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FEATURE

Building business resilience to the next economic slowdown

Perspectives from CFOs

Dr. Michela Coppola

Trade disputes that are harming growth, Brexit and other big political uncertainties, concerns about banks and corporate and public sector debt: these are among the many pressures now crowding in on business leaders. Deloitte asked more than 1,000 CFOs operating in Europe what they are planning to do to make their companies more resilient to a global slowdown.

THE WORLD ECONOMY has done quite well recently. The US economy has enjoyed one of its longest expansionary phases in recent history while the eurozone has entered its sixth year of uninterrupted growth. Unemployment rates in many countries are at historical lows and inflation has been muted. The major stock indices are at almost record levels and the financial markets are operating, it would seem, on the assumption that the risk of recession remains very low.

Yet sources of concern are plentiful: increasing trade tensions around the world, rising debt on company balance sheets, Chinese economic growth that is overly dependent on credit, large public sector debt coupled with weak banks in countries such as Italy and Greece, no end in sight to the political uncertainty challenging national and international institutions, to name just a few. These increasingly intertwined, cyclical risks come against a backdrop of long-term forces – from demographic trends to technological change – that are disrupting current business models. And, learning from the past, we can expect structural change to accelerate rather than slow down during periods of economic downturn. Take e-commerce for example. Many took the bursting of the dotcom bubble in the early 2000s as a sign of the sector's imminent death. However, the contribution of e-commerce to total retail growth not only continued but actually accelerated during the Great Recession in 2008-9, accounting for nearly all of the retail growth in that period.[1]

For business leaders the pressing question therefore becomes how to prepare for a potential recession and make their companies more resilient – that is, able to anticipate and react adequately to shocks, adapt to new circumstances and capitalise on threatening events.

THE DELOITTE EUROPEAN CFO SURVEY

Since its launch in 2015 the European CFO Survey has been part of a global cohort of surveys benchmarking the current and future intentions and opinions of Chief Financial Officers operating in 20 European countries. Twice a year, the survey gives a voice to about 1,400 CFOs, providing an overview of their hiring and investment intentions, views on critical business risks, current strategic priorities and which factors they consider vital for success. Due to its wide geographical reach, the consistently high number of participants and the privileged viewpoint of CFOs, it provides a reliable indicator of business sentiment in Europe across a range of different markets. The data for the spring 2019 edition were collected in March 2019. The question on resilience in a downturn that is at the heart of the analysis in this article was not asked in all the participating countries. Out of the 1,473 CFOs participating in the survey, 1,047 answered this question.

What drives resilience? A review of what we know

Corporate and academic interest in conceptualising and understanding what drives organisational resilience has grown steadily in recent years. The most recent business and academic research suggests three major areas are key to enabling companies not only to survive a downturn but turn the unfavourable conditions to their own advantage[2] : the ability to anticipate possible future developments and create alternative action plans; the availability of a broad set of resources; and leveraging an external network of relationships.

Anticipation capabilities and collateral pathways: An ability to see the unexpected faster than others is a cornerstone of resilient organisations. This implies scanning the environment to detect critical developments and build multiple plans for different scenarios. Ensuring that the organisation has alternative courses of action allows it not only to act faster to mitigate potential harm but also to adjust better when dealing with the emergency. However, it is not the creation of multiple pathways per se that fosters resilience. Rather it is the ability to 'look further down the line' to envision how the environment is going to change after the crisis and take actions in the present to be well positioned in the post-crisis environment. For example, companies that reinvested more during the recession – a sign they were thinking ahead – achieved higher growth rates during the recovery.[3]

Resources: A broad and accessible set of resources is fundamental to a quick and adequate reaction under challenging conditions. In this respect, financial slack is obviously key. Several analyses find that highly leveraged companies perform substantially worse during recessions. Financial resources are essential to planning and preparing for an emergency. They serve as a buffer, containing the negative effects of a crisis and protecting key activities. They are also needed to mobilise other key resources that are essential in difficult times. One of these resources is human capital. For example, analysing airline industry responses to September 11, researchers found that airlines able to retain staff were able to recover successfully, while those that responded to the crisis with high levels of layoffs languished.[5] Recent research stresses that having sufficient human resources, with the required skills and commitment to the organisation's goals, is critical to resilience. Technological resources are another example. A recent study from the Centre for European Economic Research (ZEW) shows that companies more advanced in the use of information and communication technologies were better able to withstand the economic crisis in 2008-9, as they were more efficient and able to introduce process innovations that boosted their competitiveness.[6]

Network relationships: Empirical evidence shows that organisations that establish and leverage an external network are also more resilient to challenges and shocks. A social network increases the transfer of knowledge and the dissemination of innovation. Furthermore, collaboration among organisations within a network increases the resources that can be tapped and therefore the capacity of each individual company to respond.

