EXECUTIVE INSIGHTS

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The Playbook for Successfully Managing through a Recession–Part 3 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)*. In our last *Executive Insights*, which addressed Phase II, we discussed the use of Guerrilla Innovation[SM] to persuade reluctant customers to spend. In this issue, we address the third and final phase of managing through a recession, which is to thoroughly re-evaluate and improve your competitive position. We believe you will uncover opportunities to make bold strategic moves that will create sustainable competitive advantage through the next cycle and in turn deliver significant value for your shareholders.

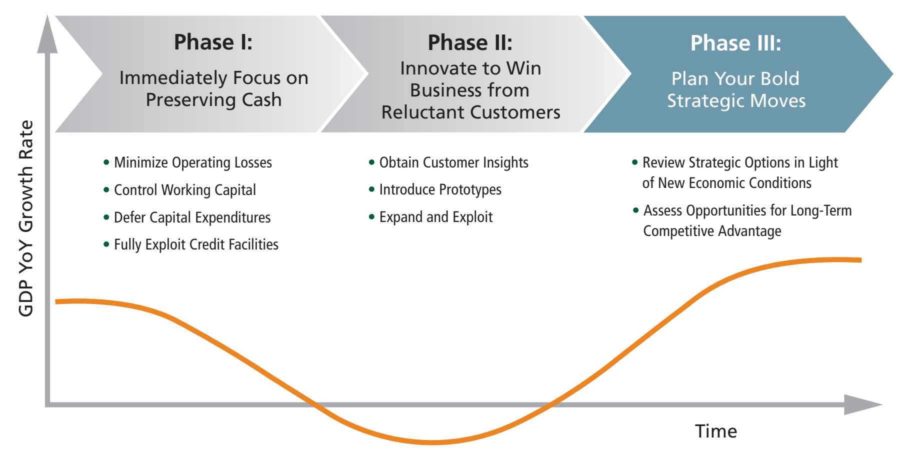
Phase I: Immediately Focus on Preserving Cash

Phase II: Innovate to Win Business From Reluctant Customers

Phase III: Plan Your Bold Strategic Moves

Figure 1

Three Phases of Managing Through a Recession



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. Both authors are located in L.E.K.'s Boston office. Please contact L.E.K. at retail@lek.com for additional information.

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 (marketing, pricing, promotion). Doing this requires immediate understanding of your customers' needs and behaviors, 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 the business model to create strategic advantage amidst the realities of the postrecession marketplace.

Phase III: Plan Your Bold Strategic Moves

Economic downturns have always resulted in a new set of companies emerging as leaders. Companies that achieve significant gains (or losses) during a recession almost always carry those legacies with them through the subsequent boom cycle. We find that the best management teams look for opportunities even in the worst of times, and the bold moves they take position their companies to be the winners in the post-recession marketplace.

Right now the market is wide open and looks nothing like it did a year ago. Just look at your competitive landscape: the weakest players are battling for survival (or have already lost the battle) and are shadows of their former selves; some have pulled out of specific markets or scaled back their operations in other ways, and nearly everyone is operating very conservatively, having postponed major investments and strategic bets. Now look at your customers: unlike past downturns, this one is likely to permanently redefine their value equation – from where they shop, to when and how often, and at what price point. And finally, your distributors and suppliers – they are more willing than ever to modify or revamp their existing business practices and terms.

These changing dynamics, coupled with the availability of discounted assets, spell a huge opportunity. Strategic options that you never considered or that were not viable even a year ago may now be available and could provide significant competitive advantage.

However, there is a limited window in which to seize this opportunity, and now is the time to start planning.

While there is no universal prescription for capitalizing on these circumstances, there are a number of areas that deserve consideration:

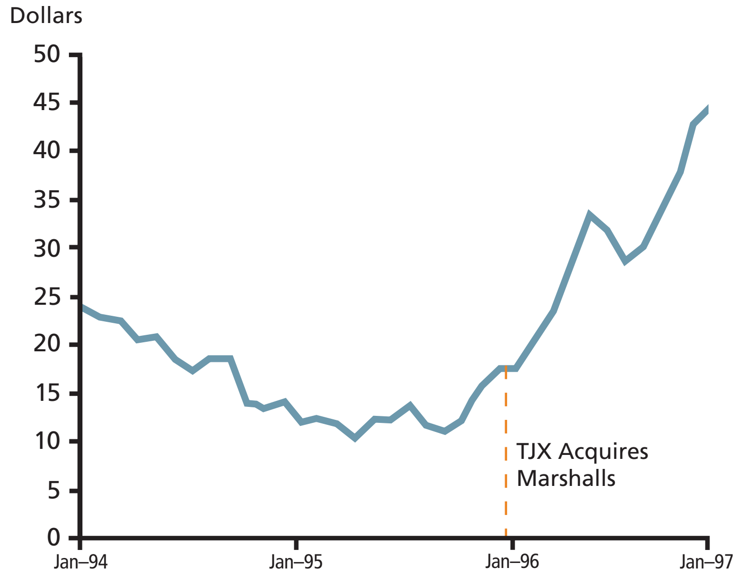
1. **Grab Share by Buying/Merging with a Major Competitor**
2. **Diversify by Buying into Adjacent Sectors**
3. **Expand into New Geographical Markets**
4. **Dramatically Re-engineer the Supply Chain to Systemically Reduce Risk**
5. **Enhance Your Channels of Distribution**

1. Grab Share by Buying/Merging with a Major Competitor:

If you're convinced your business is focused on the right market opportunities (and your model isn't "broken"), your primary goal is to increase share and gain scale. An economic downturn can turn weaker or non-core assets (of other companies) into potential targets that can immediately deliver on this goal. The goal here is not simply to acquire cheap assets (not to say this couldn't play a role in your broader strategic plan), but rather to utilize a transaction to propel you into a leadership position. To be sure, many companies have successfully employed this strategy. For example, consider TJX's acquisition of Marshalls over a decade ago. In 1995, parent company Melville Corporation considered Marshalls one

Figure 2

TJX Historical Monthly Stock Price (1994–96)



of its lowest performers after several quarters of declining operating profits. As a result, TJX was able to acquire Marshalls for $550 million, an attractive price for a business with $2.8 billion in sales at that time. The acquisition immediately transformed TJX into the clear market leader, and in two years its share price more than doubled, creating $2 billion in shareholder value *(see Figure 2)*. Today, TJX remains the leading off-price retailer, with over 1,600 stores and almost $12 billion in sales, well ahead of its main rival Ross Stores, at 890 and around $6 billion.

2. Diversify by Buying into Adjacent Sectors:

As you plan your bold strategic moves, take a close look at your value chain. You may find that the lines between segments have blurred, that some adjacencies have been more resilient to the downturn than others, or that you have the unique ability to extract more value by extending beyond your current domain. Diversifying within the value chain may provide top-line growth, protection against future downturns, and incremental value for your customers.

CVS's acquisition of Caremark is a prime example. Putting CVS, the largest U.S. retail pharmacy chain, and Caremark, one of the top pharmacy benefits managers, together was not an obvious play at the time and indeed many still have their doubts. In fact, the two entities compete in prescriptions fulfillment. However, CVS saw significant incremental opportunity in combining pharmacy benefits management capabilities with its large retail distribution network. After battling hostile counter-bids from rival pharmacy benefits company Express Scripts, Inc., CVS ultimately prevailed in combining the two entities. This bold strategic move has undoubtedly been a game-changer for CVS, transforming it into a comprehensive pharmacy services organization whose reach spans employers, health plan providers, and consumers. The combined company is now the country's largest buyer and distributor of prescription drugs, providing it much greater leverage with drugmakers *(see Figure 3)*. More broadly though, CVS/Caremark has its eyes set on leveraging the two companies' capabilities, including a massive prescription database, to improve patient compliance. If successful, this strategy could drive more traffic through its drugstores, resulting in higher drug sales, ancillary in-store add-on purchases, and future visits to its "MinuteClinics."

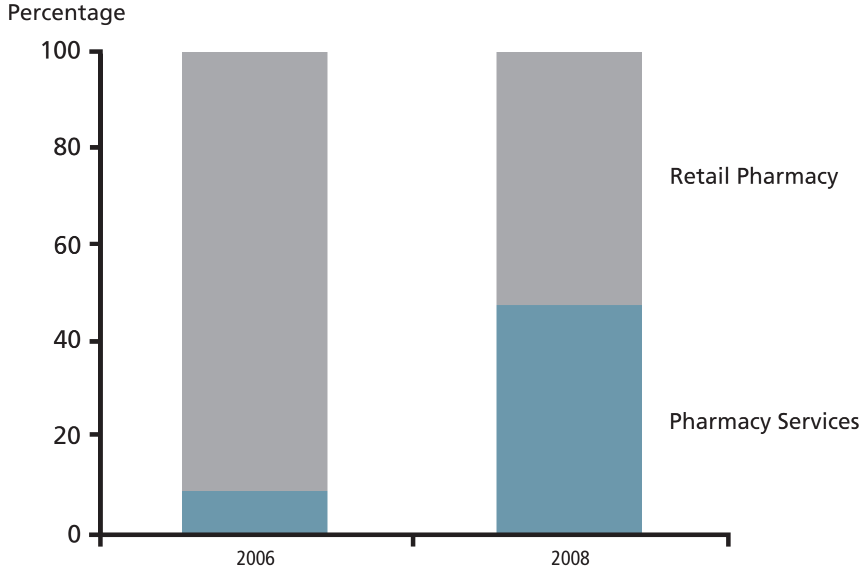
3. Expand into New Geographical Markets:

