NAVIGATING THE ECONOMIC DOWNTURN

Companies can survive the current crisis and come out ahead if they manage for value creation during the next few years.

By Mark Morgan

The fourth quarter of 2008 was a wildfire of negative economic news, including five of the 10 largest single-day losses in the history of the Dow. The housing market in the U.S. crashed, followed by the collapse of the banking sector. Shock waves of tsunami proportions moved from west to east as economic downturn began cascading across Europe and Asia.

The Dow closed at an all-time high of 14,140 on October 11, 2007. When the Dow hit 8,000 on October 10, 2008, Art Hogan, managing director at Jeffries, declared “enough was enough” on CNBC. Hogan made an argument that the market would sink no further after reaching a low we hadn’t seen since 2003. Investors wanted to believe it was true as more than two million Google searches were made on the Hogan bottom call.

But the decline was far from over. On December 11, 2008, the largest one-day loss of jobs in 25 years occurred when 58,000 new unemployment claims were filed. The new year brought optimism as the Obama administration tried to calm the economic storm with targeted stimulus investments. Instead, decline turned into free fall. February 2009 saw 600,000 jobs lost. The Dow ended January at exactly 8,000, then tumbled during the final 13 unlucky trading sessions of February to finish the month at an unthinkable 7,062.

Everyone hoped for improvement in March, but hope isn't a strategy, and the situation worsened even more. General Electric, the "iron man" of Wall Street, spiraled from $38 per share when the Dow hit its all-time high in 2007 to close at $6.66 on March 5, 2009, after cutting its dividend for the first time in 70 years and having the stability of its financing division questioned. Citibank went insolvent, and General Motors hinted at bankruptcy.

Insurance giant AIG provided the latest sucker punch in this economic fight when it declared bankruptcy. The value of the Dow is currently lower than at the time of the post-dot-com collapse and post-9/11 attack. Congress handed President Obama its latest $400 billion stimulus recommendations in early March that contained more than $200 billion of pork. Jim Cramer, host of CNBC's "Mad Money," described the package as "throwing a drowning man an anvil."

Across the globe, staggering amounts of wealth have evaporated. Japan's economy contracted at an annualized rate of more than 12% during the fourth quarter of 2008, forcing the government to invest more than one trillion yen ($10 billion) in corporate bonds and lower interest rates for borrowing to nearly zero. The economy in Latin America has contracted less than anticipated, but Brazil still experienced its largest decline in industrial production in 17 years. In China, 70,000 factories have closed, and millions of jobs have been lost in recent months.

Currency volatility continues to drive chaos as the European recession weakens the euro and Japan tries to weaken the yen to encourage consumption nations to purchase after exports fell at their fastest rate in more than 50 years.

The Dow kicked off March by closing below 7,000 for eight consecutive sessions. During this run, one share each of GE, AIG, GM, and Citibank could be purchased with a $10 bill. A share of GM stock cost less than a gallon of gasoline. The talking heads started yelling "turnaround" and "recovery" when General Motors announced better than anticipated liquidity and the Dow closed above 7,000 on the ninth trading day. If the Dow has found its bottom, then the journey to recreate the lost value can begin.

Entering a Prolonged Period of Turmoil

The economic collapse in Europe is at an early stage, while the U.S. and Japan are in full recession. Bailouts, stimulus packages, and low-cost borrowing are themes of the day, but they aren't sufficient to fix the underlying problem.

Recovery won't gain traction until normal credit flow is reestablished. The U.S. government authorized $700 billion in December 2008 for the Department of the Treasury to stabilize the nation's troubled financial sector. Half of this amount remained undistributed when the Obama administration took office, and $200 billion was diverted to the housing and automotive sectors. The housing and automotive prop-up was a gracious gesture to U.S. consumers, but there's still a gaping hole to repair in the banking sector. The stock market hasn't responded positively to the consumer-focused stimulus. The Dow closed down 20 of the first 30 days of the new administration.

