Resources – what to do when the "bean counters" call

The usual and natural reaction to downturn, as sales slow and costs come under pressure is to try harder. People try to sell more effectively, lose fewer orders, and keep operating costs to a minimum. Non-essential costs are cut, but it is easy to confuse genuine non-essentials with lifeblood costs that, while they can be cut to construct a short-term profit or cash flow, also underpin future innovation.

When marketing budgets are under attack from management accountants, sometimes self-proclaimed experts in their setting, what can be cited as evidence in their defence?

There has been thorough analysis over decades into what happens to businesses when (a) they cut expenditure, (b) maintain it or (c) actually increase it when times get tough. Perhaps the best research is the work undertaken by PIMS (Profit Impact of Market Strategy) – a database of 4,100 US, European and other corporations from around the world that has been recording 30 years of trends data.

A study has been undertaken based on evidence drawn from1,000 businesses in the database that have all experienced recession and recovery. A market in "recession" is defined as one that experiences two year's decline in volume followed by two years of growth. Importantly, this definition necessarily excludes markets that are in terminal decline.
The detailed analysis of these businesses and the strategic decisions taken by them during recession show that different strategies have profound implications for profit and market share outcomes once recovery starts.

The study investigated all areas of a business to establish where investment pays off during a recession and where it does not. It distinguishes between "Good Costs", "Bad Costs" and "It Depends Costs". Good Costs are those that should be increased and intensified during recession. Bad Costs are, of course, those that need to be pruned hard in recession. It Depends Costs are those where the right actions are dependant on the strategic position of an individual business at the time the recession begins.

Three measures have been highlighted to distinguish between successful and unsuccessful strategies:

° Average profitability during recession, defined as Return on Capital Employed
° Change in profitability (ROCE) during first two years of recovery
° Change in market share during first two years of recovery

Successful Strategies: the Evidence

The Good Costs are those associated with marketing, quality and products/services. The Bad Costs include high manufacturing and administration costs and high working and fixed capital.

The degree of the impact of getting cost decisions right or wrong is now described.

