L.E.K.

EXECUTIVE INSIGHTS

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Surviving and Ultimately Thriving Through This Recession

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 Executive Insights, we explore the critical phases companies must navigate to manage through a recession and achieve strategic advantage.

During a recession most companies cut costs and recalibrate capital budgets. Recent L.E.K. analysis demonstrates that exceptional management teams take a more holistic approach to both survive in the short term and be well positioned to achieve competitive advantage when the recession ends.

We believe that successfully navigating through a recession requires a company to astutely execute three interlocking phases *(see Figure 1)*. Each phase is meant to ensure long-term value creation. They are:

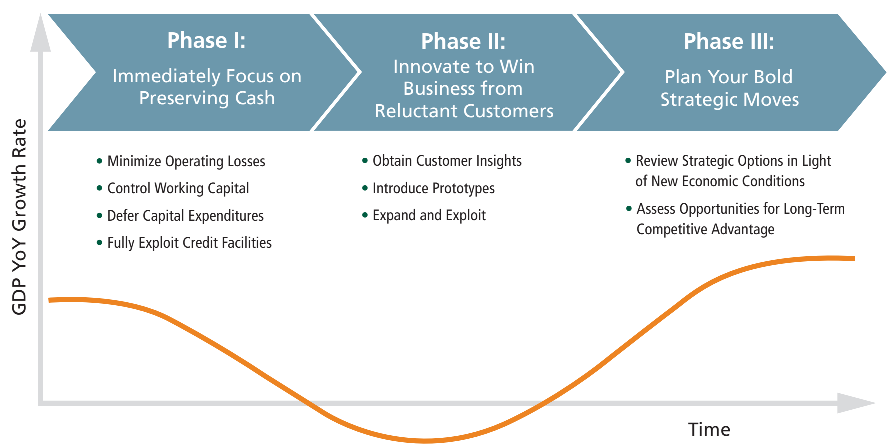
Phase I: Focus on Preserving Cash:
The primary goal of this phase is to ensure near-term survival. This requires preserving cash and minimizing operating losses. While many actions may be taken, the key ones include reducing operating costs, delaying major capital projects, tightly controlling working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

Phase II: Innovate to Win Business from Reluctant Customers:
The goal here is to maximize sales in the short term by persuading reluctant customers to spend. This is done by quickly making some critical changes (e.g., pricing, promotion, etc.). Success comes from understanding 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 and consider bold moves that will create meaningful and lasting strategic advantages. Once the recovery is underway, you will be well positioned to steal market share from your competition.

Figure 1

Three Phases of Managing Through a Recession



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Phase I: 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. During this first phase, companies must act rapidly and decisively to preserve cash. Cash will ensure survival as well as provide the ability to outperform and outmaneuver competitors. It will become an immediate source of competitive advantage during the recession. There are five priorities during Phase I:

- **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 buying new merchandise for the upcoming season. Remember you will be fighting against aggressive competition for your customers' wallets. This requires action on two fronts:
  - Liquidating current excess inventory and taking early and decisive markdowns;
  - 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-margin 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. And 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 (i.e.,12–18 months) 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 four to six weeks. 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 only on low-hanging fruit leaving significant opportunities for savings on the table, or fail to monitor the performance of cost-cutting measures against expectations. Given the severity of this recession, it may be necessary to implement incremental cost-cutting measures in the future as circumstances warrant. Flexibility and continued vigilance around your cost structure are essential.

Phase II: Innovate to Win Business from Reluctant Customers

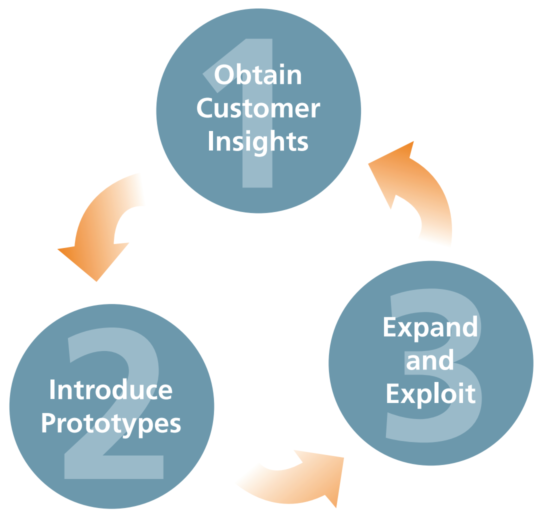
During a recession customers' requirements change: they buy less, they may want different products or services, they increasingly look for greater values, and they respond to different marketing stimuli. Your challenge as a consumer-based business is to adjust your near-term commercial tactics to maximize revenue opportunities and profits.

We believe companies can strengthen their performance during a recession. We call this approach Guerrilla Innovation. It employs a cascade of iterative engagements with customers to identify and test multiple tactics that can realign existing products and services to stimulate near-term spending.

