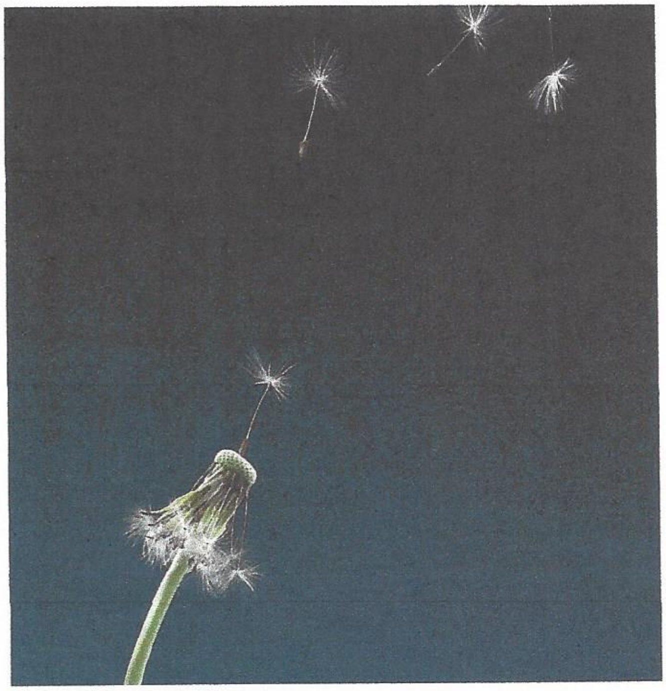
Quick Takes



1. How to Achieve Resilient Growth Throughout the Business Cycle

→ by W. CHAN KIM and RENEE MAUBORGNE

THE WORLD IS currently in the longest business cycle since the National Bureau of Economic Research has kept records. Investors, executives, and policy makers scratch their heads in wonder as they try to make sense of this new phenomenon. Many companies want to know where they are in the business cycle. Are we at the peak with growth about to come tumbling down, or still on the climb where rising growth levels can be expected?

In the U.S. there are clear indicators that we may be at the peak. These include the lowest unemployment in 50 years, rising incomes across all races and job levels, a stock market that continues to reach historic highs (even with the recent volatility sparked by the spread of coronavirus), and a GDP that has been expanding for more than 10 years, beating other expansion cycles. Simultaneously, we see other indicators associated with the trough of the business cycle, including low interest rates and low inflation.

Despite the macroeconomic uncertainty and the unpredictable business cycle, companies need to develop their investment and growth strategies. The question they face is how do you build growth and resilience, irrespective of the stage of the business cycle? Fortunately, our research provides an answer.

Buck the Business Cycle—Strategize Like a Market Creator

As we identified in our research, there are two types of strategy. One is *market-competing* strategy, which focuses on beating rivals in existing markets—what we think of as "red ocean strategy." The other is *market-creating* strategy, which focuses on generating new markets, what we think of as "blue ocean strategy."

In our research over the past 30 years, we found that while both types of strategy play a role, when it comes to growth resilience, blue ocean market-creating moves stand out. They not only unlock a growth edge when economic conditions are favorable, they also generate resilient growth in the face of business cycle downturns and unfavorable economic conditions. How so?

When economic conditions are favorable, all firms tend to benefit by a rising economic tide. But it is market-creating moves—and the leap in consumer surplus they unlock through their innovative value—that give firms a growth edge, as they not only capture a greater share of rising demand but also pull all-new buyers into the market.

Adverse economic conditions only magnify the growth edge attached to market-creating moves, because when the economy is in a downturn, there is a natural flight to value for money. Whether they're short on cash or simply overly cautious, people become far more selective about the products and services they choose to buy and those they stop purchasing. Those forgone products and services tend to offer incremental value, whereas the chosen

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We can all be the captain of our ship when we strike the right balance between market-competing and market-creating efforts.

ones offer a leap in value, or the largest consumer surplus, that makes people's lives better. Under these conditions, market-creating moves—which break away from existing offerings and offer buyers a leap in consumer surplus—fast become the products and services of choice, allowing companies to better buck contracting markets and rebound faster.

Look no further than the companies that rapidly overcame the 2008 financial crisis—Apple, Amazon, Salesforce, Cirque du Soleil, and even the U.K. charity, Comic Relief's Red Nose Day. All achieved a rapid bounce back and exceptional growth despite the economic crisis. And each countered a reliance on market-competing moves with a strong bias toward market-creating strategies that offered buyers a leap in value.

Contrast this with Microsoft, a market-competing dominator in its highly profitable Windows and Office products. It wasn't until Satya Nadella, the company's new CEO, recently shifted Microsoft to a balance of market-competing and market-creating strategies that it again became a rising star. After 10 years of an essentially flat stock price, Microsoft's new market-creating focus has catapulted it into the rarified $1 trillion market-cap club. Its new cloud-based product Azure is set to become a new growth engine for the company.

