LOOKING AHEAD
"THERE IS NO ONE-SIZE-FITS-ALL SOLUTION WHEN THE ECONOMY GOES SOUTH."

RAM'S RULES

HAPPY DAYS ARE *NOT* GOING TO BE HERE AGAIN FOR QUITE SOME TIME, SAYS ONE OF THE FORTUNE 500'S FAVORITE MANAGEMENT GURUS. BUT SMART EXECUTIVES CAN USE THE DOWNTURN TO MAKE THEIR COMPANIES BETTER, STRONGER, AND FASTER. HERE'S HOW.

By Ram Charan

Happy economic times are all alike; unhappy times are unhappy in their own way.

What makes the current economic downturn distinctively unhappy is the unprecedented confluence of three things. First, there was a Fed-induced housing bubble—too much cheap money for too long. Then there was the rampant use of exotic financial instruments, such as collateralized debt obligations, to disperse risk among people who didn't understand it. Finally, the rating agencies failed to catch the poor quality of a great deal of highly rated debt. With lots of momentum—and faulty brakes—the financial system hit the skids.

For executives, whether this turns into an official recession (two straight negative quarters) is immaterial: What matters is how their business is affected, segment by segment. Those with broad international exposure are better fixed to ride out a slump in the U.S. Those dependent on the housing market are in for a very rough time indeed. But certain principles apply broadly:

1. Keep building. When the top line looks shaky and the bottom line worse, the temptation is to go after discretionary spending. Fine—but do not consider product development, innovation, and brand building optional. Sacrificing your future for a slightly more comfortable present is not worth it. If you keep building, you can come back strong.

Consider the case of Merck. In the early part of this decade the pharma company had a number of major medicines going off patent. The stock price was falling, and revenues were flat—and this was before the Vioxx mess, which hurt the company badly. The whole industry was in a rut, and Merck's was deeper than most. So what did then-CEO Ray Gilmartin do? He increased investment in R&D from 12% of revenue in 1999 to 20% in 2004. And he didn't stop there: He made the case to the board and to all the major investors and analysts. Not everyone bought into the strategy, but at least they knew there was one.

Looking back, Gilmartin concludes, "When you are being hammered from all sides, it's important to reinforce your core values—and research excellence

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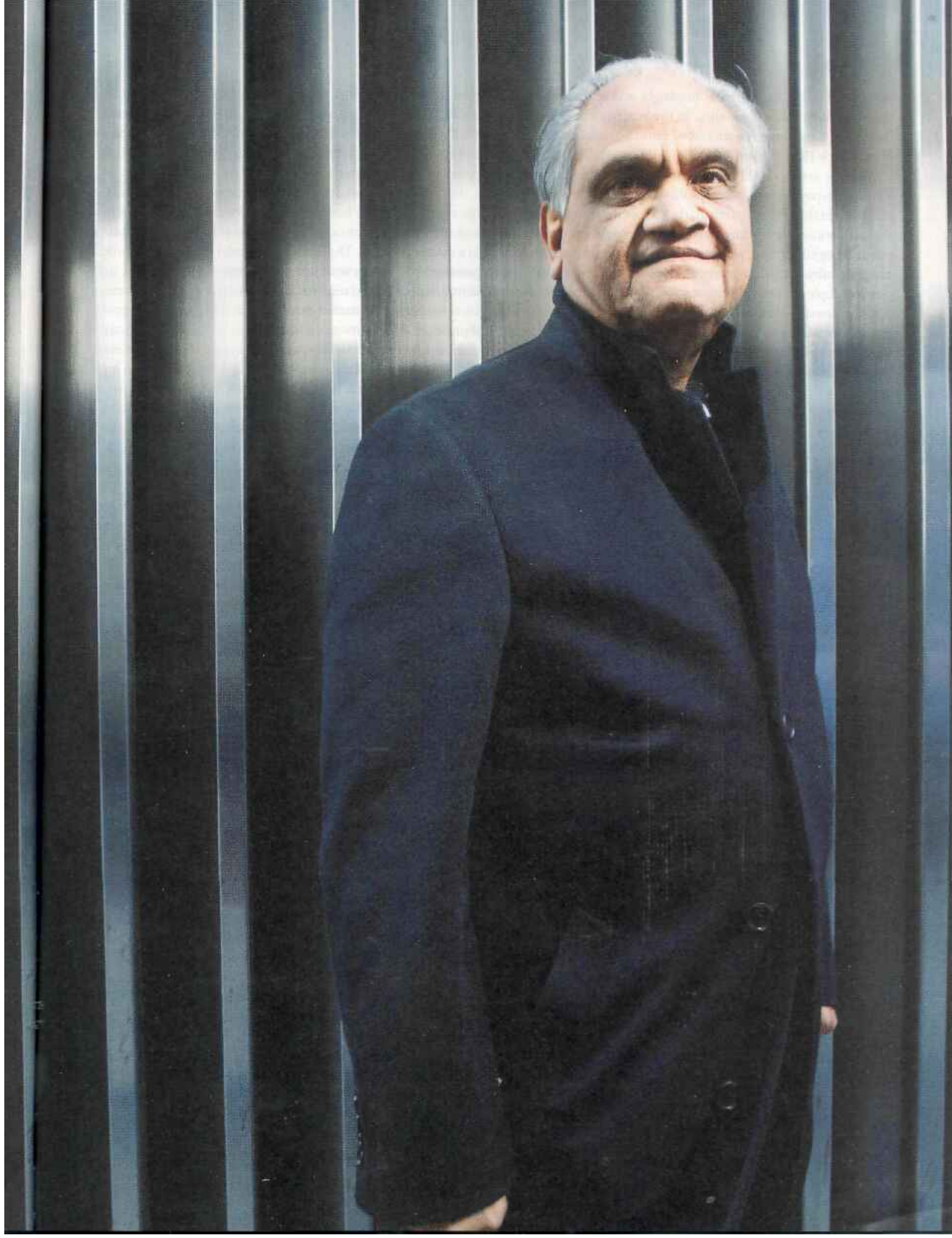