While the needs of your customers have changed, you cannot wait until your traditional innovation process identifies new products to meet those needs. Guerrilla Innovation's focus still taps into the heart of what drives solid innovation strategy: customer engagement. But instead of applying it to developing new ideas, products and services, the immediate goal is tactical adaptations of existing offerings through three sets of activities *(see Figure 2)*.

Figure 2

Guerrilla Innovation℠ Framework



1. Obtain Customer Insights:

The first step in adjusting to your customers' evolving needs is gaining information. Because customer insights must be captured and acted upon in real time, it is important to move beyond traditional customer research methods (e.g., customer surveys, store intercepts, focus groups) and leverage faster, more interactive techniques such as customer panels, online forums and shop-alongs.

In addition, greater attention must be paid to any nuances in shopping behavior metrics (e.g., average transaction size, product mix, website behavior) as these may also be immediate sources of valuable insights which should be rapidly distributed across your organization.

2. Introduce Prototypes:

Rapid or "micro" prototyping involves introducing many ideas at once and letting the market decide the winners and losers. The key to achieving quick validation of ideas is having a strong testing program that can deliver insights in a controlled and limited-risk environment.

Introducing many prototypes at once is risky, but you can mitigate this risk by limiting the test to a small sample. Start by developing a plan to introduce prototypes in select locations or for select customers. Then streamline your testing plan to ensure timely response and data collection, leveraging channels that will elicit a more immediate response (e.g., web sales). As part of your plan, assign metrics to gauge success (e.g., store traffic, transactions, basket size) and weigh the performance of each idea accordingly.

The universe of options in Phase II may be limited, so do not abandon a prototype without understanding why it failed. Consider modifying the prototype before discarding it.

We find that the best management teams look for opportunities even in the worst of times. The bold moves they make position their companies to be the winners in the post-recession marketplace.

3. Expand and Exploit:

Once you have identified the most promising tactics for attracting customer spending, these opportunities need to be immediately rolled out to relevant locations and customers.

Central to proper execution is identifying appropriate processes to manage promising projects. Progress must be measured consistently and tactics refined based on customer feedback. With market conditions changing so rapidly, a winning idea can turn into a loser if not rolled out quickly and monitored continually.

Organizing for Guerrilla Innovation requires immediate and tight coordination between multiple stores, marketing vehicles and functions of your business. You may lack the resources or expertise to do this, so consider allocating a dedicated command-and-control team.

This team will oversee customer insight management, the testing program and evaluation of results. Centralizing this effort will not only ensure rapid responses to any market fluctuations but also keep your marketing, sales and operations teams working efficiently and in concert.

Once underway you will find that Guerrilla Innovation typically focuses on changes to pricing, product mix, promotions and/or messaging. You can glean a number of lessons in each of these areas from companies that have successfully demonstrated strong customer engagement and a direct response to their customers' evolving needs. For example:

- **Pricing:** Publicized shifts in product pricing can change value perception and drive revenue gains. For example, Sonic launched its first value menu in December 2008 in recognition that value-based options are driving incremental growth in the quick service segment during this economic downturn. Traditionally, Sonic has relied on an array of signature menu items and its brand strength to drive sales but turned to strategic pricing to stem the impact of the recession. Sonic's "Everyday Value Menu," which includes 10 items priced under one dollar, is increasing store traffic by providing broader options for budget-conscious customers.

- **Product Mix:** Changing product mix to appeal to shifting consumer needs can drive sales growth. For example, Family Dollar has evolved its product portfolio and shifted its in-store product mix more heavily toward everyday necessities and consumables (e.g., food, detergents). The company also invested in equipment (coolers) to support increased food and beverage sales. Consumables now account for over 60% of sales and Family Dollar is reaping the benefits of this change in its product mix. Walmart recognized that private label products mark some of the greatest opportunities in this recession, as consumers in the food and beverage category (and beyond) are showing great interest in trading down. Walmart has responded by relaunching its "Great Value" brand to increase the share of lower-priced private label offerings in its stores.

- **Promotions:** Launching time-sensitive promotions with perceived value can increase customer loyalty during the downturn. Kroger, Food Lion and Albertsons were quick to offer value-added promotions for cashing in economic stimulus checks. In Kroger's case, customers could benefit from a value increase of 10% for immediate conversion of the full value of their checks into Kroger gift cards. The benefits of this were twofold: Kroger captured 100% of the value of the stimulus checks and it strengthened its perception among consumers as being a value retailer.

  Hyundai offered consumers the ability to return a purchased car if they lost their jobs within a year. This promotion directly addressed the finding that consumers were so worried about making payments that traditional rebates and incentives were not stimulating sales. Hyundai's success has spurred others to offer similar promotions.

  Dollar General also targeted consumers' anxiety over the economy by kicking off 2009 with its "Fresh Start New Year Sweepstakes." This promotion, which did not require purchase for eligibility, included over $180,000 in cash prizes.