Alan Greenspan estimates an additional $800 billion to $900 billion will need to be approved and assigned to the U.S. banking sector in order to stabilize the system, restore normal lending, and enable new capital investment. Meanwhile, the U.S. economy is sinking into the largest post-war recession as companies dramatically scale back production and trim inventories. The economy continues to contract faster than companies can react, and economic confidence doesn't exist in the West to restore positive outflow of product from the East.

Management teams must understand that the current economic trough is much deeper than previously experienced, global in scope, and will last a minimum of three years. Market and global economic conditions have radically changed since companies developed current operating plans and out-year strategic plans. It's essential to revise 2009 product portfolios and spending plans while recalibrating capacity investments over the next three years.

Value Creation During Economic Turmoil

The economic crisis requires a full focus on principles for value creation. Current operating plans must be reconstructed to reflect the realities of the marketplace while optimizing working capital generation and utilization. The recession presents an opportunity for companies that can act quickly and effectively to create new value. Research shows that the cost of equity hasn't fluctuated significantly despite the global economic chaos, so companies with a strong balance sheet and strategic discipline will be able to take advantage of the downturn to grow market share and create value at an attractive price.

This is an unprecedented time to mount a countercyclical investment strategy. Companies shouldn't fall into a defensive mode waiting to see how the economy develops—they must prepare to charge ahead by getting their balance sheet in an optimal position to fund growth through a countercyclical strategy of targeted investments to gain market share, broaden the portfolio, and build capacity.

The CFO must play a lead role in managing the downturn into a time of opportunity. Working capital and free cash flow will determine who is successful at creating value during the next three years. The wisest course is a micro focus on working capital and segment-specific market fundamentals while constructing a revised macro-level business strategy. The working capital and market-fundamentals analysis must redefine the current baseline for the business and shift priorities to drive a level of transformational change in both processes and functions that will significantly increase efficiency and fund the investment strategy.

Functionally, the CFO must assess the disruptive potential that volatile consumption and pricing will have on the organization's ability to generate free cash flow and diagnose the impact of the recession on liquidity within the customer base. Finally, the CFO must build a network of sound banking relationships to assure adequate resources are available when the timing is right to throw a strategic lever and make investments.

Parallel Tracks of Action

While balance sheet fundamentals are put in place on a micro level, a company must reassess its overarching business strategy. Table 1 features the fundamental concepts for working capital and value creation. The economic downturn will be a unique opportunity to grow market share and value, but speed of action, attention to detail, and execution will determine who has power and velocity to fuel their strategy during the upcoming protracted period of turmoil.

Companies most likely completed their 2009 business plan and forward-looking strategic plan prior to knowing the full impact of the domestic economic collapse that will become global in scale during 2009. The top strategic priority is to revise current portfolio and spending plans while reassessing the strategic out-years.

Current assumptions must be challenged because market conditions require a quick and dynamic response. Creating free cash flow, modeling revised planning scenarios, continuously gathering competitive data, and determining where to make targeted investments will result in value-focused execution. Companies should target to increase working capital equivalent to 20% of revenue as increased free cash flow will fuel strategic investment and fund a tactical advantage in the market. The economic downturn is a unique opportunity to make targeted countercyclical market and capacity investments.

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Companies also should construct a thorough analysis of the competitive landscape to see how the economy will impact marketing plans, R&D priorities, capacity investment, pricing, promotion, and consumption. To do this, a company should build a planning model to generate several probability-weighted scenarios that will be refined as new data is acquired and analyzed.

Marketing investment should be maintained in countries where companies hold a dominant share and increased in countries where second-tier status has been achieved. Investment should be minimized in countries where little traction exists and where the cost to achieve share growth is uneconomical.

The recession demands revised capacity analysis. It also creates an advantageous time to enter new partnerships and make portfolio acquisitions. Companies that hesitate to act will find it increasingly difficult to stand up, dust themselves off, and recover in time to finish the fight.

