Moving up in a downturn

Smart incumbents and challengers alike build advantage during slack times.

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Recessions are unnerving. Price pressures increase while sales decline. Competition intensifies. Suppliers go out of business. But some companies seem to emerge from a recession with renewed strength. Some industry leaders fight off challengers to reinforce their market leadership. Smart challenger companies move ahead of their peers and into positions of leadership.

The stock market appears to be able to identify likely postrecession leaders and reward them with significantly higher valuations relative to their peers. During the 1990 to 1991 US recession, the gap between successful and unsuccessful incumbent leaders[1] in terms of market-to-book ratio increased from 12 percent in 1990 to 24 percent in 1991 and 38 percent in 1992. Among challengers, the gap between successful and unsuccessful companies widened from 5 percent in 1989 to 14 percent in 1990 to 18 percent in 1991 and 25 percent in 1992. The resulting increase in leaders' overall share of market capitalization gave them additional power to act as shapers in their industries, building a virtuous cycle of increasing valuations and better performance.

Successful strategies in a downturn

To identify how successful companies emerge from a downturn as leaders in their industries, we segmented 1,200 US companies by the change in their relative performance over a 20-year period, including the 1990 to 1991 recession.[2] We then compared and contrasted the management strategies of winning and losing industry leaders and challengers during the recession to the strategies of winners and losers in expansion periods before and after. We emerged with a list of nearly 150 companies that either remained or became industry leaders during the recession.

What did successful companies do that can lend insights in the current economic cycle? Challengers who emerged from the recession in the top quartile of their industries acted on many of the same levers as successful leaders who maintained their position, though challengers did take advantage of the downturn in ways that top quartile incumbents could not. Also, as might be expected, the strategies of the winners in both groups were different during the recession than during times of expansion (Exhibits 1 and 2). Our research uncovered strategic patterns of pursuing M&A, driving capital and expenditure efficiency with a vision of the future, and conservative debt financing.

Opportunistic M&A

The 1990 to 1991 recession appears to have been a good time to hunt for well-priced acquisitions, despite a significant reduction of overall M&A activity in and immediately after the downturn. Leading companies that retained their leadership status conducted 33 percent more M&A activity[3] during the

Exhibit 1. Strategies of successful leaders relative to their unsuccessful peers

Strategic lever	During the recession (1990–1991)	During the expansion ('80s and '90s)
M&A activity	• Higher M&A activity • Focus on smaller deals	• Significantly lower M&A activity • Focus on larger deals
Asset efficiency	• Significantly reduced and focused capex • Higher fixed assets and working capital productivity	• Somewhat lower capex • Similar fixed assets and working capital productivity
Cost efficiency	• SG&A expenditure refocused rather than cut back • Higher employee productivity • Higher R&D expenditure • Higher advertising	• Lean SG&A expenditure management • Higher employee productivity • Similar level of R&D expenditure • Somewhat lower advertising
Financing capacity	• Significantly higher debt financing capacity • Cautious use of excess cash	• Similar debt financing capacity

Source: McKinsey analysis

recession and 75 percent less activity outside the recession than did their unsuccessful peers.

The suggestion: successful top-quartile incumbents benefit from opportunistically picking up failing competitors at knock-down prices or by making surgical acquisitions of specific desired assets. Deals completed during the recession averaged only $85 million, an almost 90 percent decrease from their prerecession average of $645 million. This pattern should not come as a surprise, given the disproportionate management attention and integration effort that large M&A deals require. Leaders in a recession focus on protecting and improving their existing businesses; they are less likely to risk shifting management focus from the recession to executing and integrating a major acquisition.

Great Lakes Chemical, for example, a leader in the specialty chemicals industry, used the recession to reinforce its position through a series of M&A transactions, projecting itself to a top ranking in the industry.[4] The company made ten acquisitions in the 1990 to 1992 period alone, which contributed to its compound annual sales growth rate of 18 percent. At the same time, Great Lakes Chemical averaged a return on invested capital of 28 percent. To achieve this M&A-driven growth, the company exploited its under-leveraged balance sheet and already high level of operational performance. As a result, in terms of total return to shareholders (TRS) Great Lakes Chemical outperformed the S&P chemicals index by almost 270 percent between 1988 and 1993.

