

Profiting from a Recession



Executive Summary

The global economy is undergoing a significant slowdown. But there is a silver lining in this dark economic cloud for companies that know how to manage their businesses proactively through a market decline. If you take this opportunity to remodel your business to be viable not only *through* but also *after* a recession, you can rebound sooner, stronger, and with a markedly improved strategic position. CEOs who adroitly leverage the right strategies can gain considerable competitive advantage at a bargain price and position themselves for powerful growth in the future.

While each company will respond with a unique set of tactics depending on its competitive environment and relative exposure to recession, in this *Viewpoint* we will focus on the two main levers companies use to achieve superior performance in a recession and beyond.

1) Release Cash from the Balance Sheet

Cash is the lifeblood of a business, particularly in a downturn. The challenge for CEOs looking to maintain shareholder value in such an environment is to find the means—direct and indirect—to accelerate or enhance cash flow. That means “working” the balance sheet in one of two ways:

- Increase Cash Velocity from Working Capital
- Monetize Non-Core Assets

2) Restructure for Cost Superiority

Instead of making hasty, across-the-board cuts at the margin, executives should leverage a market downturn to make more strategic, structural changes in their cost structure.

- Rethink the “Who” and “How” You Choose to Serve
- Lower Your Breakeven Point by Outsourcing
- Leverage Internal Best Practices

Next, we’ll examine the two environmental enablers—*e-technology* and *allianced organization models*—that, combined with the two levers, help companies create a sustained increase in shareholder value.

Profiting from a Recession

A Viewpoint by:

Vinay Couto

Frank Galioto

Rhonda Germany

Gary Neilson

Joe Nemec

Keith Oliver

Scott Wallingford

This time last year, consumers were spending freely, businesses were investing confidently, and the economy was riding a steady wave of unrelenting growth. Suddenly, however, the tide has turned. Dot-coms are wiping out. Consumer confidence is plunging. And we're no longer hailing the advent of a new economy; we're trying to rally the old one. While the signs are ambiguous, it seems increasingly apparent that the global economy is undergoing a significant slowdown, if not a recession (see Exhibit 1).

But there is a silver lining in this dark economic cloud for companies that know how to manage their businesses proactively through a market decline. Slowdowns can yield unique strategic opportunities. It is very difficult to gain relative position in a boom. By contrast, in a recession, it is easier to take stock and reconfigure your company for enhanced agility and profitability. You are not growing at breakneck speed. You have a burning platform. Even your board of directors and shareholders grant you more latitude as you make the necessary adjustments. If you can take this opportunity to remodel your business to be viable not only *through* but also *after* a recession, you can rebound sooner, stronger, and with a markedly improved strategic position.

Recessions Make the Unachievable Achievable

During the last U.S. recession, in the early nineties, one of our CEO clients expressed concerns that his quarterly performance was trending *up!* (No, he had not shorted the stock.) His worry was that he would lose a window of opportunity to really transform his company if its results improved dramatically. The company had already suffered one disappointing quarter, which had marshaled senior management's attention around the need to make some changes in the company's cost structure and processes. The CEO recognized this downturn as

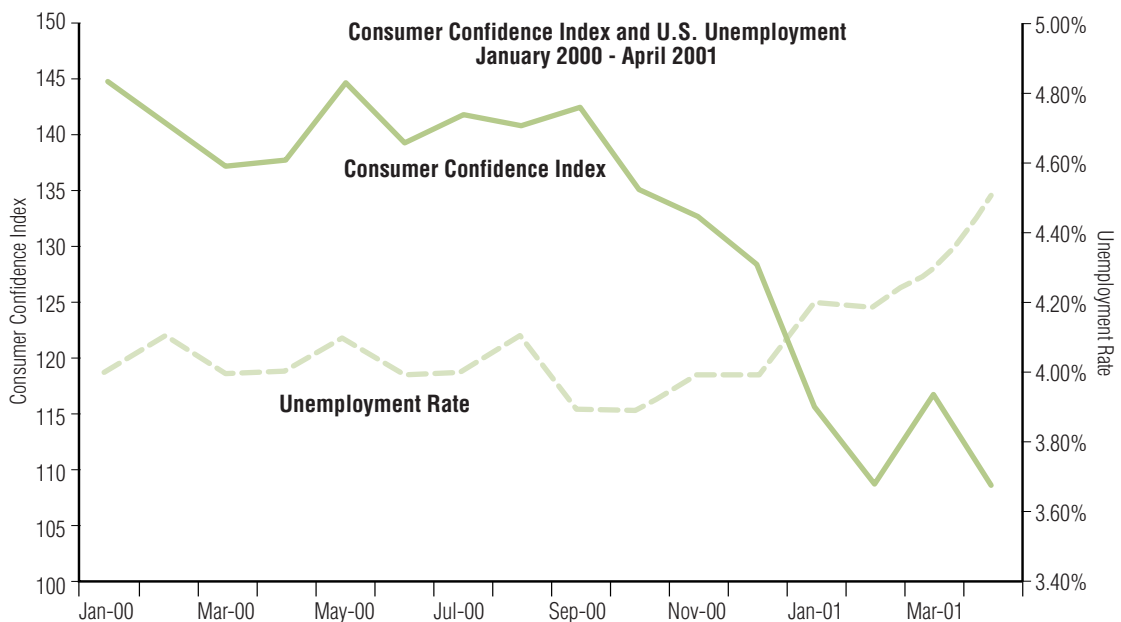
a powerful impetus to fortify the company further, drive out inefficiencies and bolster core capabilities. He and his management team did just that and prospered mightily as the economy took off in the latter part of the decade.

Recessions make the unachievable achievable. If you know what your company needs to succeed tomorrow, a recession can be the best time to build those capabilities. In a softer economy, you can capitalize on the fire sales of cash-strapped or struggling enterprises and find added incentives to pool capital and resources in new alliances and joint ventures. Indeed, a slowing economy may prove the perfect opportunity to achieve new economies of scale, develop new markets, and reach new customers.

Recessions are also great opportunities to fix the structural dents, the sloppy processes, and the associated costs that have crept into a company. When the economy is riding high, nobody notices or bothers to rectify these inefficiencies; they're too busy launching, expanding, and hiring. As that wave of economic prosperity recedes, however, the waterline shrinks with it, exposing flaws and leaving entire companies stranded as they try to deliver better-than-industry-average returns to their shareholders.

Unfortunately, all too many CEOs have responded to the threat of recession with strictly defensive strategies (see Sidebar: *How Companies Are Responding to the Downturn*). While such measures might buoy performance

Exhibit 1. Recession Indicators



Sources: Consumer Confidence Index and Bureau of Labor Statistics

Sidebar: How Companies Are Responding to the Downturn

The Center for Effective Organizations at USC's Marshall School of Business, as part of their ongoing collaboration with Booz-Allen, recently conducted a survey of top executives at large companies to understand how they are dealing with the recession.

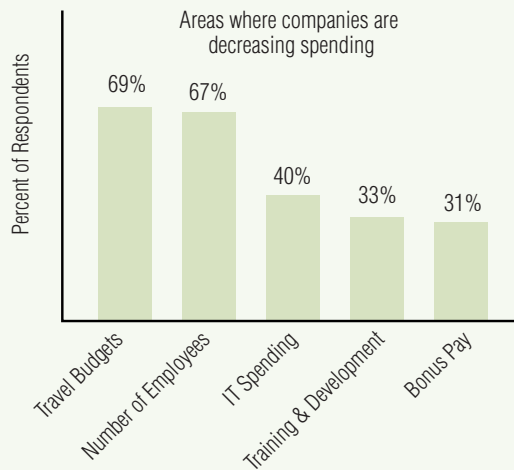
The results supported the idea that the downturn is real—fully 90 percent of those surveyed said they are either experiencing a downturn in their business or are preparing for a possible downturn. Roughly half of respondents had anticipated the downturn, and over 75 percent of respondents indicated that they had structures and systems in place ahead of time to deal with the economic environment.

Discretionary cost-cutting seems to be alive and well in this downturn, with companies taking most of the classic measures. Roughly two-thirds were reducing headcount, either through layoffs or attrition, or cutting their travel budgets. And roughly one-third are decreasing bonus pay, trimming IT investment and cutting training and development. Indeed, half of the companies surveyed said they were treating the downturn as a normal phase in the business cycle to be ridden out.

Only 30 percent viewed the downturn as an opportunity. These companies were more likely to be taking steps to win share or gain a cost advantage over weaker competitors. And less than a quarter were using the downturn as an opportunity to move operations to lower cost locations.

Why the difference in strategies? Certainly some companies are more vulnerable than others. A strong financial position allows a company to weather the storm with fewer drastic measures. Another factor may be institutional experience. Survey respondents said that roughly 40 percent of their senior executives lack experience in leading during economic downturns. Either way, just as in the early 1990s, it appears that this economic downturn will strongly influence who will win big when the next boom comes along.

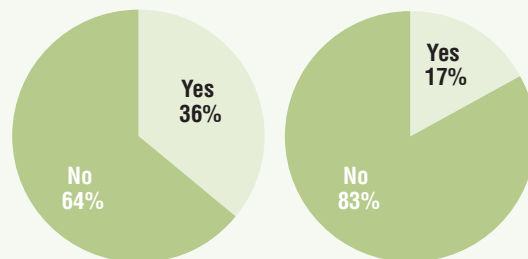
Minor Course Corrections . . . or



. . . Strategic Adjustments

Companies that are closing down or selling entire divisions, sectors or product lines

Companies that are moving operations offshore for cost reasons



Source: Joint survey between Booz-Allen & Hamilton and USC's Marshall School of Business

in the short run, they position the company poorly over the longer haul.