While each of these factors is relevant in fostering resilience, none of them alone is enough. Building resilience requires a mix of actions. The cost-reduction approach on which many companies typically rely when coping with an economic downturn, is not sufficient. They must do more in order to deal with, and indeed profit from, the negative shock.

There is a pattern in current responses by business

What are businesses doing now, if anything, and what are the differences in the strategies adopted by different firms?

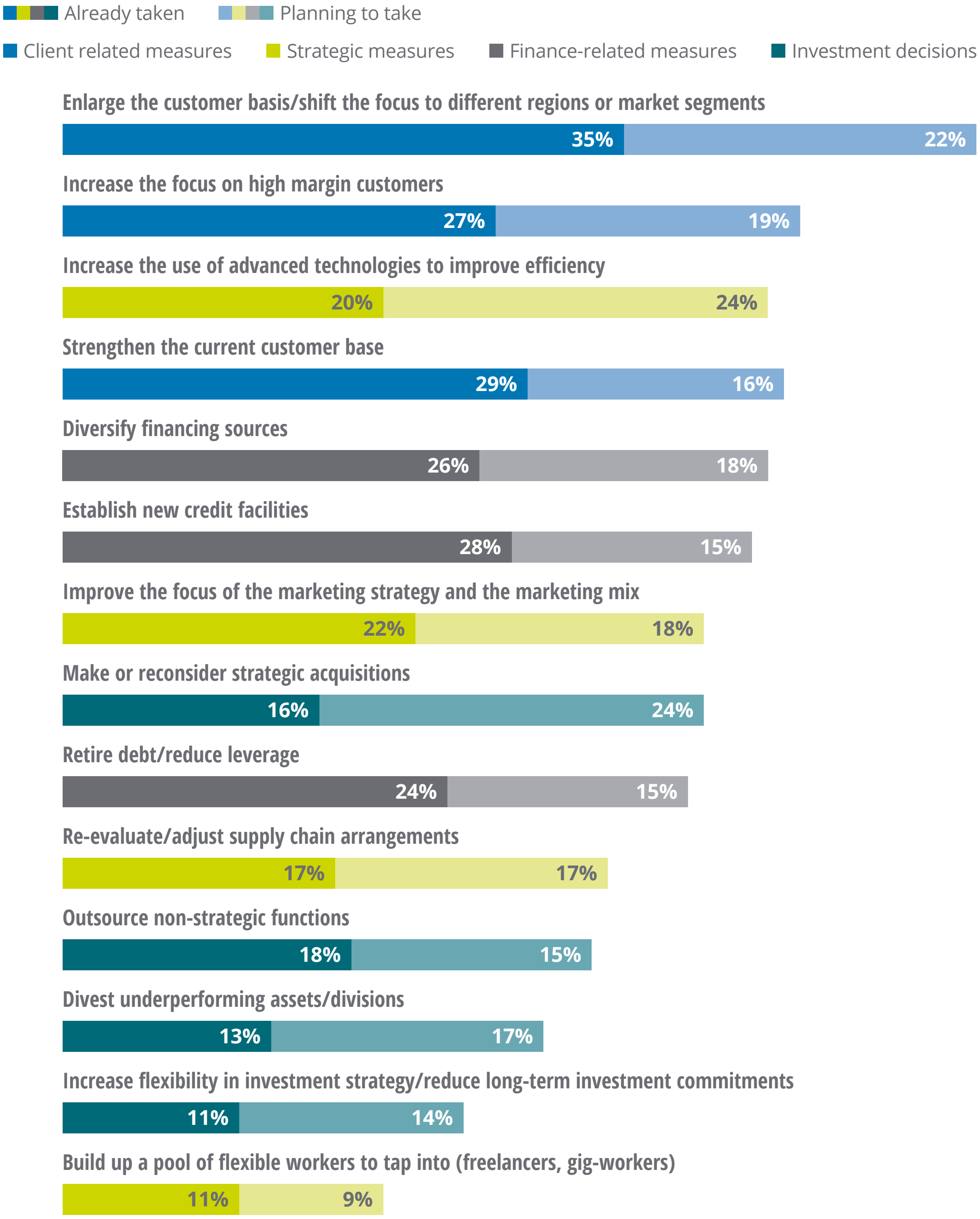
In the latest edition of the European CFO survey we asked over 1,000 CFOs operating in Europe what they are doing to make their company more resilient to a slowdown in global growth. The questionnaire provided a list of possible actions among which the CFOs had to select the five most important ones, taken or in planning. Although on average only a third of the sample actually expect a recession in their own country or the whole euro area, virtually everybody is preparing for a slowdown. European businesses are focusing on their customer base. Measures to bolster it come top of the rankings (Figure 1, blue bars). Broadening the customer base is the most popular strategy, with more than 50 per cent of respondents concentrating their efforts on different market segments or different regions.