Exhibit 2. Strategies of successful challengers relative to their unsuccessful peers

Strategic lever	During the recession (1990–1991)	During the expansion ('80s and '90s)
M&A activity	• Similar M&A activity • Focus on significantly larger deals	• Significantly lower M&A activity • Focus on somewhat larger deals
Asset efficiency	• Significantly lower capex	• Significantly lower capex
Cost efficiency	• Significant cut-back on SG&A expenditure • SIgnificant cut-back on R&D • Significant cut-back on advertising	• Similar level of SG&A expenditure • Significantly higher R&D • Somewhat higher advertising
Financing capacity	• Significantly higher debt financing capacity • Aggressive use of excess cash	• Significantly higher debt financing capacity

Source: McKinsey analysis

The acquisition activity of successful challengers does not appear on the surface to distinguish them from their less successful peers; our measure of acquisition activity shows no statistically significant differences between successful and unsuccessful companies in the challenger group. However, this belies a very significant increase over non-recession periods when successful challengers perform 63 percent less M&A activity than their less successful peers.

In fact, successful challengers executed significantly larger deals during the recession than all other groups, with an average deal size in the 1990 to 1992 period of $174 million—more than double that of the successful leaders group. At the same time, the average number of deals per company in a year decreased by more than 30 percent. This seems to suggest that during the recession, successful challengers pursued M&A transactions that provided them with greater strength to shape their individual industries and relied on superior skills in deal identification, structuring, and integration to manage the added complexity. This underlines the frequent assertion that superior M&A skills are a key success factor for successful challengers.

Southwest Airlines offers one example of a substantial targeted M&A program. Based on our ranking methodology, Southwest Airlines rose from its second-quartile status before the 1990 to 1991 recession to the top position in its industry afterwards. It achieved this by aggressively leveraging the buyer's market for Boeing 737 regional jets to boost its capacity at excellent rates. The airline then complemented the acquisition of aircraft by acquiring only the landing slots, not the entire business, of their failed competitor Midway Airlines in 1991. In terms of TRS, Southwest Airlines outperformed the S&P airlines index by almost 630 percent between 1988 and 1993.

Successful leaders spent 22 percent more on R&D during the recession than their unsuccessful peers.

Asset efficiency

During the last recession, leaders that remained leaders stood out as efficient users of assets. Over the period their capital expenditure (capex) and depreciation[5] were 29 percent and 25 percent lower than those of their unsuccessful peers. This compares with non-recession periods, when the successful leaders spent just 10 percent less on capex than their peers, and show similar depreciation/sales ratios to them. Of course, such an attitude to assets did not preclude aggressive expansion.

Duke Power, for example, successfully defended its leadership status during the last recession, accelerating the development of a series of alliances to expand its capabilities in nonregulated areas ranging from engineering to nuclear waste to trading. The use of alliances during the recession provided an excellent way to obtain a foothold in new markets with limited capex and prepared the way for a subsequent program of acquisitions. Between 1988 and 1993 Duke Power outperformed the S&P utilities index by almost 60 percent in terms of TRS. Moreover, the recent acquisition of Westcoast Energy is a further example of Duke Power's sustained capacity to successfully execute M&A even in the current time of uncertainty.

Challengers that succeeded had a similar approach to asset productivity in and out of recession: those that moved up to become industry leaders had capital expenditures nearly 10 percent below the average of their industries during both the recession and the period of economic growth. There is some evidence, however, that many of the challengers that were successful during the recession had excess capacity at the start—collectively, successful challengers had a median depreciation/sales ratio 6 percent above the industry median—and were able to transform their capacity advantage into market share advantage.

Dell Computer is one example of a good execution of this aggressive approach. Dell started investing significantly before the recession and continued expanding its capital base despite the downturn. Dell's invested capital grew by 20 percent in 1989 and by more than 60 percent per year from 1990 to 1991. The results are well known: Dell's market share quadrupled from less than 1 percent in 1989 to almost 4 percent in 1992. Between 1988 and 1993 Dell Computer outperformed the S&P IT hardware index by more than 520 percent in terms of TRS.

Efficiency, but with an eye to the future

Leaders that remained leaders typically enjoyed sound employee efficiency, but during the last recession this particularly distinguished them from their unsuccessful peers: the employee/sales ratio versus the average of their industry was 27 percent lower for leaders that maintained their top-quartile status than it was for leaders that did not.

This is not to say that the leaders that succeeded during the recession were those that religiously cut costs across the board. Indeed, successful leaders actually spent 14 percent

more on SG&A[6] than unsuccessful ones during the recession. This stands in sharp contrast to nonrecession periods, during which successful leaders spent 14 percent *less* on SG&A than their peers. In other words, leaders that succeeded during the recession cut back less than others on the nonpersonnel part of SG&A spend. Successful leaders spent 9 percent more (as a percentage of sales) on advertising, for example, than unsuccessful leaders in the recession compared to 3 percent less in nonrecession periods. Furthermore, successful leaders also spent 22 percent more on R&D[7] during the recession than their unsuccessful peers, contrasted with 9 percent more outside of the recession. The message seems to be that the industry leaders that remain successful concentrate on refocusing their SG&A expenditure during recessions, and do not merely cut it across the board.

