

Profiting from Leaner Times

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During leaner economic times, strong companies can capitalize on competitors' weakness to gain significant marketplace advantage. As a result, such companies can enter the next up-cycle in the economy much stronger than the rest of their industry and earn materially larger profits. In this paper we examine several strategies to achieve these goals.

There is little question that the US economy is going into a very difficult period after an extended period of remarkable growth and prosperity. For many companies this slower period has resulted in hunkering down to wait for the return of prosperity. The conventional wisdom is that companies should retrench, cut costs, lay off staff, squeeze their suppliers, sell peripheral assets and wait out the hard times. Indeed the classical remedy for companies with over-leveraged balance sheets or whose cash flow wanes to dangerously low levels during bad times is to decree across-the-board cuts from on-high, and in so doing to pick up short-term financial gains.

Are these financially-driven steps enough to ensure a return to prosperity when good times return? In short, the answer is a resounding "No!" There are additional steps that companies should take to position themselves to become much more powerful in their industry during the next up-cycle. For companies with solid balance sheets, good cash flow, and a competitive bent, bad times become the catalyst to make themselves much, much stronger. They think and act well beyond mere hunkering down. And, when they do cut costs, they do so with a scalpel instead of a bludgeon, focusing only on removing real excesses and protecting the capabilities that will be key to future prosperity. Such companies emerge from hard times significantly more powerful than their peers and can go on to dominate their industries. In this paper, I will review a variety of strategies for achieving such results and give a more detailed case study to show how to customize them to meet your company's particular challenges.

Some general strategies for profiting from leaner times

In the course of our client work over the past two decades we have employed a variety of strategies for helping financially strong companies gain further advantage over their weaker competitors during hard times. These strategies generally combine approaches of three general types:

1. Exploiting your competitors' problems to your own advantage.
2. Using the economic downturn as a galvanizing event to resolve festering internal issues.
3. Refining your company's go-to-market and product strategies.

To make these strategies more tangible, we will give several examples of each and illustrate these examples with situations in which they have been successfully employed. These examples are not meant to be an exhaustive list of all possible ways to gain from harder times. Rather, they are meant to stimulate thinking about how different elements of your company's strategy can benefit from taking this more aggressive posture in the face of a weakening economy.

Exploiting your competitors' problems to your own advantage

The two sample strategies we will give below show how an aggressive, financially sound company can gain major advantages at the expense of its competitors when lean times make them weaker and more vulnerable than usual.

- *Using your competitors' distress as a time to buy assets on the cheap.* Often competitors are forced to raise cash to meet the exigencies of hard times. They wind up selling business units, product lines, customer bases, distribution channels, intellectual property or facilities at prices below replacement cost. Your company with its stronger strong balance sheet and cash flow can capitalize on their neediness by buying these assets at distressed prices to build its position for the coming better times. Fuji Photo Film is currently profiting in this way from Xerox's cash crunch. Fuji has already purchased a half-interest in Xerox' Chinese subsidiary at an attractive price by arranging for Xerox to sell it to their 50/50 joint Venture Fuji-Xerox. Moreover, as Xerox' woes have worsened, Fuji is about to buy half of its partner's share in their 50/50 JV, giving it a controlling 75% interest. At the same time, financial players such as LBO houses are negotiating to buy other solid parts of Xerox' business, thus taking advantage of the seller's weakened financial position.
- *Out-innovating your currently weakened competitors.* Exciting new products that offer customers significantly better value may help your company gain market and profit share at a time when your competitors are more inwardly focused as they try to cope with the financial downside of the recession. As better times return, customers will perceive your company as the market leader with new thinking, new ideas, and a strong focus on helping its customers. Intel followed this strategy as it abandoned the memory chip business in the 1980-81 recession and concentrated on the then-new technology of microprocessors. In this way, Intel moved from being one of several players in the fiercely competitive memory systems market, to being the unquestioned leader in the microprocessor market, and, in so doing, grew its business approximately ten-fold over the ensuing decade.

Using the economic downturn as a galvanizing event to resolve festering internal issues

With these three strategies we illustrate how companies can use the downturn as a lens to focus on strength-sapping efforts that were begun in better times and that have not delivered on their promises.

'Actually the stronger companies really benefit in a difficult situation'
COO, Dell

'The only way to come out of a recession is with new products.'
CEO, Intel

- *Facing up to the long-running development project or new market initiative that seems to have taken on a life of its own and is no closer to success than it was a year ago.* A weaker economy is a perfect time to scale this initiative back to a more realistic level of effort...or pull the plug. The resources thus freed up can often be put to much better uses that will assure a faster return to corporate prosperity. Al Zeien, the former CEO at Gillette, was famous for offering the leaders of such projects the choice of continuing what they were doing or a plum assignment elsewhere in the company. With this clever approach, he did not need to close down the bad projects—the projects’ leaders quickly ended them for him.