An economic recession can serve as a death knell or an invitation to gain competitive advantage. What separates those that fall victim from those that adapt and survive? Perspective. Winning leaders in the new millennium greet a downturn as an opportunity—an opportunity to fix structural flaws, launch bold moves, in short, reinvent their companies before they get boxed in by deteriorating economic conditions.

While each company will respond with a unique set of tactics depending on its competitive environment and relative exposure to recession, in this *Viewpoint* we will focus on the two main levers companies use to achieve superior performance in a recession and beyond.

- 1) Release Cash from the Balance Sheet
- 2) Restructure for Cost Superiority

Then we'll examine the two environmental enablers—e-technology and allied organization models—that, combined with the two levers, help companies create a sustained increase in shareholder value (see Exhibit 2).

Lever 1: Release Cash from the Balance Sheet

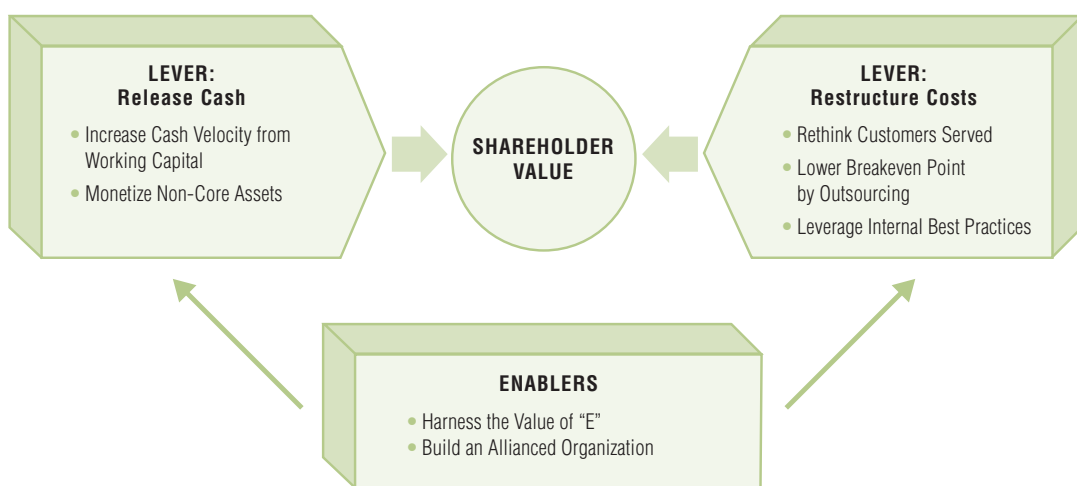
When confronted with a recession, most companies look first to cut costs. The immediate priority is to bolster earnings, but recessions demand that companies keep an equally vigilant eye on their cash balances. Most of the

businesses that file for bankruptcy protection in the United States do so because they have run out of cash, not because of a disruption in earnings. Cash, not profits, pays creditors.

Cash is the lifeblood of a business, particularly in a downturn. The challenge for CEOs looking to maintain shareholder value in such an environment is to find the means—direct and indirect—to accelerate or enhance cash flow (see Exhibit 3). That means “working” the balance sheet in one of two ways:

- Increase Cash Velocity from Working Capital
- Monetize Non-Core Assets

Exhibit 2. Profiting from a Recession Framework



Source: Booz-Allen & Hamilton

Increase Cash Velocity from Working Capital

As companies have expanded aggressively in recent years, so has their appetite for working capital—inventory, receivables, and payables. Unfortunately, there has not been commensurate improvement in the efficiency with which these current assets and liabilities are managed. Building up working capital is an expensive and, ultimately, unhealthy way to finance a

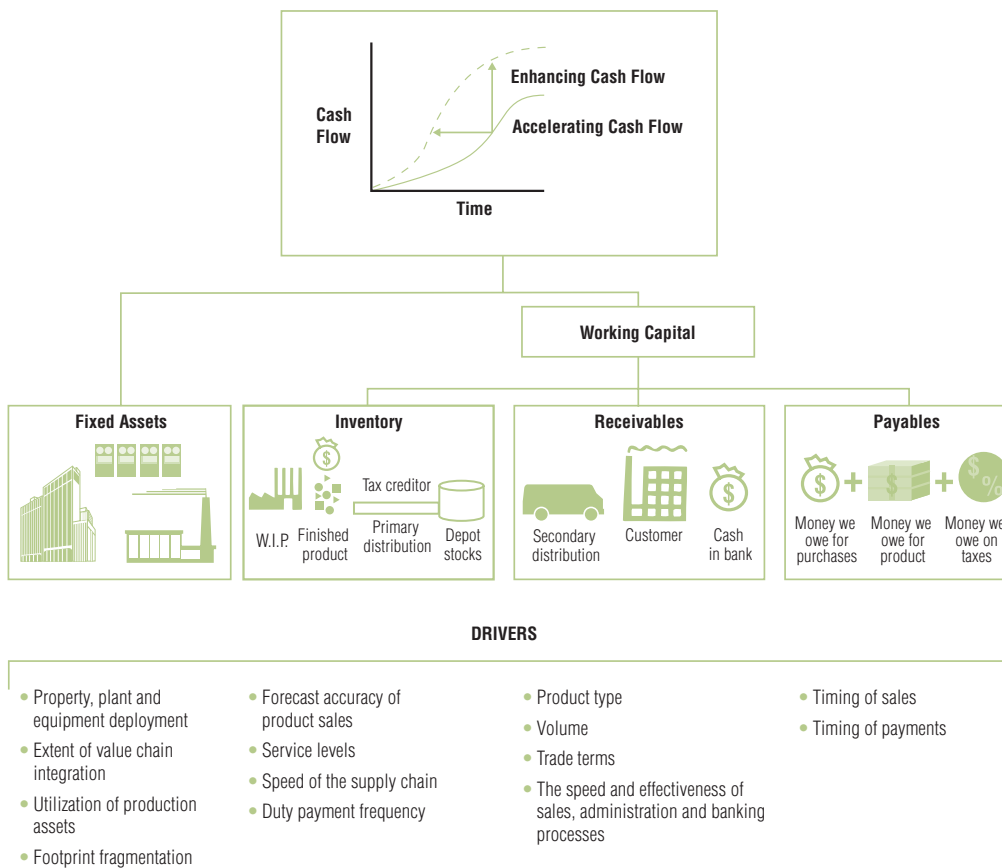
business. Working capital masks underlying operational issues, increases the cost-to-serve of various customers, ties up the balance sheet, and can negatively impact net income.

Working capital varies by industry, ranging from approximately 8 percent to over 60 percent of net income (see Exhibit 4). Actively pursuing working capital can immediately contribute to the bottom line. For example, a client in the petroleum industry realized \$500 million in reduced working

capital in the first six months of the effort and \$1.7 billion overall, representing over 6 percent of their net income.

Unfortunately, it is hard to “unwind” working capital from the many links in the value chain it touches. From sourcing through production to fulfillment and accounting, working capital figures largely. It is tightly integrated with information and product flows, as well as being a prominent factor in customer relationships.

Exhibit 3. Strategies to Enhance Cash Flow



Source: Booz-Allen & Hamilton

Working capital essentially funds “lags” in the value chain, so it follows that many of the “levers” used to decrease working capital involve speeding things up (e.g., the transition from raw material to finished good, the order-to-payment cycle). The three principal strategies used to increase the cash velocity of working capital are:

- Reduce inventory across the value chain
- Reduce receivables by understanding the “cost” to customers
- Leverage your market power to delay payables

While these might appear to be short-term solutions, they can drive significant and lasting operational improvements throughout the company. Moreover, they generate cash very quickly. In a downturn, it is irresponsible *not* to implement these strategies.

Reduce Inventory across the Value Chain

Understanding how much inventory should be kept, and where, is the critical first step to reducing the toll inventory can exact on your value chain. And

reducing inventory levels prudently becomes an imperative in a downturn. History has shown that leaner inventories can help temper the ferocity of a market downturn. Certainly elevated inventory levels can exacerbate a falloff in demand. Slashing the working capital tied up in inventory requires that companies apply firm and consistent measures along the full length of the value chain (see Exhibit 5).

- First, *stop inventory growth* by canceling or delaying incoming raw material shipments and stopping production on any orders that have not been confirmed by the customer.

- Second, *triage the inventory* for conversion to cash, keeping in mind key customer needs. As part of this process migrate inventory further upstream. Most companies hold too much inventory late in the value chain (i.e., finished goods). This is the riskiest and most expensive place to hold inventory. Holding more inventory as raw materials not only furnishes companies with greater flexibility, it is far cheaper.

