

CHAPTER SIX

Reexamine Your Strategy and Business Model

The importance of knowing what you must change—and what you must not

On a freezing night in February 2009, Giorgio Armani stood in the center of his brand-new store on Fifth Avenue in Manhattan, the host of the store's glittering, celebrity-filled grand opening. The U.S. recession was in its fourteenth month. In New York, tens of thousands of former investment bankers were out of work, their magnificent year-end bonuses cut drastically or completely, their prospects unattractive. Much of the New York City economy, and a huge portion of the luxury goods industry in which Armani operates, depends on these now unemployed people and their multimillion-dollar incomes.

Yet Armani pushed ahead with the opening of his store, a space that would have seemed stunning even in the headiest economic boom. Calling it a shop would not be accurate. Standing at the corner of Fifty-sixth Street, one of the most expensive retail locations on earth, it occupies forty-three thousand square feet devoted to three separate merchandise collections, a restaurant, and a chocolate shop. Armani wasn't saying what it had cost, but a good guess would be something close to \$40 million—to open the most extravagant

store in New York in the depths of the worst recession in seventy-five years.

The obvious question: was he crazy? Time will tell, but he seemed serenely confident in what he had done. “An entrepreneur shows his true colors in a period of crisis, not in a period when everybody is having success,” he was quoted as saying. He seemed to understand the financial reality of it all: “Understand that the investments that I made in this store I will probably not get back for twenty to twenty-five years,” he said, displaying a long-term orientation that most of us can only admire—especially considering that he was seventy-four years old when he said it.

Three Questions

Would you have the courage to invest a ton of money in an audacious project during a terrible recession? You would if you were utterly certain of your business’s core, of its central, unchangeable meaning. Armani understood that recession or no, certain traits of his company would not waver: the design sensibility established over forty years, its standing as a preeminent luxury brand, its assertive yet tasteful way of engaging retail customers. The new Manhattan store embodied all those things. He would cut costs elsewhere if necessary, but not there.

Armani’s decision to go ahead with his New York store raises a larger issue that all companies face in a bad recession. Is our strategy going to work in this environment? What must we change—and what must we not change? Will the recession fundamentally change our industry and our place in it? Or will this downturn just throw us off the long-term trend line for a couple of years? Do we need a new business model?

Those are large and deep questions for any company, and reconsidering strategy can turn into a miasma that consumes endless time and yields nothing. Yet the process is manageable. One way to think

through the matter of your strategy and business model in this recession is to answer three basic questions.

1. What is our core?

A finding that's consistent across many recessions is that the best-performing companies keep investing in their core, no matter how bad things get. One of the most inspiring examples is what DuPont decided about research during the Depression. As revenues plunged in that downturn's first three years, the company reduced its R & D spending commensurately. But then the company's leaders realized that this policy would destroy the firm's future. Leading-edge research and the resulting new products were the very heart of the company. Elmer Bolton, who became famous as DuPont's director of chemical research, wrote that "it is a demonstrated fact that progress in the expansion of an industry cannot be accomplished by intermittent efforts in research that is curtailed at the first sign of reduced profits." So DuPont resolved to keep funding chemical research—its core—straight through the Depression, no matter what. Among the results: nylon, neoprene, and other products that brought DuPont billions of dollars over the following decades.

Excellent companies are certain of their core. Early in this recession, Brad Smith, CEO of the Intuit software firm, told us at *Fortune*, "We're not going to cut innovation. This company for twenty-five years has been fueled by new product innovation. We're protecting the innovation pipeline so we come out of this strong." He would cut elsewhere if necessary, but in the realm of personal and small-business finance software, he's up against mammoth competitors, including Microsoft. He cannot afford to fall even a fraction of a generation behind them.

As wonderful as innovation is, it isn't every company's core. Kohl's, the big midmarket retailer, spent more on marketing in the recessionary 2008 holiday season than it had in 2007 because market-

ing is part of its core. Like Intuit, it's also threatened by a giant—in this case Wal-Mart—and can't give up even an inch of territory, regardless of tough times. At Domino's Pizza, a key element of the core is delivering the pizza within thirty minutes. No matter how the company chooses to cope with this recession, it will not jeopardize the delivery time. Several market trends favor pizza just now—it's a low-cost food that's consumed at home—but Chris Moore, CEO of Domino's in the UK, told a British magazine that “none of that means anything to us unless we can deliver the pizza on time.” He understands his company's core.

