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HOW TO SURVIVE A RECESSION *& Thrive* AFTERWARD

A Research Roundup

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In early 2000, a five-year-old online bookseller called Amazon.com sold $672 million in convertible bonds to shore up its financial position. One month later, the dot-com bubble burst. More than half of all digital start-ups went out of business over the next few years—including lots of Amazon's then-rivals in e-commerce. Had the bubble burst just a few weeks earlier, one of the most successful companies ever might have fallen victim to that recession.

Recessions—defined as two consecutive quarters of negative economic growth—can be caused by economic shocks (such as a spike in oil prices), financial panics (like the one that preceded the Great Recession), rapid changes in economic expectations (the so-called "animal spirits" described by John Maynard Keynes; this is what caused the dot-com bubble to burst), or some combination of the three. Most firms suffer during a recession, primarily because demand (and revenue) falls and uncertainty about the future increases. But research shows that there are ways to mitigate the damage.

In their 2010 HBR article "Roaring Out of Recession," Ranjay Gulati, Nitin Nohria, and Franz Wohlgezogen found that during the recessions of 1980, 1990, and 2000, 17% of the 4,700 public companies they studied fared particularly badly: They went bankrupt, went private, or were acquired. But just as striking, 9% of the companies didn't simply recover in the three years after a recession—they flourished, outperforming competitors by at least 10% in sales and profits growth. A more recent analysis by Bain using data from the Great Recession reinforced that finding. The top 10% of companies in Bain's analysis saw their earnings climb steadily throughout the period and continue to rise afterward. A third study, by McKinsey, found similar results.

The difference maker was preparation. Among the companies that stagnated in the aftermath of the Great Recession, "few made contingency plans or thought through alternative scenarios," according to the Bain report. "When the downturn hit, they switched to survival mode, making deep cuts and reacting defensively." Many of the companies

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that merely limp through a recession are slower to recover and never really catch up.

How should a company prepare in advance of a recession and what moves should it make when one hits? Research and case studies examining the Great Recession shed light on those questions. In some cases, they cement conventional wisdom; in others, they challenge it. Some of the most interesting findings deal with four areas: debt, decision making, workforce management, and digital transformation. The underlying message across all areas is that recessions are a high-pressure exercise in change management, and to navigate one successfully, a company needs to be flexible and ready to adjust.

DELEVERAGE BEFORE A DOWNTURN

Rebecca Henderson (of Harvard Business School) likes to remind her students, "Rule one is: Don't crash the company." That means, first and foremost, don't run out of money. Because a recession usually brings lower sales and therefore less cash to fund operations, surviving a downturn requires deft financial management. If Amazon hadn't raised all that money prior to the dot-com bust, its options would have been much more limited. Instead, it was able to absorb losses in its investments in other start-ups and also launch Amazon Marketplace, its platform for third-party sellers, later that year. It further expanded during and after the recession into new segments (kitchens, travel, and apparel) and markets (Canada).

Companies with high levels of debt are especially vulnerable during a recession, studies show. In a 2017 study, Xavier Giroud (of MIT's Sloan School of Management) and Holger Mueller (of NYU's Stern School of Business) looked at the relationship between business closures and associated unemployment and falling housing prices in various U.S. counties. Overall, the more housing prices declined, the more consumer demand fell, driving increased business closures and higher unemployment. But the researchers found that this effect was most pronounced among companies with the highest levels of debt. They divided up companies on the basis of whether they became more or less leveraged in the run-up to the recession, as measured by the change in their debt-to-assets ratio. The vast majority of businesses that shuttered because of falling demand were highly leveraged.

"The more debt you have, the more cash you need to make your interest and principal payment," Mueller explains. When a recession hits and less cash is coming in the door, "it puts you at risk of defaulting." To keep up with payments, companies with more debt are forced to cut costs more aggressively, often through layoffs. These deep cuts can impair their productivity and ability to fund new investments. Leverage effectively limits companies' options, forcing their hand and leaving them little room to act opportunistically.

The extent to which high levels of debt pose a risk during a recession depends on various factors. Shai Bernstein (of the Stanford Graduate School of Business), Josh Lerner (of Harvard Business School), and Filippo Mezzanotti (of Northwestern University's Kellogg School of Management) have found that companies owned by private equity firms—which often require the companies they finance to take on debt—fared better during the Great Recession than similarly leveraged non-PE-owned firms. Companies with lots of debt struggle in part because access to capital slows to a trickle during a downturn. PE-backed firms emerged in better shape, the study suggests, because their owners were able to help them raise capital when they needed it. Issuing equity is another way companies can avoid the burden of debt obligations. "If you issue equity in the run-up to a recession," Mueller says, "the problem of defaulting will be less pronounced."