We all know that periods of disruption redefine markets, but never before has a downturn been so global in nature that disruption has redefined virtually every market in the world. While large global players have been hurt by the recession, smaller regional players have experienced a weakening of their dominance in local markets. This is the time to reconsider your existing global footprint and determine which geographies are good prospects for gaining share.

Expanding into new geographical markets is different than placing bets on emerging markets where your company's growth will be highly correlated with GDP. It involves exploiting pockets of unmet customer demand in mature markets which, if successful, could be hugely profitable.

Figure 3

CVS Revenues by Product Type (2006–08)



Take the German discount grocery chain ALDI: It is seizing on the disruption created by the economic downturn to ratchet up its expansion into the U.S. ALDI is launching an aggressive strategy to enter mature markets and steal share from Walmart, other discount stores and traditional grocers. Many of its 75 new store openings in 2009 were in the heart of Walmart territory, with prices between 15% and 20% lower than Walmart. Furthermore, as ALDI moves through this round of expansion, it is also refining its offering to better meet the needs of its target consumers based on valuable learnings from ALDI's current stores. ALDI is able to price so low because nearly 95% of goods sold in its stores are private label. ALDI's vast and global purchasing power allows it to secure contracts with suppliers at a lower cost than its competitors. While grocery chains across the U.S. are seeing higher sales from private-label products, most are only stocking them at 20% to 30% levels. With a business model perfectly suited to the economic environment and pursuing bold strategic expansion into mature markets, ALDI is in a prime position to win share.

4. Dramatically Re-engineer the Supply Chain to Systemically Reduce Risk:

Many strategic options focus on external growth (new markets, new products and services), but bold strategic moves can also be focused internally to make your existing business more nimble and profitable. You will need to retool your model to reduce exposure to risks inherent in the current business.

Spanish retailer Zara has systematically reduced its fashion risk by bringing virtually every function across the value chain, from design to manufacturing, in-house. Using an efficient value chain, Zara is capable of taking a design from concept to shelf within a two-week time frame. No retailer can beat that.

Zara's model of quick inventory turnaround mitigates one of the greatest risks for any retailer: unsold inventory. The reasons for this are twofold: first, designers can build out a line after seeing which fashions have already succeeded in the market and second, no line is ever produced in significant quantity. This has made Zara one of the most flexible and dynamic retailers in the world.

5. Enhance Your Channels of Distribution:

As you gain a greater understanding of your customers, you will find that your current customers no longer purchase the same way and in the same places. Furthermore, the market has redefined which customer segments are the most attractive, and you must now gain access to them. There are many ways to broaden your distribution to reach different customers. For Gap Inc., it has meant looking to its online division (Gap Inc. Direct) to create opportunities beyond simply making the product in its stores available to consumers online. Gap Inc. Direct has built an online-only brand, Piperlime, to sell branded footwear and accessories. It has also acquired the women's active wear company Athleta, Inc., with the intention of dramatically growing this nascent brand through exposure to its large volume of online traffic. In short, Gap Inc. Direct is establishing a growth strategy independent of Gap's physical stores.

For an experienced management team, being able to step back and objectively assess how their own business, competitive position and marketplace have changed due to the recession can be challenging. There are no shortcuts. We believe that every business needs to undertake a thorough situation assessment that will form the basis of a refreshed market view and allow the management team to systematically evaluate and prioritize their strategic options.

Conclusion

In this series of articles, we have outlined a comprehensive path for successfully navigating your company through this recession. The three phases we have outlined are all necessary to secure the long-term strength of your business postrecession, and require both short-term focus and long-term planning. Phases I and II are focused on the near term: preserving cash and persuading reluctant customers to spend with you and not your competitors. In Phase III, the focus is the future, taking a hard look at the macro factors at play to develop innovative and game-changing strategic moves. Each phase has its own distinct objectives and benefits, and companies that successfully execute on them are poised to be the winners in the post-recession marketplace.

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