- Third, *solve the underlying problem*. High inventory levels often mask more deep-rooted operational issues. For instance, many manufacturers still build to a sales forecast, not a firm order. When the forecast is incorrect, expensive finished goods sit in inventory, driving the cost to serve customers higher. Not only does this result in a very expensive supply model, but it also distracts attention from the root

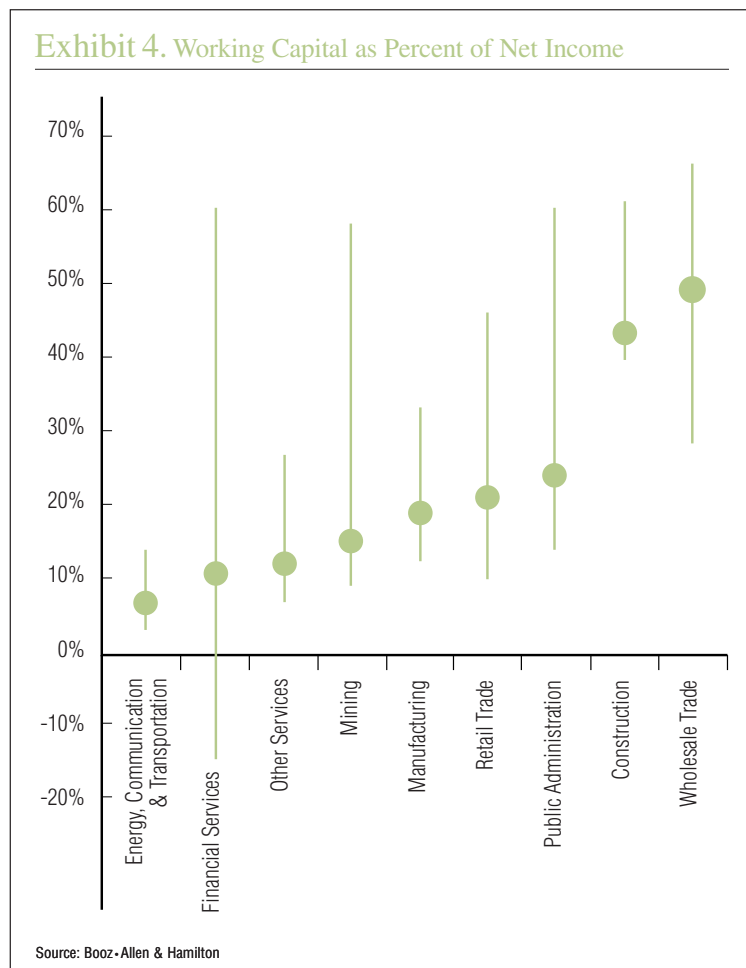
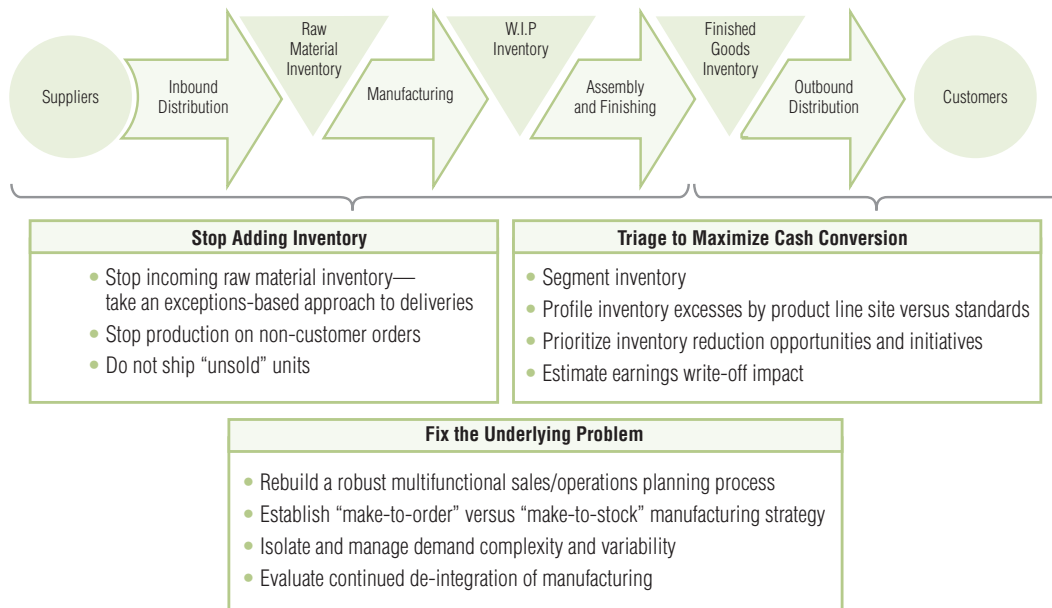


Exhibit 5. Inventory Reduction Strategies



Source: Booz-Allen & Hamilton

cause of the problem (i.e., sales/marketing is generating poor demand data).

By thoroughly understanding your product portfolio and production processes, you can determine the appropriate “supply policy” for each product line. Translated, that means holding the right inventory at the right place. The more custom the product, the more critical it is that a firm order be in place prior to manufacturing. Risk-adjusted inventory policies can help balance customers’ needs with the company’s capital. And, in the immediate future, Internet-based information systems can help companies reduce inventory to just-in-time levels as information flows from customer through the company to its supply network seamlessly and immediately.

Reduce Receivables by Understanding Customer “Cost”

As revenues decline, many businesses redouble their sales efforts without beefing up their cash collections. Some may extend credit to high-risk customers to create the illusion of sales growth. Others resist taking a reduced price on aging finished goods, forgoing critical cash to spare margins.

Effectively managing the working capital employed across the order-to-payment cycle requires that management pay greater attention to detail and adopt a new perspective on customers. The goal is quite simple: to generate a reasonable return on each transaction and

get paid for goods and services as fast as possible.

Like any other asset, customers need to show a positive return on investment. If they fail that litmus test, there are four options at a company’s disposal:

First, *stop serving them*. To arrest a dangerous escalation in receivables, companies can simply stop selling to high-risk customers and tighten credit and sales approval policies (e.g., stop shipping to marginal customers). Moreover, they can sell the receivables and let someone else collect. These are clearly dramatic measures that will immediately impact revenues; they need to be carefully communicated to the sales force.

Second, *charge customers for the capital they employ*. This is not as heretical a suggestion as it might first appear. The more

you understand about your individual customers, the more flexible you can be in your approach to reducing working capital. We're not suggesting unilateral price increases here, but rather creative strategies for knocking receivables down. For example, customers who have a high cost of capital may be willing to pay a slight price premium for extended payment terms. Conversely, companies with low cost of capital might be amenable to paying more quickly if they get a small discount. Work with the customers to find the right balance.

Third, *accelerate collections*. All companies have payment terms. Many customers disregard them or fall behind. Segment your customers based on their account status and overall financial health. Where there is no dispute, go after the money; oftentimes healthy companies have simply overlooked the bill. For financially weaker customers, devise a strategy with them for paying off the outstanding balance while imposing more rigorous credit standards on future orders. Where there are disputes over a receivable, establish a SWAT team to investigate, resolve, and collect.

Finally, *leverage e-enabled information flows* to collapse the time necessary for correct invoices to be received, reconciled, and paid. The administrative cost associated with handling invoices from order to payment is remarkably high. Invoices are often shuttled back and forth and

logged into systems several times before they are paid. The Internet is facilitating the movement toward a single "document" that captures every step in the process and eliminates repeated data entry, which should dramatically reduce invoice disputes. New open protocol standards are extending this seamless web to every corner of a company's supply network, reducing invoice-processing time from an average of 45 days to a mere one.

Leverage Your Market Power to Delay Payables

Accounts payable actually *reduce* working capital, so mirror logic operates here. Just as you want to accelerate payments from customers, you want to delay payments to suppliers for as long as possible, effectively using your suppliers' working capital to finance your business. At the extreme, companies such as Dell employ negative working capital. Dell receives payment for a new computer before it pays suppliers for the materials to build it.

Again, there is more than one way to address the payables issue.

First, *examine and segment your suppliers*. Understand which suppliers consume your capital, either through aggressive payment terms or penalties. By examining the transactions and working capital-adjusted margins for each supplier, you may find that a low price supplier is actually costing you more than you think.

Second, *standardize terms* with your vendors, pushing for the most favorable. Then push to

extend these terms to the other divisions within your company. A favorable contracting agreement is one "best practice" you definitely want to transfer. Consider the trade-off between discounts and extended payment terms.

Determine why you pay early, if you pay early, and capture a financial benefit in the form of a discount if you plan to persist.

Monetize Non-Core Assets

In the go-go economic environment of the past several years, companies were engaged in an all-out assault to gain market share and drive rapid revenue growth. As a result, many became extravagant in their capital expenditures. As mergers and acquisitions became the centerpiece of corporate growth strategies in the nineties, fixed assets accumulated on the balance sheet. The focus on top-line growth diverted attention from asset productivity and efficiency.

Now that the economy has cooled, however, many companies have redirected their focus to the assets they have deployed along their value chain, and they are identifying major inefficiencies and excess capacity.

Extraneous and expensive assets populate nearly every company's value chain today, whether they be raw materials, computer workstations, or idle plants. These assets are a continuing drain on a company's cash reserves, since the initial purchase price of an asset is only the tip of its total cost. Most assets consume considerable cash to deploy and

maintain on an ongoing basis. These hidden overhead costs can be substantial.

Assets need to deliver an economic return that exceeds the cost of capital consumed or else be replaced by lower-cost solutions. Typically, as companies evaluate return on assets, they review each asset to find ways of producing “more of the same.” That approach, however, misses the larger issue of whether the assets, all told, are as *effective* as they might be. Oftentimes, it’s not an ROA issue; the asset simply shouldn’t be there. Underperforming assets weigh down a company’s entire operation and pollute the balance sheet.