For some companies, investing in the core is mandatory for maintaining the firm's competitive position. For other companies it can be a powerful way to extend the firm's lead and pound competitors that are already suffering. An instructive example is Intel, which announced plans to invest \$7 billion to upgrade technology at its plants in 2009 and 2010. Intel has a high cost of capital, so such a large investment would be brave in any environment, but consider that the firm was announcing it at the beginning of a year when overall microchip demand was forecast to drop by 25 to 30 percent. Most of its competitors were cutting way back on capacity, and its most direct competitor, Advanced Micro Devices, was spinning off its manufacturing operations entirely. Yet Intel was choosing this moment to strengthen its core. Foreseeing how advantageously it will be positioned when the economy rebounds was not difficult.

For many companies, investing in the core requires first deciding what the core is. That's a valuable discussion to have at any time, and especially in a recession; what it often reveals is that the concept of the core was forgotten during the good times. That's when companies wander into businesses for which they command no special capability but that get along while the economy is strong. Then, when the downturn hits, the noncore businesses blow up and have to be axed. It has happened this time just as it always does. Pioneer, the Japanese maker of audio and other electronic products, bailed out of

the grindingly competitive flat-screen TV business. Home Depot shut down its Expo chain of home design centers. UBS closed businesses that dealt in real estate and U.S. municipal bonds. Even Google, while still highly profitable, closed down noncore businesses that sold advertising on radio stations and in newspapers. None of those companies could keep investing in the core as long as money-losing noncore businesses continued to drain cash.

Of course, it's possible for the core to change, especially in momentous times like these. Entire industries can be restructured, and wise companies may have to shift their core in response. A bit later we'll consider the issue of whether this recession is altering your business so significantly that you need to rethink your core. But if that isn't happening, then the exercise of understanding your true core, and gaining the confidence to invest in it even now, will create strengths that will last a long time. Consider Procter & Gamble, which understands that product innovation and brand building are at the center of all it does. It's investing in gene-based research to create better cosmetics. When the decoding of the human genome was hailed as one of the great scientific achievements of all time, you probably weren't thinking about how it could lead to wrinkle-smoothing skin cream, but P&G scientists were. It turns out there's also a genomic angle to dandruff and the gum disease gingivitis. No one knows if the company's research will produce any breakthrough products, but it certainly could, and if even one or two prove successful, P&G's competitive advantage—and the financial benefits—could be vast.

That's the power of knowing your core and having the confidence to keep investing in it. But even if you're clear about that, your world is still shifting, and you must ask the next question.

2. How is this recession changing our customers and their behavior?

In chapter 8 we'll look at how successful companies adjust their value propositions to meet the changing needs of specific customers. But

from a strategic perspective, we need to consider the larger question of how the recession is creating broad shifts in customers and what they want. Spotting those shifts and responding to them before competitors do is a valuable way to avoid new threats and make hay from new opportunities.

A recession as wide and deep as this one can change behavior in significant ways. In the Depression, when the U.S. unemployment rate reached 25 percent, people became devoted to radio listening like never before or since. Social workers found that Americans who needed to raise money to pay the rent would sell their refrigerators, bathtubs, telephones, and beds before they would part with their radios. The effects of Depression-induced radio mania were transformative for radio set manufacturers, radio station owners, radio performers, advertisers, ad agencies, and many other businesses.

We're all familiar with the Depression generation's ultracautious attitudes toward investing and jobs. Such attitudes were hardly surprising, and this recession could affect today's young people similarly, with long-lasting consequences for financial services firms and others. Companies began responding almost immediately, with several marketing "ultrasafe" investment vehicles, often with considerable fees attached. Traumatized investors are willing to pay more for safety than they have been in a long time.

Some other effects of bad times are more surprising. For example, in developed economies physical health tends to improve during a downturn. Exactly why isn't clear, though maybe it's because people eat healthier food, drink less, possibly smoke less, and drive less. From whatever cause, researchers have found that in the United States, a 1 percent increase in the unemployment rate correlates with a 0.5 percent decline in the death rate, and similar results have turned up in Australia and other advanced countries.

