

# Responding to the New Economic Reality

## *A Fresh Perspective from Marakon*

During the past 15 months, the economic landscape has been through a sea change. Managing a company in the next decade will be materially different than managing during the past decade. Every company is now focused on managing through a recession, taking steps to preserve cash, reduce costs and adjust demand expectations. However, for most businesses, this is not enough: a more fundamental response is required. We believe there are three macro changes that will shape the economic and competitive landscape over the next 5-10 years. Each of these changes has important implications for business leaders and what they should be doing today to position the company effectively for the new tomorrow.

### **1. The global economy has now entered what Business Week called the 'age of frugality'**

Deleveraging by consumers, companies and financial institutions alike is causing demand to decline in most markets. For many companies, the surprise is how much and how fast demand changed in the past couple of months – with one client referring to September as a 'buyers strike'. And while the decline in demand mandates a quick response, the shift in demand across and within markets has been just as dramatic. With significantly less to spend, customers are rethinking what they need and what benefits they are willing to pay for, making demand more fluid than anytime in recent memory.

#### **Implications:**

- The fluidity in demand is causing customer loyalty to shift in a way that is changing traditional market segment boundaries and creating larger pools of 'switchers' – i.e., previously loyal customers who are now shopping for the best deal
- Changes in customer willingness to pay are creating big gaps between the features and attributes of most product/service offerings and what customers truly value
- Declining willingness to pay means that the costs and assets supporting many existing product/service features are no longer necessary – in essence, a large part of the existing cost and asset base has become obsolete
- The customer, product and service line forecasts that underpin overall budgets and plans are no longer relevant and must be reworked to incorporate the new economic reality

### **2. The global economy has entered a prolonged period of step-change volatility**

In the past year volatility across a broad cross-section of markets – equities, commodities, exchange rates, and interest rates – has jumped to levels not seen before. For example, stock prices are 4 times as volatile today as they have been on average over the past few decades. Nearly all risk models failed as assets that were supposed to be uncorrelated turned out to move in lockstep, magnifying uncertainty. And while there is hope that volatility will return to normal levels, current option prices on common stock imply that volatility is going to be several times higher than historical norms for many years to come.

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**Implications:**

- Risk premiums are much higher and have caused the cost of both debt and equity to jump. The range in risk premiums across assets and businesses has also widened, and therefore the costs of capital used for resource allocation and business valuation must all be reset.
- Business performance is now exposed to a range of risks that are not easily understood, making planning and performance assessment far more difficult. Explicitly incorporating the new dimensions of uncertainty around commodity prices, exchange rates and interest rates into decision-making must become a core competency.
- High levels of volatility make contracting with all stakeholders far more important and challenging. Volatility increases the underlying value of any option, and therefore understanding the option value inherent in supply or delivery contracts, warranties, and even stock options used to compensate executives is critical to pricing them effectively.
- On the one hand, the benefits of diversification through vertical and horizontal integration have increased as they offer a way to mitigate the rise of risk. On the other hand, the cost benefits of supplier and customer concentration are now at least partially offset by risk considerations.
- With increased volatility comes increased risk of insolvency. Strong balance sheets, secure sources of free cash flow and access to capital have all become significant competitive advantages.

**3. The sustainable levels of profitability have declined across all industries, some far more than others, while competitive positions have changed for most businesses**

Economic profitability, defined as the spread between sustainable returns on capital and the cost of capital, is being squeezed by falling margins, slower capital turnover, deleveraging and the rising cost of capital. The squeeze in economic profitability combined with bearish views on future avenues for new capital investment has driven the massive declines in shareholder value across most companies.

**Implications:**

- Value creation has become more concentrated in every company's portfolio of businesses, products, customers and activities. When market profit pools were large, businesses in attractive markets could create value even if they were disadvantaged on differentiation or costs. But like the tide going out, these businesses have now been exposed as at best value neutral. In all likelihood 70-80% of enterprise value is being generated by the 20-30% of a company's capital invested.
- Disadvantaged businesses in economically unprofitable markets must be dealt with quickly – their business models are essentially broken and must be fixed or divestment options explored. On the other hand, advantaged businesses in attractive markets are likely facing unprecedented opportunities to create value if they can adapt to changing customer needs faster than competitors.
- While excellence in execution is as necessary now as it's ever been, it is no longer sufficient -- strategy and resource allocation must assume far greater importance. Management must rethink where the company's bets can be placed with full understanding of how returns and risk have shifted – no one should assert today that our strategy is fine, we just need to execute better.
- The economic impact of linkages across and within businesses (integration and sharing) has changed and should be rethought. The cost and value added (or not) of the corporate center is now far more important than it was in an era of larger profit pools.

