Building up for leaner times

When the going gets tough, not all companies fare the same. Here's how to join the ranks of the resilient.

by Martin Hirt, Kevin Laczkowski, and Mihir Mysore

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Geopolitical shifts, economic downturns, and other "shocks" that can significantly affect your company's fortunes are inevitable—and not entirely predictable. Recessions, for instance, may come on fast and cut deep, only for markets to bounce back quickly. Or they may be prolonged, with uncertain recovery periods. Scenario analyses can help put some boundaries around such uncertainties, but there is no guarantee that in today's volatile business environment they will be 100 percent bulletproof. A big question for executives, then, is: How can we best prepare for crises whenever they strike?

In times of crisis, not everybody fares the same. When we traced the paths of more than 1,000 publicly traded companies, we found that during the 2008 recession, only about 10 percent fared materially better than the rest. What made this cohort of resilient companies different? Was it because of the industries they operated in, or was it just luck?

We investigated more deeply and found some noteworthy characteristics in how the resilient companies weathered storms, how they prepared for them, how they acted during tougher periods, and how they came out of them. We saw that they reacted to market shifts earlier than industry peers did, so they entered the crisis in better shape. As a result, their performance dipped comparatively less than that of their peers during the downturn, and they came out stronger on the other side of the recession. Their moves are instructive for companies seeking to be similarly resilient—to ride the waves of uncertainty instead of being overpowered by them.

How the resilient companies performed

The focal point of our analysis was a group of approximately 1,100 publicly traded companies, across a range of industries and geographies, with revenue exceeding $1 billion. We found that, between 2007 and 2011, in each of 12 economic sectors analyzed, there was a power curve[1] of corporate performance.[2] The top quintile of companies in each sector—the resilients—delivered total returns to shareholders (TRS) growth that was higher than the median in their sector.

Further review revealed that in the three boom years before 2007, these resilient companies actually

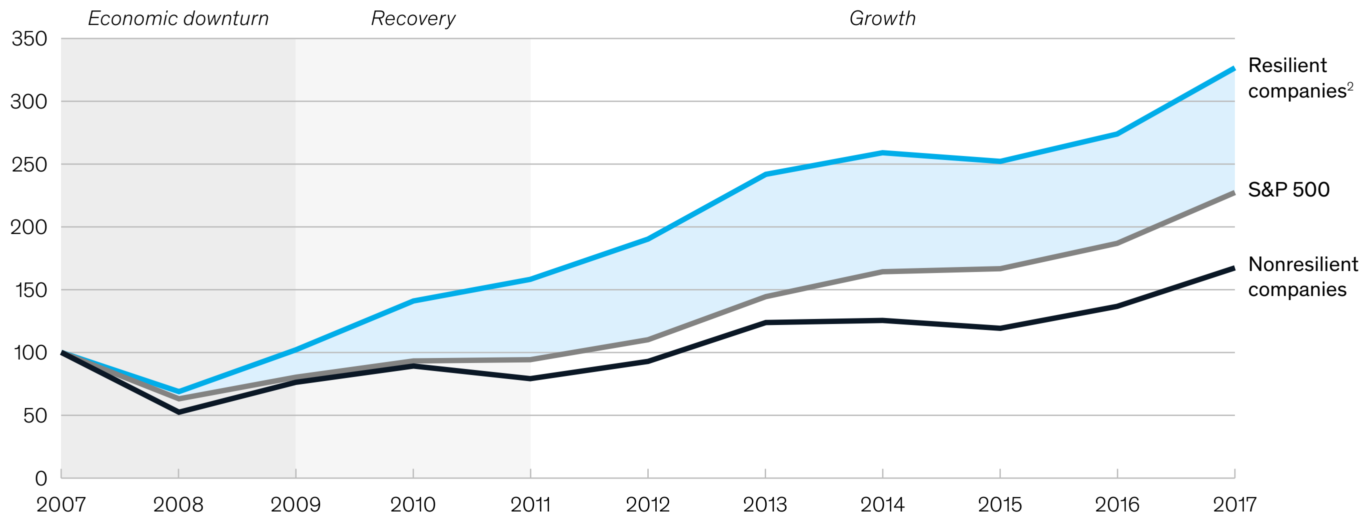
Resilient companies prepared earlier, moved faster, and continued to try to grow earnings, even when revenue declined significantly.

[1] Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 2018, McKinsey.com.
[2] Performance was measured in terms of companies' total returns to shareholders (TRS) or excess TRS growth between 2007 and 2011, relative to the sector median.

Exhibit

Resilient companies did better at the outset of the downturn and after.

Cumulative TRS performance[1]



[1] TRS = total returns to shareholders; calculated as average of subsectors' median performance within resilient and nonresilient categories; n = 1,140 companies; excludes financial companies and real-estate investment trusts.
[2] Resilient companies defined as being in top quintile of TRS performance by sector.

Source: S&P Capital IQ; McKinsey analysis

underdelivered on TRS, but they opened up a slight lead in TRS relative to sector peers during the downturn, and they extended this lead through the recession (exhibit). By 2017, the cumulative TRS lead of a typical resilient company had grown to more than 150 percent over industry peers. This lead was tough to reverse: nearly 70 percent of the resilients remained top-quintile performers in their sectors, with just a small fraction of the industry peers joining them.

