

Managing Downturns

Ladies and Gentlemen

A very good morning to all of you.

The recent past has seen a number of terms becoming a part of daily conversation. Words like bailout, recession, downturn etc have always been a part of discussions involving economists and accountants. Today a layman has come to use these terms in the normal course of his conversation. If the unfortunate events which shook Mumbai in late November are also taken account, one can easily understand the depth of the current difficulties being experienced by all businesses.

'The World is Flat' is what the author Thomas L Freidman, wrote in his book by the same name when he stated that globalisation has levelled the competitive playing fields between industrialised and the emerging economies of the world. The same view seems to be holding true even now when the slowdown has impacted economies across the world. Thus although the origins of the current problems can be traced back to the USA, it has impacted economies all over the world including India.

The year 2008 was ushered in an environment characterised by all round optimism particularly with regard to the Indian economy. Although there were rumblings about the potential problems in the sub prime mortgages market in the USA, there was a belief that India will not be impacted much and that the Indian growth story was set to continue. The stock markets had touched record highs. Foreign capital flows were buoyant. Companies were aggressively tapping the capital markets for raising funds. Although the commodity prices had touched record levels and inflationary pressures were being felt in the economy, Companies were generally confident of being able to deal with these issues and sustain their growth rates.

Things changed once the financial crisis in the USA quickly moved from being limited to the sub prime mortgage securities market to become a broader credit crisis involving the private issuance of all debt securities. The US Government has had to intervene in an attempt to infuse confidence in the market. The crisis quickly spread to institutions across the world. Even countries were impacted badly. As losses mounted, a crisis on confidence enveloped the credit markets. The world is therefore seeing and experiencing a major credit crunch which is severely limiting the availability of credit even for credit worthy customers.

Governments and Central Banks across the world have initiated emergency responses to deal with the situation. Huge amounts of money are being pumped into the global economy in a bid to ward off threats of imminent recession and open up the clogged credit lines. The problems in the credit market have been accompanied by a sharp fall in commodity prices as investors brace for a period of sustained global slowdown. Major economies like USA, Japan, Canada, European economies are now in recession. The tight liquidity position and reduced spending levels have started hurting companies.

The Indian economy has not remained immune to the developments impacting the world markets. As global institutions rushed to raise the badly needed cash, emerging markets including India witnessed a rapid sell off in their stock markets leading to an unprecedented slide in the indices. This has had a severe impact on the exchange rate leading to a sharp jump in the cost of imports. Although crude oil prices have declined sharply, the depreciation of the rupee has meant that the favourable impact has been negated to a large extent. With the forecasts for the global economies being grim, Indian companies need to brace themselves for coping with the difficult times.

The world has been through several major crisis situations. This crisis is however, fundamentally different as it has badly hit the three pillars of the modern financial system viz capital, liquidity and confidence. Not since the Great Depression in 1929 has the world experienced anything like this. The travails of the financial system will impact the economy at large. As the Boston Consulting Group in a paper called "Collateral Damage: What the Crisis in the Credit Markets Means for Everyone else," states that while no one can predict with certainty the severity and duration of the global economic slowdown, a recession now seems inevitable and is likely to be relatively long. In this context, it becomes very critical for companies to equip themselves so that they can manage the downturn effectively.

What are the implications of the current crisis on businesses?

As the Boston Consulting Group states in its paper, the combination of less available and hence more expensive credit coupled with stagnant or even declining demand will hurt even healthy companies. With financial institutions having suffered major losses, their ability and appetite for extending credit even to prime borrowers has been reduced considerably which will only lead to increased cost of funds. Businesses are already experiencing difficulties in raising their fund requirements and even where available, the costs are significantly higher. Thus firms are going to face difficulties in ensuring availability of adequate funds which form the lifeline of business enterprises.

As raising funds become more difficult and expensive for businesses, companies having an excellent cash position will be perceived to be strong and markets will place a premium on such enterprises. In a difficult environment, all enterprises will encounter pressures on volumes and margins. As cash flows become difficult, a strong cash position can come in very handy to effectively tackle the situation.

One of the most important fallouts of the crisis is expected to be the sharp rise in credit losses. In this situation efficient management of working capital becomes very critical. Also there is a rising danger of asset price deflation due to which balance sheets of major companies are likely to be impacted. Further with the slow down affecting all sections of the economy, companies have to brace themselves for a period when profit levels remain depressed. Companies would also have to be prepared to live with rising volatility in areas like commodity prices, exchange rate of major currencies etc all of which will have a major bearing on their operations.

Finally there is bound to be significant changes in consumer behaviour. Consumer spending will be adversely affected even as people become more oriented to savings rather than consumption leading to a fall in demand in the market place.

What needs to be done

Any crisis situation calls for urgent action. This can either be a 'knee jerk' reaction or it can be a well thought out plan of action. Typically, the first category will include decisions like zero capex, delaying creditor payments, drastic pruning of inventory etc. The second category will cover actions like an organisational re design, revisiting the corporate strategy, decision on selling parts of the business etc. While the first category is extremely short term, the second is quite long term in nature and needs time which may not be available. The challenge therefore lies in achieving a balance between the two approaches. This will typically involve creating awareness, motivation and action towards accelerating a value focused culture while simultaneously generating real bottom line impact through a careful and smart consideration of the cost base.