There are several asset monetization strategies a company can pursue (see Exhibit 6). One answer is to outsource. Outsourcing sounds like a fairly straightforward exercise, but it can quickly become a balance sheet bloodbath. When you decide to discontinue doing something in-house, you are essentially removing assets from the balance sheet. To completely remove a plant asset, for example, necessitates closing and selling the entire site. Since it is unlikely that a company will recover book value, there is often an asset write-down. Further, there are the extensive collateral costs involved in a plant shut-down, expenses you would rather not incur in a recessionary environment.

The organizational implications of increased outsourcing are profound. While there have been high-profile examples of recent failures, we believe

outsourcing is a viable strategy—as long as there is a clear understanding of performance expectations, capabilities, and the risks involved (see Sidebar: *Outsourcing—A Failed Theory?*).

A second strategy is to arrange an asset buyout (i.e., sell operation assets to a new partner). Redeployment and consolidation of assets is a third option that weighs less heavily

Sidebar: Outsourcing—A Failed Theory?

Last year, Cisco was poised to become the first trillion-dollar enterprise, wielding a market cap greater than that of General Electric Company. One of the things that gave Cisco its glow was its development of a virtual supply chain. It didn’t build most of what it sold; instead it outsourced most of its manufacturing to contract manufacturers. They called it “global virtual manufacturing.”

In mid-April of this year, it all came crashing down when Cisco announced that third-quarter revenues would be 30 percent lower than second-quarter revenues, and that it would write off \$2.5 billion in inventory and cut 8,500 jobs. And Cisco is not alone. The Sony Corporation, Apple Computer Inc., Philips, Palm Inc., and The Compaq Computer Corporation all experienced problems with their contract manufacturers. What went wrong? Is outsourcing a truly failed theory?

We believe the flaw lies in the practice of outsourcing, not the theory. These companies outsourced their manufacturing of essential components without a full understanding of the changes required in their business models. They didn’t translate the old practices that had made them successful into their new business relationships. They hadn’t adequately codified informal communications practices and channels within their supply chain. They didn’t align incentives through contract terms and agreements, which rendered it almost impossible for the supply chain to scale up in relationship to a hit product, or scale down in response to declining demand.

In the rush to outsource, many original equipment manufacturers didn’t understand how the old model worked, and never took the time to understand the newer contract manufacturing model. The result: A one-two combination that sent them reeling. Not only were they unable to take advantage of the full benefits of outsourcing, but they also exposed themselves to new and different types of risk. When outsourcing didn’t work, they exacerbated their problem by pulling the wrong levers trying to fix it.

Outsourcing can be successful, but not if the partners approach it with the wrong assumptions. A clear understanding of performance expectations, capabilities, and risks separates the winners from the losers.

An excerpt from the upcoming article, *Why Cisco Fell: Outsourcing and Its Perils*, **strategy+business**, Third Quarter 2001

on the balance sheet. Typically, it involves rethinking where you make different products or assemblies so as to minimize the excess overhead in your value chain.

Whatever approach a company takes to monetize its assets, there are ways to minimize its deleterious impact. The first step should be a clear assessment of the total asset costs involved. That means assigning the appropriate overhead to each asset you are considering exiting. These costs fall into three buckets:

- *Product Overhead*—costs attributable to the specific prod-

ucts being produced (e.g., inventory management, production scheduling, changeover-related maintenance, parts engineering)

- *Process Overhead*—costs associated with running a process (e.g., maintenance, quality control, production supervision, production planning)

- *Site Overhead*—costs related to operating the site (e.g., factory management, facilities management, security, finance, human resources, customer service and logistics)

An overall asset strategy explicitly considers each type of

overhead cost to identify where the greatest potential savings lie (see Exhibit 7). Then it implements a strategy targeted at reducing those specific costs. Even if the company does not dispose of an asset entirely, it can dispose of some of the consequential costs associated with it.

The methods employed to “rationalize” assets cover the gamut. At one extreme is the company that has grown through acquisition and that has a lot of deadwood. Such a company increases its asset effectiveness by consolidating its footprint (i.e., reducing site overhead) and moving toward more focused and fully utilized factories.

Other options include exiting part of the asset (e.g., closing down a production line within a facility). Utilizing this approach, companies can avoid the sizable exit costs of leaving an entire site (e.g., union challenges, write-downs). Simply selling the equipment from a production line may also work. Additionally, leveraging the scale within a particular process over multiple plants can increase asset efficiency. These are all lean operator techniques that can help companies reduce nondepreciable, recurring overhead expenses.

In short, assets can be made more productive by challenging the consequential costs they attract. Pushing this envelope can drive improved economics and a higher return on capital employed.

Exhibit 6. Asset Monetization Strategies

ACTION	DESCRIPTION	BALANCE SHEET IMPACT
Outsource	De-integrate key elements of the manufacturing process Buy product/service from outside supplier Dispose of assets, even if below book value, to clean the balance sheet	High
Asset Buyout	Sell operation assets to new partner	Medium
Consolidation, Redeployment	Keep assets, but rethink what is done where Consolidate plants based on achieving process and overhead scale	Low

Source: Booz-Allen & Hamilton

Exhibit 7. Overhead Reduction Strategies

ASSET RELATED COST	OPTIMAL ECONOMIC CONDITION	RATIONALE
Product Overhead	Fewer products per site	Minimize complexity
Process Overhead	Fewer processes per site	Capture scale
Site Overhead	Fewer sites	Footprint scale

Source: Booz-Allen & Hamilton

Lever 2: Restructure for Cost Superiority

When a downturn looms, everyone's focus shifts to the bottom line. And the quickest way to protect the margins the market demands is to cut costs. Imposing some immediate discipline is clearly necessary. Companies should proactively:

- 1) Cut discretionary expenditures (e.g., office redecorating, holiday parties, executive education, travel budgets)
- 2) Step up collection efforts on outstanding receivables
- 3) Control capital and avoid investments that yield an uncompetitive payoff
- 4) Refinance or terminate office leases

- 5) Lease rather than purchase non-core equipment
- 6) Challenge the need for staffing new and open positions with full-time staff and consider use of temporary labor
- 7) Take action on "C" players

That said, not all cuts are good cuts. In fact, many can compromise a company's long-term competitiveness, if not viability. So how do you cut costs without hitting an artery?

Instead of making hasty, across-the-board cuts at the margin, executives should leverage a market downturn to make more strategic, structural changes in their cost structure. If you want to profit from a recession, take the opportunity to:

- Rethink the "who" and "how" you choose to serve
- Lower your breakeven point by outsourcing
- Leverage internal best practices

Rethink the "Who" and "How" You Choose to Serve

The first step in any cost-cutting program should be a careful assessment of your customer base. Many companies allow customer care and service quality to deteriorate as they slash costs. This is a very short-sighted strategy, particularly in a recession. Your best customers are the key to achieving long-term success. In fact, they generally provide an even greater share of your profits in a market downturn, while your worst customers typically become margin destroyers (see Exhibit 8). The strategic imperative that implies is clear: Cut the deadwood, while lavishing fresh attention on your most productive relationships.

As you cull your portfolio of customers, assess the *long-term* cost-to-serve and profitability of

servicing various customer segments. Then cut out the weakest prospects, while revamping your value proposition to better serve your most profitable customers. Determine how those customers buy, what they value, and what they are willing to pay for.

As part of this review, determine how the recession affects your best customers' needs and how your products and services affect their overall economics. Collaborate on joint supply chain planning, optimize payment terms and/or move to a solutions-based selling model in which your sales force works collaboratively with customers to "solve" a pressing need they have rather than "sell" a discrete product you have.

In other words, use a recession to expand and cement your

best relationships and reinforce your status as the supplier of choice. Over-serving customers is expensive, true, but under-serving good customers costs you far more in the long run.

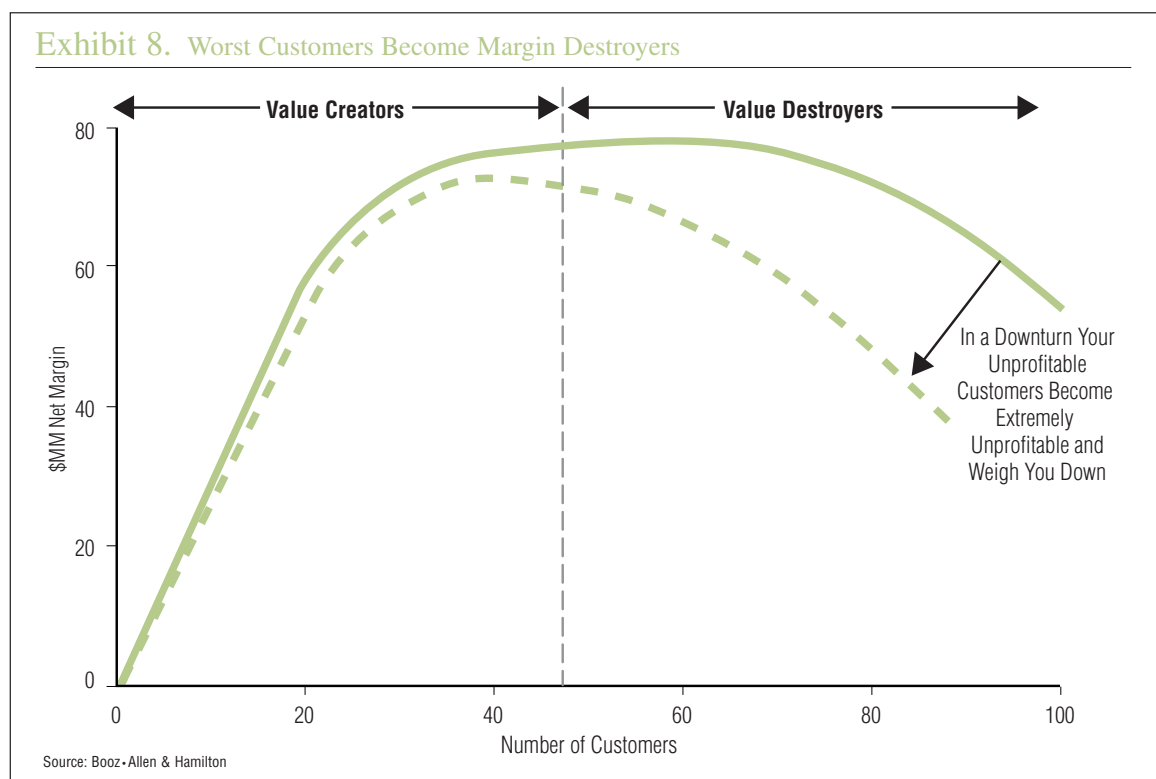
Lower Your Breakeven Point by Outsourcing

