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Thriving in the eye of the storm

Gearing up in a downturn

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The financial meltdown of late 2008 has morphed into a full-blown global economic downturn – causing business failures, layoffs and, consequently, shrinking demand. As governments worldwide battle the crisis, businesses are bracing themselves for an even more challenging year ahead. The most progressive firms will aim not just to survive but to emerge ahead of competitors. In this article, we examine the typical business responses to collapsing demand – from slashing capacity to price cuts and diversification – and argue that firms need to ride out the storm in a way that builds competitive advantages for the inevitable recovery.

Global meltdown

While the world has experienced several recessions – from the Great Depression in America during the 1930s, the stagflation of the 1970s and early 1980s, the Asian financial crisis of 1997-98 and, most recently, the dotcom bust and recession of 2001-2002 – the current economic crisis is widely seen as the worst since the second world war, both in terms of scale and the speed with which it is spreading globally.

During the Great Depression, it was estimated that a total of 9,000 banking institutions in America closed down. The Asian financial crisis marked the collapse of many iconic corporations in the region such as Finance One (Thailand's largest financial company at the time of the crisis), Daewoo Group and Kia Motors in South Korea. The 2000 dotcom bust resulted in the failure of approximately 50 percent of IT companies in the US.

The recent crisis began with some of the largest business failures in the history of the financial and banking sector. Global investment banks, which just a year ago had boasted enviable profits, such as Bear Stearns, Washington Mutual and Lehman Brothers, were forced into liquidation or acquisition at the point of bankruptcy, sending shockwaves across the world. The subsequent credit crunch sent the real economy into a slump.

The current crisis underscores the powerful links between countries and between the financial sector & real economy

Compared to past crises, businesses are now more globally-integrated than they have ever been. This has accelerated the movement of the crisis from the US and Europe to the rest of the world.

Economies with large export sectors, including many Asian economies such as China, Korea, Taiwan, Thailand and Vietnam, are experiencing severe difficulties. As China's exports fell by 17.5

percent year on year in January 2009, the IMF revised its 2009 China GDP forecast to a little over 6 percent, a shocking development in light of the 10-11 percent growth rates China has become accustomed to. Thousands of small and medium-sized factories in China are facing closure due to slowing export demand. Singapore, one of the most export-reliant countries in the region, has braced itself for a GDP contraction of approximately 4 percent in 2009.

In December 2008, China's consumer confidence fell to a six year low.

lowest level in six years as plant shutdowns and employee layoffs gathered pace¹.

Apart from the wide geographic scope, the current crisis is also notable for spreading quickly from the financial sector to the real economy. In China, for instance, consumer confidence in December 2008 fell to its

The depth of the current crisis has prompted many firms to resort to traditional remedies, such as reducing capacity and cutting prices. Nevertheless, it is always darkest before the dawn. The true test for companies does not just lie in weathering the current crisis but in thriving during the recovery that will inevitably follow.

Paving the way for success

Business reactions to the economic downturn have been largely similar across the decades. Cost-cutting exercises such as downsizing staff and plants are the order of the day. However, there is now a widespread recognition that excessive cost-cutting may hurt a company's long-term viability. This was the lesson learnt since the year 2000, when excessive downsizing in reaction to the crisis of 2001-2002 weakened the ability of many firms to take advantage of the boom years of 2005-2007.

According to recent research by consultancy Hay, more than half of UK business leaders admitted that they had the wrong strategy for coping with the economic slowdown. In the US, eight out of 10 executives believed their companies were better prepared for a downturn than their competitors, but few had taken any practical measures beyond cost cutting. The survey identified a lack of forward planning for the post-recession recovery².

An economic downturn can be an excellent time for change and innovation.

For some companies, the current economic environment will challenge their very survival. But for others, the downturn offers the chance to extend their lead over the competition. Despite the downsides, an

¹ China Daily, "Consumer confidence hits 6-year low", 9 Jan 2009

² Management-Issues.com, "Boom generation can't cope with downturn", 9 Jul 2008

economic crisis can be an excellent time for change and innovation.

In fact, many of today's largest corporations were founded during hard times. Companies such as P&G and GE grew substantially during the long depression starting in 1873, and have been growing since. Fedex, one of the world's leading delivery service providers, was established during the oil crisis of 1973. Those soaring oil prices of the 1970s also aided the breakthrough of Japanese carmakers into the US market, laying the foundations for their huge success over the next three decades. Technology companies, such as Cisco and Google, were able to take advantage of the dotcom crash in 2000 to develop their leading positions in the IT industry.