[We are] cutting out anything that is not absolutely necessary, but avoiding cutting into anything that affects long term strategy and growth ‘ CEO, Sprint

- *Addressing the structural issues that you have been putting off solving.* Every company has those marginal extra sales people who never quite earn their keep or that extra layer of management or staff department that seemed so necessary during the fat times. Deal with these issues by either redeploying this staff to more useful roles or letting them go. One client of ours had the interesting problem that each of its five divisions reported fat margins, but the company as a whole was only modestly profitable. The root cause of this seeming oxymoron was a large block of “corporate costs” that seemed to be no one’s direct responsibility. When we examined these costs in detail, 77% of them could be unambiguously associated with activities of specific operating divisions, while the remainder were truly corporate costs such as the CEO’s office, treasury operations, benefits administration, and investor relations. The resulting restatement of the company’s accounts the showed that virtually all of the company’s profits came from just two of its five divisions. The other three divisions were then put on strict fiscal diets, and two of them were sold to competitors who could realize scale economies and make them profitable.
- *Reviewing past automation or restructuring projects to make sure that the promised savings have been realized.* I recall one company that had, through a succession of automation steps and process improvements, reduced its headcount of front line customer service reps from 450 to 230. Unfortunately it had retained the same 5-layer, 73-person management team with its eleven million dollar annual cost despite the obviously much reduced management workload. When leaner times came, the company saved a quick five million dollars annually by de-layering and shrinking Customer Service’s management team with no adverse impact on the customer’s experience.

Refining your company’s go-to-market and product strategies

Harder times are often the best times to review the product line and customer base. Is every product a profitable winner? Are all customers solidly profitable? Are the sales force and marketing programs as vigorous as they need to be? Are they targeted on the best market opportunities? The four example strategies below illustrate ways in which to address any of these questions where the answer is “No”.

- *Rethinking the customer base and/or the product line.* Our experience with numerous companies is that 10-30% of the customer base is marginally profitable at best and, in many case, outright unprofitable. Similar results apply to most companies’ product

lines, where the peripheral line extensions that once seemed to be good ideas add more to cost than they do to revenue. Leaner times often skew this curve even more strongly, as some formerly attractive customers may suddenly become quite marginal. By changing the terms under which you do business with these customers and/or streamlining the range of offers that your company brings to market you can make these marginal customers and products profitable or shift them from being drains on your company's P&L to problems for your competitors. Published reports suggest that several of the telecommunications equipment companies such as Lucent and Nortel need to take just these sorts of steps. Many of the 'new breed' service providers who had been large buyers of their new equipment thanks to the assistance of vendor financing will likely become problem credits for the vendors' finance subsidiaries.

- *Re-energizing the sales force.* During prosperous times sales forces often get lazy and simply become order takers. They forget how to scratch for a living, and, when harder times come, have trouble making their numbers. Wake up the educable members of the team and replace the others with reps who still know how to sell. This effort may entail any or all of the following:
 - Refresher training in how to identify the best-qualified prospects in light of changed economic circumstances.
 - Updating the sales force's understanding of customers' buying criteria, since customers' needs are likely to have changed in the new business environment.
 - Adjusting how the sales force positions your company relative to the competition, as some of the competitors' strength has been sapped by weaker financial performance.

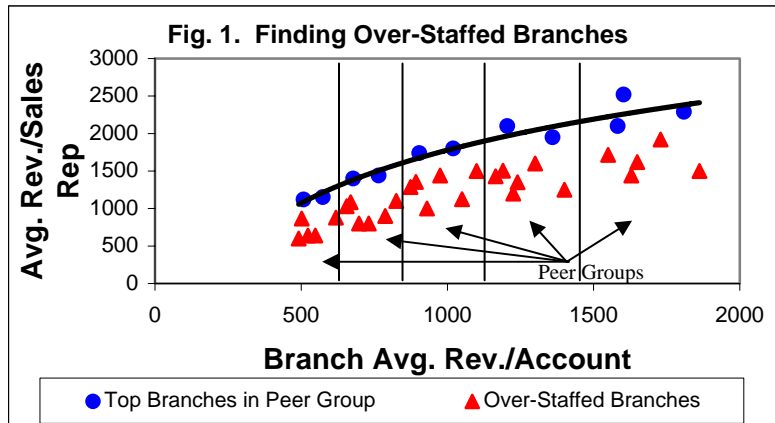
In recent work with a large information services company we used new market research and competitive intelligence to drive such a program. By positioning the sales refresher meetings as "Here is how we need to compete in the changed market", the sales force viewed the program as a help to their earning more commissions instead of as a personnel review and winnowing process. The resulting focus on selling more effectively to better prospects has been to raise the sales win rate by five to ten percentage points.

