# **Economist Intelligence Unit** The Economist Taking advantage of the pit stop How to prosper in a recession

Sponsored by

ineum ♥ ♥ ♬ ☐ consulting

A report from the Economist Intelligence Unit



## **Preface**

Taking advantage of the pit stop: How to prosper in a recession is an Economist Intelligence Unit briefing paper, sponsored by Ineum Consulting. The Economist Intelligence Unit bears sole responsibility for this report. The Economist Intelligence Unit's editorial team wrote the report, and the findings and views expressed do not necessarily reflect the views of the sponsor. Clint Witchalls wrote the report and Delia MethCohn was the editor. Our thanks are due to all interviewees for their time and insights.

April 2009



# Prospering in the crisis?

In a moment of hubris, the British prime minister, Gordon Brown, once declared the death of boom and bust economic cycles. Recent events have proved him wrong. Boom and bust is here to stay. While governments and businesses can play a part in lessening the frequency and severity of recessions, they are unlikely to be able to put an end to these periods of market correction.

The current global recession started as a housing bubble in the US—known as the subprime crisis because mortgages were sold to people who had little or no means of paying them back. The debt was then pooled into mortgage-backed securities, which were then packaged into securities, such as collateralised debt obligations, and sold to the world's banks as AAA-rated debt.

Ruptures in the subprime market began to appear in 2007. Highly geared banks with vault-loads of securitised debt suddenly found themselves in serious trouble. As Lehman Brothers, IKB Deutsche Industriebank, Northern Rock and other banks across the globe faltered under their debt obligation, panic spread through the market. Banks stopped lending to each other, they stopped lending to other businesses and they stopped lending to consumers. The "subprime crisis" had evolved into the "credit crunch", which in turn evolved into the "global economic downturn" that eventually became the "global recession". To summarise the events in George W Bush's words: "Wall Street got drunk."

Some pundits believed that the emerging markets, with their double-digit growth and trillion dollar sovereign wealth funds, were sufficiently "decoupled" from the global economy to prosper despite the downturn. This prediction proved to be wrong. Other pundits believed that only countries heavily reliant on financial services would be adversely impacted. This too proved to be wrong—the world's largest exporter, Germany, is deep in recession.

"All recessions are different, but this one is particularly unique," says James Henderson, professor of strategic management at IMD, a Swiss business school. "This is not just a housing crisis or a recession caused by high oil prices, or by high productivity—like the Internet bubble. This is an institutional crisis. People have lost faith in banks and the institutions that are supposed to monitor them."

As a result, although businesses are used to conserving cash during recessions, the problem of cash is particularly acute this time round. "Businesses and people can no longer go to banks for working capital," explains Professor Henderson. "There is no credit available, so business is at a standstill."



But not all businesses are at a standstill. In any recession, there are those who fail, those who struggle through, and those who prosper. This report will focus on those firms that prosper, not just by virtue of the industry they operate in, but because they have taken decisive action to be ahead of the pack when the gloom finally lifts.

### Strategies for thriving in a recession

The first thing most companies do in a recession is cut discretionary costs, such as marketing, training, travel, infrastructure maintenance and research and development (R&D). They tighten up on receivables, reduce inventory and look at selling non-core assets. But although focusing on cash and costs is necessary to survive, those companies that prosper take a more proactive approach to managing through recessions, seeing the slowdown as a "pit-stop"—a chance to rethink the future of the business and ensure that the company is geared up to achieve it.

The pit-stop check includes five key areas:

- rethinking business models
- investing in infrastructure, R&D and people
- continued focus on innovation, collaboration and sustainability
- finding new markets
- communicating with stake-holders

## Rethinking the business model

As traditional sources of revenue dry up, recessions often prompt companies to rethink their business model. A recent survey of senior executives, conducted by the Economist Intelligence Unit found that 25% of companies have changed their business model as a result of the financial crisis and a further 24% aim to do so in the near future.

For technology companies especially, where today's leader can rapidly become tomorrow's lagger, the ability to make radical moves when circumstances change is crucial. Apple was an ailing computer maker before it launched the iPod during the US recession of 2001. Its business model innovation was not just the new product but the decision to tie the iPod to its online iTunes store, where customers could browse and buy music online. If Apple had merely launched a new MP3 player, a competitor could have responded with a cheaper "me too" product. Shifting to a business model that was more akin to the entertainment industry than a hardware manufacturer made Apple a hard act for would-be imitators to follow.

