L.E.K.

EXECUTIVE INSIGHTS

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The Playbook for Successfully Managing Through a Recession – Part 1 of a 3 Part Series

The Three Phases of Managing Through a Recession:

We all know that successfully managing through a recession requires fast, decisive action. Indeed, few companies sit idle, just hoping to weather the storm. Most companies take action, usually on the seemingly obvious fronts, such as cutting near-term costs and recalibrating capital budgets. In L.E.K.'s recent client work, we have observed that exceptional management teams are developing a holistic plan to ensure immediate survival and enable them to retool their business to exit the recession a stronger entity.

In this three-part L.E.K. Executive Insights, we explore the critical phases companies must navigate to manage through the recession and achieve strategic advantage.

L.E.K. has found that successfully managing through a recession requires astutely executing three interlocking phases *(see Figure 1)*. Each phase has goals, which if achieved, should ensure long-term value creation. In this three part series, we will examine each phase in-depth, and highlight priorities for success: Phase I is the focus of this *Executive Insights*. Phase II and Phase III will be sent to you in the coming weeks.

Phase I: Immediately Focus on Preserving Cash.

The primary goal of the first phase is to ensure near-term survival. This requires preserving cash and minimizing operating losses. While many actions may be taken, the key levers include reducing operating costs, delaying major capital projects, tightly controlling working capital, and fully exploiting existing credit facilities.

Phase II: Innovate to Win Business from Reluctant Customers.

The goal here is to maximize sales and margins in the short term by persuading reluctant customers to spend by quickly adjusting a limited set of levers (pricing, promotion, etc.). Doing this requires immediate understanding of your customers' needs and competitors' movements, rapid prototyping, and quick optimization of winning commercial tactics. Success in Phase II will require simultaneous observation and experimentation, which is not a trivial task.

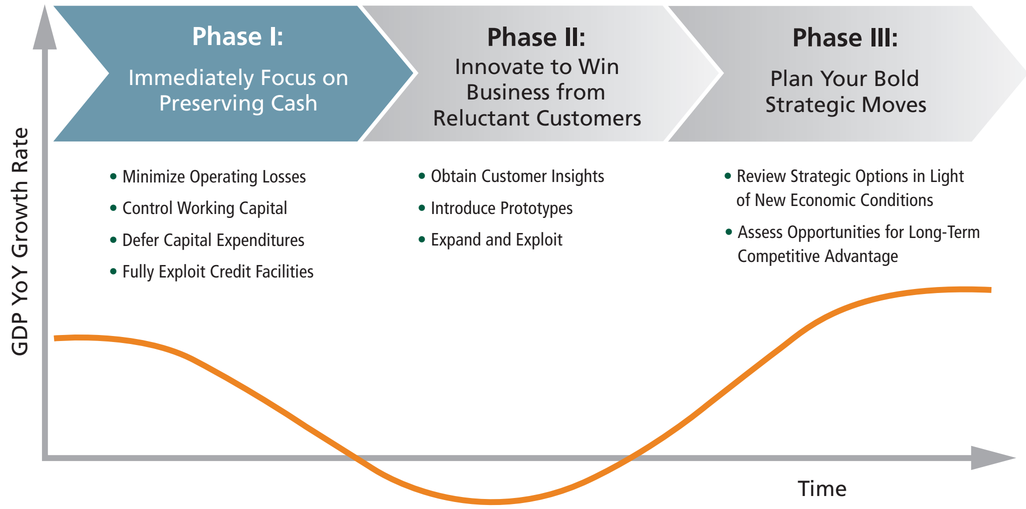
Phase III: Plan Your Bold Strategic Moves.

The goal of this final phase is to take a fresh and critical look at your strategic options, considering bold moves that will meaningfully augment your business model to create strategic advantage amidst the realities of the post-recession marketplace.

The Playbook for Successfully Managing Through a Recession was written by **Andrew Rees,** Vice President, and Retail and Consumer Products Practice Leader; and **Jon Weber,** Vice President of L.E.K. Consulting. Please contact L.E.K. at retail@lek.com for additional information.

Figure 1

Three Phases of Managing Through a Recession



Phase I: Immediately Focus on Preserving Cash

During a recession, companies will typically experience a series of hits to their financial position: revenues decline rapidly, profits evaporate, inventories balloon and receivables expand. The net result is a dramatic reduction in cash flow and a commensurate depletion of cash reserves. For some companies, taking the right actions here will be the difference between survival and extinction.

During this first phase, companies must act rapidly and decisively to preserve cash. Cash will ensure survival, as well as provide the ability to outperformand outmaneuver competitors. It will become an immediate source of strategic advantage during the recession.