The second prominent area of action relates to financing (grey bars). Adequate access to capital is of vital importance for a company in a downturn and even more so in a recession. It is therefore sensible to secure new lines of credit and diversify financing sources when economic conditions are still favourable. However, other measures that could improve the financial position of the company – such as divesting unproductive assets or outsourcing non-core functions – are less popular (green bars). Such decisions are generally difficult to make, but exiting from investments and activities that are not working well frees up financial resources.

As for the last set of actions – those relating to more strategic measures (yellow bars), European companies seem to be favouring the use of advanced technologies to improve efficiency, which is the third most popular strategy, with 45 per cent of respondents reporting that they are pursuing or planning to pursue it. Other strategic measures are less in focus. In particular, very few CFOs mention the need to "build up a pool of flexible workers" as something they are considering as a way to become more resilient. This result confirms that companies tend to manage the ecosystem of alternative workers more in a tactical rather than a strategic way, as the latest Deloitte's Global Human Capital Trends Survey reveals.[7]

FIGURE 1

What CFOs are doing, or plan to do



Surveyed question: Which of the following actions have you already taken/are planning to take to make your company more resilient against a potential slowdown in global growth over the next 12 to 18 months? Please select the top five.

Source: Deloitte European CFO Survey, 2019.

Companies bet on three different resilience strategies

To understand the strategic direction that European businesses are taking we went a step further and carried out a cluster analysis of the answers, to identify and group together observations that are similar based on the set of actions to build up resilience that they have taken or plan to undertake.[8] Three high level clusters emerge, corresponding to three broad underlying strategies (Figure 2).

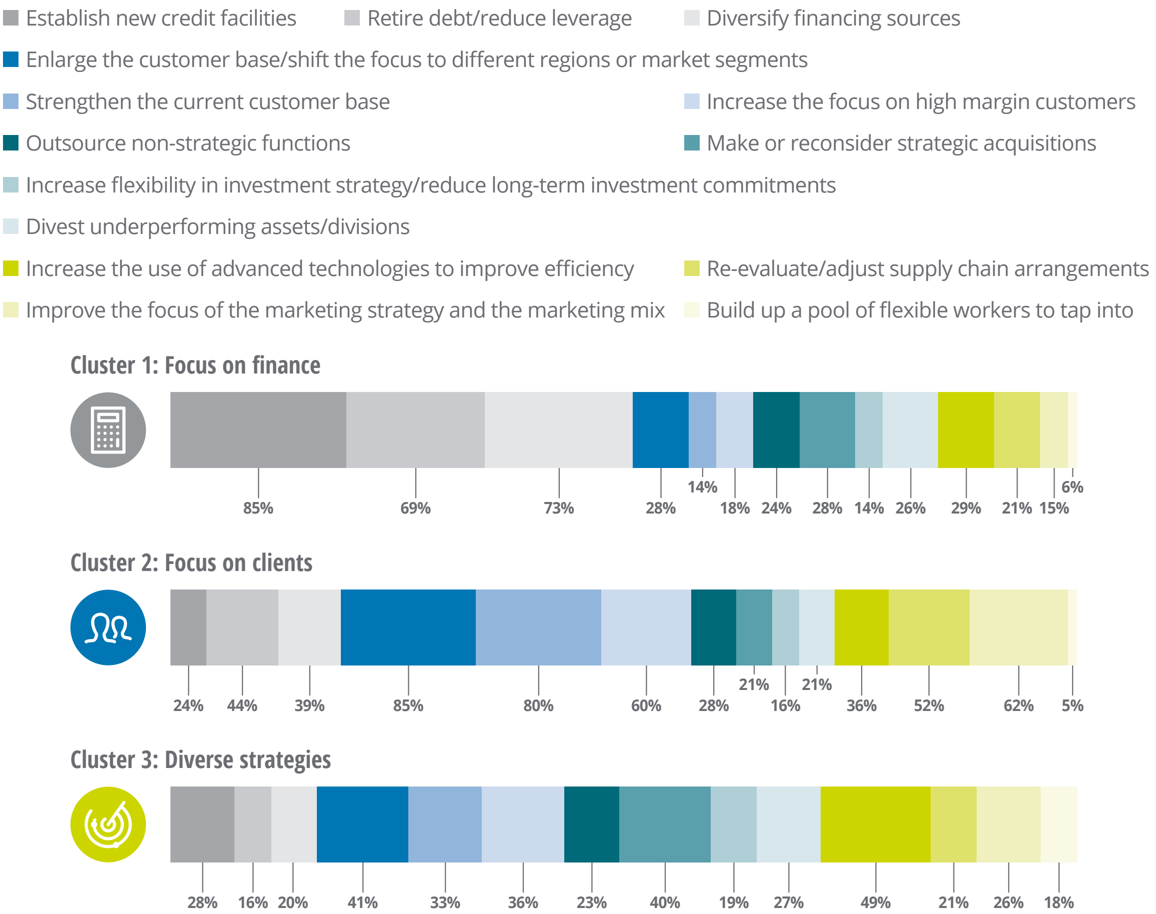
The first group of companies seem to be focusing mainly on their finances. The vast majority of respondents within this group see putting the firm's financing on a solid footing and reducing debt as the best way to withstand the next economic downturn. Many companies within the automotive and industrial products and services sectors are within this cluster.

