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Businesses that survive will emerge from the recession in better shape

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Economic Life



Anyone arguing that there are upsides to the downturn becomes the target for abuse from the many people who have found their lives savaged by recession. But now that the world economy has almost certainly stabilised and there is a reasonable prospect of a return to some sort of growth next year, maybe sooner, it is surely worth trying to identify the possible benefits that might accrue.

My own perception is that company managements fall into two broad groups: those that are still in survival mode and those that see this period as a once-in-a-decade opportunity to position themselves for the next expansion. Certainly the recession has created extraordinary opportunities, and in some cases extraordinary reversals of fortune. There are a host of examples of this. To take yesterday's news, the partial takeover of Porsche by VW, that has really become possible because both Porsche's finances and its underlying business were weakened by recession. Had the boom continued the battle between the two family companies might have gone the other way, for it looked as though Porsche would succeed in taking control of VW. Or to take the example of Lloyds Bank and HBOS, the banking collapse enabled Lloyds to secure a takeover that would normally have been blocked by the competition authorities. But the victory

became a pyrrhic one because the condition of HBOS was even worse than the Lloyds team thought, and the merger will probably be broken up when the government changes.

These are the sort of big headline stories, but all over the world other examples of restructuring are taking place, some big, some small, and it is hard to get a handle on the scale of what is happening. We can see the macroeconomic version of the recession story: the extent to which some parts of the world, notably China and India, are coming through the downturn in better nick than the rest of us. But we only get snatches of the microeconomic consequences, including the impact on companies worldwide. The best analysis I have seen yet on this aspect of the story comes from the management consultants Arthur D Little. It is their twice-a-year ideas booklet, called *Prism*, with this issue titled "The Upside of the Downturn".

The starting point for the exercise is a survey carried out earlier this year on the priorities of companies of all sizes on their responses to the recession. They were asked first how long they thought it would be before output reached pre-crisis levels. As you can see from the first graph, most of the companies think it will be end-2010 or end-2011, with only a few beyond that. Now that is quite optimistic by the standards of most economic forecasts.

Even if growth does resume next year, the drop from peak to trough has been so large that most forecasts suggest that getting back to the peak will not be until 2013 or beyond.

You can draw one of two conclusions from that. One is that company executives are an optimistic bunch; the other that economists, having underestimated the scale of the downturn, are now underestimating the pace of recovery.

Responses vary a great deal from industry to industry, as the next graph shows. Business services, health care and ICT are all up at the top of the tree, with a majority of firms expecting to be back to the peak by end-2010. By contrast, finance, manufacturing and, most gloomy of all, construction, see the return to peak not coming until the end of 2011 or even later. This would square with what most of us probably expect. Construction always lags the economic cycle and finance is going to take a long time to climb back. On the other hand, some business services have actually been stimulated by recession, and health care and ICT seem always to be in demand.

Other aspects of the survey look at executives' views as to the impact of the crisis on their business and the nature of the crisis – where most agree that what is happening is different from previous ones in that "it is not so much a cyclical downturn

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but a fundamental questioning of the way businesses are run". They also agree overwhelmingly that "this crisis may have had a cleansing effect by eliminating weaker competitors and enabling the survivors to come out stronger".

That leads to the points in the third graph, where managers were asked about their priorities. Some of the rankings are obvious enough: rationalising operations and cutting overheads must surely come at the top, though I was surprised to see that retaining talent was high up too. The surprises at the bottom were the relatively low priority given to paying down debts and to raising new equity capital. I suppose raising new equity very much depends on the availability of such funds and this survey was done in the spring when shares were still flat on their backs.

The rest of the paper focuses on three sets of action that Arthur D Little thinks companies should consider/carry out. One it calls "hygiene". By this it means the things companies have to do to cope with the short-term problems they face. Separate articles look at how they might cut overheads and release capital. Actually it is possible for financially strong companies to build better relationships with their suppliers and customers by helping them through their cash difficulties. One company I was talking with recently explained that it offered to pay suppliers earlier than the normal terms in exchange for a discount and allow customers to pay later than normal in exchange for

used to invest in innovation. Maintaining R&D spending at a time like this is very tough, but cutting it may put the company's survival at stake. The report notes one hi-tech company that cut back most of its development after the dot.com bubble burst, making a bet on one particular project. The bet failed and the company lost its independence.

The third category is "muscle-building", which means preparing for the world beyond the downturn. The report cites things such as making money from green consumerism and taking advantage of competitors'

weaknesses. I suppose the VW example may become a case of the latter, for the real prize is not taking over Porsche but putting itself in a position to take on Toyota, which has now passed General Motors as the world's largest car maker.