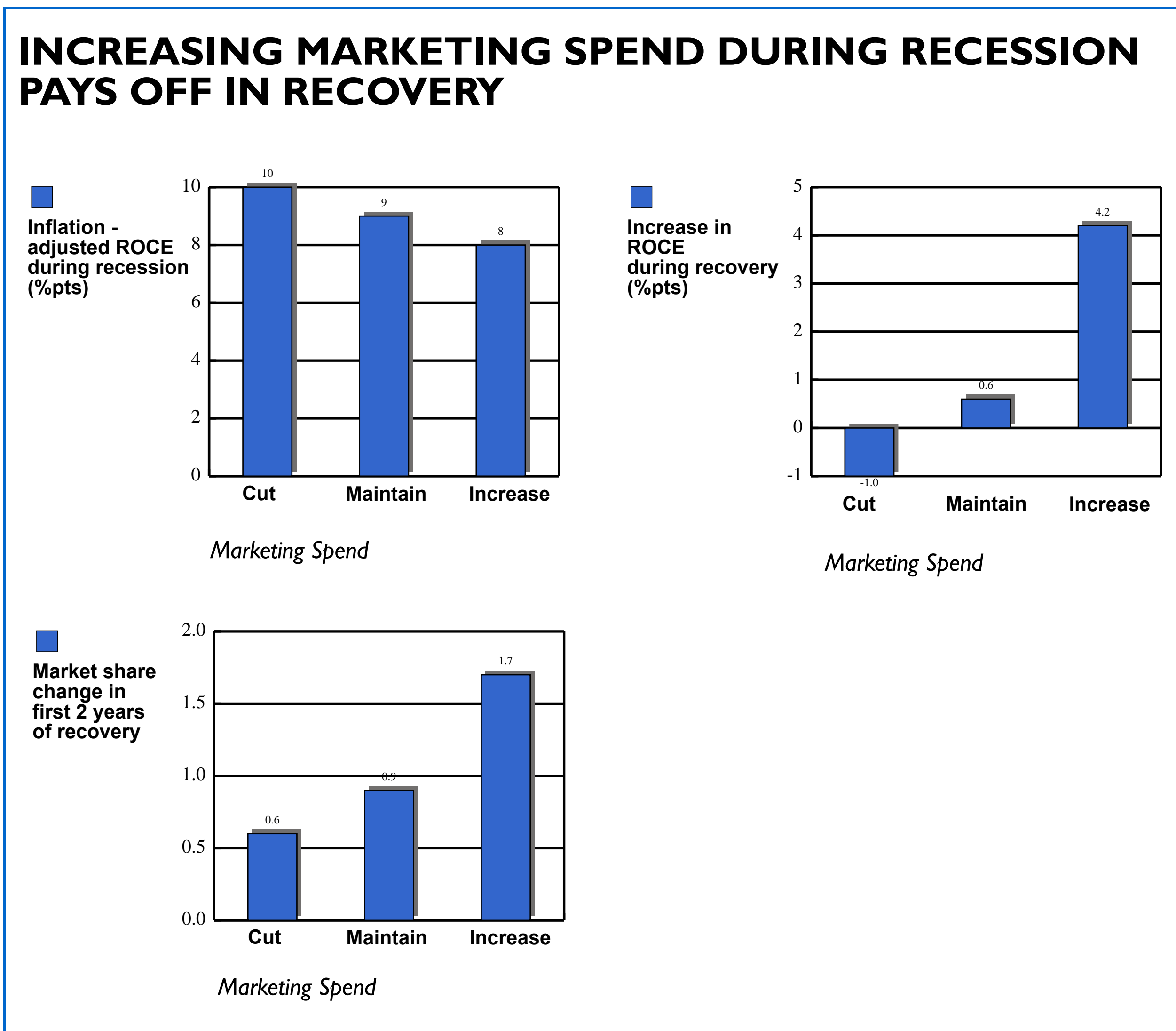
First, what have proved to be good costs during recession are examined. The most pointed of these findings is the importance of marketing. The natural reaction of many businesses experiencing a downturn in their revenue is to cut costs in areas like advertising and promotion. The findings prove that they should do exactly the opposite if they are to ride out the recession and thrive thereafter.

The 1000 businesses were divided between those that cut, maintained and increased marketing spend during recession. The data shows that businesses that increased spend were not significantly less profitable during recession. However, their profits increased dramatically faster once recovery started, unlike "cutters" of marketing spend whose profitability actually fell when recovery began. And, businesses that increased spend in recession, gained market share three times as fast as "cutters" once recovery began! (See Fig. 1)

For marketing spend to be effective, of course, it needs to be based on a sound customer proposition. Those businesses that, in their customers' eyes, provide better value for money than their competitors, are both more profitable during recession and grow faster once recovery starts.

Improving, in customers' eyes, the quality of the offering relative to competitors during recession, also pays off in better profits and growth.

Fig. 1



Innovation Pays off

What about product innovation during recession? R&D spend in recession, both in absolute terms and relative to the competition, pays off handsomely (See Fig. 2).

Why should R&D spend be such a particularly "good cost" during recession?

Because successful, new product introductions during recession are crucial to strong recovery in profitability and growth (See Fig. 3).