The resilient companies were distinguished by their earnings, not their revenues. Barring those in a few outlier sectors, such as oil and gas and pharmaceuticals, resilient companies lost nearly as much revenue as industry peers did during the downturn. However, by the time the downturn reached its trough in 2009, the resilients' earnings (measured as earnings before interest, taxes, depreciation, and amortization [EBITDA]) had risen by 10 percent, while industry peers had lost nearly 15 percent.

What the resilient companies did differently

To create this earnings advantage, the resilients trained their attention in four main areas.

They grew earnings without interruption

There is little evidence to suggest that the resilient companies were better at timing the market. However, we can see that they prepared earlier, moved faster, and continued to try to grow earnings, even when revenue declined significantly. Many resilients accomplished this through deep cost cutting: by the first quarter of 2008, they had already cut operating costs by 1 percent compared with the year before, even as their peers' year-on-year costs were growing by a similar amount. The resilients maintained and expanded their cost lead as the recession moved toward its trough, improving their operating edge in seven out of the eight quarters during 2008 and 2009.

They kept their eye on the highest-value customers

The resilient companies didn't forget about growth in the middle of the recession—nor did they succumb to a "revenue at all costs" mind-set. Instead, they managed the decline in revenue by overinvesting in a few high-value customer segments, effectively positioning themselves as the "organization of choice" for critical customer groups that could help the company grow in the future. This approach allowed the resilient companies to maintain customer loyalty during the downturn and grow faster than peers during the recovery period.

They built a buffer

The resilient companies cleaned up their balance sheets before the trough of the 2008 recession, which gave them the flexibility they needed to be more acquisitive afterward. During 2007, resilient companies reduced their debt by more than $1 for every dollar of total capital on their balance sheet, while peers added more than $3 of debt. Of course, there were some exceptions: some companies sacrificed financial flexibility and increased their leverage while shifting to variable contracts and increasing operational flexibility.

They divested and acquired—early and often

The resilient companies entered the trough with more financial flexibility, and at the first sign of economic recovery, they shifted their attention to M&A—using their deeper troves of cash to acquire assets that their peers were dumping in order to survive. Overall, the resilients were 11 percent more acquisitive early in the recovery. They accelerated when the economy was stuck in low gear.

There were some sectors where "resiliency" looked different from what we've described so far, primarily because these industries saw little impact on their revenues from the downturn and only slightly slower growth. The oil and gas sector, for instance, was in the middle of a commodities boom in the early part of the 2008 recession, with prices going as high as $120 per barrel. Meanwhile, demand for healthcare and pharmaceuticals proved relatively inelastic. Resilient companies in these sectors actually overdelivered significantly on revenue, while taking on higher costs.

The road ahead

The takeaways from our study of resilient companies are consistent with findings from previous McKinsey research outlining the importance of making big moves.[3] You'll need cash to get through a recession, which means cleaning up your balance sheet, as the resilient companies did. You'll want to maintain a target list of assets and companies you'd like to acquire if they become inexpensive as other companies dump their portfolios. Ideally, you'll follow the resilient companies' lead and divest your own noncore assets early, before the fire sales start.

At the same time, though, you must be cognizant of changes in the external environment. For example, reducing costs in the way that the resilients did during 2008 and 2009 is likely to be difficult for companies in most industries. That's partly because competition in global markets and the relentless pressure of activist shareholders have left businesses with less fat to trim than in previous cycles. Cost cuts also create risks, starting with the risk of underinvesting in people at a time when our increasingly digitized, knowledge-based economy means many organizations need more talent, not less. And then there are the wider social costs of layoffs, which companies are starting to feel in the form of backlash from communities, customers, politicians, and workers.

[3] Chris Bradley, Martin Hirt, and Sven Smit, "Eight shifts that will take your strategy into high gear," *McKinsey Quarterly*, April 2018, McKinsey.com.

Meanwhile, the accelerating pace of digitization since 2008 also has been changing competitive dynamics in significant ways. There's a widening gap in capabilities and performance between digital leaders and laggards (nearly 6 percent in EBITDA growth, according to McKinsey research). The next downturn could be extremely challenging for the laggards.

At the same time, digital and analytics capabilities may also be a critical piece of the response to the obsolescence of across-the-board cost-cutting efforts and an alternative to the pursuit of cross-border labor-cost arbitrage. We expect companies to increasingly turn to digital tools and advanced analytics to bolster productivity and drive growth.

To ensure some measure of resiliency in the future, business leaders should start now to assess the degree of exposure they have to economic and geopolitical shocks, identify initiatives that can help to mitigate that exposure, and establish a "nerve center" to monitor progress on those initiatives. Indeed, citing the lessons we've learned from the resilient companies may help executives jump-start conversations about these moves in their own businesses and accelerate their preparation for the competition that lies ahead.

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The authors wish to thank Cindy Levy, Mary Meaney, Philipp Radtke, Kirk Rieckhoff, Hamid Samandari, and Sven Smit for their contributions to this article.