## Investing in the future

Conserving cash is a necessity for some, but for companies with a strong balance sheet a recession is an opportunity to invest. While it may seem counterintuitive to spend money when everyone else is focusing on cutting costs, a countercyclical approach often pays dividends.



Professor Henderson is a firm believer in going against the business cycle. "Do the exact opposite of what everyone else is doing," he advises. "If you have cash during a recession, it's time to start spending and expanding." There are three areas where firms should focus their investments, cash permitting: information technology (IT), R&D and people.

#### IT

IT is the great enabler of productivity gains. During busy times, firms are reluctant to rip out old but functioning systems to replace them with the latest technology, and during recessions, companies delay investments to free up cash. This does not mean that new systems never get implemented, but it might explain why 80% of back-office systems in financial services firms still run on Cobol—a programming language developed in the 1950s.

New systems can save costs, improve time-to-market, provide additional sales channels and give firms a competitive advantage. "We continue to invest in our IT infrastructure because IT infrastructures are almost by definition antiquated pretty much as soon as you install them," confirms Kenneth Wilcox, CEO of Silicon Valley Bank. "There is more opportunity for getting concessions out of vendors than has been true for years and years."

IT chiefs should also be resourceful in finding ways to run projects at a lower cost. "There are many ways to run a project and you are more creative in a tough time," says Eric Mansuy, CIO at RBC Dexia, a financial services firm.

#### R&D

Gordon Moore, one of Intel's founders, once said: "You can't save your way out of a recession." The company lives by this motto. Intel consistently invests in research and development during downturns, and always to good effect (see charts below).

In 2001, when the dotcom bubble burst, Intel increased its R&D and capital expenditure to over US\$11bn. The company was barely profitable that year, but the increased investments in innovation

#### Research and development & diluted earnings per share



(a) Excluding purchased in-process research and development. Source: Intel.



**Taking advantage of the pit stop** How to prosper in a recession

paid off in following years.

"Intel is a good example of a company that embraces countercyclical business strategies," says Professor Henderson. "Now they are increasing their capacity and doing it cheaply because there is an oversupply of services. There are no delays and constructing of plants is cheaper—labour is available."

R&D is also vital for the airline industry. The incumbents, Airbus and Boeing, will soon find themselves competing with national industries. The Chinese, the Russians and the Japanese are all pursuing aircraft programmes, backed by public money. "With the emergence of new competitors in very powerful places around the world, setting the standards and differentiating ourselves through technological advances is the way forward," says Christian Scherer, head of strategy at Airbus. "And that's the reason our company has made the smart decision to maintain its level of spending on research even though times are tough right now."

Companies that develop a portfolio of new products and services are well placed to profit during the inevitable upturn.

#### People

Before the financial crisis took hold, senior executives cited the global war for talent as one of the main constraints on business growth, especially in emerging markets. Now most companies are focusing on lay-offs—hoping to cut just the fat, but in some cases also losing the talent that was built up at great cost over the past few years.

When the recession bottoms out, the war for talent will pick up where it left off, and, as with R&D, those that invested wisely will be in a more advantageous position when business picks up. In many developed countries, declining populations point to a long-term worsening of talent shortages, while in emerging economies the supply of skills and experience is still very limited.

Recognising the importance of talent, professional services firms have learned a trick from the manufacturing industry and adopted the strategy of putting employees on shorter working weeks rather than laying them off. Mr Wilcox of Silicon Valley Bank says they have done everything to avoid having to cut staff. "The reason for that is loyalty is obviously reciprocal and the other thing is, having to lay people off is an indication of having not been that good at anticipating the future," he says.

A recession is also a great time for acquiring new talent. Since the collapse of Lehman Brothers, banks such as Credit Suisse, Rothschild and Deutsche Bank have engaged in a huge hiring programme. The Financial Times described it as "the biggest banker poaching exercise seen in Europe for years". However, Professor Henderson advises firms not to overdo it—conserving cash is still crucial.

For companies that have a hiring freeze, developing the talent they have got is also a good strategy. "It's difficult to find good people," says Laurent Rouaud, vice-president of market and product strategy at Airbus. "We have decided to invest in our people and take this opportunity to train our people so that when we have a ramp up we have a completely engaged workforce."

To get the most from their people, companies should also consider moving away from the old command-and-control style of leadership. "There is an urgent need for companies to adopt a more distributed model of leadership, rather than one based on the charisma and knowledge of a few individuals at the top," says Julian Birkinshaw, professor of strategic and international management at



London Business School. Professor Birkinshaw points out that it was "charismatic" leaders that led us into the current financial crisis.

