly.

---

Underlying the priorities we've been describing is a bias toward action—an urgency that reminds us of a quote: “Every morning in Africa, a gazelle wakes up. It knows it must run faster than the fastest lion or it will be killed. Every morning a lion wakes up. It knows it must outrun the slowest gazelle or it will starve to death. It doesn't matter whether you are a lion or a gazelle: when the sun comes up, you'd better be running.”<sup>2</sup>

Are you a lion or a gazelle?

Or, put differently: If you are concerned about the resilience of your business, are you already moving? Q

**Martin Hirt** is a senior partner in McKinsey's Greater China office, **Kevin Laczkowski** is a senior partner in the Chicago office, and **Mihir Mysore** is a partner in the Houston office.

The authors wish to thank Tanguy Catlin, Peeyush Karnani, Cindy Levy, Mary Meaney, Philipp Radtke, Kirk Rieckhoff, Hamid Samandari, Sven Smit, and Maria Valdivieso de Uster for their contributions to this article.

Copyright © 2019 McKinsey & Company. All rights reserved.

---

<sup>2</sup>“Lions or gazelles?,” in “The other dimension: Technology and the city of London—A survey,” *Economist*, July 6, 1985. For more on this quote, which has been attributed to a variety of individuals, see [quoteinvestigator.com/2011/08/05/lion-gazelle](https://quoteinvestigator.com/2011/08/05/lion-gazelle).