While the story of each of these companies is different, the evidence suggests that hunkering down and focusing on survival is the wrong recipe for a recession. This article will explore different ways in which firms can use the current downturn as an opportunity to build competitive advantages.

Taking the lead

Business strategies in a downturn should aim to build shock absorbers for the plunge in demand, yet at the same time seek new pastures for growth.

1. Corporate and operations restructuring

During recessions, companies are under more intense pressure to maintain a strong financial position in view of market uncertainties. As a result, almost all organizations engage in short-term measures to reduce operating costs during this period. But for established companies, there are many corners that can be cut without jeopardizing long-term business viability - and in fact enhancing it.

Off-shoring and outsourcing

Traditionally, off-shoring and outsourcing have been driven by the search for lower costs. However, globalization and the rise of emerging markets since the late 1990s have led more and more companies to invest in R&D, production and after-sales service in emerging economies in order to be closer to their customers in these markets.

As these emerging countries developed, the scope being outsourced to them gradually expanded beyond manufacturing and basic services towards higher value-added services.

Logitech, a global IT manufacturer, placed its global design centre in China so as to draw on China's less costly talent pool. For similar reasons, various other

companies such as Hewlett-Packard, Sony, Siemens and Hitachi established R&D centers in India, China and Southeast Asia.

The downturn may create the impetus to relocate higher value-added facilities closer to the world's fastest growing markets, which usually offer lower cost structures as well.

Shopping for acquisitions

The underlying trends that have driven consolidation across a range of industries persist. For those in the privileged position of having surplus cash or access to financing, a downturn offers an opportunity to acquire new assets or capabilities at attractive prices. And it should be recalled that recent estimates place the largest US corporations as holding well over US\$ 500 billion in cash, with the top Japanese firms holding a similar cash position.

Many large corporations pursue an aggressive merger and acquisition (M&A) strategy during times of crisis. The recession forces a great number of companies to divest their assets for liquidity, creating an exciting environment for cash-rich companies seeking mergers, acquisitions and alliances.

Emerson Network Power, a leading vendor in the network power equipment and data centre solutions market, acquired Huawei Avansys Power Inc during the period of market slowdown in the beginning of 2000. This investment was a strategically important step for Emerson, which emerged as the China market leader in later years. Avansys provided Emerson with Chinese production lines and enabled it to gain access to an extensive China-wide distribution network, a crucial competitive advantage.

Likewise, in the aftermath of the Asian financial crisis in 1997-1998, many large corporations were able to proceed with profitable M&A deals. Hyundai, for instance, acquired Kia Motors, marking its entrance into the automotive big league. GM's purchase of Daewoo Motor helped the former to establish a strong foothold in the growing Asian market.

In the same vein, in late 2008 financial giants such as Bank of America were able to acquire troubled investment banks at a fraction of what they were valued at just a year earlier.

The benefits of scale, broader geographic reach and access to scarce resources, combined with low asset prices, will continue to make M&A attractive in these troubled times.

IT-orientation

During recessions, the IT sector tends to see more demand for cost-optimizing solutions. When companies are cutting budgets and capacity, they tend to implement IT processes that help reduce operating costs – for example Warehouse Management Software to reduce inventory levels in warehouses, or VOIP systems to reduce telecommunications costs.

Such cost reductions include alternatives to travel, such as virtual meeting rooms or video conferencing. Microsoft's Unified Communications Service, which provides video-conferencing, recorded approximately 100 more clients in the Asia-Pacific region in the 12 months leading up to March 2009⁴. Other companies such as SingTel and Cisco Telepresence have also experienced a surge in customer demand for video conferencing and related software.

Another area where the application of technology promises to reduce cost is document and printer/copier fleet management solutions. Such services aim to reduce the cost of printing, copying, paper and hard-copy document storage - for example, by cutting the machine installed base to raise machine utilization and by shifting more document workload towards paperless systems of approval and storage. Printer/copier vendors such as Hewlett-Packard, Fuji-Xerox and Ricoh offer solutions around this theme.

One of the best ways to stay ahead of competitors is by adopting cutting-edge technology and one of the best times to deploy such technology is during crises, when low priced mid-to-long term contracts are available from vendors. It makes sense to invest in innovation during such times, not only to reduce cost but also to improve information access to enable better strategic decision-making, for example by investing in on-line channel management systems or Customer Relationship Management (CRM) solutions.

The current downturn will create opportunities aplenty for vendors to sell cost-optimization solutions as well as for customers to bargain down the price of previously unaffordable productivity-enhancing technologies.