How will the recession affect your customers? Sometimes the consequences seem obvious, yet some companies fail to foresee them. In the personal computer business, it doesn't take a genius to figure

that consumers will probably move toward less expensive machines. That trend would clearly seem to favor netbooks, also called mini-notebooks—smaller devices with fewer features and lower prices. Yet self-evident as all that may seem, many of the world's top PC makers, such as Dell and Hewlett-Packard, were late to the party, while makers such as Acer and ASUSTeK Computer were cashing in on the new demand for those machines. Acer's CEO, J. T. Wang, was frankly surprised: "We found out that our American competitors are not aggressive in [the netbook] segment," he was quoted as saying, "but we think this segment is very big." It's big and growing fast because of the recession.

In other ways the recession's effects on customers are not obvious. While consumers spend less overall, for example, they don't spend less on everything; they actually spend much more on certain things, and the changes in consumption patterns aren't necessarily what you might expect. During the previous two recessions (1990–91 and 2001), U.S. consumers cut sharply their spending on food away from home—no surprise there. But they also cut their consumption of tobacco products, despite the addictive nature of those items. Consumers spent less on leisure, broadly defined, though conventional wisdom holds that people spend more on entertainment to cheer themselves up when times are tough.

The spectrum's other end includes several surprises. Consumers considerably increased their spending on health care, for example. That result may be specific to the United States, where some 60 percent of health-care spending is funneled through employer-sponsored coverage; employees, worried about losing their jobs, increase their doctor visits and try to address every possible health issue while they're still employed and still covered. Consumers also spent more on personal insurance and pensions, which may seem odd at a time when we'd expect people to be focused on their most immediate needs. Again, the prospect of losing their jobs—or the actual loss of them—combined with a newly sharpened consciousness of the risks they

face, probably explains the trend. The category of spending that increased most (among those studied by McKinsey, which compiled this information) was education. This also may seem surprising, considering that it too is a discretionary purchase that yields its benefits years in the future. Why spend more on something like that when every bit of income is increasingly precious? The answer seems to be that many people figured they may as well improve their employability at a time when they can't get a decent job or perhaps any job. As for the cost, they can probably borrow some or all of it and pay it back when they get a new and better job. The trend seems to be playing out in this recession as well. Applications to U.S. business schools rose markedly as the economy deteriorated.

The larger point is that as the recession alters buyer behavior, the effects may be counterintuitive and need to be addressed fast. They may not require changes in business strategy, but they may well demand adjustments to the business model, with resources shifted to the new opportunities—taking advantage of the fact that in a recession, some businesses actually grow.

A deep global recession changes much more than buyer behavior, of course. It alters the courses of national economies, reshapes capital markets, strengthens or weakens suppliers—all of which can reorder whole industries. Which leads to the next question.

3. Will this recession hasten—or even cause—a large-scale restructuring of our industry, and if so, how will it affect us?

Extreme economic conditions have a way of accelerating trends that were already under way. Excellent examples in this recession involve the media industry and U.S. automakers. In the media world, newspapers have been in decline for many years as the Internet has lured away readers with free content and has siphoned off highly profitable classified advertising. Those trends have been apparent since 1995, clearly dooming many newspapers, yet these papers hung on until

the current recession, which finally pushed them over the edge. The story in autos is remarkably similar, with the secular decline of the three Detroit manufacturers observable for at least twenty years. Those companies limped from year to year, progressing with excruciating slowness toward a clearly inevitable future as much smaller outfits, possibly merging with outside firms or with one another. This recession just compressed the timeline from years to months.

The pattern is similar, if not necessarily so apocalyptic, in most big, old, product-based industries. Production has been shifting from higher-cost facilities in the developed world to lower-cost facilities in the developing world, and this recession has hastened that trend. Look for it to happen in the chemical industry, for example. In newer industries, by contrast, even a recession as bad as this one may just throw production temporarily off its long-term trend line. The growth of information technology, for example, has lurched through peaks and valleys but over time has followed a reliably rising line. A few years of below-trend growth will most likely be followed by a catch-up period of above-average growth.

Knowing which kind of future your industry faces—a world-changing, once-in-a-lifetime revolution or an era of major adaptation—is critical before you can form your response. A danger in a recession as deep as this one is that it may accelerate trends that will affect your business but that weren't even on your worry list. Three broad, multi-industry trends, already well under way, are especially worth watching because a bad recession could fuel them significantly.

Cocreation. The idea is that the most successful companies no longer invent new products and services on their own. They create them along with their customers, and they do it in a way that produces a unique experience for each customer. The critically important corollary is that no company owns enough resources, or can possibly own enough, to furnish unique experiences for every customer, so companies must organize a constantly shifting global web

of suppliers and partners to do the job. In good times, the incentives to rethink a business in such bold terms are weak. But in a historic recession, a substantially different business model that may demand far fewer resources is a suddenly attractive proposition.