- *Redeploying the sales force to where they can do the most good.* One of our clients had dramatically increased the size of his sales force during a prosperous period. Whenever a branch manager saw additional sales opportunities in his territory, he would ask for and receive authority to hire more sales people. Unfortunately, no branch manager ever asked to have the size of his team decreased. As the economy tightened, the CEO suspected that he had too many salespeople in weak markets and asked us to help determine where there were opportunities to reassign salespeople to better territories.

'We're looking at the skills in our work force to make sure we have the right skills in the right places'

CEO, EMC

When we began to analyze the situation, each branch manager patiently explained to us that his territory was different from everyone else's and that we should not compare his results to those of his peers. Indeed, situations did vary: branches serving larger accounts tended to enjoy scale economies in selling, and different branches addressed radically different sizes of accounts. Nonetheless, by comparing sales branches in the same peer group, i.e., with a similar mix of business, we could identify which branches were over-staffed by examining those with low revenue per sales rep relative to their peers. See Figure 1. In this way we could pinpoint the 20% of the sales staff that could be safely re-assigned without impairing the ability of over-staffed branches in meeting their quotas.



- *Positioning your company for a “more for less” strategy by driving unit cost out of your company’s primary products and services and related back office operations.* In many industries, such as semiconductors, software, and video games companies compete by offering ever more value for less cost. For such companies constantly falling unit cost is a way of life. Thus, a given unit of computing power or telecommunications switching capacity can be delivered for half what it cost last year. For the telecommunications carriers, the dramatically increased capacity made possible by technological breakthroughs has caused unit prices to fall more than 25% plus in each of the past several years. The carriers in turn are forced to learn quickly how to deliver services at sharply lower unit costs to sustain their profitability.

By adopting a similar model (even if the rate at which unit costs drop will be less steep) other industries can improve the cost-value proposition that they offer to their customers without suffering financial penalties. Leaner times are often the best times to ask how your company can do the same.

A Case Study

To understand how to adapt some of the above strategies to a particular company's situation in a down economy, we need to look to the last recession for lessons. Accordingly, I have prepared the following case study based on how one of our clients, a business process outsourcing company, responded to the 1990-91 economic downturn and wove together some of these elements to produce a winning strategy. This company was

exquisitely successful in capitalizing on the weakened condition of its competitors, and in paring away only corporate fat when it was time to cut costs. In order to protect client confidentiality, I have masked both their name and some of the details of their business. Let's call them Wall Street Data Systems.

Wall Street Data Systems' situation

Wall Street Data Systems and its four main competitors had prospered mightily during the 1980s Wall Street boom supplying what we now call business process outsourcing to the securities industry. However, in the recession that followed, three of Wall Street Data Systems' four competitors had declared Chapter 11 within the span of seven months. These bankrupt competitors then started a price war to generate cash flow and Wall Street Data Systems' after-tax margins fell from 10%-plus to low single digits. Wall Street Data Systems' CEO called upon us for advice on what to do after several members of his Board led by the representatives of the controlling Stoner family began pressuring him to cut costs very aggressively. Their concern was that Wall Street Data Systems might be the next to go, endangering its own future and the Stoners' wealth and enviable lifestyle.

Analysis of Wall Street Data Systems' business

A quick review of Wall Street Data Systems' finances showed little danger of its following the competition into Chapter 11—Wall Street Data Systems had a strong balance sheet and sufficient liquid assets and cash flow to weather any but a 1930s-level depression. Conversely the three failed companies had all gone through LBOs during the fat times and now could not service their debt with their reduced cash flows.

Further, when we reviewed long-term financial trends among its primary customers, we discovered that Wall Street Data Systems' customers operated in a cyclical market, but one with a strong upward trend. See Figure 2 below. Moreover, Wall Street Data