was one of ours." In this case, hindsight was rewarded: Merck now has the plumpest pipeline in the business, and investors have seen handsome returns (see "From Scandal to Stardom: How Merck Healed Itself").

Another area to build on is personnel. It may seem counter-intuitive to pay bonuses when profits are falling, but sometimes it's the right thing to do, particularly if a specific unit is creaming the competition. Rewarding excellence—through new challenges, public recognition, and, yes, money—in bad times as well as good builds loyalty. In fact, a downturn can be an excellent time to poach; people who might have stuck with a company because of vested options or other monetary incentives may be more willing to consider joining your company when those vanish. In general, I am against cutting salaries as a first resort. If that has to happen, though, top management absolutely must suffer a cut too.

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For boards, a downturn is an excellent time to take a hard look at CEO pay and ensure it is structured in a way that rewards genuine performance and does not simply piggyback on a rising market.

2. Communicate *intensively.* Get information from where the customer action is, and get it to the operating people—fast. Companies should do so routinely, of course. But they don't. It's counter-intuitive but true that when the economy slows down, the pace of decision-making has to speed up, because you can't put off the tough choices anymore. The companies that are readiest to act on solid information are primed to shoot ahead of the business cycle.

I saw this in the early 2ooos, when I was working with EMC[1], an information-storage company in Massachusetts. In two years the stock price dropped by more than 90%, due to falling sales and confidence. Customers told the sales force that sure, demand was softening, but it wasn't a big deal. Then the CEO, Joe Tucci, got out of his office and talked to the CEOs and CFOs of his customers' customers. Tucci heard something very different—that they were anticipating a deep and prolonged drop in demand, He acted on that information, reconfiguring the business to fit the new, unpleasant reality.

When the economy recovered, so did EMC[2]—and more. Its gross and operating margins are now better than the industry median, and its P/E ratio higher. While the stock price is still miles away from its bubble-era peak, it has almost quintupled since the trough. The lesson: When you're down, don't just sit there—talk to people, inside and outside, to figure out an escape plan.

Employees in particular deserve your candor. Intranet letters, division meetings, town hall gatherings—the form does not matter; the frequency and honesty of the communication do. Outline the problems, explain your plans, ask for advice. Listen. You will be amazed how much good will such simple courtesies can create.

Finally, communication needs to happen among teams in the company. In the hot summer of 1787, the Founding Fathers locked themselves into a room and wrote the entire Constitution in a matter of weeks. That's not a bad model for a company under pressure. Fill a room with people from operations, service, marketing, and sales, and require them to hash out their expectations for the next eight quarters or so—what if demand goes down? if prices of key inputs go up?—and then to devise coordinated plans to meet them. And keep it up, repeating the exercise every month. When the facts change, to paraphrase Keynes, so must your strategy. Research has shown that when people have thought through their reactions to high-stress scenarios—such as a disaster or being a victim of a crime—they are much more likely to survive it. Ditto for business.

3. *Evaluate your* customers. In good times, companies manage the P&L; in bad times, cash and receivables matter more. Therefore, you need to identify your higher-risk, cash-poor customers. You could decide to simply not supply them anymore—that's harsh but sometimes necessary. You don't want to be this decade's Nortel or Lucent, which continued to ship to companies whose ability to pay for equipment, it turned out, was nil. Alternatively, and this helps build good relations, work out a way to keep going—for example, by helping finance purchases or supplying smaller quantities. The point is, a downturn is a very good time to do a quality check on your customers.

4, Just say no to **across-the-board cuts.** By all means cut costs if it makes sense to do so, but make sure there is purpose in how you do it. It may be useful to clean out the metaphorical attic—for example, by pruning your product line. Procter & Gamble did that in the late 1990s and early 2000s, shedding stagnant brands like Comet and Crisco. It then used that money to invest in higher-growth areas, to good effect. It was painful for P&G to sell off such historic entities, but doing so delivered a strategic punch that slicing 2% here or there would not have. The key: If you have to cut costs, don't try to be fair about it. As I have said before, the world does not inflict pain evenly, and you have to deal with that reality.

BEING ON THE DOWNSIDE of the business cycle is not much fun. That said, a slump can also be an opportunity if you use the sense of urgency to improve strategy, management, and discipline. In that sense, happy and unhappy times are alike: The companies that take charge and outcompete will win.

RAM CHARAN *is the author of many management books,* including Leaders at All Levels: Deepening Your Talent Pool to Solve the Succession Crisis and What the Customer Wants You to Know.

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