With all aspects of running a company getting more competitive and more complex, it is little wonder that companies are refocusing their efforts on what they do best and outsourcing the rest. The current economic downturn will only accelerate this trend. Companies that once had huge, monolithic shared services or functional organizations are revisiting their assumptions about what needs to be in-house, as they leverage the enhanced

expertise, greater scale, and lower cost structures of outside goods and service providers. While once restricted to highly transactional, back-office processes, outsourcing now spans the gamut, with some companies offloading entire segments of their value chain. For example, General Motors, once a bastion of "not invented here" thinking, has outsourced everything from logistics to financial services to telecommunications in recent years.

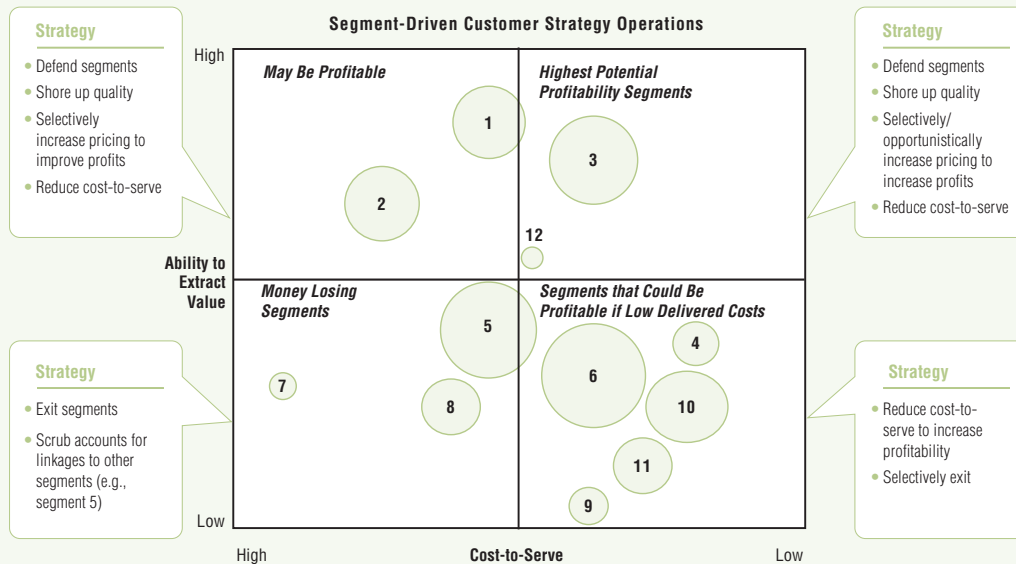
Innovations in technology have unleashed a whole new wave of outsourcers specializing in service delivery, and corporations are flocking to these businesses to improve quality, reduce costs, and spread their business risk. These scale-advantaged outsourcers have the tools and

Exhibit 8. Worst Customers Become Margin Destroyers



Case Study: Customer Segmentation in International Pharmaceuticals

The key to determining who your best customers are is to segment them based on key variables such as how they buy, what they value (e.g., quality, lead time, technical support) and their willingness to pay. Booz-Allen recently went through this exercise with an international pharmaceutical firm and laid the results out on the 4x4 matrix shown below. The vertical axis measures the company's ability to extract value and the horizontal axis reflects relative cost-to-serve. Clearly the most attractive customers will be those that fall in the top right quadrant. These are the relationships to target and "protect" in a recession. By segmenting their customer base and realigning their strategy for each segment, the company was able to increase its return on sales from 3 percent to 11 percent.



Source: Booz-Allen & Hamilton

expertise to offer superior customer and employee services at a price equal to or better than what the best internal shared services unit can deliver. Their access to external capital and their exposure to market forces keep them ahead of the learning curve in their select niches. In short, many outsourcers can do a company's work better *and* cheaper (sometimes up to 30 percent cheaper) than can the company itself (see Exhibit 9).

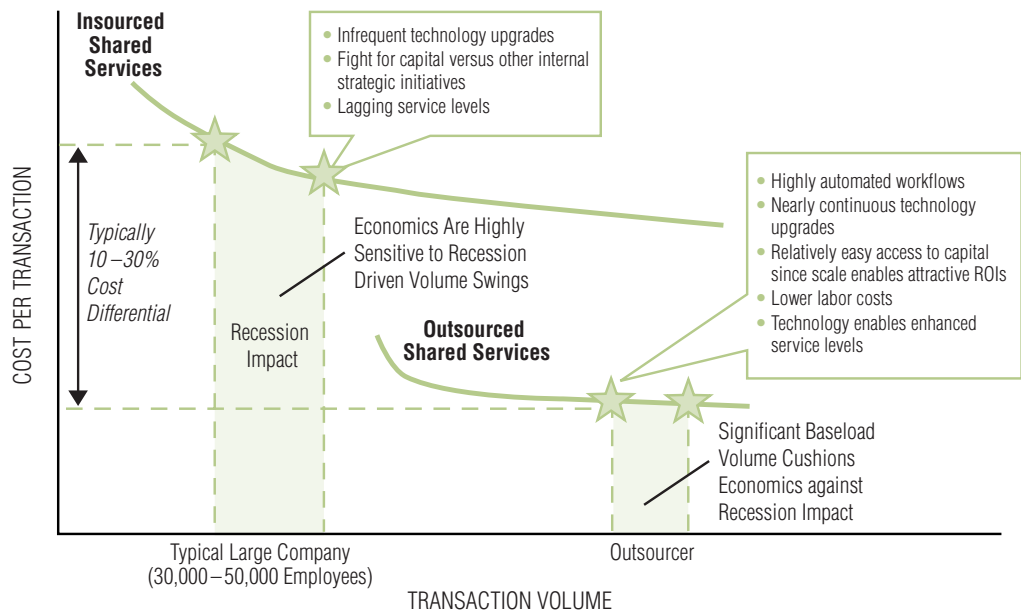
When recession looms, outsourcing can have an immediate

impact on the cost structure of your company. Lower transaction costs are only the beginning of the savings. The true magic of outsourcing is the conversion of fixed costs into variable costs and the consequent lowering of a company's breakeven point. As the fixed costs of operating internal service delivery functions give way to variable outsourcing arrangements, your overall business risk is reduced; your cost structure is now insulated against the vagaries of a market economy. Furthermore, outsourcing

typically delivers results faster than long and involved reengineering efforts. Depending on the activities outsourced, the arrangement can be implemented in three to twelve months, compared with the eight to thirty-six months it typically takes to reengineer a given function.

You should view a downturn as an opportune time to outsource. But with the universe of outsourcers growing so rapidly, choosing the right one and structuring the right relationship is becoming more complex. As

Exhibit 9. Scale Allows Outsourcers to Use Better Technology at Lower Costs



Source: Booz-Allen & Hamilton

Business Process Outsourcing

Over the past year or two, business process outsourcing (BPO) has gained great currency as companies such as Coca-Cola, Bank of America, Nortel, and BP Amoco have outsourced entire functions in their human resources and/or finance departments to third-party providers. While these mammoth outsourcing arrangements with companies such as Arthur Andersen, Exult, and PWC grab much of the media spotlight, outsourcing alliances are struck on a smaller scale every day with the hundreds of companies who have entered the BPO market—a market that Gartner Dataquest estimates will grow to \$300 billion in revenues by 2004. Companies such as MetLife, American Express, and UPS are leveraging Affiliated Computer Services, Inc.'s superior process knowledge and low-cost facilities to handle claims and applications. Microsoft in Europe is expanding its relationship with order-to-cash specialist French & Associates. More and more, large companies are farming their business processes out to the benefit of their bottom line.

Exhibit 10 indicates, not all outsourcers are created equal. Some focus on reducing factor costs, while others rely on technology to deliver improved capabilities and greater efficiency. Still others serve as aggregators, managing and consolidating the work of still other, third-party outsourcers to reduce complexity for their clients.