The starkest examples so far involve the Internet. Facebook isn't a product or a service, but rather a platform on which users create their own unique experiences; since it opened itself to software applications created by outsiders in 2007, more than thirty thousand have appeared. Facebook couldn't possibly do all this on its own; the whole user experience is cocreated.

A radically different example that suggests even broader possibilities is described by professors C. K. Prahalad and M. S. Krishnan of the University of Michigan's Ross School of Business, who have studied and developed the idea of cocreation. Suppose the health insurance premiums of a customer with diabetes could be reset continually based on monitoring of that person's vital signs and compliance with a regimen of diet, exercise, and medication. In theory that model is possible today, and an early version is being used by ICICI Prudential Insurance in India. The service and what it costs are continually cocreated by the customer and the company in conjunction with a network of doctors, exercise facilities, and pharmaceutical firms that have joined the project.

If this sounds like the old mass-customization idea, it decidedly isn't. That concept was about a company offering customers many choices on a wide range of product or service attributes, but the company still had to decide which choices to offer and then had to deliver them. In cocreation, the choices are infinite, and the company neither imagines nor delivers them all. Similarly, if this sounds like Web 2.0, it sort of is, but it's much bigger because it's more than an Internet phenomenon.

The challenges are clear. Most companies, especially old ones, are organized exactly wrong to capitalize on cocreation. They're built around the processes of creating products and services and managing

owned resources, just the opposite of the skills needed in the new model. In the same way, most managers (especially old ones) lack an intuitive feel for how the new model works. But in times that are challenging or even desperate for many companies, managers will be strongly incentivized to develop new business models that create value by using the resources of others.

Brand building in developing economies. Paulo Zegna knows all about product counterfeiting in China, but he was still surprised to see his own name being stolen. He's cochief of Ermenegildo Zegna Group, the Milan-based men's fashion house that also manufactures some of the world's best wool cloth, and a few years ago employees in southern China discovered thousands of yards of fabric with the Zegna name woven into the selvedge—but his company hadn't made it. Zegna cloth had joined the long list of products being faked in China.

A familiar tale but for one unexpected detail: instead of the low-quality rip-off you'd expect, the cloth was pretty good. Zegna won't say it matched the real thing, but it was good. And why shouldn't it be? As he told me, "The Chinese now buy the same machines as everybody else, they hire the same consultants, they compete with us to buy the same raw wool in Australia." Result: somewhere in China a company was turning out high-quality woollens worthy of being marketed under their own name, which could presumably be built into a valuable brand, yet the firm chose instead to steal someone else's name.

That sounds crazy to an increasing number of businesspeople in the developing world. It has been apparent for some time that the next great phase of business development in China and other developing economies will center on brand building, but it was slow going as long as the world clamored for low-cost manufacturing as fast as these countries could provide it. Now thousands of factories are closing, millions of factory workers are without jobs, and these countries need another, more stable, more lucrative model for prosperity.

Motivated by the current slowdown, they may become brand powerhouses far more quickly than many Western companies expect.

That's worrisome for today's incumbents because brands are where the money is. Brand owners typically collect most of the profit in an industry. A pair of Nike running shoes that leaves a factory in eastern China at a cost of five dollars may sell in the United States for a hundred dollars, and while Nike doesn't pocket all the difference, it pockets much more than the factory owner. The situation is the same in consumer electronics, clothing, toys, and many of the other industries in which developing economies produce most of the world output. Until recently, those nations' firms were happy to cash in on their labor-cost advantage and make more money than they'd ever seen. Now, led by companies like Lenovo (computers), Haier (appliances), TCL (consumer electronics), and others, they're going after the enormously larger sums flowing to the brand owners.

Companies in these countries may command no special brand-building talent. They possess no analog to their labor-cost advantage in manufacturing. But they do hold other advantages. They understand their home markets better than anyone else, a significant edge when those markets hold 40 percent of the world's people. And a company that builds a powerful brand in Asian markets may develop scale economies and learning-curve advantages that will strengthen it globally. For decades those phenomena helped Western companies, operating in their vast home economies, to stay on top. Now, in industries such as cell phones and PCs, where developing economies are already the world's largest market or soon will be, the tables may be turning.