The playbook for preserving cash is relatively well understood and has been successfully applied by many in the past six months:

- **Priority One** is inventory. For most retailers, the greatest and most immediate source of financial pressure is unsold inventory. Converting inventory back into cash is critical for funding payment of near-term operating costs, as well as for buying new merchandise for the upcoming season.This requires action on two fronts:

  – Liquidating current excess inventory and taking early and decisive markdowns; remember, you are not the only one in this position and you will be fighting against aggressive competitors for your customers' wallets

  – Recalibrating future sales expectations, reducing open-to-buy for future seasons, and negotiating with vendors to reduce and/or cancel orders already in the supply chain

- **Priority Two** is operating expenses. Effectively reducing expenses first requires a realistic expectation of future revenues. Operating expenses should be cut to levels that ensure the business earns a minimum return. These reductions ideally take place only once and are carefully coordinated and communicated. For most retailers, there are three primary drivers of expense, all of which should be considered in any cost-cutting program:

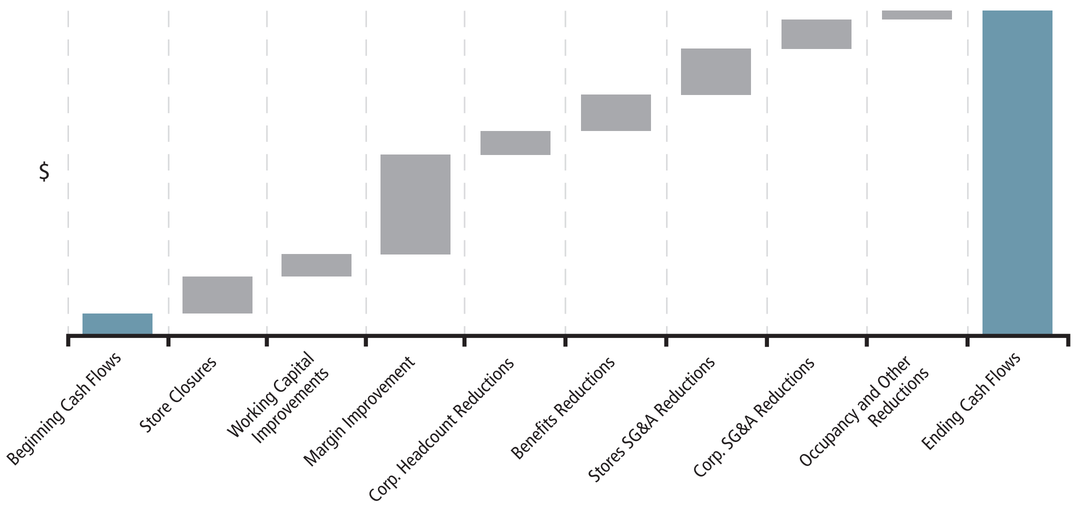
  – **Stores:** The number of stores you operate drives significant expense throughout your organization. Although not traditionally viewed as the first place to cut costs, pruning the store portfolio will yield substantive savings.

  – **SKUs:** Eliminating low-volume and low-margins SKUs will help by both managing inventory levels and eliminating extraneous selling expenses.

  – **People:** SKU rationalization and store closures will already start to reduce headcount. In addition, look closely at functions that might not be as busy in the future, like store construction and IT.

Figure 2

Sample Cash Flow Enhancement Opportunities



Also, closely examine the layers of your organization and reconsider their respective spans of control.

- **Priority Three** is capital expenditures. It is important to cancel or delay major capital expenditure projects that do not put the business in immediate jeopardy or do not have a very short (12–18 month) cash payback time frame. This would typically include major IT upgrades, new store openings and new distribution centers.

- **Priority Four** is accounts payable. If possible, take advantage of payment terms (e.g., pay early to get a discount). Work with vendors to extend payment terms if necessary, but do so without impairing relationships or access to future goods and services.

- **Priority Five** is to fully exploit your credit facilities. If you entered the recession with attractive credit facilities, this will likely become a source of strategic advantage.

It goes without saying that time is of the essence in Phase I. We believe that strong management teams should be able to develop and execute a cash preservation strategy within a four-to-six-week window. A cross-section of cost-reduction actions is shown in Figure 2.

While many of these priorities may seem obvious, implementing a comprehensive cost-cutting plan is not trivial. We have found that companies either tend to focus on the low-hanging fruit, leaving significant opportunities for savings on the table, or fail to monitor the performance of cost-cutting measures against expectation. Given the severity of this recession, it may be necessary to implement incremental cost-cutting measures in the future as circumstances evolve. Flexibility and continued vigilance around your cost-structure are essential to effective execution of Phase I. To gain greater insight into how to design a strategic cost-cutting program, read *Rooting Out Costs in All the Right Places* by Jon Weber (Volume X Issue I).

Conclusion

Phase I and its priorities are entirely focused on survival and cash preservation. In Phase II we look at immediate ways to win business from reluctant customers. This involves a rapid innovation cycle that captures customers' insights and generates immediate tactical adaptations to existing offerings. In Phase III, we shift focus to the long term and consider strategic opportunities for your company to reposition itself to be a winner in the post-recession marketplace.

For further information contact:

Boston
28 State Street
16th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9392

Chicago
One North Wacker Drive
39th Floor
Chicago, IL 60606
Telephone: 312.913.6400
Facsimile: 312.782.4583

Los Angeles
1100 Glendon Avenue
21st Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

New York
650 Fifth Avenue
25th Floor
New York, NY 10019
Telephone: 212.582.2499
Facsimile: 212.582.8505

San Francisco
100 Pine Street
Suite 2000
San Francisco, CA 94111
Telephone: 415.676.5500
Facsimile: 415.627.9071

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