Intel, for example, boosted its R&D expenditure during the 1990 to 1991 recession, reaching $780 million in 1992—an increase of 114 percent over 1989—with an increase in sales of 87 percent. Investment was also extended to Intel Penang in Southeast Asia, along with new operations in Ireland and New Mexico. The increase in R&D expense was considered necessary by Intel to "build the product . . . customers are demanding." Intel's commitment to R&D underpinned its strong performance during and after the recession, which helped strengthen its leadership position—between 1988 and 1993, Intel delivered TRS of almost 430 percent, outperforming the S&P semiconductors index by almost 40 percent.

Again, the story is quite different for challengers. During the 1990 to 1991 recession the successful challengers showed 13 percent lower SG&A-to-sales ratios than less

Challengers' excess cash/total assets dropped from a level 6 percent less than their industries prerecession to 41 percent below in 1990.

successful challengers, and had slightly better efficiency as measured by their employees-to-sales ratio. Unlike the situation with leaders, however, cutting back SG&A appears to have been successful for challengers. POGO Producing, an oil and gas exploration company, moved from the fourth to the first quartile of industry performers precisely by employing this strategy. During a period in which the company's sales increased by 15 percent, POGO reduced costs by 3 percent by focusing on profitable oil production and lower-risk oil exploration. This strategy paid off as POGO outperformed the S&P oil & gas index by over 150 percent in terms of TRS between 1988 and 1993.

Wise use of financing capacity

Finance theory suggests that debt-financing capacity should not have an impact on success, as companies always have an ability to raise equity. However, in our research lower leverage emerges as an important enabler of success both in and out of recession.

During the 1990 to 1991 recession, leaders that remained successful had 16 percent lower interest expense/EBITDA[8] compared with leaders who lost their top-quartile position. This compares to a difference of only 5 percent out of recession. These figures illustrate how

important low leverage can be during a recession. Similarly, successful challengers had 28 percent lower interest during the recession compared with 22 percent in nonrecession periods, underlining the importance of lower leverage both in recessions and expansions. Those leaders and challengers that entered the recession with significantly lower leverage than their peers were typically more successful, possibly because their lower leverage gave them much higher flexibility for opportunistic M&A, or to build for the future. The implication for highly leveraged companies is that they may need to focus their business portfolios through disposals. Unfortunately, a recession is generally a singularly bad time for this activity.

A source of significant difference among successful leaders and challengers was their ability and willingness to use excess cash to finance acquisitions and expansions. While the leaders that remained successful protected the excess cash on their balance sheet and their ratio of excess cash to total assets fluctuated around the average of their industry, successful challengers used their excess cash in their aggressive expansion. These challengers' excess cash/total assets dropped from a level 6 percent less than their industries prerecession to 41 percent below in 1990, and 30 percent below in 1991. At the same time, unsuccessful challengers entered the recession with significant excess cash balances and they continued to accumulate excess cash throughout the recession. The same measure for them stood at 19 percent above the industry in 1989 and reached 39 percent above the industry in 1991.

The 1990 to 1991 recession provided a significant opportunity for ambitious challengers to reposition themselves. Leaders, too, had to rethink and refine strategies to successfully defend their positions. While no two recessions are identical, corporate leaders in today's environment would do well to heed the lessons of the past. **MoF**

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[1] In our research project, we defined industry leaders as those in the top quartile of their industries. Challengers are those companies in the other quartiles as well as new entrants to the sample.

[2] Preceded by a long period of growth and characterized by low inflation, the 1990 to 1991 US recession is arguably the most appropriate comparison for the current global slowdown.

[3] Measured by an index of acquired asset value to total assets versus the average of their industries.

[4] According to our ranking method based on MVA (market value added) and ROIC (return on invested capital).

[5] We have used depreciation as a surrogate for asset intensity as it is not impacted by the age of the asset unlike net asset value; capex and depreciation were compared as a ratio of sales and versus the average of their industry.

[6] Sales, general, and administrative, measured by an index of SG&A-to-sales versus the average of their industries.

[7] Measured by an index of R&D to sales versus the average of their industries.

[8] Earnings before interest, taxes, depreciation, and amortization measured versus the average of their industries.

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