Given the criticality of the situation and the challenges confronting businesses, experts have come out with their suggestions on areas that companies should focus upon in these difficult times. The Boston Consulting Group in their paper referred to earlier talks about 16 key measures that companies need to focus upon. The suggestions include reducing trade credit, restructuring of debt, reassessment of investment programmes, exploring out of the box pricing policies, divestment of non core businesses, installation of crisis monitoring teams, closely watching the cash position etc.

Patrick Harlington in an essay on 'Managing in a Downturn – Shaping your business for the future' suggests that companies should focus on increasing top line sales in a downturn ie maintaining customers, reduce costs ie tightening the business and getting better prices and price increases through regularly and quickly ie keep the business profitable.

These are some examples of what experts have identified as to what are the levers that CEOs should focus on in these difficult times. In all these, the key focus is on strategy, funding and people and stakeholder management. The one thing that comes out quite starkly is the need to manage cash. Effective cash management can guarantee the survival and growth of the enterprise notwithstanding the current tough times.

Given that 'cash is king' today, companies need to adopt what can be termed as a 'cash lab' approach. The objective of a cash lab is basically to monitor and improve the company's cash position. This will require an excellent cash monitoring and forecasting system. Simultaneously it will be critical to identify the internal and external cash levers that can have the maximum impact. These levers would typically include capital turnover levers, operating expenses levers and capital structure levers.

The cash position can be looked at three levels ie cash from operations, cash from investing and cash from financing. Each of the levels will have their sub branches and attention needs to be focused at these so that all available opportunities for cash generation are utilised.

On the operations front, the challenge will lie in managing the simultaneous activities of protecting volumes, reducing costs and increasing prices. Managing these critical levers which impact the operating margins will hold the key to the success of the enterprise. As Patrick Harlington states whilst reducing costs and protecting volume is essential for managing a downturn, there is a need to focus upon price management to shape the business for the future. Although these are tough times, it is a fact that difficult economic conditions throw up numerous opportunities. Companies that can grab these would be in a position to take a leadership position when the economy picks up. It is therefore critical to judiciously manage the capital expenditure plans notwithstanding the current difficult scenario. Finally, all options for reducing the funding costs need to be explored with a view to achieve a lower level of cost of capital.

The benefits of adopting this approach is that it will bring about stability and full control of cash position which is so critical for the survival and growth of the business in these extraordinary times.

Business Model Innovation

Besides focusing on cash, the current economic conditions make it critical for companies to think creatively. It is no longer a “business as usual” scenario. It is therefore essential for businesses to have a re-look at their existing business models. It is an ideal time to look at Business model innovations. Business Model innovations have reshaped entire industries and redistributed billions of dollars of value. They have caused powerful companies operating according to traditional models to fail while those that adopt new models – often new entrants – achieve fantastic growth.

Three primary components – customer value proposition, profit formula, and resources and processes – form the core identity of a business and make up the base upon which the rest of it is built. By necessity, they precede strategy. The business model defines a venture’s playing field, structure, priorities, and identity, but strategy determines how it applies its business model, how it differentiates itself, succeeds, and wins.

Business model innovation is the introduction of a compelling new business model to a market. Innovative business models can be fundamentally new – entirely fresh formulations from the ground up – or incrementally new – strong existing models applied in new contexts. Either way, they reshape markets by changing the basis of competition; if calibrated correctly.

Business model innovation is difficult, but following approach makes it increasingly achievable and repeatable.

1. **Discover the job:** figure out what type of innovation – low-end, high-end, or new market – to pursue based on unmet customer needs
2. **Design the value propositions:** shape the value-creating components of your business model – the customer value proposition and the profit formula – to deliver attractive performance to consumers and to your corporation

3. **Align resources and processes:** make sure that corporate resources and processes are optimized for your new business

4. **Test and build:** identify foothold markets, iterate towards success, and begin to scale

Business Model Innovation is increasingly becoming a recognized driver of long term growth. Most firms approach innovation as the development of new products, services, or technologies. Recent research, however, is pointing to innovative business models as the source of the greatest and most enduring growth. Furthermore, research suggests that business model innovators achieve higher operating margins than those companies focused on product or service innovation.

Conclusion

A key aspect of managing in a downturn is the need to continue looking for opportunities and plan for the upturn. It is important for companies to continue with their innovations and investment in areas which offer growth opportunities for the future. The economic cycle would turn in the future and when that happens, a company which is well prepared can leverage the opportunities and establish a leadership position in the market. Thus managing cash and being prepared for the future will hold the key for the ability of a business enterprise in not only surviving but also growing in the coming days.

It is said that every dark cloud has a silver lining. In the Indian context, it is the expectation that India will be one of the countries that will ride the storm of recession. Given the fact that India has a low exposure to global trade, favourable demographics and long term growth potential, the future holds considerable promise for business enterprises. Also experience shows that appropriate response to recession typically makes a big difference in the long term. Studies undertaken by McKinsey of companies in the USA, shows that during the period 1998 – 2002 when there was a recession like situation, only 60% of companies that were in the top quartile before the recession retained their leadership position after the recession. Similarly the companies managing better than their peers in recessionary times delivered better returns to their shareholders.

Thank You