## Investing effort, not money

For those companies without a strong balance sheet, key areas of investment—in terms of time and effort—should be innovation, collaboration and sustainability. Naturally, these should also be areas of focus for firms with a strong balance sheet.

Before the recession took hold, companies experimented with innovation hot-houses; others used Web 2.0 products to collaborate with people on the other side of the globe; and many looked for ways to reduce their carbon footprint. Unfortunately, these sorts of "experimental" projects are often the first in the firing line when times get tough. Many firms are going "back to basics". This is unfortunate as innovation, collaboration and sustainability are no less relevant now than they were a year or two ago.

#### Innovation

Recessions are great for highlighting the weaknesses in a company. But doing something about those weaknesses requires a culture of innovation—a frame of mind that needs to be inculcated in every employee. Innovation is vital for rethinking business models, organisation structures and processes, getting the most out of R&D and finding new markets.

Companies certainly do not need designer "incubation rooms" to innovate but they do need to reward employees for creative thought and give them permission to be creative.

Innovation, however, like technology, can be destructive in the wrong hands, as we have learnt coming out of the mass destruction wrought by recent financial novelties. Innovation only makes sense if it creates real value for the long term, argues Umair Haque, Harvard Business Review blogger and director of Havas Media Lab (see The way forward).

#### Collaboration

Collaboration became a buzzword because the Internet gave companies access to people all over the globe. As Bill Joy, co-founder of Sun Microsystems put it: "No matter who you are, most of the smartest people work for someone else." What the Internet has provided is access to all of those people. Possibly the apotheosis of Internet collaboration is something called "crowdsourcing" where a task is delegated to a diffuse, leaderless group over the Internet.

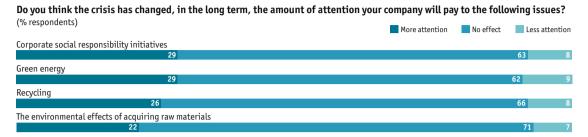
Radical new initiatives of this sort will be rarer during the recession, but collaboration can also take place through partnerships, strategic alliances or joint ventures. As firms cut costs, they can compensate for lost capacities by partnering. For example, if a firm cannot justify investing in a particular market, it can partner with peers to retain exposure to the market at a lower cost.

#### Sustainability and carbon footprints

A MORI poll conducted in 1989 showed that 35% of people believed the environment was a major issue. This figure fell to just 5% in the recession of 1991. But times have changed. A survey¹ conducted by the Economist Intelligence Unit in 2009 shows that companies will be focusing more attention on sustainability as a result of the financial crisis, not less.

<sup>&</sup>lt;sup>1</sup> Risk and regulation, Economist Intelligence Unit survey of executives, sponsored by Dubai Holdings, March 2009



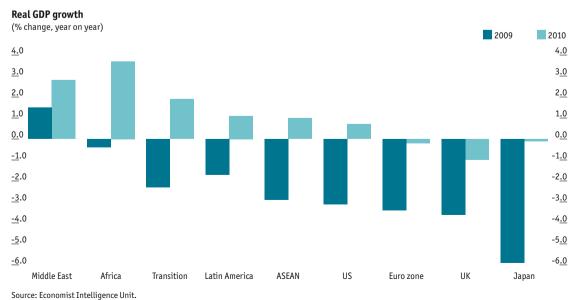


"Continually working at improving your sustainability can be a way to differentiate a product and is also likely to lead to improved profitability," says Nick Thompson, CEO of New Britain Palm Oil, a company that has focused on improving and certifying the quality of its environmental management systems and also the health and safety of its employees. "Sustainability can help drive an industry forward and is being led by companies that are responding to NGO [non-governmental organisation] calls and also calls from the ever more ethical consumer," says Mr Thompson.

If there have been two casualties in this recession, they are confidence and trust. As firms try to rebuild their trust among the public, they are going to have to look at investments in more than just economic terms, factoring in both social and environmental concerns too.

## Finding new markets

During a recession, many traditional markets dry up encouraging firms to look for new markets. Although emerging markets have been hit by the global recession, they still have massive growth potential and are likely to rebound for business faster than developed markets. "Many Western markets, even if they recover, will remain 'mature'," notes Hellmut Schütte, senior affiliate professor of international management at INSEAD, a French business school. "Many markets in Asia are still at the early stage of the product life cycle and promise high growth rates for many years."