Leadership Excellence

Good leadership is the act of moving a group to a future point more effectively than they could arrive unassisted. While the definition of the act is basic, the leaders of an organization will ultimately determine the degree of effectiveness in progressing from current to future state.

The global business climate is in such an unprecedented state that leaders don't have learned experience to draw from. Financial journals, websites, and talking heads fill the pages and airwaves with fear and Draconian solutions. Leaders who succeed during this economic downturn and period of global chaos will resemble a gene-splicing of Vince Lombardi (a great coach), Peter Drucker (a management expert), and Ronald Reagan (the last great capitalist).

Leaders must bring a determined focus on maintaining

Table 1: Strategic Imperatives and Tactical Actions for Working Capital and Value Creation

STRATEGIC IMPERATIVES

- Recognize the economic downturn is deeper than previously experienced and is more global in scale.
- Immediately reconstruct the current operating plan and strategic out-years to reflect current conditions.
- Conduct a thorough assessment of the competitive landscape to identify likely business initiatives, strengths, and weaknesses.
- Build multiple operating scenarios linked to key internal and external assumptions.
- Build efficient and effective business models to optimize scenario analysis.
- Assign cross-functional strategic teams to drive transformational change across key process areas, such as order-to-cash, supplier relations, inventory management, cycle-time reduction, and capacity utilization.
- Reevaluate the existing product portfolio and regional marketing plans to prioritize programs and optimize return on investment.
- Identify targeted investment opportunities to outspend the competition in R&D and portfolio management where market share can be gained.
- Reevaluate R&D projects and associated capacity investments.
- Identify licensing and partnerships to expand market presence or economically gain resource scale.
- Make quality a priority for competitive advantage and to assure an uninterrupted market presence.
- Evaluate key business processes such as Order to Cash (OTC) and Sales and Operations Planning (S&OP) to optimize effectiveness.
- Maintain a compliant business environment for transaction processing and financial reporting.
- Open a war room for program management, cross-functional teams, and visibility to the strategic initiatives.
- Establish innovation cells within the organization to develop new methods and processes with increased speed of action.
- Empower teams to act, measure progress, and respond efficiently when a change of direction is needed.
- Identify realistic improvement targets for each internal process team, link to the overall working capital improvement goal, and report on a program dashboard.
- Increase diligence on gross-to-net revenue reconciliation, and implement senior management approval requirement for pricing and term deviations.
- Identify talent gaps in the organization, and monitor the environment for key talent hires to accelerate the execution curve.
- Measure and communicate the progress of process-improvement teams and initiatives against both timelines and financial targets.
- Monitor both key suppliers and customers for potential liquidity issues.
- Implement credit controls for customers where solvency is a concern.

TACTICAL ACTIONS

Cash Management and Cash Generation

- Increase detail, frequency, and accuracy of the cash management forecast.
- Increase liquidity updates from banks to a daily basis.
- Freeze headcount except for business-critical hires.
- Eliminate overtime and entitlement spending.
- Manage low performers out of the workforce while minimizing severance costs.
- Minimize pay raises, and tie bonus incentives to working capital generation.
- Cancel all offsite meetings except if sales and marketing related.
- Minimize travel in absolute terms while leveraging telephone and video conferences.
- Reduce contributions and trade-association funding to a minimum.
- Demand price concessions from consulting firms while monitoring quality of resources.
- Negotiate price concessions from vendors in top external spend areas (for example, advertising and R&D).

Accounts Receivable

- Work with key trade partners to optimize payment terms to a maximum of 30 days.
- Don't give extended terms to cause top-line growth that may come back as returns or obsolescence.
- Link discount incentives to improved customer inventory turns and shorter payment cycles.

Inventory

- Reduce days on hand by 20%.
- Focus resources to dramatically increase forecast accuracy and minimize obsolescence.
- Tighten capacity utilization associated with inventory control and cost to produce.
- Focus resources to optimize supplier performance for quality and delivery.
- Perform Pareto analysis of suppliers, target price reductions from the top tier, and identify consolidation opportunities in the lower tier.
- Motivate the procurement group with incentives to identify savings for both direct and indirect purchases.

