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What is your recession playbook?

Ajit Kambil

By the time you read this column, the National Bureau of Economic Research may declare the United States to be in recession. Economists define a recession as a decline in the gross domestic product for two or more consecutive quarters. If not a recession, economic growth in the world's largest economy is likely to have slowed in successive quarters as a consequence of the credit crunch arising from the failures in the sub prime and collateralized debt obligation markets.

How should companies navigate the current economic climate or a recession? What can we learn from prior economic down turns. My colleague Atanu Chauduri and I analyzed data from prior down turns to identify those companies in the consumer and industrial products sectors who were high flyers in the prior two recessions and outdistanced their competitors. We also identified those companies who performed poorly in both recessions and those that transitioned from a moderate performer to high performer and vice versa over prior recessions. To discriminate between high- and low-performers, we examined the share prices and return on capital of S&P 500 companies in relation to the S&P 500 index over two five-year periods: 1990–1995 and 1998–2003. We also considered other variables such as revenue growth, asset turnover, and capital expenditure as a percentage of sales to understand what contributed to their growth. To indicate their capabilities at managing costs, we also examined operating margins, SGA expenses and the cost of goods sold as a percentage of sales during these periods. While many companies experienced some dips in performance during the recession years, many were able to quickly bounce back and thus, over a five-year period, they were able to outperform their industry peers and the S&P 500. Among consumer and industrial product companies only a few consistently outperformed their peers across both periods

of analysis. These included companies like Danaher, Sysco, Johnson and Johnson Colgate Palmolive, Avon Products, and Illinois Tool Works.

This column summarizes key findings and ideas to consider in addressing downturns. As we sampled on the dependent variable of performance in prior recessions to identify companies to study – the results in this column are more truly hypotheses to guide executive action rather than a fully validated theory of strategy in the face of recession. Nevertheless our preliminary research provides useful managerial guidelines for strategy. We found managers who got past the knee-jerk reaction of cutting staff and costs to a well reasoned strategy were most likely to successfully navigate their company to a good place.

Managing in a Downturn

- 1) ***Recessions do not last forever.*** Most recessions since World War II have lasted less than a year. This is a relatively short period in which to manage significant organizational change. The current slowdown is expected to be relatively shallow and last closer to eighteen months rather than one year. But managers are well advised to be use to recession to position to take advantage of renewed growth at the end of that period.
- 2) ***Focus on revenue growth and market share.*** We found high performing companies did not stop for a recession. They continued to introduce new products, adjust products to offer new lower-priced options that appeal to more value-conscious customers, and continue improvements in customer experience. In short they focused on continuing to grow both revenue and market share simultaneously.
- 3) ***Increase financial efficiency.*** Recessions are an opportunity and burning platform for finance transformation. High performers improved their financial operations, lowering the cost of working capital when feasible, reducing the cost of debt-service by retiring debt or lower cost refinancing, and improving order-to-cash cycles by better receivables management. Given many of the S&P 500 have

- excellent balance sheets and cash reserves this recession may be a good time to retire debt if it cannot be renewed on favorable terms.
- 4) ***Increase operational efficiency.*** In addition to financial efficiency recessions provide a burning platform to improve operational efficiency. This includes lowering costs across various dimensions of a company from procurement, to travel to production costs. For example, retailers may find this an opportune time to renegotiate and reduce prices for real estate.
 - 5) ***Acquire, divest and refocus.*** High flyers used the recession to buy on the cheap, redefine the business portfolio and divest businesses to improve short-term cash flow, reduce losses, and position for future growth. Recessions are often a good time to buy assets for the short and long term. As recessions may be localized to countries – global companies may find price and currency advantages they can exploit in acquiring assets. Today a number of Asian and European companies are looking at acquiring US assets.
 - 6) ***Improve pricing to grow margins*** – as companies revisit their pricing, they are able to be more disciplined in pricing to customer value and price execution. One area for gaining returns is to focus on how well sales and marketing adhere to pricing policies across customers. Are they leaving too much on the table?
 - 7) ***Manage with data driven models*** – Using data driven models can help managers make more effective choices in preparing for and navigating a recession. A high correlation between GDP and sales can lead to better sales and likely revenue forecasts. Others may use EVA and other financial analyses to assess how well individual businesses contribute to the overall portfolio. A common fact base approach reduces the impact of distributive politics in organizational decision making.

