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How to Get Ready for Economic Cycles

Many companies put more effort into planning for a power outage than they do preparing for the inevitable cyclical downturn. Here are some points to consider.

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The Red Cross recommends you prepare your home and your family for the possible emergencies and disasters that are most likely to occur where you live. They recommend you prepare a home disaster plan, rehearse it with your family and set up a kit full of first aid, food, water and other supplies you are likely to need during a disaster. This is sound advice.

Many companies prepare for business disasters using similar and often more comprehensive guidelines. Business continuity plans are designed to keep the company up and running through disruptions such as power failures, IT system crashes, natural disasters, supply chain problems, etc.

But do CFOs and other senior executives have a deliberate plan to be prepared for the inevitable downturn in the business cycle?

OPINION

This is by no means meant to scare you as I have no proprietary insight on when the next downturn will start and how severe it will be, but I do know that following every other economic expansion we have ever had there has been a contraction.

On average there have been 66 months between economic peaks since World War II and in recent years this has stretched to an average of 106 months. The last peak was in December of 2007 so sometime over the next few years we are likely to hit an economic peak and then a decline so it seems worthwhile to prepare now.

One of the most difficult problems companies face in an economic downturn is over capacity. As demand slows they find they have more employees and productive equipment than they need. This leads to layoffs, which are expensive and disruptive to those losing their jobs, and distressed sales of equipment and real estate. Management, employees and shareholders all suffer.

But if we know a peak is likely over the next few years we can think twice about our growth investments and maybe miss some of the potential upside at the peak in exchange for being more “right sized” before the downturn happens. Of course many investments are so good it’s better to just do them but the more marginal investments that won’t hold up in a recession should be avoided for now.

One way to accomplish this is to think differently about fixed and variable costs as we approach the downturn. Although most companies strive to reduce their average cost run rate by making investments that automate processes, they are in effect replacing a high variable cost with a lower fixed cost. But in a downturn, fixed costs can cause average costs to rise while variable costs can be shed often quite easily.

Another strategy is to embed cancellation and deferral options in contracts for large new capital investments. In this way, management retains the option of reducing cash outflows which can prove very valuable in a downturn. Sometimes there is a tradeoff on the price of the capital equipment to get such an option but it can prove to be a very valuable option to have.

On a related note it is important to have adequate financial flexibility when the economy turns down. This was especially true in our recent credit driven slump which followed an easy money period when many companies levered up, often just to give the money to shareholders in a stock buyback. Those that sold into the buyback made out well and those that held the stock suffered. Buybacks and anything that drives leverage higher and liquidity lower are the worst when at or near a peak.

For companies with the ability to lease a substantial portion of their assets, they can enhance financial flexibility and manage the potential for overcapacity by staggering the end points of these leases. Whenever a downturn occurs they can simply not renew a share of the leases and *voila!* financial flexibility is created and the overcapacity problem goes away.

It's also important in advance to consider investments that might be quite attractively priced when demand wanes. For example, the purchase and installation of capital equipment can be cheaper when manufacturers and installers face tough economic times so considering such opportunities in advance can help you prepare to seize the day while others hunker down. This can payoff quite well in the next upturn.

A stellar example of this was Intel's February 2009 announcement that they would spend $6-8 billion to accelerate their drive toward a 32nm processor. It was bold and beautiful in that it probably saved them billions versus the cost during an up market.

The strategy of buying in a trough should apply to acquisitions as well. Acquiring during a downturn is like buying companies at Wal-Mart. Why acquire companies at full retail (i.e. current prices) when you can acquire them in a few years on sale (i.e. 25-50% cheaper than today).

But CFOs and other senior executives cannot wait until the downturn to start looking for targets, they need to start planning now by preparing a list and beginning to track them. They will need to distinguish those that are cheap simply because the market is down from those that are crippled by the downturn and may never recover. And above all, it's best to avoid driving acquisition plans based on which companies are for sale - probably because they have no choice. Buying in a downturn requires a proactive strategy not a reactive one.

This whole topic may seem oddly timed to some. Sure there are many companies that continue to build cash and even though we may be getting late in the growth cycle they still haven't stepped up their growth investments much yet. Am I really suggesting these companies continue to cut investment and build cash?

Well, yes I am. Every down cycle seems easy to see in the rear view mirror but when it's happening most of us are faked out until it builds up some steam. It's human nature. We extrapolate what we are experiencing into the future and at the top we tend to think it will keep going up for a while. At the bottom we think it will keep going down. Somehow, despite all of history we never seem to be ready for each cyclical turn.

My goal is to make sure people are ready the next time it turns - whenever that turns out to be.

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