Those looking to outsource will capture maximum value by making smart decisions up front. For example, as an executive reviewing such a relationship, you should know going in whether to:

- Outsource entire functions to a single-process aggregator who may, in turn, subcontract to others, or outsource to several

Exhibit 10. Choosing the Right Outsourcing Partner

		SOURCES OF OUTSOURCING VALUE					
		Leverages Scale Across Multiple Clients	Converts Clients to Best Practices Processes	Migrates Clients to Proprietary Systems	Re-Engineers Clients' Processes Over Time	Aggregates Other Vendor Spending	Moves Process to Low-Cost Facility
ASPS	Standardized Technology Platforms	✓	✓	✓			
	End-To-End Badge Swappers	✓			✓	✓	
BPOS	Remote Processing Centers	✓			✓		✓

Source: Booz-Allen & Hamilton

best-of-breed outsourcers who may perform fewer processes better but require increased oversight.

- Standardize processes to fit the outsourcer's model or have the outsourcer customize its processes to fit your business.
- Enter into short-term contracts that maximize business flexibility or enter into longer-term agreements that may lock in greater savings.

Transfer Internal Best Practices

One mistake many CEOs make in a recession is looking exclusively *outside* the walls of the company for answers. In their search to find “best-in-class” methods for streamlining costs,

they often overlook pockets of excellence within their own four walls. Most large organizations need look no further than their own doorstep to locate best practices, which is fortunate, since the pressure to start exploiting them is intensifying.

It is rare to find a business unit or division that performs at best-practice levels against all metrics. In our experience, there is often a 4:1 performance differential among business units performing similar functions within a given company. In other words, one group has identified a way to be four times more effective at the same task than another. Much of the variation lies in the processes, tools, work methods, and capabilities employed. Eliminating the variation among

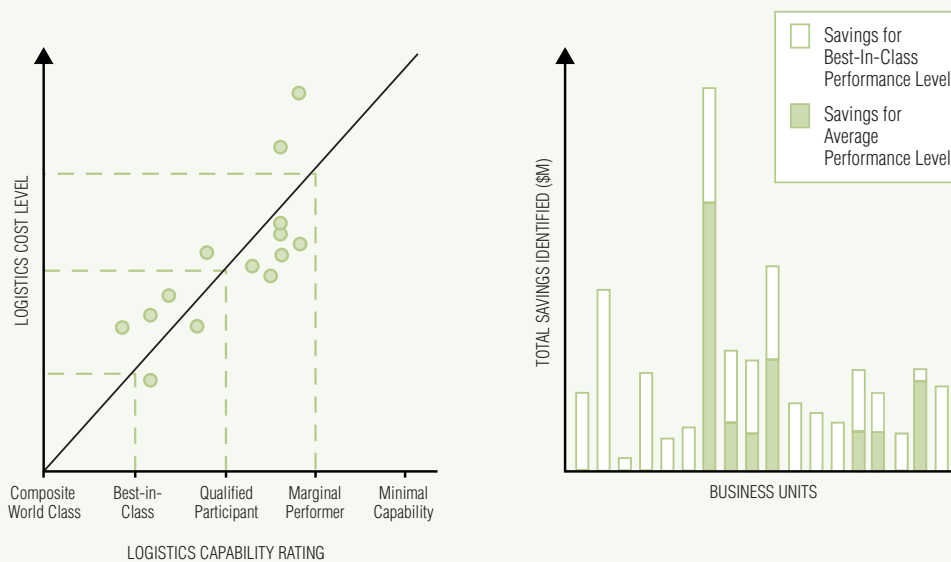
units and bringing every unit up to best-in-class standards is the first objective of any best-practices program.

The aim is not simply to encourage the best performing business units—the “lead dogs”—to run faster. It's to boost the performance of the trailing pack. That's where the immediate and easier gains lie. By focusing on bringing underperforming units up to par, you can generate steady improvements in total performance and output, while laying a foundation for breakthroughs to the next level. The result is increased process discipline, higher levels of performance, and far greater consistency and predictability in terms of overall results...not to mention sharply reduced costs.

Case Study: Internal Best Practices Transfer

Industry consolidation and consequent earnings pressures prompted a Booz•Allen client in the aerospace and defense sector to launch a corporate-wide best practices program in the mid-'90s. Itself the product of multiple mergers and acquisitions, this company had 40 business units operating in highly diverse product lines. In looking to cut costs and improve performance, the company's senior management probed every function—from finance to procurement to engineering to R&D—to uncover internal best practices. In each area, participating business units performed a diagnostic that measured costs by business unit and benchmarked internal capabilities (see exhibit below).

Identified Best Practice Savings



Source: Booz•Allen & Hamilton

This exercise revealed a wide variation in costs and practices across the company. The cost differential between top performers and a typical unit averaged between 15 percent and 25 percent, and the gap between “first” and worst was as large as 90 percent for some processes. Rather than simply mimicking the practices that produced the best result, team members sought to understand why and what specific process actions contributed to improved performance. Based on individual business unit needs, the magnitude of the opportunity and the relative importance of particular processes in various areas, each business unit selected three to five processes to focus on. Implementation teams comprising both “sources” and “receivers” then transferred best practices. Corporate-wide, these teams targeted more than \$4 billion in recurring cost savings, \$1.4 billion of which was attainable in the first year. Having identified potential savings up-front on a business unit by business unit basis, the company was able to track progress against implementation goals to assess bottom-line impact.

For most companies in a recession, sharing winning capabilities internally is far faster and easier than hauling them in from the outside. And because employees are leveraging internal know-how to pull themselves out of a recession, it also tends to be easier on the organization than an externally focused transformation or turnaround initiative.

The levers we've just discussed—releasing cash from the balance sheet and restructuring for cost superiority—encompass the short- to medium-term steps companies can take to mitigate the impact of a recession on their business. Used wisely, they can position a company to weather a downturn well. But they will not enable a company to profit from recession. To gain material advantage in a market downturn, companies need to exploit the enablers that are transforming the competitive landscape across industries—e-technology and new allied organizational models. Then they need to implement a strategy for sustainable growth built around operational excellence and the development of a compelling growth engine.

Enabler 1: Harness the Value of E

Many executives are now feeling the hangover of their early Internet euphoria. As they now pay for their overexuberance and contend with the market backlash it has unleashed, there's a strong temptation to dismiss or, at least, delay anything with an "e" in it. But the plain truth is: There has never been a better time to leverage the dramatic efficiencies of the Internet.

The current economic downturn should serve as a signal to companies to harvest the value of their existing e-initiatives and even accelerate their e-transformation in selected areas. With mounting pressures both to cut costs and augment growth, organizations should be accelerating their efforts to e-enable core businesses even as recession looms. As we embark on the second wave of the Internet era, the market will favor those who scavenge well. Many traditional firms are now unloading scattered, subscale, and overlapping e-business initiatives

that have yet to add value. That spells opportunity for companies willing to step up to the plate. The winners will be those who identify pockets of value in the abundance of technological capacity and skills now available and invest to gain advantage.

The Internet is one of history's best tools for realizing internal and external efficiencies, extending reach to customers, and building new business models (see Exhibit 11). While the days of splashy storefronts and instant riches are gone, you can still reduce costs by leveraging the Internet to:

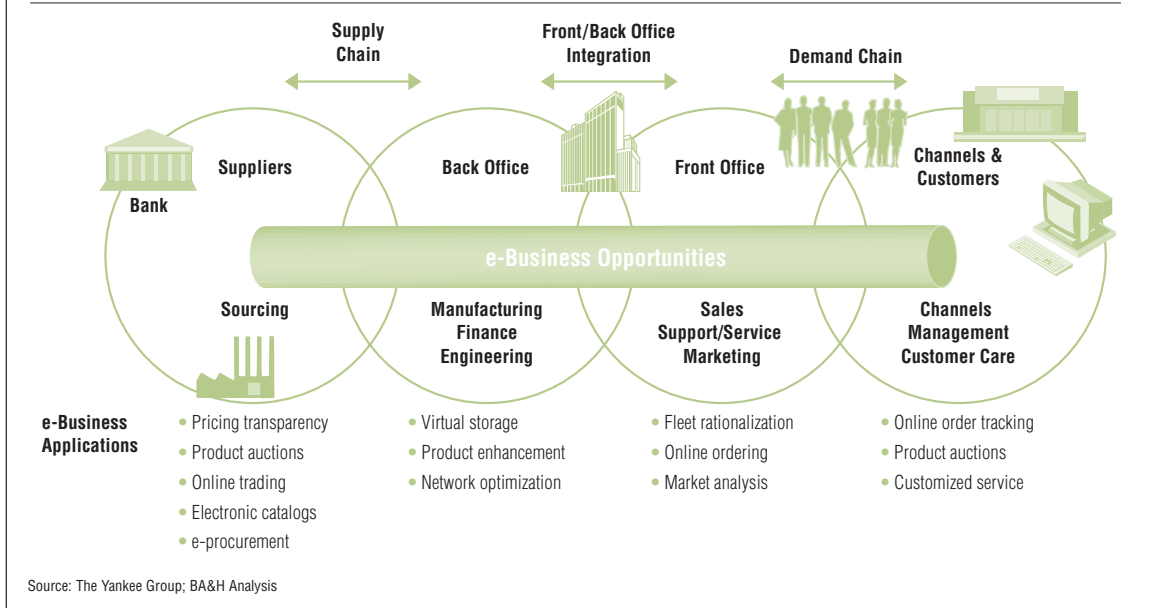
- Migrate customers and employees to Web transactions and self-service to reduce transaction costs
- Render customer information on demand more transparent, enabling tighter supply-chain management
- Build a network of alliances and promote standards that accommodate outsourcing

Not only does the Internet collapse transaction costs, it also enables organizational

GE Capital: Harvesting the Value from e-Business

GE Capital is an example of a business intent on capturing value through e-business. In implementing GE's *e-Buy*, *e-Make*, and *e-Sell* strategy, the company has focused on the Internet as the major lever in driving efficiency gains in their business. The *e-Auctions* tool it uses for procurement has helped the company save 25 percent on office supplies. By pushing its credit card application process online (and away from a call center), it is saving a further \$2 to \$3 per transaction. Even GE Capital's deal-making process has gone under the e-scalpel, with savings passed along to the customer. As management indicated in the most recent GE annual report, "In the end there is no e-Business, there's only business."

