



KEVIN CURRY

Learning to **love** recessions

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Most companies battered down the hatches during the recession of the early '90s. But the more successful competitors pressed their advantages.

Some companies emerge from a recession stronger and more highly valued than they were before the economy soured. By making strategic choices that sometimes defy conventional wisdom, they increase their stock market valuations relative to those of their former peers and thus gain more power to shape their industries.

To see how recessions can be used to advantage, we studied nearly 1,000 mainly industrial US companies over an 18-year period (1982–99) that included the US recession of 1990 to 1991.¹ We identified companies that either remained industry leaders (those that stayed in the top quartile of performance in their industries) or became successful challengers (those that moved up into the top quartile).² We then investigated the attributes of successful companies, both during the recession and in healthier economic times.

Successful challengers, we found, maintained a greater appetite for acquisitions during the recession than did their less successful former peers. In periods of growth, these challengers were M&A laggards—they made 63 percent fewer deals³ than their former peers did. But during the recession, while competitors brought their deal-making activity nearly to a halt, successful challengers dropped relatively few of their transaction plans, erasing the gap with the rest of their industries. The transactions were much larger, too, with an average deal size during the recession of \$174 million. Successful challengers seem to have pursued transactions that offered greater opportunity to shape industries, and even in demanding economic conditions these companies mobilized the management time and talent needed to identify, execute, and integrate acquisitions.

¹Since this recession was characterized by low rates of inflation and preceded by a long period of growth, it is arguably the most appropriate point of comparison for the current global slowdown.

²The ranking of companies was based on their standing in financial markets and their internal performance as measured by market value added (MVA) and return on invested capital (ROIC).

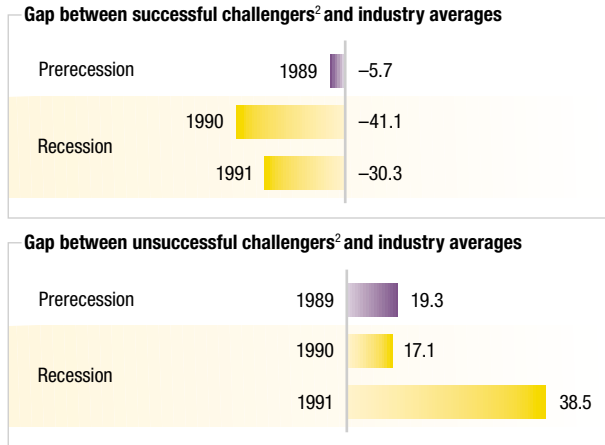
³Measured by an index of acquired-asset value to total assets as compared with the averages for the industries in which these companies compete.

Moreover, successful challengers, unlike their more conservative former peers, were not afraid to spend their cash reserves in a recession. In 1990, they lowered their reserves to a level 41 percent below⁴ that of their former peers, though before the recession, their excess cash level had been just 6 percent lower (Exhibit 1). Meanwhile, leaders that remained successful during the recession pursued a larger number of much smaller deals than did their less successful former peers. But the most dramatic, and least expected, response of the leaders to the recession was their approach to operating expenses (Exhibit 2). While most companies tightened their belts, successful leaders, trading lower short-term profitability for long-term gain, refocused rather than cut spending. Indeed, these successful leaders, perhaps reasoning that a soft market required greater effort or provided greater opportunity, actually spent significantly more on selling, general, and administrative (SG&A) costs⁵ than did companies that lost their market leadership. Yet in expansionary periods, successful leaders spent

EXHIBIT 1

Spend to succeed

Change in excess cash balances,¹ 1989–91, percent

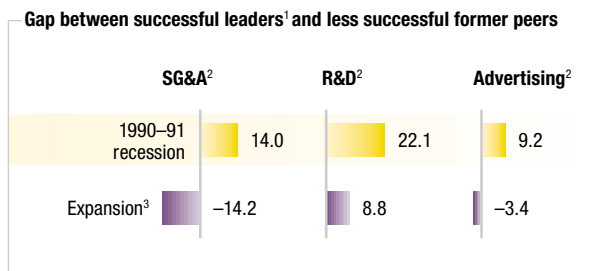


¹Cash and equivalents in excess of 2% of revenues; measured on size-adjusted basis by index of excess cash to total assets as compared with industry averages.
²Successful challengers moved into top quartile of their industries as reckoned by market value added and return on invested capital during the period 1982–99; unsuccessful challengers remained outside top quartile during that period.

EXHIBIT 2

A contrarian approach to operating expenses

Change in spending behavior, percent



¹Successful leaders remained in top quartile of their industries as reckoned by market value added and return on invested capital during the period 1982–99.
²Selling, general, and administrative (SG&A) expenses are measured by index of SG&A spending to sales, R&D expenses by index of R&D spending to sales, and advertising expenses by index of advertising spending to sales; all are measured on size-adjusted basis and compared with industry averages.
³1985–86 and 1995–96.

⁴Measured by an index of excess cash to total assets.

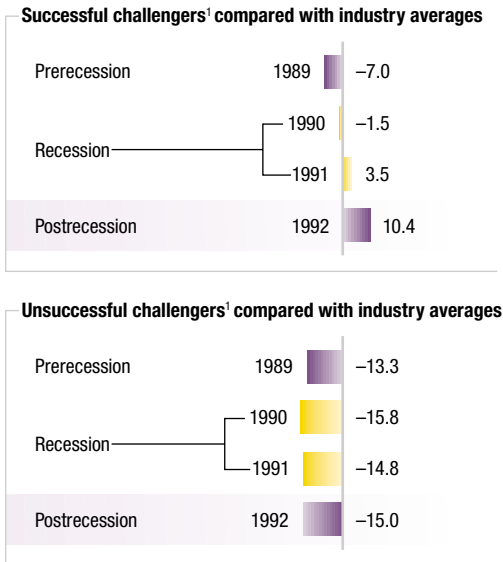
⁵Measured by an index of SG&A spending to sales as compared with the averages of the industries in which these companies compete.

significantly less on SG&A than did their former peers. Furthermore, successful leaders, seeking to extend their position through innovation, more than doubled their already higher-than-average level of spending on R&D⁶ during the recession relative to their former peers.

EXHIBIT 3

Challengers are rewarded

Change in market-to-book ratio, 1989–92, percent



¹Successful challengers moved into top quartile of their industries as reckoned by market value added and return on invested capital during the period 1982–99; unsuccessful challengers remained outside top quartile during that period.

Expenditures on advertising followed a similar pattern, with successful leaders spending more money (as a percentage of sales) than did their former peers during the recession and smaller amounts of money in periods of growth. Despite selective spending increases during the 1990–91 downturn, successful leaders, which maintain an employee-to-sales ratio 27 percent lower than that of their industries, were still far more efficient than their former peers.

The financial markets rewarded companies

willing to pursue contrarian strategies during the downturn. By the end of the 1990–91 recession, successful challengers had market-to-book ratios that were 25 percent higher than those of the unsuccessful challengers (Exhibit 3). Successful leaders increased their market-to-book advantage over their former peers by more than 38 percent. Thus, when other companies simply battened down the hatches, seeing only risk during the recession, the more successful competitors found opportunity and pressed their advantages. As companies today look to the end of the present downturn, they should consider that managing risk doesn't mean avoiding it altogether. **Q**

⁶Measured by an index of R&D spending to sales as compared with the averages of these companies' industries.

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