Fig. 2. The Customers' Business Had a Long-Term Upward Trend

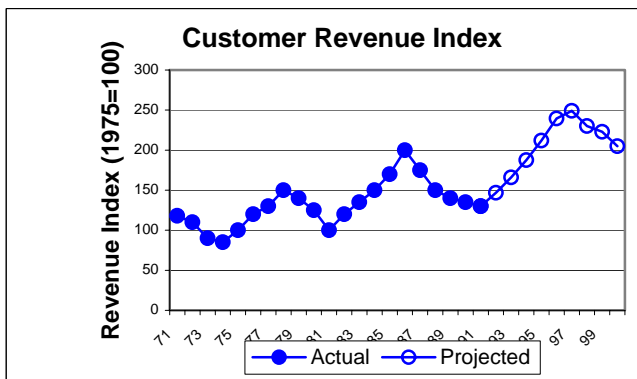
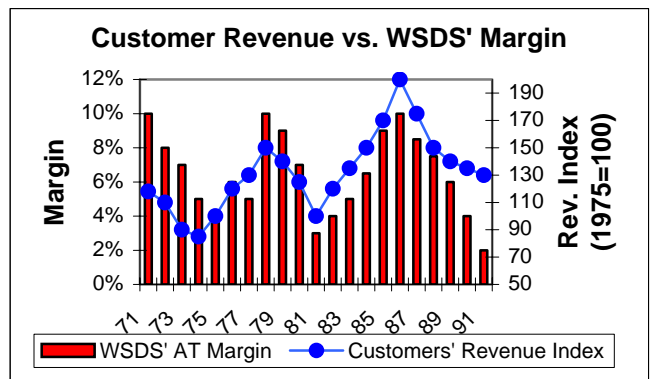


Fig. 3. Customer Revenue Linked Closely to WSDS' AT Margin



Systems' margins had historically fluctuated in lock step with the customers' business cycles; that is, when the customers had lots of business, Wall Street Data Systems had fat margins, and when the customers went through lean times, so did Wall Street Data Systems. Further, the American economy's need for future financing and therefore the scale of customers' future business revivals was clear. The customers' business had a

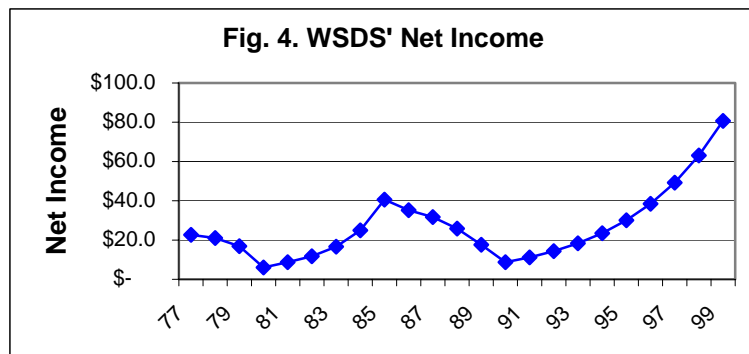
long-term upward trend, even as it cycled through richer and leaner times. The only thing we could not be sure about was precisely when that next cyclical peak would occur. See Figure 3 above.

Finally, we looked at the details of Wall Street Data Systems' business. Theirs was a business in which sales and service were paramount. Wall Street Data Systems went to great lengths to develop long-term client relationships and then defended those relationships by giving customers superior service. Although Wall Street Data Systems and its competitors tried to woo each other's customers, in practice customers tended to stick with the vendors who had delivered for them in the past.

How Wall Street Data Systems responded

With three competitors in bankruptcy, many customer relationships were suddenly up for grabs. Consequently we counseled Wall Street Data Systems to follow the twin strategies of (1) aggressively pursuing new customers, and (2) hiring top performing sales reps when its competition was in trouble. More specifically, we developed the following plan for Wall Street Data Systems:

- Aggressively woo the three weakened competitors' customers to gain additional volume with which to help cover overheads and boost Wall Street Data Systems' margins; in the down economy of the time, Wall Street Data Systems could handle the increased volume without adding production staff or facilities.
- Selectively hire the top 20-30 sales reps from the bankrupt competitors by focusing on those with deep relationships with marquee accounts.
- Very selectively pare away bits of added cost overhead that had accreted during the 80s Wall Street boom to free up room in the budget for these added sales reps.
- As the business recovered after the recession, carefully add new production capacity to sustain Wall Street Data Systems' traditional superior service with its newly enlarged business base.



Wall Street Data Systems' results

The net result is that Wall Street Data Systems entered the 90s Wall Street boom much stronger than its competitors. It went from approximately 30% market share to 45%, with the rest of the market evenly divided between its one surviving traditional competitor and a new company formed from the remains of the three bankrupt

companies. Further, among the most attractive and profitable customers, Wall Street Data Systems was clearly the supplier of choice, giving it a disproportionately large share of industry profits. During the 90s, Wall Street Data Systems' profits more than doubled the previous cyclical peak. See Figure 4 above.

The example of Wall Street Data Systems, which is tied to the cyclical ups and downs of its customers' businesses is typical of the situation in which many companies, especially high tech companies with their dependence on the capital investment cycle, find themselves today. As we have seen, a bit of cleverness and forward thinking can turn great advantage from the current economic downturn.

Sacerdote & Co., Inc counsels major technology-based companies on issues of market strategy and operations effectiveness. This white paper is the third in our current series on improving business processes for greater sales force throughput. We invite your questions and comments at gss@sacerdote-co.com.