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Strategic Management Consultants

SUCCESS STRATEGIES FOR THE NEW ECONOMY'S SLOWDOWN

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Obviously, the U.S. economy has slowed considerably over the past two quarters (from 5.6% growth in the second quarter in 2000 to 1.4% growth in the fourth quarter). However, much of the manufacturing sector has been fighting through tough economic conditions for a year or more. Further, dot.com start-ups have been in perpetual decline since spring 2000 – starved of new capital and often reliant on money losing business models, they have been slowly bleeding into bankruptcy.

While only time will tell how deep and prolonged the current slowdown will be, we at SMC firmly believe that there are important strategic considerations that can help you to manage your company through this downturn successfully. You cannot control the economy, but you can control how you react to the slowdown. And, how you react to and manage through the economic downturn will directly impact your company's strategic position when better economic times return.

This monograph addresses what is driving the current slowdown, why despite this slowdown it is still entirely valid to think in new economic terms, and most importantly, what you can do to succeed despite the downturn.

What's Going On Here, Wasn't the New Economy Supposed to be Recession Proof?

Before the economy started to cool during the second half of last year, there was considerable debate and discussion among economists about how "new" the new economy really is. That debate centered on such questions as whether productivity gains were real and sustainable and, more fundamentally, whether the economy had entered "a new era where recessions are a thing of the past." While we are as optimistic as anyone, we were never deluded into thinking that the economy ceased to be subject to economic cycles.

In part that view grew out of the breadth of our own practice. For instance, our work with integrated steel and aluminum manufacturers underscored the fact that the new economy was not delivering riches universally across all sectors of the economy. Likewise, our work with major metropolitan newspapers highlighted the mixed blessing that the Internet brought to some companies – new costs, challenges, and opportunities, without an immediate positive jolt to revenues. At the same time we serve clients who are working on the cutting edge of new technologies – underscoring for us why the economy has changed in fundamental ways.

We believe it is very easy to understand where the slowdown is coming from. There are basically three causes – an extended softness in manufacturing, an abrupt slowdown in demand for computer hardware and software, and of course the Federal Reserve Bank's actions.

Manufacturing Sector Softness

The heavy manufacturing sector of the economy has been under pressure from globalization and other competitive dynamics for some time.

- The crash in Asian and Latin American financial markets in 1998 precipitated much of the downturn. In many basic industries, Asian and Latin American competitors were forced to sell product below their marginal cost of production simply to survive in the short term. Credit markets in those regions contracted so severely that companies were essentially forced to sell at any price to generate cash flow and keep the doors open. In turn, commodity prices collapsed on a worldwide basis.

- Meanwhile, the strength of the rest of the U.S. economy drove the trade deficit ever higher. As global prices collapsed, the market those manufactured goods found was primarily the U.S.
- Further, the ease with which capital flows globally has applied sustained pressure on many commodity markets – including aluminum and steel, industrial and agricultural chemicals, and other manufactured goods (i.e., price pressures are increased by the rapid flow of capital around the world).

The problems facing the basic manufacturing sector are now exacerbated by the slowdown in the automotive market. The softness in the manufacturing sector would have been much more pronounced had the auto industry not had record years in 1999 and 2000. By the fourth quarter of 2000 light vehicle sales in the U.S. had slowed considerably. And, the most optimistic projections have sales down by 1 million vehicles in 2001 (to roughly 16 million vehicles sold – likely at a substantial discount).

Although manufacturing is no longer the central driver of the U.S. economy, the prolonged softness of the manufacturing sector has left the rest of the economy vulnerable to a slowdown.

High Technology Slowdown

The high technology sector of the economy has experienced an abrupt slowdown. As recently as last fall projections for microchip demand, wireless equipment demand, and computer hardware were all solid. But, the high technology market came to a screeching halt – with computer hardware the first hit and most affected.

Interestingly, the high tech sector has never had to manage through a genuine downturn.

- During the last recession, the information technology market was experiencing such strong growth that the recession simply slowed that rate of growth. Many companies in the high tech sector still struggled to keep up with demand, despite the recession.
- Our friends and clients in the high tech sector are the first to say that, “*we have been spoiled by the never ending growth*” in the market. As a result, many high tech companies have no meaningful context from which to react to a genuine slowdown.
- When one adds the rapid descent of the dot.com market to the slowdown the high tech sector as a whole was facing (the hardware market in particular), the sector now finds itself facing an extremely difficult situation.

Given the irrationality of many of the dot.com valuations of a year ago, there is a very real temptation to take a measure of satisfaction in seeing high tech companies struggle. However, it is a short-sighted (and petty) point of view. Much of the productivity boom the broader economy experienced in the second half of the 1990’s can be directly traced to hardware, software, and networking (including and especially the commercial Internet).

Federal Reserve Bank Actions

In addition to measurable slowdowns in manufacturing and high technology, the current weakness in the overall economy can also be traced to monetary policy executed by The Federal Reserve. With energy prices spiking and other inflationary pressures playing out last spring (remember, third quarter growth was 5.6% and unemployment was roughly four percent nationally), the Fed aggressively raised interest rates.

It worked – by the fourth quarter the economy had cooled significantly. By January 2001 the Fed was cutting rates. And although unemployment rates are still near historic lows, the recent rash of layoffs by the Fortune 500 and others has eased some of the tightness in labor markets.