Illustrative Examples

Colgate-Palmolive achieved consistent increases to their global revenues and profits in prior downturns. This was done through *innovative product launches and increased advertising spending to support their product sales, complemented by improved*

acquisitions, divestitures, and efficiency. In 1991, Colgate acquired the Murphy-Phoenix company, bringing a unique product to its portfolio that increased revenues and had significant international potential.¹ In 1992, it launched the Stand-Up tube and positioned it as a cleaner, environmentally friendly alternative to tubes and pumps.² In the first quarter of 2000, Colgate launched Total Fresh Stripe, which strengthened its leading position in toothpaste. The introduction of Speed Stick clear antiperspirant and Palmolive Spring Sensations dishwashing liquid also increased market share during 2000.³ While introducing new product-variations, Colgate also improved its margins by consolidating manufacturing and distribution, investing heavily to automate old plants, and getting rid of unrelated businesses.⁴ While some may argue that personal-care products are recession-proof, Colgate-Palmolive's unwavering commitment to investing in product development and growing both revenue and profitability enabled it to outperform peers with similar products in both the recessions.

Danaher Corporation also performed well during both the 1990–1995 and 1998–2003 periods through a combination of acquisitions, improved efficiency, and better product and financial management. In 1990, it acquired Easco Hand Tools to grow incremental sales and earnings by broadening distribution channels, increasing international sales, and generating efficiencies from consolidating overheads and improving factory utilization. In 1991, the company also formed Danaher Tool Group, Industrial Products Division to become more market-focused by bringing leading brands under one umbrella and providing end-users with a complete package of industrial products.⁵ Danaher was able to reap the benefits of acquisition and consolidation and its profit more than doubled while revenue grew by 14 percent in 1992.

The “Danaher Business System” and its discipline with mergers, acquisitions, and consolidation was a key to this success. While many companies believe it is best to maintain the culture of an acquired company, Danaher focuses on how to improve

¹ “Colgate to acquire Murphy oil soap”, PR Newswire, July 2, 1991

² Kathleen Deveny, “Toothpaste Makers Tout New Packaging”, The Wall Street Journal, November 10, 1992

³ Form 10-K filed by Colgate-Palmolive to Securities and Exchange Commission for the fiscal year ended December 31, 1999

⁴ Gretchen Morgenson, “Is Efficiency Enough?”, Forbes, March 18, 1991

⁵ “Danaher forms Industrial Group”, Industrial Distribution, August 1, 1991

margins through all available means. Even before a deal, its executives undertake a careful estimation of an acquisition-target's profit margins as a Danaher company. For example, when Danaher bought Fluke in 1998, margins were 8 percent, but managers believed these margins couldn't climb to 20 percent without hurting quality and innovation. Fluke had an engineer-centric culture where most good ideas got funding. Danaher changed this. Fluke narrowed its product focus, sped-up inventory turns, and reduced floor space, and by 2006, margins rose to 21.5 percent.⁶

Danaher also restructured its finances to lower its cost of capital and improve performance. It entered into a credit agreement with Bankers Trust Company in 1990 for \$300 million. The proceeds from the financing were used primarily to refinance Danaher's existing senior debt, including debt assumed as part of the company's acquisition of Easco Hand Tools, Inc. Annualized interest savings from the refinancing were expected to exceed \$1 million.⁷ Danaher also completed a \$100 million private placement debt financing in 1992 to improve the capital structure of the company. This debt-financing represented the lowest cost of long-term capital in the company's history and provided added flexibility to finance its future growth.⁸ Effectively synchronizing strategies pertaining to acquisitions, finance and operations maintained Danaher's high-flyer status through multiple downdrafts.

As these brief examples illustrate there are a variety of strategies that contribute to the bottom line and help companies navigate through recessions. Managers at high performers during recessions seem to approach strategy from a broader perspective, using alternatives beyond cost cutting and lay-offs and focusing resources to the core longer term mission and success of the company. Indeed when we looked at the contrasting low performers, we found they often managed core processes like receivables poorly or chose to indiscriminately cost cut through lay-offs, only to find it difficult to restore staff to

⁶ "A Dynamo Called Danaher - The Rales brothers' sprawling conglomerate makes everything--especially money", Business Week, February 19, 2007, http://www.businessweek.com/magazine/content/07_08/b4022065.htm

⁷ "Danaher announces \$300 million refinancing", PR Newswire, September 10, 1990

⁸ "Danaher announce \$100 million debt placement", PR Newswire, December 1, 1992

support future growth after the recession. As recessions do not last forever, it will be prudent to set up playbooks in advance for navigating back to growth.