Barter trade

Bartering refers to the age-old practice of exchanging products and services among businesses, eliminating the need for cash transactions.

Bartercard New Zealand, a prominent an online platform for barter trade among its members, reported a 12.6 percent growth in December 2008 from the previous year, with total trade volume through the site reaching USD23.5 million⁶.

⁴ The Straits Times, "Fly to conferences? Now, it's via video", 12 Mar 2009

⁶ Bartercard New Zealand, Press Releases, 16 Jan 2009

A Singapore accounting software firm A2000 Solutions adopted this strategy in 2008⁷. In exchange for its accounting software, the company received free printing, air-conditioner servicing and meals worth SGD10,000. And instead of time-consuming and often futile direct barter, the firm used Internet-based barter brokerages to get the deals sewn up.

Now might be the time to experiment with bartering to reduce the cash flow challenges that are the bane of so many businesses.

Sales leaseback

Sales leaseback contracting has become popular amidst the current credit crunch. Such arrangements can help companies to manage the risk of hefty capital investments while freeing up much-needed cash.

Under sales leaseback arrangements, after purchasing assets such as capital goods, the buyer enters a long-term agreement with a leasing firm whereby the asset is sold to the leasing firm and then leased back to the buyer at an agreed rate. One motivation is for the buyer to reduce financing costs and risks while at the same time maximizing cash holdings. Another is to manage the risk surrounding the ROI on the asset in a time of economic crisis.

Such arrangements have been common in the airline industry as the preferred mechanism for airlines to acquire planes. A number of US companies such as General Motors and The New York Times have recently explored sales-leaseback contracts for their office buildings.⁸

Now might be the time to get smart about capital expenditures – and for leasing firms to explore market expansion.

2. Revisiting Market segmentation

In times of crisis, the scramble for value intensifies as customers become more willing to “trade down” their purchases in terms of brand and product quality. The challenge for firms is to figure out how to maximize value to the customer while minimizing any erosion of brand equity and profit.

⁷ The Straits Times, “Age-old barter trade back in vogue”, 8 Feb 2009

⁸ International Herald Tribune, “Cash-hungry U.S. companies turn to leaseback deals”, 28 Jan 2009

Raising value to customers

Price drops are common responses to recessions, when competition is fierce and consumers are both price-sensitive and price-elastic.

Price drops are a common tactical response to recessions, especially for products and services where competition is fierce and consumers are both price-sensitive and price-elastic.

In February 2009, McDonald's in China reduced the prices of its set meals by up to one-third in response to falling demand and the easing of oil prices. The company has also committed to sell some items for as little as RMB 6 (USD 88 cents)¹⁰ in an effort to remain competitive. Similar price reductions have been noted among other fast-food chains throughout the country.

However, while it might boost sales volume, price cutting could actually hurt a company's performance if not properly executed. For instance, Dell announced an aggressive price reduction across its product range in the US in response to the recession in 2008. Consequently, its Q208 revenue fell by 17 percent¹¹. Clearly there is a need to cut prices smartly, ensuring that one's products are at a competitive premium and that prices are cut only for relatively price-elastic customer segments.

Meanwhile, "discount suppliers" who position themselves as selling at low-cost with no-frills, are using price discrimination to help ride out the crisis. This process involves charging higher prices to customers who are willing to pay for "frills." Asian budget airlines such as AirAsia and Tiger Airways have been noted to offer such pricing schemes, charging extra for add-on services such as check-in baggage, seat selection, in-flight meals and extra leg-room.

New products for hard times

New product introductions to address heightened price-sensitivity can be a powerful tool to increase the perceived value provided to customers.

One of the best-known examples of this strategy was the success of Japanese automobile manufacturers in expanding in the US market during the 1970s. Back then, the economic recession coincided with rising gasoline prices. Capitalizing on this trend, Japanese automakers such as Toyota and Honda were able to successfully penetrate the US automotive market by releasing compact, fuel-efficient cars. American automakers such as Ford and GM, on the other hand, failed to respond quickly enough to this consumer demand shift.

¹⁰ International Herald Tribune, "McDonald's lowers prices in China", 5 Feb 2009

¹¹ Business Week, "Dell's Quarter Saved by Cost Cuts", 21 Nov 2008

The success story of Lotus, a business software vendor, offers another example of how new products can help a company thrive despite harsh economic conditions. Even though it was established in the midst of the economic recession of the 1980s, Lotus software recorded sales of USD53 million during its first year of operation¹². It was the first software to fully demonstrate the effectiveness of computerization in improving business productivity, a function sorely needed by firms grappling with the crisis.