How to Build Resilient Growth

So, how can companies best manage growth through market cycles? Here are four pieces of advice borne out of our 30-year research journey to the blue ocean.

First, to create growth resilience, focus on building a healthy, balanced portfolio of market-competing and market-creating strategic moves, of red and blue ocean strategies. Both are important: Market-competing moves generate today's cash; market-creating moves ensure tomorrow's growth. Relying on market-competing moves alone, as many companies do, won't build growth resilience across the business cycle. It will hold you hostage to swings in the business cycle.

Second, don't wait for growth to slow to make market creation a strategic priority. Act now. In a downturn you want to be buffered by your market-creating move, and that can happen only when your market-creating move is already launched or set to launch. It is in economic downturns that you need to rely on the resilience of market-creating growth, and for that you need to prepare in advance.

Third, ensure that your market-creating efforts are a core component of your corporate strategy and not siloed into a function, effectively a sideshow. To achieve market creation, you need to make it a priority. To figure out if you are doing that, check who owns the initiative. Is it your top management—like at Apple, Amazon, or Microsoft under the leadership of Nadella? If not, it should be. That sets an important tone, driven from the top, that market creation is front and center to your company's future.

Lastly, remember, technology itself doesn't create new markets. The use of technology does. Is it linked to value innovation or not? Will your product or service make a positive change in people's lives and hence unlock a windfall of consumer surplus? There are lots of technology companies out there. But the ones that achieve resilient growth across cycles—not only in an upturn—link innovation to value, such as Amazon, Apple, and Netflix. That's why so many people are loyal to them.

Don't wait for monetary policy adjustments or fiscal stimulus to propel your growth. You have limited—if any—control over these. Instead, look to yourself. The good news is you need not be driftwood on the roaring ocean of the business cycle, rising and falling with the vicissitudes of the market. We can all be the captain of our ship when we strike the right balance between market-competing and market-creating efforts. Red ocean and blue ocean strategies are not a binary choice. Companies need both. But to find a healthy balance, most companies need to put a lot more heft behind market-creating moves and anchoring these efforts in the heart of corporate strategy.

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2. Companies Need to Prepare for the Next Economic Downturn

→ by MARTIN REEVES, KEVIN WHITAKER, and CHRISTIAN KETELS

MANY ECONOMISTS ARE forecasting a downturn, if not a full-blown recession, over the next 12 to 24 months. We have seen one of the longest expansionary phases in recent history, leading indicators have softened in many countries, stock markets are volatile, and several risks cloud the horizon. Naturally, business leaders are considering how to best position themselves for harsher macroeconomic conditions.

If history is any guide, many companies will prepare too little, too late, and too defensively. Yet our analysis of more than 5,000 companies across the last four business cycles suggests that slowdowns bring opportunities as well as challenges: Some companies actually benefited competitively during and after a downturn, and a common set of actions led to that success.

Today's business landscape has several unique features, which will add new complexities on top of the historical playbook. This makes it important for business leaders to prepare for the specific circumstances of the *next* downturn, as well as exploiting the right lessons from the past.

Some Companies Gain Advantage in Economic Downturns

We studied all U.S. public companies with greater than $50 million in annual sales during the last four downturns—including not only recessions but also periods of substantially slowing growth (we define downturns to include recessions [periods of negative GDP growth] as well as periods of cumulative decline in annual GDP growth of at least 1 percentage point over two years)—and found that nearly three-quarters of those companies experienced a decline in revenue growth. However, 14% of companies were able to not only acceler-

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Leaders need to ensure that their business can withstand many different scenarios, not only a singular forecast.

ate growth but also increase profitability.

The competitive stakes are high: Those 14% of outperformers grew sales by 9% annually during the downturn and increased earnings before interest and taxes (EBIT) margin by 3 percentage points on average, whereas all other companies' sales declined by 2% and EBIT margin declined by 2 percentage points. Competitive volatility—as measured by the change in composition and ranking of the *Fortune* 100—rose by 30% in recent downturns, also suggesting opportunity for some. Notably, competitive volatility rose by just as much during more-moderate downturns as in deeper recessions.

The companies that weather downturns successfully tended to respond differently on a few key dimensions:

They acted early. Leaders may understandably be reluctant to take major actions until they see clear evidence that they are affected by economic headwinds. However, we found that the companies that proactively recognized the threat—by discussing the possibility of a downturn in their earnings calls before the economic recession officially began in December 2007—achieved 6 percentage points better total shareholder return (defined as total returns to investors including capital gains and dividends) in the downturn than companies that did not address the challenge early.