Every industry is different, and it is much easier to set out principles of how companies should respond than to make the appropriate response in each situation. But there can be no question that the businesses that do survive the present harsh climate will emerge in much better shape. All downturns speed up the process of structural change in the sense that things that were going to happen anyway happen much faster than they would have done. But the speed of this one has been so extreme that the world is cramming a decade of such change into a year or 18 months. As a result a lot of firms that still appear weak right now may emerge in rather good shape when demand returns.

Some business services have actually been stimulated by the recession

a premium. It has cash balances earning near-zero interest so it made financial sense for it to use those balances to earn more by in effect lending to their business partners.

The second category was dubbed "fitness". This was how companies could preserve themselves in good shape through the downturn, making sure, for example, that they contin-

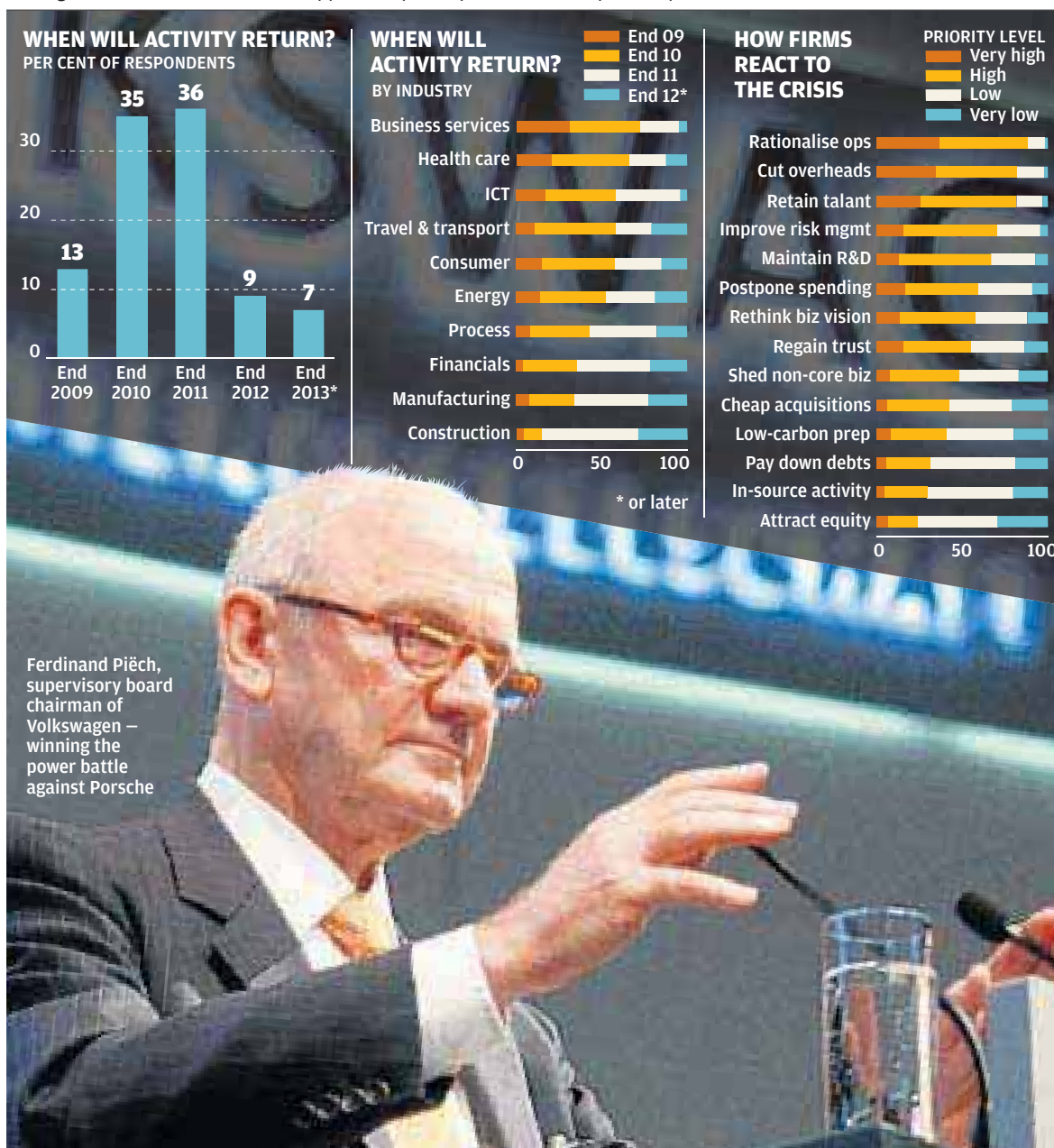
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How firms are responding to the downturn

Stronger firms see this time as an opportunity to improve their competitive position



Source: Arthur D. Little

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