We don't know all the ways the present crisis will affect companies in the developing world, but if it drives them to master the ineffable, emotional, magic power of brands, then what they've achieved so far will seem insignificant by comparison.

Imagination-based business models. As living standards decline in Western economies, a conventional response is to urge greater

achievement in science and technology, long the foundation of economic dominance.

But a contrarian school argues that the whole debate is wrong—that focusing on science and technology is fighting the last war. This school holds that the very basis of value creation is shifting from the disciplines of logic and linear thinking to the intuitive, nonlinear processes of creativity and imagination. Tech advances will cease to confer much competitive advantage as they circle the world almost instantly. Authors like Daniel Pink (*A Whole New Mind*), Richard Florida (*The Rise of the Creative Class*), and Virginia Postrel (*The Substance of Style*) see the value shift happening already and say the trend is just getting started. Because it's a sharp break with past beliefs about wealth creation, the shift has been happening slowly. But now, with managers and policy makers newly open to radical-seeming solutions, it could make sudden progress.

Exhibit A in this argument is the iPod. Its success isn't based on any tech breakthrough. MP3 players had been around for years and had never done much commercially. Apple's achievement was creating an appealing design and a superior, intuitive user interface, plus the crucial business innovation of the iTunes online music store. The company then imbued the whole thing with an undeniable coolness. The result is an overwhelmingly dominant business, with about 75 percent of the MP3 player market and of the online music market—all based on existing basic technology plus a lot of ingenious creativity.

Could that model—expressed already in a thousand forms, from the carefully created Starbucks environment to Michael Graves-designed toilet brushes at Target—be the new basis of economic success? It's an extremely audacious claim. Left-brain logical rigor has been the foundation of economic growth for more than three hundred years. Most people instinctively rebel at the notion that touchy-feeliness could power great economies or even major corporations. It's fine for a few, but how can it employ the vast numbers who will no longer be working in factories, mills, and back offices?

I put that objection to Daniel Pink. He responded that in massive economic shifts, people are terrible at foreseeing what's next. The conventional view thirty years ago was that an economy couldn't be based on services—manufacturing had to be the foundation. No one “envisioned search engine optimizers or Web designers or executive coaches or nanotechnologists,” he told me. “When we're cabined in the present, we suffer from a certain poverty of imagination. We massively underestimate human ingenuity and resilience.” The future, he says, will bring “industries we can't imagine and jobs for which we lack the vocabulary to describe. Yes, it represents a leap of faith of sorts, but that's how it has always worked.”

The vision of the right-brain future is appealing in the developed world because it plays to the West's strengths today. Some of these countries, notably the United States, are falling behind in science and math but are awesomely good at creating games, humor, design, story, emotion, and other elements of the hypothesized future. Yet the power of these right-brain creations may be highly culture specific. Indians and Chinese have right brains too—what's to stop them from charging into the economy's next phase? And don't they hold an obvious advantage in creating new industries that will dominate their own mushrooming markets?

Imagination-based business models probably don't favor any particular industry or part of the world. On the contrary, they hold the potential to disrupt almost any business and will probably be much more widely tried in an environment where, for many companies, anything is worth trying.

All three of these trends are disruptive ideas that may not have seemed worth chancing in better times. But in a deep recession, many companies have no choice but to rethink their strategies or business models, and they realize that incremental changes won't be enough to save them. As a result, many companies will embrace these trends and change their businesses significantly. Not all will succeed, but some will, and they will be among the leaders when the economy turns up.

Not every company needs to alter its strategy or business model in a recession, even a deep one. Indeed, as we've seen, one of the most important traits of the world's great companies is a strong, stable strategy that works well in all parts of the business cycle. Many work even better in a recession. Toyota's central brand promise of value and reliability is a greater advantage now than ever. Wal-Mart and Southwest Airlines typically perform great in recessions because of their low-cost strategy, and the new customers they attract in bad times tend to stay with them when good times return. Intel's towering dominance in the microprocessor business lets it increase its lead in recessions by underpricing and outlasting competitors. These fortunate outfits already possess great recession strategies.

Yet in a downturn all companies, even the best, need to reconsider strategies and business models to see if they need tweaks, refinements, or large-scale changes. In making those crucial judgments, managers must be utterly clear about the basis for their decisions—their ultimate, bottom-line objective—yet on this matter many leaders go astray, with results that can be financially fatal. Understanding the financial reality of a business in a deep recession is therefore the subject of the next chapter.