The reality, of course, is that many companies have some level of debt going into a recession. Mueller's study found that the average debt-to-assets ratio among firms that had increased debt levels in the run-up to the Great Recession was 38.3%. Among the group that had deleveraged, it was 19.5%. Although there's no magic number, modest levels of debt aren't necessarily a problem, research shows. Nonetheless, Mueller suggests that if a company thinks a recession is coming, it should consider deleveraging. McKinsey's recent recession research supports this: Firms that emerged in better shape from the Great Recession had reduced their leverage more dramatically from 2007 to 2011 than had less successful ones.

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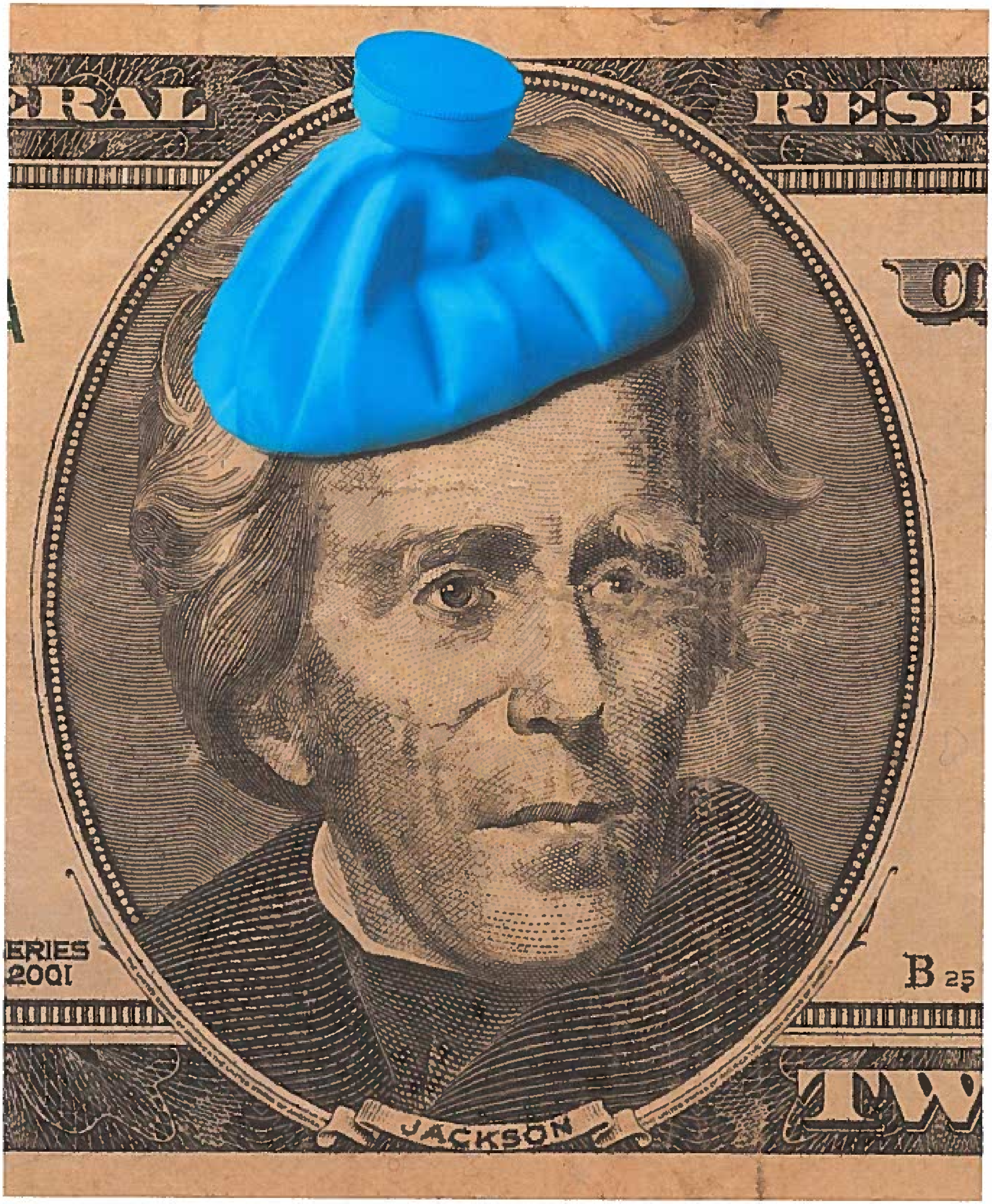
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When it comes to deleveraging, it helps to start early, says McKinsey's Mihir Mysore. That means reducing debt levels before it's clear the economy is in recession. "You need to take a hard look at your portfolio," Mysore advises, because shedding assets can be a way to reduce leverage without necessarily cutting core aspects of operations.