China and India are still showing the fastest growth in the world, followed by the Middle East and Africa. Although China's growth has slowed, it is still 6-8% ahead of established markets. The Economist Intelligence Unit forecasts China's economic growth in 2009 to be around 6%. India is also looking relatively healthy thanks to protectionist policies that insulated the country from the worst excesses of the global economic fallout. India's real GDP is expected to grow at 5% this year. The country has a young population, a high savings rate and a rapidly growing middle class, all of which make it an attractive place for consumer-oriented companies to do business. "Future growth will not be achieved anymore in territories of the past," says Professor Schütte. "It will be driven out of Asia."

But companies do not always have to go as far as Asia to find new markets. Often, new customers are right under their noses. Sharp cut-backs by some companies mean market-share gains for others. "On a selective basis, we are seeking to get customers or clients out of other people's portfolios and bring them into our own," says Mr Wilcox of Silicon Valley Bank.

Taking customers from direct competitors is one tactic, competing in substitute markets is another (see box, *Finding substitute markets: Southwest Airlines*). "What companies should be doing is thinking about how they can expand their market by bringing in people that were not their customers before," says Andrew Shipilov, a Professor of strategy at INSEAD. "Those who go into non-traditional markets, those are going to be the winners in the post-recession time."

## **Communicating with stakeholders**

Because recessions are times of high anxiety, it is important to keep honest, open channels of communication with all stakeholders. In a world with Facebook, LinkedIn, SecondLife, YouTube plus an array of influential blogs, bad news spreads at the speed of light. It has never been more important to maintain a good corporate reputation, both online and off.

#### Finding substitute markets: Southwest Airlines

In 1971 US-based Southwest Airlines introduced a low-cost, no-frills, short-haul shuttle service between Texas's main cities. The plan was simple enough: offer commuters a fun, efficient, viable alternative to using the car or bus.

Among Southwest's early innovations were unassigned seating, flight attendants who also cleaned the aircraft to guarantee a 15-minute turnaround and employee compensation in the form of stock options.

To get it off the ground, in February 1973 the company announced a half-price sale accompanied by a radio marketing campaign. The fare was \$13 and the strapline: Take the bus. It only costs a little more and is just four hours longer.

"Targeting people who caught the bus was Southwest's biggest insight", says Andrew Shipilov, a Professor of strategy at INSEAD,

"because these were people who had a need which could be satisfied by an alternative product or service."

The strategy worked. In 1973 Southwest reported its first profits and just a year later was carrying 1m passengers. The campaign was so successful that the company survived the 1973/4 oil crisis which saw oil prices soar 135% in a month. Through the bad times of the first Gulf War in the early 1990s to the September 11th attacks in 2001, Southwest continued to innovate, creating a model for low-cost airlines across the world. It was one of the first airlines to introduce ticketless travel. It managed to save billions in fuel costs by aggressively hedging its fuel usage. After 9/11 other airlines cut routes and laid-off staff but Southwest decided to "fly its way back to profitability". The move inspired such loyalty that, after the attacks, its 32,000 employees elected to give back a proportion of their pay. Today, Southwest is ranked seventh most admired firm in the world by Fortune magazine.



Gerard Dufour, an independent consultant who specialises in brand strategy and corporate culture, believes that firms often have a split personality. They communicate their brand image to the outside world—which carries with it a certain set of values—yet inside the company, people behave in a different way. "In the age of the Internet," says Mr Dufour, "there are more and more people who say, 'This is a schizophrenic company. They project this image to the outside world, but this is what's happening on the inside.' There has to be more of an alignment between the brand on the outside and the brand on the inside."

At Airbus, honest communication is crucial during a downturn. "I wouldn't say that communication is more important in recessionary times than in good times," says Mr Scherer of Airbus, "it's more a matter of transparency. It's a matter of trying not to play games with communication, but using communication simply as a means of advice to the market." By "games", Mr Scherer is referring to firms that use an anomalous frenzy of orders here and there to convince analysts and investors that their firm is prospering, or using strikes and other social action to "hide industrial realities".

"Very often when firms get into trouble," says Mr Dufour, "it's because they didn't explain what they were doing."

#### The way forward

"This [crisis] is really an opportunity to change the way we do business," says Mr Dufour. "It's time to rethink what we mean by a career, to rethink how we measure success ... I'm just not seeing this radical thinking yet."

The ongoing financial crisis has been dramatic enough to force people to ask the question: how do we go forward? For Mr Haque, that means focusing on real value creation. Not the sort of "value" that is derived from currency hedging, complicated derivatives or wage arbitrage, but real, lasting value. Mr Haque calls it "thick value".