The slowdown has led many pundits to question whether or not there is a “*new economy,*” to which we reply.

Yes Virginia, There Is a New Economy, But It's Not What You Think

First, new economy or old, business cycles still exist. But, in the new economy the downturns should be less extreme and less prolonged. For example, look at how quickly most businesses have reacted to the slowdown. In the past, it would take months (sometimes years) for businesses to stem the growth of excess inventories as the economy cooled. It appears that the economy has already turned the corner on inventory growth – an extraordinarily fast reaction to the problem made possible by ERP (enterprise resource planning) and other technology tools.

More importantly, we believe there is a fundamental misunderstanding of what technology means to this economy. There has been so much talk (and hype) about the “*Internet changing everything*” that people have lost sight of how broad and deep the technology boom really is. Price Pritchett notes that, “*there has been more knowledge created in the past 30 years than during the previous 5,000.*” In industry after industry far reaching technological breakthroughs are being made – fuel cell technology, advances in material science, mapping the human genome, the list goes on.

Take one example of this type of technological advancement and consider the scope and reach of the strategic implications. Alcoa and others in the aluminum industry have made significant progress on new smelting technologies that Credit Suisse First Boston (an investment bank closely following the industry) believes “*will substantially lower primary aluminum production costs.*”

- Today, the average production cost per pound of aluminum produced is a little more than \$0.50. Credit Suisse estimates the “*probable cash cost savings*” of the new technology to be between \$0.11 and \$0.25 per pound. That represents a 20-50% reduction of production costs.
- The impact of that technology breakthrough reaches well beyond the aluminum smelters themselves. If primary aluminum costs fall 25-50%, how much more aluminum will Detroit put into automobiles? What are the potential fuel savings from lighter weight vehicles? What about packaging, what does that cost savings mean for beverage companies and other canners? Likewise, what might the impact be in construction? The list can go on and on.

Aluminum production is just one example of what technological transformation is doing and can continue to do for the economy. What impacts might we expect in health care and pharmaceuticals stemming from the human genome project? What, in turn, might that mean for health insurance costs and Medicare?

Viewing the “*new economy*” as a product of the Internet or of information technology is taking far too narrow a view of technology and its impact on our lives and the economy. Technological advancement is much broader and deeper than simply information technology. That said, information technology is a critical driver in the new economy in two important ways.

- First, information technology is a critical source of productivity growth. The sustained productivity growth we have experienced in the U.S. is a key reason why we have enjoyed low unemployment and low inflation for several years. That productivity growth flows from two aspects of information technology.
 - Software tools (e.g., ERP, customer relationship management, etc.) are having a tremendous positive impact on business productivity.
 - And, networking (via the Internet, local area networks, and other means) is doubling the number of people connected to each other via computers each year. That is leading to significant productivity gains as it changes how we all work.
- Second, despite the collapse of the dot.com start-ups, the Internet remains a valuable tool and an important element of strategy (see our *Whatever.com* monographs for discussions of the strategic role of the Internet). As bad as the hype (and the valuations) were, dismissing the Internet now would be an even worse mistake than overstating its importance was a year ago.

So, What Are the Strategies for the New Economy Slowdown?

The fundamental strategic issue has always been (and remains) defining what is unique and distinctive about your company. The very essence of strategy is being different from the competition in ways that have value to the marketplace and executing effectively against those points of difference.

- Michael Porter has been hammering on this point for five years now (see *Harvard Business Review*, November-December 1996 or the most recent *Fast Company*, March 2001 for more on Porter's view of this topic).
- Here at Smock•Sterling, we have helped dozens of companies identify and pursue those unique strategic positions. Our FOCUS strategic planning methodology is structured entirely around getting to those points of difference.

Slow economic times also present special challenges and opportunities. Depending upon your business and the industry you are in, we suggest you focus near term attention on the following.

- **Costs and productivity** – a slower economy almost demands a hard look at costs.
- **Market share gains** – slowdowns almost always hurt the weakest and least focused companies the hardest. Now is the time to grow share at the expense of the weak. And, it may also be a great time to acquire a competitor at “*fire sale*” prices.
- **People** – pragmatism suggests that one benefit of the slowdown is that it provides some relief from tight labor market pressures and presents an opportunity to focus on human capital.
 - Tom Davenport notes that “*ideas and human attention are the limiting factors.*” The key then becomes helping your people stay engaged and focused.
 - Mike Abrashoff goes further saying, “*you have to grow your people to grow your business.*” That becomes especially true in tougher economic times.
 - Ultimately, it boils down to knowledge and learning. Everyone says that their people are their greatest asset, but only companies that invest in their people's knowledge and development are truly improving the value of those assets.
- **Technology** – view technology in its broadest sense. By doing so, you can get cost and productivity improvements in the plant, in raw materials and yields, and in the white collar/soft collar environment. Further, technology is a primary tool to advance operational excellence – to extend strategic advantages and/or to defend unique strategic positions.

In closing, we want to emphasize that regardless of what lies ahead – good times or bad – strategy matters. We have been in business as strategic management consultants through recessions, slowdowns, and booming economic times. We understand the underlying dynamics of the new economy. And, we can help you with the strategic questions and issues you face today. As always, we welcome your calls.

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