FOCUS ON DECISION MAKING

A company's performance during and after a recession depends not just on the decisions it makes but also on who makes them. In a 2017 study, Raffaella Sadun (of Harvard Business School), Philippe Aghion (of Collège de France), Nicholas Bloom and Brian Lucking (of Stanford), and John Van Reenen (of MIT) examined how organizational structure affects a company's ability to navigate downturns. On the one hand, "the need to make tough decisions may favor centralized firms," the researchers write, because they have a better picture of the organization as a whole and their incentives are typically more closely aligned with company performance. On the other hand, decentralized firms may be better positioned to weather macro shocks "because the value of local information increases."

The researchers relied on data from the World Management Survey of manufacturers, which includes questions on how much autonomy a plant manager has to make investments, introduce new products, make sales and marketing decisions, and hire employees. Companies in which plant managers had little discretion were considered highly centralized; those in which they had a lot of discretion were scored as less so. The researchers also examined results from a similar survey run by the U.S. Census and matched them with company reports of sales, employment levels, profits, and other performance measures. And they gathered data on which industries were hardest hit by the Great Recession. "Decentralization was associated with relatively better performance for firms or establishments facing the toughest environment during the crisis," the researchers report. They also found that the benefits of decentralization faded as economic conditions improved—a sign that delegation has particular value during uncertain times.

Why did decentralization help? "The recession introduced a lot of uncertainty and turbulence," says Sadun. Because decentralized firms delegated decision making further down the hierarchy, they were better able to adapt to changing conditions. For example, they were more aggressive in adjusting their product offerings in response to changes in demand. "One [piece of] advice would be [to] really think carefully about your organizational structure because that's one way you cope with uncertainty," says Sadun.

Of course, organizational structure isn't easy to adjust quickly in preparation for a recession, but that doesn't mean companies can't learn from these findings. "What decentralization does," says Sadun, "is match decisions with expertise." She says companies can fall into the trap of hoarding decision rights during a downturn. But the uncertainty of a recession necessitates experimentation, which requires that decisions be made throughout the organization. Even if companies decide not to decentralize, they can try to do a better job of gathering input from employees at all levels when making key decisions. "Recessions offer opportunities for change," notes Sadun.

LOOK BEYOND LAYOFFS

Some layoffs are inevitable in a downturn; during the Great Recession, 2.1 million Americans were laid off in 2009 alone. However, the companies that emerged from the crisis in the strongest shape relied less on layoffs to cut costs and leaned more on operational improvements, Ranjay Gulati and his colleagues found in their study of public companies.

That's because layoffs aren't just harmful to workers; they're costly for companies, too. Hiring and training are expensive, so companies prefer not to have to rehire when the economy picks back up, particularly if they think the downturn will be brief. Layoffs can also hurt morale, dampening productivity at a time when companies can ill afford it.

Fortunately, layoffs aren't the only way to cut labor costs. Companies should consider hour reductions, furloughs, and performance pay. After the stock market crash in 2000, Honeywell laid off nearly 20% of its workforce and then struggled to recover in the downturn that followed. So when the Great Recession hit, in 2008, the company took a different approach, as Sandra J. Sucher and Shalene Gupta describe in their 2018 HBR article, "Layoffs That Don't Break

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Companies invest in technology during recessions because their opportunity cost is lower than it would be in good times.

Your Company." "Honeywell furloughed employees for one to five weeks, providing unpaid or partially compensated leaves, depending on local labor regulations," Sucher and Gupta wrote. That saved an estimated 20,000 jobs. Honeywell emerged from the Great Recession in better shape than it did the 2000 recession in terms of sales, net income, and cash flow, despite the fact that the 2008 downturn was much more severe.