Accounts Payable

- Advise vendors that payments will be extended to a 60-day window with no loss of discount.

Debt

- Build lines of credit with banks where a strong partnership exists with a global presence. These banks can propose innovative solutions, finance receivables, and assure adequate operating resources.
- Utilize long-term debt at attractive rates to fund targeted capacity and scale investments.

Equity

- Market conditions will make a share buy-back program an attractive strategy if adequate free cash flow exists.
- Continue paying dividends at current return rate, cash permitting.

quality and compliance, fundamental process execution, strategic excellence, contagious enthusiasm, unchallenged integrity, superior preparation, and dynamic action. They must be visible and approachable, enrolling and empowering, confident and consistent. Selflessness and absence of individual motivation must be evident throughout the management team. Communication of the current state, future vision, and progress toward achievement must be continuous and transparent.

Quality and Compliance

When making spending decisions during tough economic times, consumers are more attuned to value and functional benefits. Keeping reliable products in the market that have demonstrated value to the consumer is essential. A quality failure during these times will be disastrous as trade channels tighten their inventories and retail places a higher value on product turn.

The performance of the supply chain and order-to-cash process must be aligned around tight quality and compliance disciplines. Tough economic times shouldn't lead to cost reductions and process changes that compromise product performance or process standards. Effective quality procedures and regulatory process integrity are business insurance as a product recall or regulatory citation could pull your product from the market and paralyze business.

Financial compliance and reporting also ensure market integrity. When replenishment is low and pressure to deliver quarterly financial results is high, extended terms and channel loading is a great temptation. Overloading the market not only leads to audit, regulatory, and legal purgatory, but it also creates a significant cost barrier to bring product back into the space. Inventory-management agreements and internal process governance are essential disciplines to guard against shortsighted actions and poor judgment.

Optimizing Human Capital

Coordinating and executing the substantial list of actions requires the mobilization of significant resources from within the organization as well as enrolling trusted external business partners who are capable of adding the most value. Every person in the organization is a resource to the overall goals and should be tapped to contribute ideas, strengths, and focus. This will require senior management to significantly increase communication and coaching throughout the organization in order to build a winning culture while stretching resources.

Companies should also pursue new licensing agreements and partnerships to economically increase revenue-generating resource scale. New partnerships provide access to headcount, share the cost of capital, and shorten the time to market.

Forward-thinking companies recognize that a recession provides a prime opportunity for talent acquisition. Broad business experience and specialty skill sets will be available and potentially sourced from key competitors. Targeted talent infusion is an opportunity to increase the impact and velocity of initiatives while preparing the organization for post-recession execution.

Shared Traits among Winners

Companies that will emerge as winners over the next three years will demonstrate the following 10 "best-in-execution" characteristics:

- Take action immediately to create a dynamic strategy.
- Experience no product quality failures or business compliance issues.
- Become best in class at competitive intelligence, business modeling, and continuous improvement execution.
- Create a culture focused on building positive momentum and creating value.
- Build dashboards that link operating plans and tactical progress with strategic goals.
- Evaluate portfolio investment on a regional basis and make trade-offs effectively.
- Excel at internal and external communications to build culture, boost empowerment, and achieve shared understanding.
- Make targeted, countercyclical portfolio investments and outspend competition in R&D, capacity, marketing, and advertising to create value.
- Link incentives to goal delivery.
- Recognize that recessions are a good time to acquire talent and build loyalty for when the downturn ends.

The global economic downturn hasn't yet reached bottom and is far from over. While the deep economic downturn experienced in the U.S. is still less developed in Europe and Asia, it will continue to build globally. CFOs have a unique opportunity to provide leadership that impacts the quality of the operating results during an unprecedented time when effective action is required and value creation is essential. **SF**

Mark Morgan is a vice president of finance with Bayer HealthCare in Tarrytown, N.Y. You can reach Mark at (914) 582-4298 or mark.morgan.b@bayer.com.