Exhibit 11. Opportunities to Exploit e-Technologies



transformation. By simultaneously providing both global reach and intimate customer contact, the Internet furnishes companies with cost-effective new ways to present brands, bring customers inside the organization, and roll businesses into new channels.

Technologies and skills acquired in the early going of the e-business revolution—e-enabled outsourcing, alliance management, innovative customer interface models, distinctive knowledge integration tools—can be

leveraged into new business extensions, even new breakout businesses. With shareholders unwilling to accept the incremental growth they tolerated in the past and a recession on the horizon, Internet technologies let firms seek value boldly.

Case Study: Straight-Through Processing

In the securities industry, the Internet is collapsing the time and manual intervention required to process a trade. Presently, settlement on an equity transaction occurs three days after the trade, or T+3, but thanks to e-enablement, the entire industry is moving toward a T+1 standard, which should be in effect by 2004. Straight-through processing (STP) is the ultimate goal, meaning a trade is executed through to settlement with no manual intervention or “break.”

Most firms have had to evaluate their infrastructure and transaction processes to size the investment needed to move to a T+1 environment. Despite the current economic downturn, leading firms like Goldman Sachs are plowing ahead, viewing STP/T+1 as a strategic investment with clear benefits in terms of reduced operating costs. The new infrastructure design streamlines processes, improves execution accuracy and incorporates scalability in capacity to address future growth.

Enabler 2: Build an Allied Organization

While the economics and apparatus of decision-making and information exchange have changed so radically in recent years, most organization models have not kept up. A recession, ironically, affords companies the opportunity to address pending organizational issues and put in place a revitalized business model built on a leaner organizational structure. The aim is to create a

more agile and networked organization that can effectively leverage new productivity tools enabled by the Internet.

We at Booz·Allen call this evolving business model the Constellation Organization (see Exhibit 12). In a Constellation Organization, companies focus on what they do best and “alliance” the rest. They direct far less of their capital and management attention to back-office tasks and other non-strategic activities. Instead they outsource these activities and focus on core competencies.

In this networked world, governance becomes the nerve center and the glue that holds the Constellation Organization together. In a world where the boundaries within and among firms are collapsing and your

business is everyone’s business, defining the “rules of engagement” in alliances becomes a tricky issue. Previously guarded business processes are now

“New alliance structures may be the most powerful force that will shape the 21st century competitive landscape.”

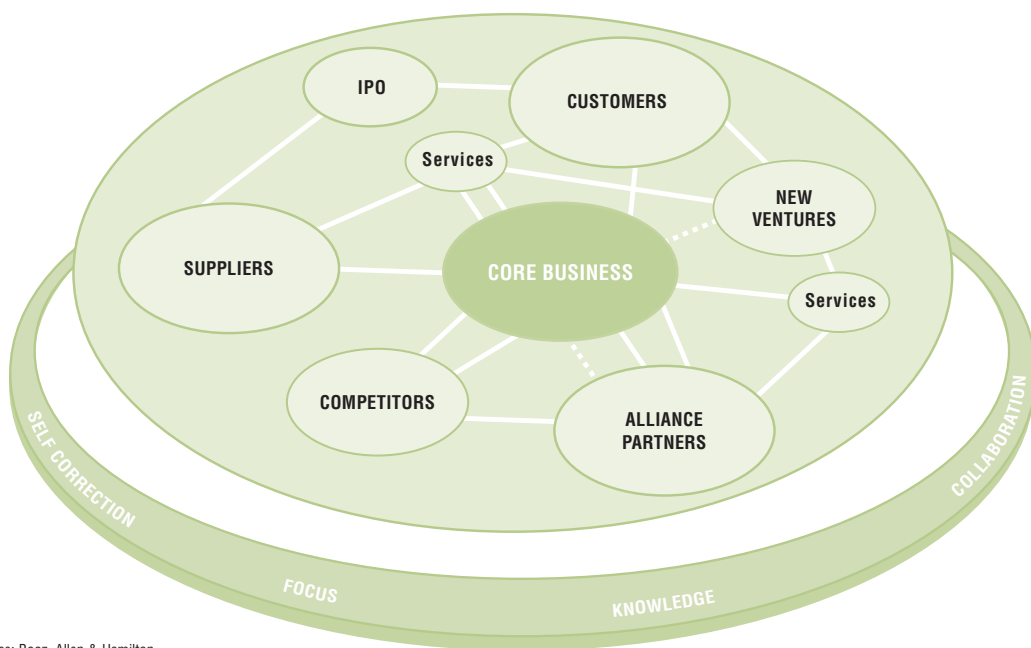
—Ranjay Gulati
Kellogg Graduate School of Management

open—either partially or entirely—to outside partners. Controls, operating protocols, and IT standards must now be agreed upon and embedded in the processes of all participants, creating an electronically linked, real-time information-sharing network.

To facilitate the smooth operation of key alliances, two separate governing bodies are usually necessary—a supervisory group and an operating team. The supervisory group is charged with driving the vision—setting goals, monitoring budgets, and mediating disputes among the partners. They set measurable milestones to judge progress and are responsible for directing the operating team. The operating team reports directly to the supervisory group and is responsible for coordinating the day-to-day operations of the alliance, e.g., sales, marketing, research, and training.

As companies begin to adopt the Constellation Organization model, many are becoming smaller. Others are “atomizing” their giant divisions into clusters of smaller, more

Exhibit 12. The Constellation Organization



Source: Booz·Allen & Hamilton

agile, market-focused business units. While the company will still exist as a separate entity, it will, by necessity, become part of a broader constellation of entities that includes suppliers and customers collaborating on specific sets of opportunities. In this new world, access to information and other key assets will become commoditized. People will become the critical source of competitive advantage.

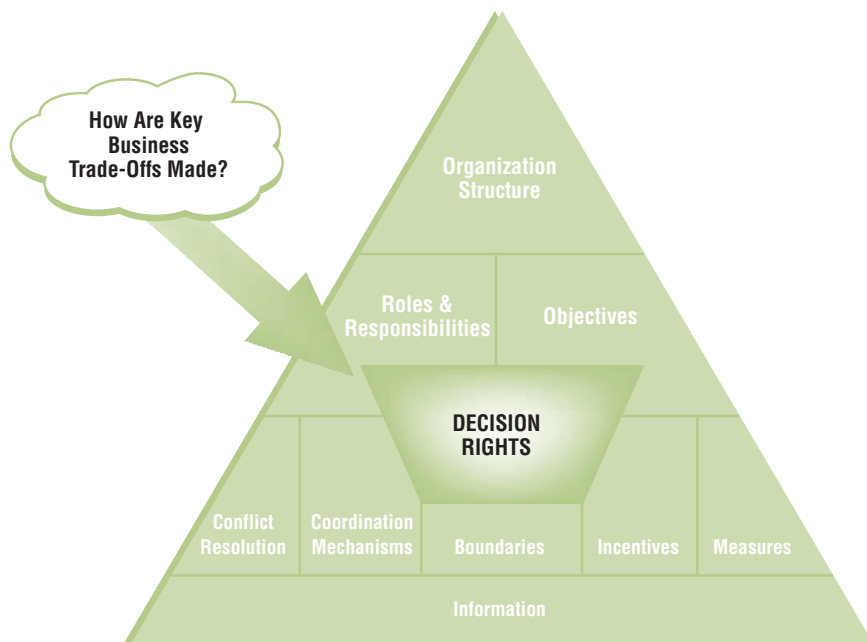
The key to unlocking superior performance in this environment will not be so much a matter of strategy as it will be of organization. The solution lies in changing the organizational model to encourage individual employees to make decisions that are aligned with the overall goals of the company.

Leaders can no longer *dictate* progress from the top; they need to *motivate* their people to make the thousands of daily decisions, choices and trade-offs that collectively drive organizational performance in an accelerated competitive environment. They need to provide these decision-makers with the context and tools necessary to find their own best path to the overall goal, trusting that individuals are rational and will make sensible decisions based on what they know, see, and understand. We call this concept “decision rights”—the *right* people making the *right* decisions with the *right* information. A market-based mechanism, decision rights help ensure that every employee acts in accordance and in alignment

with the organization’s objectives (see Exhibit 13).

The concept of decision rights recognizes that the head office is no longer capable of dealing directly with the rapid pace of change. The bureaucracy of traditional corporate decision-making processes generally slows or stifles innovation and is biased against risk and uncertainty. Delegation of decision-making to the lowest possible level of the organization will improve the speed and effectiveness of decision-making, as the decisions now rest with those closest to the markets being served. We describe this as a “self-correcting” organization, a notion that can prove particularly appealing as markets turn south quickly.