Fig. 2

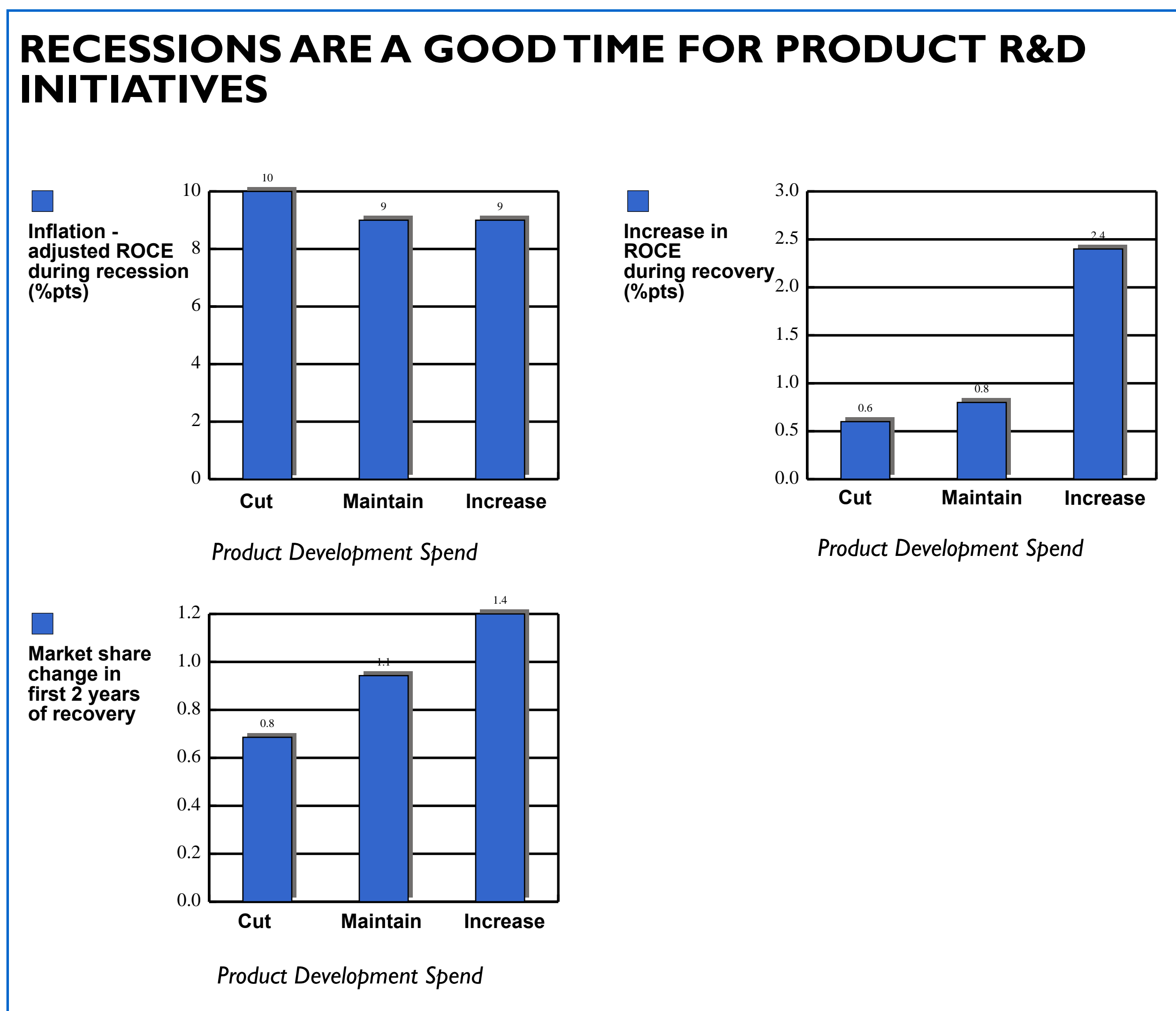
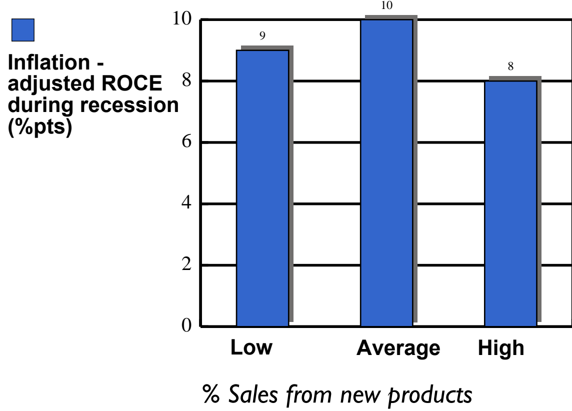
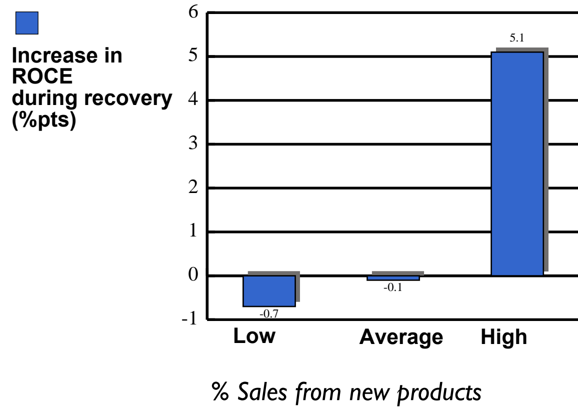
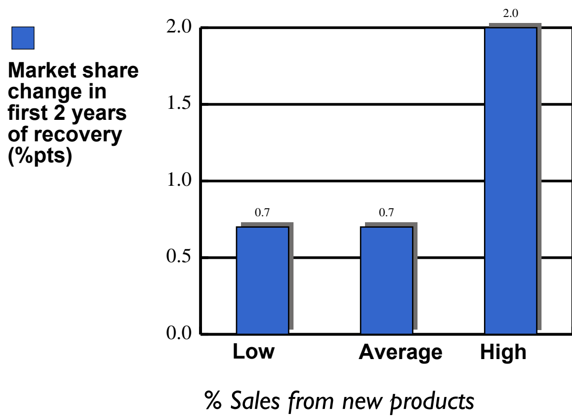


