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Managing In a Stagnant Economy

In a sluggish economy, cutting costs and hoping for an economic upturn isn't enough; a business must remain dynamic.

by William S. Hanneman

Don't expect economic growth in 2003 to solve all business woes. It appears that the economy will remain sluggish for some time. As many of our clients have found, managing a business during a sustained economic slowdown can be extremely challenging. Simply cutting costs and riding out the downturn is unlikely to yield the desired results.

SURVIVAL FIRST

In order to survive during sustained periods of slack demand, most firms must cut costs and maintain liquidity. Capital investment is typically the first to go, quickly followed by costs that are not absolutely necessary for day-to-day operations, such as advertising, R&D spending, and certain administrative functions.

Lowering its breakeven cost structure may allow a business to buy time; but it is rarely a prescription for improving the competitive position.

Lowering its breakeven cost structure may allow a business to buy time; but it is rarely a prescription for improving one's competitive position. If the company is to thrive as the economy turns, its owners and managers must think more broadly and be willing to take steps to improve the strategic position.

UNDERSTAND HOW THE BUSINESS MAKES MONEY

It may seem odd, but one area of weakness that we repeatedly see among middle-market businesses is the lack of a clear understanding of just how and where money is made, and how much profit is necessary to justify the capital invested in an enterprise. In a robust market, business owners and managers deal with shortages of employees, managers, and capital. Success is principally predicated upon removing those constraints. When demand slows, the natural tendency is to scale back the business in essentially the reverse order of its growth. This is a mistake.

In a slow economy, there is an extreme reluctance to scale back customers or trim product offerings for fear of having to spread overheads over even less volume.

Managers must critically examine where profits are derived. It is a rare occasion when some form of the 80/20 rule is not at work. That is, 80% of the profits are earned from 20% of the customers or from 20% of the products. In a slow economy, there is an extreme reluctance to scale back customers or trim product offerings for fear of having to spread overheads over even less volume. However, long-term success often requires difficult choices. The approach should be to resize the business to the core customers who best fit its strengths and capabilities.

RECOGNIZE SUNK COSTS

As businesses grow, decisions are made to pursue certain markets and customers, to invest in certain assets and to hire new employees. Now, with dampened demand, many businesses find themselves saddled with excess capacity and/or assets that no longer earn adequate returns. Many owners/managers find this particularly difficult to acknowledge. As hard as it may be, business managers must force themselves to think of each asset, strategy, product, and customer as if there were no previous commitment to it. Past expenditures are sunk costs. That is, the original rationale for a capital investment and its cost is no longer relevant. It must be rejustified regularly.

Capital is a scarce resource, especially during a sustained downturn. Most small- and medium-sized firms do not have the luxury of tying up capital in substandard or non-performing assets. In many cases, companies would be better served by culling substandard operations, products or assets, converting the assets into cash, and using the proceeds to reduce leverage. Failing products or businesses sap strength, time and energy. Continuing to nurture operations that are unlikely to earn sufficient returns puts the business in a position of weakness from which it is very difficult to recover. In fact, the inability to focus on successful operations is one of the primary reasons for failure. Put plainly, you can't afford to keep whipping a dead horse.

ZERO BASED BUDGETING AND PLANNING

As operations are being re-engineered, the company's business plans should be redeveloped from the ground up. Just as historical expenditures are sunk costs, historical operating metrics are not the proper gauge of future performance. In concert with re-engineering business processes, budgets and plans should not be (as they often are) linear extensions of past history. No more revenues up 10-percent and costs down 5-percent from the prior year. Instead, each item of the business plan needs to be carefully considered and justified.

CONTINUE TO INNOVATE

Even though growth is slow (or non-existent), businesses must continue to evolve in order to position themselves to achieve above average performance when the economy turns. This evolution may take forms that were previously not contemplated or may be unconventional. For example, it may mean partnering with suppliers to leverage their capabilities and expertise, shifting production to a lower cost setting, and/or to exploring ways to add greater value to products and services targeted at specific market segments.

Success in business, however, requires confronting the reality of the present position and dealing with it.

In this process, it is imperative to determine what the business does or can do better than

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anyone else in its market. There needs to be a well-defined strategic vision—who are we, what do we do really well, and why? It may be that as the market has evolved, the strategic vision has slipped a little out of focus, and some readjustment is now called for. Researchers at McKinsey & Company found that during the 1990-91 US recession, successful companies spent relatively more on research and development than their peers. Businesses that eliminate spending on innovation are sowing the seeds of substandard performance.

It is much easier to wait for things to improve than to admit they have gone awry. Success in business, however, requires confronting the reality of the present position and dealing with it. As the business environment continues to evolve, the most effective way to cope with the change is to lead it. If this can be done effectively, the business will be in a much-improved position to compete as economic conditions improve. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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