## ***How best to respond***

In light of these macro changes and their implications, we believe there are six ways that management should respond to ensure that the company not only survives but thrives in the new economic era:

### **1. Get a grip on value**

Fundamental shifts in business performance, risk and constraints create a need to re-think investment strategies, plans and decisions

- Rethink your view of the future in terms of the fundamental sources and drivers of value creation.
- Update and tailor the cost of capital based on the differences in risk across your portfolio of businesses, customers and products
- Use multiple lenses to assess value creation – not just current organizational units
- Rethink linkage benefits – e.g. vertical integration, horizontal integration, complements, substitutes, loss leaders – within the portfolio and in adjacent markets
- Formulate, debate and choose from a more robust set of alternatives given clearly defined constraints – e.g., cash, capital, earnings, risk, people – and new information on value creation per constraint

### **2. Recession-proof your business**

Existing plans are no longer valid and the step-change increase in future uncertainty makes the task of effective planning and management more difficult

- Get realistic with grounded forecasts that explicitly separate the profitability impact of market economics vs. competitive position
- Refocus the organization on competitive advantage and being distinctive – simply playing in an attractive market won't cut it going forward
- Minimize cross subsidization between the 'good' and 'bad'; adopt 'zero tolerance for value destruction'
- Rethink your total corporate 'risk budget' and allocate risk within the company the same way capital and other resources are allocated.
- Build contingencies and response strategies for a wider range of scenarios than normal
- Adopt a more flexible management model – eliminate calendar-based planning and switch to continuous decision making using agendas that reflect the highest value-at-stake issues

### **3. Re-arm the sales force**

Significant changes in customer demand and economics will force companies to re-think their sales force focus, operations and investment

- Start with the customer, not sales – get better insight than your competitors on how and why customer loyalty and switching are changing
- Define your own 'good' – not just best practice – by better linking your sales force model, investment and performance to the drivers of competitive advantage and company value
- Re-think your headroom for growth and align sales force investment accordingly – who are the 35% of the customers that represent 65% of the opportunity – i.e., the "switchers"
- Get visibility into "needs-offer gaps" to guide immediate changes to your selling proposition
- Cycle your talent aggressively by segmenting the sales force by both performance and competency
- Build institutional capabilities – not just individual skills

#### 4. Use customer benefit to re-base cost

In an environment where customers' willingness to pay has changed, and in most cases declined, companies must preserve profits without sacrificing growth or long-term value

- Put customer benefits, as measured by willingness to pay, at the heart of your drive to create a business model that is fully adapted to the age of frugality
- Re-set target levels of performance for each feature of your product/service offer based on willingness to pay and desired differentiation vs. alternatives
- Link costs to customer benefit in order to differentiate 'good' vs. 'bad' costs – i.e., those which contribute little to customer benefit and long-term value creation
- Zero-base the operating model to eliminate bad costs and create fuel for growth in good costs
- Create tailored pricing, offer and operating models that address differences in willingness to pay across customers
- Attack the hidden costs of complexity in portfolio linkages and organizational models

#### 5. Work your 'problem businesses'

Market turmoil has exposed many businesses whose underperformance risks dragging down the enterprise as a whole

- Ring fence businesses and activities that are infecting company value
- Understand the merits between save/re-build and dispose
- Give first priority to minimizing value destruction, then to maximizing value
- Align incentives with near-term cash and value delivery
- Compare the best out-of-court options to the best in-court options

#### 6. Create room to play offense

On the one hand, every business is seeing 'once in a lifetime' opportunities for investment bargains; on the other hand, most businesses are distracted or cash poor and cannot take advantage

- Close off time sinks in your management population, processes and bureaucracy
- Get focused on cash and value – reduce time spent on managing earnings and EPS
- Sell profitable businesses that are not key to achieving your long-term strategic direction and may be worth more to someone else
- Zero-base your balance sheet to unlock hidden sources of liquidity and capital (e.g. real estate holdings)
- Refresh the 'A' list of assets you would like to own, and the price you would be willing to pay
- Identify the 'disruptive innovations' that would enable you to extend your position with advantaged businesses

All companies now face a burning platform. Decisions made in the next few months have the potential to materially change the value of the enterprise in either direction. A detailed understanding of how value has changed for both customers and shareholders, rapid but disciplined evaluation of alternatives, value-based decision-making and excellence in execution will separate the winners from the losers.

If you want to learn more about any of these ideas please call, e-mail or visit us at [www.marakon.com](http://www.marakon.com).