- **Messaging:** Simple tweaks can make your marketing messages align more closely with your customers' most immediate concerns. Staples shifted the message of its iconic "Easy Button" campaign. When the campaign launched in 2003, the "Easy Button" was created to demonstrate ease of shopping. Amid poor economic conditions, Staples' advertisements were repositioned to convey that shopping at Staples makes it easy for consumers to save money, acknowledging the increased importance to consumers of savings over convenience.

Phase III: Plan Your Bold Strategic Moves

Economic downturns have always resulted in a new set of companies emerging as leaders. We find that the best management teams look for opportunities even in the worst of times. The bold moves they make 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 perhaps have already lost the battle). Some have pulled out of specific markets or scaled back their operations in other ways. And nearly everyone is operating very conservatively.

Now look at your customers: unlike past downturns, this one is likely to redefine their value equation – from where they shop, to when and how often, and at what price point. And finally look at 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 huge opportunities. Strategic options that you never considered or were not viable even a year ago may now be available and could provide significant competitive advantage. Now is the time to start planning.

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

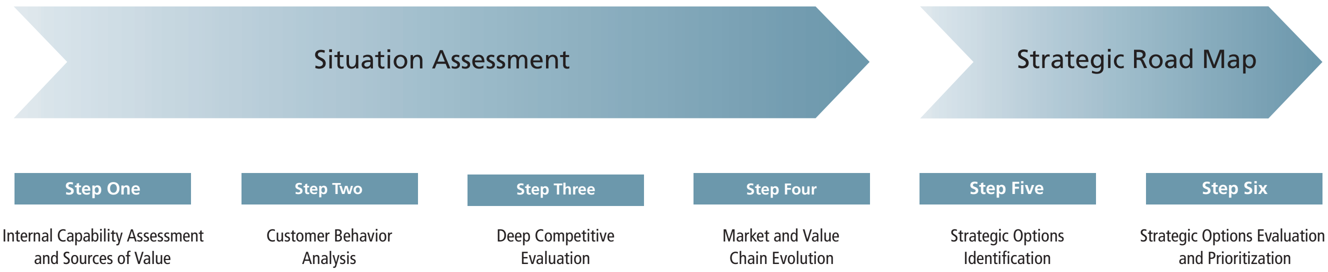
1. **Grab Share by Buying/Merging with a Major Competitor:**
   If you're convinced your business is focused on the right market opportunities, your primary goal should be to increase market share and gain scale. An economic downturn can turn the weaker or non-core assets of other companies into potential targets that can immediately deliver on this goal.

   It is not simply enough to acquire cheap assets (though this could play a role in your broader strategic plan). You should also look to take advantage of a transaction that will propel you into a leadership position. Many companies have successfully employed this strategy. For example, consider TJX's acquisition of Marshalls over a decade ago. In 1995, Melville Corporation considered Marshalls one of its lowest performers after several quarters of declining operating profits. 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.

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.

Figure 3

Sample Framework for Surviving and Ultimately Thriving Through This Recession



CVS's acquisition of Caremark is a prime example. Combining CVS, the largest U.S. retail pharmacy chain, and Caremark, one of the top pharmacy benefits managers, was not an obvious play at the time and indeed some still have their doubts. The two entities compete in prescriptions fulfillment. However, CVS saw a significant 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. More broadly though, CVS/Caremark has its eyes set on leveraging the two companies' capabilities, including a massive prescription database to improve patient compliance.

3. Expand into New Geographical Markets:

Virtually every market in the world is being redefined by the global nature of this downturn. Global as well as regional players have experienced a weakening of their dominance in the markets they serve. Now is the time to reconsider your existing global footprint and determine which geographies are good prospects for gaining market share.

This expansion into new geographical markets is different from placing bets on emerging markets where your company's growth will be highly correlated with GDP. Instead it involves identifying and exploiting pockets of unmet customer demand in mature markets which, if successful, could be hugely profitable.

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 will be in the heart of Walmart territory, with prices between 15% and 20% lower than Walmart. 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.

Furthermore, as ALDI expands into the U.S., it is also refining its offerings to better meet the needs of its target consumers based on valuable learnings from ALDI's current stores. With a business model perfectly suited to the economic environment, ALDI is in a prime position to steal market share.

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

Many strategic options focus on external growth (e.g., 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 business 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. By creating a more efficient value chain, Zara is now capable of taking a design from concept to shelf within two weeks. 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 two-fold. 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 activewear company Athleta 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 most management teams, being able to objectively assess how their business, its competitive position and the marketplace have changed due to the recession can be challenging and require substantial resources. There are no short cuts. 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. We outline a framework *(see Figure 3)*, that L.E.K. Consulting has used to lead clients through this process.

Conclusion

In this article we have described how the best companies can survive and ultimately thrive despite this pernicious recession. The three phases we have outlined are all necessary to secure the long-term strength of your business post-recession, 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. 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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