"The value we taught companies to create in the 20th century was thin value and the central challenge of next-generation capitalism is thickening it," says Mr Haque. "Thin value means that the

#### Starting out in a recession: Walt Disney Corporation

In the summer of 1923, Walt Disney arrived in Los Angeles to find a distributor for one of his first animations. With America two months into a recession this seemed, at best, hopeful. But by October 1923 Walt Disney had signed a contract with a well-known film distributor. The deal marked the formal beginnings of a film studio which started in a garage, went on to survive the stock market crash of 1929 and today is one of the world's biggest entertainment businesses.

The Walt Disney Corporation was not the first to launch in a recession. Of the 30 companies on the Dow Jones industrial index, 16 started in a downturn. Indeed, household names like General Electric, Kodak, Hewlett Packard, Microsoft and Burger King all

launched in tough times. So did some of the most successful products—the iPod, Sellotape and Monopoly.

Walt Disney was a pioneer in animation and his distributor recognised that. But as Tim Dirks, a film historian at American Movie Classics points out, recession or no recession this was also the golden age for film-makers and by the mid-1920s \$2bn had been invested. In fact, the 1920s and 1930s saw the greatest output of feature films in America—on average, 800 films were released annually versus around 500 today.

There are some advantages to launching a company in a recession. Start-up costs are lower, with real estate, computer equipment and labour more abundant and cheaper. What is more, in a recession there is less competition and less advertising is needed to get people's attention—all of which, undoubtedly, helped the Walt Disney Corporation in its early years.



**Taking advantage of the pit stop** How to prosper in a recession

value we've taught boardrooms to create—and Wall Street to allocate and monitor—is inauthentic."

Mr Haque believes the value we create today is inauthentic in three ways. First, it is artificial: corporate profits are counterbalanced by a slew of human, social and environmental costs. Second, it is brittle: it is easily reversed, and yesterday's gains quickly become today's losses, as bubbles and crashes intensify in frequency. Third, it is inequitable: it accrues to the already rich vastly more than the chronically poor.

"The result is that the 'value' companies create is almost totally divorced from tangible human outcomes—like well-being, happiness, security, trusted relationships, or meaningful work," says Mr Haque.

This also means that companies need to focus their strategies more clearly, rather than following the herd to relentless growth. "When it comes to coming out of this recession companies should realise that it should be okay for the senior management to say we're not growing beyond a certain point if that means profitability is going to go down," says Mr Shipilov. "If people realise this, then we will have many fewer recessions than what we've had."



## **Conclusion**

There is no silver bullet to surviving a recession, and this recession is broad enough and deep enough that it will affect everyone. The Economist Intelligence Unit's forecast—as at March 2009—puts a one in three chance of the world entering a depression. "To believe you will come out of it completely unscathed is a bit of a pipe dream," says Mr Wilcox, CEO of Silicon Valley Bank. But with every crisis comes opportunity. As Barack Obama's team keeps repeating: "Never waste a good crisis."

Companies with strong balance sheets are in a particularly advantageous position. They are able to invest in research, in people and in new systems. But even those companies without strong balance sheets, a lull in business activity can provide the space to be more innovative, to experiment with new business models and to think of new ways to collaborate and conserve.

Broader than this, the crisis is a catalyst for lasting change, not just at an individual company level, but in the way we do business as a whole. Jorma Ollila, the chairman of Royal Dutch Shell and Nokia, was recently quoted in the Financial Times saying: "The crisis will lead to a rethink in the corporate world. It is not just about short-term, mid-term or long-term profitability but it is also about certain values and how we deal with stakeholders."

Trust and confidence are the two biggest victims of this recession. To rebuild trust and confidence, companies will need to adopt more sustainable business practices—practices which run the gamut from investing in local communities to reducing carbon footprints. Trust will not be rebuilt if firms continue with business as usual, that is to say chasing quarterly figures to please financial analysts. Corporate success needs to be more multidimensional than that.

Companies now face an enormous opportunity to shape the future of business. To squander this opportunity would be a tragedy.

Whilst every effort has been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Ltd. nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this white paper or any of the information, opinions or conclusions set out in the white paper.

LONDON
26 Red Lion Square
London
WC1R 4HQ
United Kingdom

Tel: (44.20) 7576 8000 Fax: (44.20) 7576 8476 E-mail: london@eiu.com

NEW YORK 111 West 57th Street New York NY 10019 United States

Tel: (1.212) 554 0600 Fax: (1.212) 586 1181/2 E-mail: newyork@eiu.com

HONG KONG 6001, Central Plaza 18 Harbour Road Wanchai Hong Kong

Tel: (852) 2585 3888 Fax: (852) 2802 7638

E-mail: hongkong@eiu.com