In some parts of the world, policy makers encourage shorter hours as an alternative to layoffs. Many countries and more than half the states in the U.S. have some sort of "short-time" compensation program, whereby workers whose hours are reduced receive partial unemployment compensation. In France, 4% of workers and 1% of firms took advantage of short-time work programs in 2009, and the program paid off for both workers and companies. In a 2018 discussion paper for the European think tank Centre for Economic Policy Research, Pierre Cahuc, Francis Kramarz, and Sandra Nevoux found that companies that took advantage of the short-time work program laid off fewer workers and were more likely to survive during the Great Recession. The effect was most significant among the companies most severely hit by the recession and those with the highest levels of debt. According to the researchers, the short-time work approach allowed vulnerable companies to hold on to more of their workforce. Absent the subsidies, they most likely would have had to lay off more employees, making it more difficult to recover after the recession or causing them to go out of business altogether. The researchers estimate that for every five workers on short-time work, one job was saved. And they estimate that the cost per job saved was less than that of comparable programs; since the alternative was paying unemployment, the program actually saved the French government money.

One appealing thing about both furloughs and short-time work is that, as with layoffs, companies have discretion over which workers are affected. By contrast, across-the-board pay cuts or hiring freezes that fail to consider employee productivity can backfire, damaging morale and driving away the most productive employees. Similarly, hiring freezes affect every department indiscriminately, without weighing the value of various potential hires.

Performance pay—compensation based on some measure of productivity or business outcome—is another way to control labor costs without hurting productivity. There is a long-running debate about performance pay, for executives and frontline workers, and plenty of evidence for and against the management tool on both sides. But a recent study by Christos Makridis (of the White House Council of Economic Advisers) and Maury Gittleman (of the U.S. Bureau of Labor Statistics) documents an important fact. Using responses to the National Compensation Survey from 2004 to 2014, the study shows that U.S. companies rely on performance pay more frequently during economic downturns. Although they can't say whether this strategy works out for companies, they show that a given job is more likely to come with performance pay when times are tough. They hypothesize that this is because performance pay makes companies more flexible by aligning workers' incentives with changing conditions.

INVEST IN TECHNOLOGY

It's tempting to think of a recession as a time to batten down the hatches and play it safe. However, downturns actually appear to encourage the adoption of new technologies. In a 2018 paper, Brad Hershbein (of the Upjohn Institute for Employment Research) and Lisa B. Kahn (of the University of Rochester) compared more than 100 million online job listings posted from 2007 to 2015 with economic data to see how the Great Recession affected the types of skills employers were looking for. They found that the U.S. cities hardest hit by the recession saw a greater demand for higher-order skills—including computer-related skills. The boost in demand was partly due to employers' taking advantage of high unemployment to be choosier, as suggested by Alicia Sasser Modestino (of Northeastern), Daniel Shoag (of Harvard Kennedy School and Case Western Reserve), and Joshua Ballance (of the New England Public Policy Center). Their study found that the demand for tech skills returns to more normal levels once the labor market improves.

But companies weren't only being choosier, Hershbein and Kahn found; they were becoming more digital, too. In those hard-hit areas of the United States, companies also increased their investment in information technology,

driving the surge in IT skill requirements in their job postings.

Why do companies invest in technology during a recession when money is tight? Economists theorize that it's because their opportunity cost is lower than it would be in good times. When the economy is in great shape, a company has every incentive to produce as much as it can; if it diverts resources to invest in new technologies, it may be leaving money on the table. But when fewer people are willing to buy what you're selling, operations need not be kept humming at maximum capacity, which frees up operating budget to fund IT initiatives without dampening sales. For that reason, adopting technology costs less, in a sense, during a recession.

That's fine in theory, but other reasons may make more practical sense to managers. Technology can make your business more transparent, more flexible, and more efficient. According to Katy George, a senior partner at McKinsey, the first reason to prioritize digital transformation ahead of or during a downturn is that improved analytics can help management better understand the business, how the recession is affecting it, and where there's potential for operational improvements.

The second reason is that digital technology can help cut costs. Companies should prioritize "self-funding" transformation projects that pay off quickly, George says, such as automating tasks or adopting data-driven decision making. The third reason is that IT investments make companies more agile and therefore better able to handle the uncertainty and rapid change that come with a recession. In manufacturing, "we are finally seeing uptake now in the adoption of digital and advanced analytics," she says. It used to be that a manufacturer could be the cheapest in the market or could stay nimble—but not both. Flexibility came with serious costs. However, digital technologies "create much more flexibility around product changes, volume changes, etc., as well as around movement of your supply chain around the world."

That, in George's view, is one way the next recession might be different from past ones. Companies that have already made an investment in digital technology, analytics, and agile business practices may be better able to understand the threat they face and respond more quickly. As we've seen, recessions can create wide and long-standing performance gaps between companies. Research has found that digital technology can do the same. Companies that have neglected digital transformation may find that the next recession makes those gaps insurmountable. ⊜

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