Exhibit 13. Decision Rights in the New Organizational Model



Source: Booz-Allen & Hamilton

Case Study: Decision Rights

A media distributor reaped the benefits of “decision rights” in short order. A year into the implementation of a new organizational model, the firm achieved revenue growth of 10 percent in an industry that grew only 2 percent. The solution was not strategy, but rather a realigned organization that delegated more authority to the field sales representatives actually stocking the shelves.

Having restructured the company to focus on music and its largest mass merchant accounts, this distributor thought it had unlocked the door to growth. But the centrally driven organization that remained could not execute the new store-specific strategy. The music business is a complex, hit-driven, and intensely local enterprise. What sells well in one store won't necessarily sell well in the next. From a universe of 250,000-plus CD titles, this distributor had to pick the “right” 2,000 for each of its customers' music departments. . . on a store-by-store basis. The challenge was twofold: 1) get more decision-making authority delegated to field reps and 2) arm these reps with rich merchandising data on what sells well where.

Booz•Allen helped this company design a new organizational model featuring empowered district managers. These DMs were given input into nearly all decisions that affected product flow into their stores and were encouraged to develop new and innovative ideas, such as niche product merchandising and custom promotions. The other key innovation was the creation of a core merchandising planning function to coordinate transactional decisions between purchasing, the customer teams, and the field. While not every manager in the new model made every decision optimally (especially at first), the decisions that resulted were, on average, far better than the one-size-fits-all execution observed in the old model.

So Where Do I Begin?

Experienced business leaders always have a game plan in mind before they act. Armed with a keen understanding of where value resides within their company—both now

and in the future — winners actively exploit the opportunities presented by every kind of market environment. A recession is no exception.

Still, there are factors that influence what levers a company will pull in its recession game plan. Those factors are captured in the following questions:

- ***How vulnerable are you to competition in the industry?***

In a recession, smaller, nondifferentiated competitors suffer losses well in advance of industry leaders. These players need to attack costs early and extract cash from their balance sheet to survive. Leading competitors have more flexibility and clout. They can take the time to revitalize and e-enable their business models for future growth. In fact, industry leaders are well advised to “up the ante” in terms of customer service and product quality in a recession. A downturn provides them with the unique opportunity to extend and consolidate their lead.

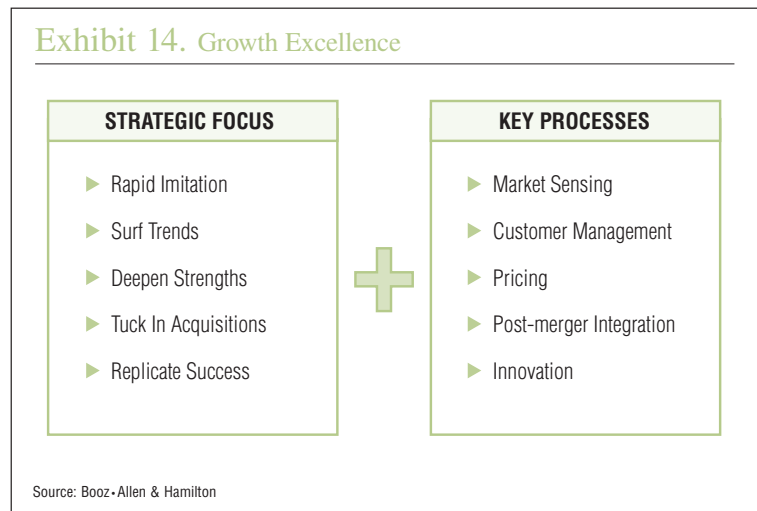
- ***How sound is your financial position?***

Companies with financial resources and cash reserves can better weather a recession. By contrast, companies with deteriorating income statements, high financial leverage, and low cash reserves will find it difficult to remain afloat unless they can reduce costs and/or strengthen their balance sheet. A recession will likely prompt a restructuring of the value chain for these competitors, as they focus on a sustainable core set of activities and outsource the rest.

Where you fall on these two dimensions—competitive vulnerability and financial soundness—determines the types of strategies you should consider employing to rebound, even profit, from recession. To

grow in a recessionary environment, however, requires the development of a breakthrough strategy grounded in operational excellence and the development of a major growth engine. Looking at hundreds of companies in 55 industries over the past 35 years, Booz-Allen has identified the formula for growth that has consistently produced the greatest results in terms of shareholder returns. While this strategy is discussed in further detail in a companion *Viewpoint*, the basic elements of success are as follows:

- Top performers exist in every industry, as do poor performers. What distinguishes a successful growth strategy is the combination of what we call “growth excellence” (i.e., doing what you do exceptionally well across the board) and a “major growth engine” (i.e., a standout business unit or process that raises the performance bar for the whole company). Other strategies, including major acquisitions, just don’t yield above-average results as a rule.



- Growth excellence requires more than the standard tactics involved in finding new customers or developing new products. It requires the marriage of strategic focus and key processes (see Exhibit 14).
- Contrary to a widely held belief, the best way to develop a growth engine, according to our research, is not to think outside the box but rather to transfer and build on the successful models that have worked in other industries.

An economic slowdown necessitates a rapid response. Companies that fail to recognize the market’s shifts and changing expectations will continue to lose share and value to more nimble, well-heeled competitors. Those CEOs who adroitly leverage the right recessionary strategies, however, can gain considerable competitive advantage at a bargain price and position themselves for powerful growth in the future.

What Booz·Allen Brings

Booz·Allen & Hamilton is a global management and technology consulting firm, privately owned by its partners, all of whom are officers in the firm and actively engaged in client service. As world markets mature, and competition on an international scale quickens, our global perspective on business issues grows increasingly critical. In more than 100 countries, our team of 10,000 professionals serves the world's leading industrial, service, and governmental organizations. Each member of our multinational team has a single common goal—to help every client we serve achieve and maintain success.

The Organization and Strategic Leadership Team focuses on organizational issues at the CEO agenda level. Our team of consultants combines in-depth industry understanding with expertise in organization, business model transformation, leadership, alliance, post-merger integration, people, and culture issues to assist companies in developing and implementing the capabilities they need to compete and thrive in the global marketplace.

We judge the quality of our work just as our clients do—by the results. Their confidence in our abilities is reflected in the fact that more than 85 percent of the work we do is for clients we have served before. Since our founding in 1914, we have always considered client satisfaction our most important measure of success.

Consistent with our position as a business thought leader, Booz·Allen sponsors *strategy+business*, a quarterly journal containing the best ideas in business. Visit the Booz·Allen Web site at www.boozallen.com or the *strategy+business* Web site at www.strategy-business.com.

For more information, please contact any member of the Booz·Allen team:

Boston

John Harris
Senior Vice President
617-428-4424
harris_john@bah.com

Buenos Aires

Jorge Forteza
Senior Vice President
54-11-4-326-3261
forteza_jorge@bah.com

Chicago

Gary Neilson
Senior Vice President
312-578-4727
neilson_gary@bah.com

Vinay Couto
Vice President
312-578-4617
couto_vinay@bah.com

Rhonda Germany
Vice President
312-578-4679
germany_rhonda@bah.com

Shelley Keller
Vice President
312-578-4537
keller_shelley@bah.com

Dianna Sasina
Principal
312-578-4556
sasina_dianna@bah.com

Andrew Tipping
Principal
312-578-4633
tipping_andrew@bah.com

Frank Galieto
Senior Associate
312-578-4603
galieto_frank@bah.com

Frankfurt

Fabienne Lambert
Principal
49-69-97167-428
lambert_fabienne@bah.com

Gothenburg

Goran Hult
Principal
46-31-725-93-00
hult_goran@bah.com

Houston

Scott Wallingford
Principal
713-650-4108
wallingford_scott@bah.com

London

Keith Oliver
Senior Vice President
44-20-7393-3227
oliver_keith@bah.com

Munich

Tom Williams
Vice President
49-89-89949-541
williams_tom@bah.com

New York

Paul Kocourek
Senior Vice President
212-551-6627
kocourek_paul@bah.com

Joe Nemec
Senior Vice President
212-551-6666
nemec_joe@bah.com

Paul Hyde
Vice President
212-551-6069
hyde_paul@bah.com

John Jones
Vice President
212-551-6713
jones_john@bah.com

David Kletter
Principal
212-551-6501
kletter_david@bah.com

Oslo

Arne Kjorstad
Principal
47-23-11-39-00
kjorstad_arne@bah.com

Henrik Seip
Principal
47-23-11-39-00
seip_henrik@bah.com

Paris

Panos Cavoulacos
Vice President
33-1-44-34-3045
cavoulacos_panos@bah.com

San Francisco

Bruce Pasternack
Senior Vice President
415-627-4215
pasternack_bruce@bah.com

São Paulo

Maurizio Mauro
Senior Vice President
55-11-5501-6201
mauro_maurizio@bah.com

Seoul

Jong Hyun Chang
Vice President
82-2-551-2220
chang_jongh@bah.com

Stockholm

Lennart Jonsson
Vice President
46-8-506-190-00
jonsson_lennart@bah.com

Henrik Oestberg
Principal
46-8-506-190-00
oestberg_henrik@bah.com

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