They took a long-term perspective. Leaders have to attend to short-term issues during a downturn to make sure their business remains solvent. But substantial competitive opportunities await the leaders who can also keep one eye on the long-run picture. We used natural-language-processing algorithms to assess companies' long-term orientation from SEC filings and found that companies with a longer-term perspective achieved 4 percentage points higher annual growth during the downturn as well as 2 percentage points higher total shareholder return.

They focused on growth, not just cost-cutting. To go beyond survival and gain a sustainable advantage, companies need a balanced approach to performance. The small minority of companies that achieved double-digit annualized total shareholder return in downturns pursued efficiencies, improving their profit margins. But the most important driver was revenue growth, which accounted for nearly 50% of their shareholder return—twice as large as the impact of cost reductions. (The remainder was driven by investor expectations.)

Current Risks to the Economy

Though historical lessons can help business leaders prepare for a slowdown, there are several unique features of today's business landscape that also need to be taken into account.

Economic forecasting is an inexact science at the best of times, but views are particularly divergent today, ranging from the possibility that the worst may already be over to the prospect of a more severe recession in the near term. The uncertainty is driven by elevated risks on many fronts: *technological risks,* including cybersecurity and trust; *economic policy risks,* including challenges to international institutions; *social risks,* including increasing inequality in many countries; and *planetary risks,* including climate change. As Christine Lagarde, former chair of the International Monetary Fund (IMF), said, "The global economy is facing significantly higher risks...[and] these risks are now increasingly intertwined."

We organize the current critical risks to the economy into these categories:

1. **Technology,** including AI governance, data privacy, and trust
2. **Economy,** including growth, uncertainty, trade, and U.S. versus China
3. **Society,** including the future of work, inequality, inclusion, and cohesion
4. **Planet,** including plastics, global warming, and clean water

In many previous downturns, falling economic growth was the dominant issue. In the next downturn, however, decelerating growth should be thought of as only one disruptive force—and probably not the most important one. Leaders will need to continue contending with technological disruption and its effects on competition, supply-chain disruption driven by trade barriers, and competitive disruption driven by players with new business models.

The spread of performance across companies, as measured by the average difference in EBIT margin between companies in the top quartile of their industries compared with the bottom quartile, is greater than at any time in recent history.

Corporate cash and debt are both at record highs, and companies at extremes of the balance sheet spectrum will have different concerns: Highly leveraged companies perform significantly worse during downturns, controlling for industry and other factors. Because businesses are starting from disparate positions, they will need to customize their responses accordingly.

How to Prepare for the *Next* Downturn

By combining what we know about company performance in past downturns with the special features of the current situation, we can identify several things companies should consider in preparing for the next one:

De-average your response. A company's various geographic and business units may be affected very differently by a downturn. For example, although growth is expected to slow in most developing countries, the IMF projects will accelerate in India and Africa and remain strong in Southeast Asia. Downturns will also have sector-specific effects: Whereas discretionary consumer-products sectors have been strongly affected by past downturns, consumer-staples sectors (like food products) have been less exposed. Leaders need to understand the specific environment in which *each* of their businesses operates and choose their resource allocation, as well as their approach to strategy, accordingly.

Build resilience to the unexpected. There's a lot of uncertainty facing the global economy. Leaders need to ensure that their business can withstand many different scenarios, not only a singular forecast. For example, companies that preserve financial buffers will be better able to respond to unanticipated threats or opportunities, and those with shorter planning cycles can better adapt to new information. And stress testing against a range of scenarios can help test resilience.

Invest in growth. Downturns make growth more difficult in the short term, but they should not undermine the potential for long-term growth—unless leaders starve their companies of the necessary investment. Sustained growth is more difficult to achieve than ever, but our study shows that companies that continue to invest in R&D and innovation will have the best chance to successfully grow in the long run.

Don't lose sight of your long-term transformation agenda. As economist Paul Romer once said, "A crisis is a terrible thing to waste." Downturns can shine a spotlight on the long-term health of a business, revealing vulnerabilities that might not have been as visible in good times. Leaders should use downturns as an opportunity to create a sense of urgency within their organizations, helping drive the large-scale change needed to succeed in the future.

Focus on technological competitiveness. Technological change is reshaping all industries and causing competitive positions to become more fragile. Downturns also tend to amplify competitive volatility, which means the next downturn is likely to increase the potential risks and rewards of digital disruption even further. Technological progress will not stop during a downturn, so companies cannot afford to put their digital-change agendas on hold.

Contribute to common problems collaboratively. Today's pressing technological, economic, social, and environmental risks cannot be solved without collective action. However, the next downturn may inflame social tensions and reduce governments' ability to act on such issues. Business leaders need to play a proactive role in addressing the biggest challenges of our time, collaborating with all stakeholders and moving from discussion to pragmatic action.

The next downturn will challenge many companies, but a few will emerge stronger—competitively and financially. Leaders who leverage lessons from the winners in previous downturns, as well as attending to the unique features of today's environment, will be in the best position to succeed.

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