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Retail Practice

How retailers can build resilience ahead of a recession

Recent history shows how retailers can prepare for a downturn to create competitive advantage.

by Sajal Kohli, Nicholas Landry, and Steve Noble

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Retailers beware: although the US economy began a record expansion in 2009, there were already signs of moderating growth and consumer spending when the coronavirus hit. No one can say if the economy will tip into recession (nor how long it will last, it if does). Still, retailers can be sure that when there is a slump, it will pose challenges.

That was certainly the case during the Great Recession. Officially, it lasted from December 2007 through June 2009, but its effects lingered for some time thereafter. Our research found that 42 percent delivered no returns for shareholders between 2007 and 2011. Others did not survive: dozens of large retailers filed for bankruptcy.

And yet, under the exact same conditions, other retailers thrived. Take Domino's Pizza, for example. From 2007 to 2011, it delivered 16 percent total returns to shareholders (TRS); for one of its competitors, that figure was –7 percent. What differentiated success from failure?

To answer that question, we interviewed dozens of retail executives and examined the 2007 to 2011 performance of 1,100 publicly traded companies, including more than 250 retailers. Most did poorly. But the top fifth of retailers ("retail resilients") did well, delivering 21 percent TRS. For the rest ("retail nonresilients"), the figure was –4 percent.[1]

In most industries, cost management was the most important performance factor for success. For retail, while this was important, earnings growth from higher sales was more so. Specifically, the retail resilients increased revenues by more than a third from 2007 to 2011, much more than the retail nonresilients.

This was likely not happenstance. Our research found that retail resilients anticipated a recession and prepared for it (see sidebar, "Questions for retailers"). One to two years before the downturn hit, they took steps to enable them to adapt to whatever happened—and to act decisively.

Questions for retailers

Leaders from resilient retailers didn't wait for a downturn to act. Instead, they were always ready to answer questions like these:

— *Sources of growth.* Do we know where, how, and from whom to pick up additional market share?

— *Balance sheet.* Do we have enough cash to ride out tougher times—or better yet, to invest?

— *Cost structure.* If a recession hit tomorrow, could we make it out unscarred? Have we taken full advantage of our cost-saving initiatives?

— *Resilience.* What would happen if we took a 10 to 15 percent margin hit? Are we agreed on a plan and ready to act? Are we organized and agile enough to respond quickly to changes in the market?

Here are six actions that set the retail resilients apart:

— *Build cash reserves.* Resilients unlocked more cash, and sooner, than other retailers. Having this war chest enabled them to navigate the downturn successfully. Retail resilients increased cash reserves by 18 percent between 2007 and 2009, whereas nonresilients had flat cash reserves. Resilient retailers also divested more aggressively. Ahead of the downturn, the share of change in revenues that were tied to divestitures was 35 percent for retail resilients versus 7 percent for nonresilients. For example, shortly before

[1] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly*, May 2019, McKinsey.com.

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the recession hit, Yum! Brands reduced the share of its corporate-owned restaurants in the United States from 22 percent to about 10 percent, an action that released capital at a good time. Some retail nonresilients made similar moves to unlock cash, but they typically did so 12 to 24 months later than the resilients did—during (rather than before) the recession, when circumstances were worse.

— *Create margin headroom.* In the period immediately before the downturn, the selling, general, and administrative expenses for retail nonresilients rose to 15 percent of sales, from 13 percent. For the retail resilients, by contrast, they fell to 11 percent, from 13 percent. Dollar Tree shaved seven percentage points off such expenses between 2007 and 2008, giving it room to take the margin hit on stores adversely affected by the downturn. It was also able to invest in growth, such as expanding its grocery business, financing an aggressive marketing campaign, and opening new stores to capture customers who were trading down as the economy soured. These and other strategies helped the resilients to recover faster. By 2011, 76 percent of them were exceeding predownturn earnings before interest, taxes, and depreciation, compared with 46 percent of the nonresilients.

— *Go on the offensive.* Because retail resilients had already tightened their belts and stocked cash war chests, they were able to invest when the economy soured. They increased their marketing and operating costs by 2.2 percentage points from 2009 to 2011. Revenues rose ten percentage points for resilient retailers during the downturn; for the rest, they fell six points. For example, while other discount stores were cutting back, T.J.Maxx increased its advertising spending by 15 percent as part of a strategy to target customers outside its core who had been affected by the downturn. In 2009, the company reported that 75 percent of that year's shoppers had not shopped at the store the year before. In fact, all the resilient players we spoke to maintained or increased their marketing spending during the downturn in an effort to increase their market share.

— *Move into new markets.* In the latest downturn, many retailers were forced to close stores or cut back growth plans. But the resilients were more likely to take the opportunity to enter new markets. Zara added premium, long-term retail space that its competitors had abandoned. In 2009 alone, it opened 28 stores in North America and international flagships in Beijing and Tokyo. Starbucks Coffee grew impressively in China, even as it closed poorly performing stores in the United States.

— *Reshape the value proposition.* Reading the trends and repositioning assortment, pricing, and merchandising helped resilient retailers safeguard their existing sales and find new

customers. Many nonresilient retailers offered broad discounts to retain customers and boost sales during the recession, which had the side effect of reducing margins in a manner that can be difficult to restore when conditions improve. Resilient retailers were more adept at careful segmentation. T&CO (Tiffany's), for example, dropped the average price of its high-end fashion jewelry by 25 percent in 2008–09 but increased the prices of its recession-proof engagement jewelry by 10 percent. The result: its net revenues rose, and its margins were stable.

— *Maintain customer service.* Nonresilients were apt to make mass layoffs, both in corporate headquarters and inside their stores. But resilients tended not to cut frontline costs—some even invested in additional training. When the retail sector in general was cutting staff, T.J.Maxx seized the opportunity to hire more high-performing sales associates and thus upgrade its talent pool.

Retail resilients not only survived the Great Recession but also came out of it stronger. We believe that how retailers perform in the next downturn will be determined, in large part, by how well they prepare now, and then how decisively they act. Many retailers are already investing time and resources in such preparations—for example, by conducting stress tests to evaluate their readiness and enhance their resilience. Such efforts should focus on ensuring that the organization is primed to act decisively when the economy does turn and to identify specific interventions.

No one can be certain when a recession will come or how severe it will be. What we do know is that expansions do not last forever. We also know that, even in a strong economy, the retail sector is under stress because of the rise of online shopping. Being prepared is the best way to ride out the storm, whenever it arrives.

Sajal Kohli is a senior partner in McKinsey's Chicago office, **Nicholas Landry** is an associate partner in the Vancouver office, and **Steve Noble** is a partner in the Minneapolis office.

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