Fig. 3

NEW PRODUCTS ARE CRUCIAL FOR PROFIT AND GROWTH RECOVERY







Bad costs

Investing in new fixed assets during recession, supposedly to improve cost competitiveness and productivity, does not usually bring positive benefits and, if anything, the opposite is the case. Why should this be? Because the supposed benefits of new assets tend to get competed away in the form of lower prices and profit margins in an attempt to fill capacity.

Other Bad costs are high working capital, high manufacturing costs and high administrative overheads.

Understanding when "It Depends"

There are certain strategies that do not contribute only positively or negatively to business performance. This is because their impact depends on the strategic position of the business in hand. These strategies include output capacity and outsourcing.

Cutting output capacity during recession (and, thus, people and costs) may see a very appropriate strategy. For market leaders, however, the PIMS evidence suggests that cutting capacity holds back profit and share improvement during recovery.

Then there is the issue of outsourcing. This is a rapidly increasing trend, partly to allow businesses to concentrate on their core competencies and partly to realise supposed cost savings and efficiencies. So, what better time to outsource more services than in a recession? The PIMS evidence suggests "it depends" on a company's market position and whether its priority for recovery is profit or share improvement.

A Word of Caution

The PIMS evidence outlined here provides a guide for which strategies should prove successful during recession for many businesses much of the time. They are not a panacea for all businesses in all circumstances. Indeed, for some, opposite "rules" seem to apply. For example, one type of business was evaluated where a successful strategy in recession was to cut back product launches and to increase investment in overheads to improve the quality of interaction with customers and suppliers. (This is an important example of how the business landscape in 2001 is radically different from that in previous generations. See The new thinking – how will it impact your business?)

Then, what occurred catastrophically on 11th September has also distorted and exaggerated the current business picture. The big airlines, for example, are all having to cut services and staff. But, by contrast, the new low cost products are doing extremely well. Did British Airways let go of GO to soon?

In recession, the best way to ensure that a business adopts the right strategy is to determine which strategies have proved successful for businesses analogous to itself.