Similarly, SAP, a leading provider of business IT solutions, launched a new software – SAP Business Suite 7 – in 2009 to enable customers to optimize their IT and other operational costs.

Service

As an economic slowdown often freezes capital expenditure, services become increasingly important to maintain and optimize existing plant and equipment. A number of manufacturers have successfully switched from being hardware-oriented to being service-oriented. This is especially true in the IT industry.

In recent years, leading IT hardware manufacturers have moved towards providing total solutions around the boxes they sell, including software and services. Companies such as Hewlett-Packard, Fuji-Xerox and Lexmark now provide office optimization solutions alongside their traditional hardware products like printers and copiers machines. In mid-2008, Hewlett-Packard acquired Electronic Data Systems Corp in an attempt to boost its services footprint. Equipment manufacturers such as Siemens now provide logistics and business consulting services for assembly line optimization.

Amidst the current drought in capital expenditure, more investment will shift towards servicing and optimizing the existing stock of capital goods rather than buying new ones – creating opportunities for vendors and customers alike.

Customer focus

As an economic crisis tends to change old-established buying habits, now might be the time to build linkages to new and unfamiliar customer segments.

Since the worsening of the downturn in 2008, a number of US companies have been rolling out marketing and promotion campaigns to target female customers, a segment which is perceived to be more stable during an economic downturn and which controls the bulk of household spending¹³.

¹² Business Week, "Startups in a downturn", 23 Feb 2009

¹³ The Economist, "Hello, girls", 12 Mar 2009

Frito-lay, a snack food division of Pepsi Co, has launched a marketing campaign named "Only in a Woman's World", aimed at attracting female consumers. McDonald's was seen for the first time to sponsor New York Fashion Week. Companies in the financial services sector are also increasingly targeting this customer segment for credit card and insurance plans.

As the economic crisis deepens, companies are also increasing focus on the growing population of more cost-conscious customers. This trend is especially evident among premium brands and manufacturers.

In 2009, Starbucks officially introduced an instant coffee mix for the US market, a significant departure from its traditional premium brand positioning. The same product has already been launched in China. This is not, however, Starbucks' only foray into a non-traditional category. In 2007, the company launched a line of ready-to-drink, chilled cup coffee in South Korea, marking its entry into this new segment.

In the IT space, Dell launched low-cost notebooks for both consumers and small businesses in Asian markets last year, and plans to roll out even more¹⁴. Hewlett-Packard and Acer are likewise launching low-cost notebooks.

With both inflation and inequality on the rise, the field of marketing is becoming increasingly bipolarized between high-volume/low margin and low-volume/high margin. A number of businesses are trying to move in the opposite direction along the value chain, targeting the more affluent customer.

Tata Motors, for instance, was present only in the low- to mid-end segments in India and a handful of other developing markets. But with its purchase of the venerable Jaguar and Land Rover brands, it will sell luxury vehicles alongside the compacts.

In 2008, Korea's Hyundai launched the Genesis, the company's first luxury car, in the US market. Hyundai's new car was comparable to BMW and Mercedes vehicles, but at a slightly lower pricing. With this positioning launched during the start of the economic slowdown, the car captured the interest of US consumers. It was awarded the Car of the Year award at the 2009 Detroit Auto Show¹⁵.

Light of dawn

Despite the challenges it brings, a recession will at the same time present businesses with opportunities to expand and gain leadership over competitors.

¹⁴ Washington Post, "Dell plans more low-cost models in Asian notebook push", 29 February 2008

¹⁵ The Economist, "Why the South Korean carmaker is doing well in the downturn", 5 March 2009

Companies should not sacrifice long-term competitiveness for short-term advantage.

competitive advantage.

While coping with the sharp decline in demand and delays in capital investment, it is important for businesses to not only look at short-term measures but at the same time, focus on strengthening their long-term

Economic downturns bring more than just lower asset prices. They also bring an expectation on the part of customers and suppliers that long-established patterns should change. Hence downturns have long been considered a golden opportunity for businesses to invest in the long-term and at the same time change the rules of the game to make disruptive market share gains in the short-term.

However, the advantage in this game will accrue only to firms with healthy reserves of cash or access to financing – and in the current crisis, these are in a minority.

Having said that, small and medium business will have the advantage of focusing on niche customer segments where the investments needed are not huge. Large and well managed corporations may still be able to tap capital markets when these eventually stabilize, and some signs point to this already happening. And as for the small group of firms that are considered “too big to fail”, they will enjoy access to government bail-out funds to support strategic improvements – provided, of course, that they keep those executive bonuses in check.