The second group of companies focuses more on their clients, strengthening their customer base or reassessing it, and also improving the marketing mix. Interestingly, respondents within this group are also more likely to be reassessing their current supply chain. Many companies in the consumer goods and retail sectors are within this cluster.

Finally, the third group consists of companies that are focusing on using advanced technologies to

FIGURE 2

Differences in focus: finance, customers or a diversified strategy



The percentage numbers in the bars represent the proportion of respondents within the cluster that selected the respective option as one of the actions that have been taken or are in planning to improve the company's resilience. Percentages in each cluster add up to more than 100 per cent due to multiple answers.

Source: Deloitte European CFO Survey, 2019.

improve efficiency as they put their customer base under the spotlight. They are also more likely to be looking at strategic acquisitions. Compared to the other two clusters, respondents in this group are much less likely to be considering retiring debt and reducing leverage: only 16 per cent selected this option, compared to 69 per cent and 44 per cent within clusters one and two respectively. In general, however, the answers within this third cluster are more diverse. In the first two groups there is a clear preference for a set of actions in the same area and other possibilities tend to be neglected.

The CFOs in the survey might have very good reasons for concentrating on a single type of strategy, as their company may already be strong in the other areas. However, that might be a sign of short-sightedness if they have not considered the other aspects that contribute to resilience. Businesses that are in cluster two or three, for example, might be missing a crucial aspect if they have not thought about how their financing will look in the event of a downturn. If they want to focus on their customers, they will need to invest, which might be difficult if access to credit is limited. Similarly, while respondents in cluster one are right in securing access to credit while conditions are still good, they might miss out on opportunities if they have not thought enough about their customers as a source of strength during a downturn.

Conclusion

It is unclear when the next economic downturn will hit. But companies need to prepare now if they want to escape its worst consequences and exit the downturn in a strong position financially and relative to competitors. Our survey of over 1,000 CFOs across Europe reveals that businesses are indeed already preparing, focusing mainly on three sets of strategies. While each company is unique and there is no single measure that fits the needs of all, it is important to have a broad approach when selecting a course of action to prepare for a downturn.

The following steps might help companies gain a broad view for structuring the discussion and facilitating decision making:

1) Look 'down the line': Think about how relevant markets and the industry are going to evolve not only because of economic slowdown but also as a result of structural change. What are the long-term forces that will shape the industry's future over the next ten to 20 years? Identify the strategic areas of growth.

2) Consider the necessary resources: Create some financial room for manoeuvre so as to be able to secure the right resources, in terms of human capital and technology, and finance the strategic areas of growth. This implies not only thinking about the current level of debt and possible sources of financing, but also considering divestment of underperforming or non-core assets while the market remains strong.

3) Reconsider the current external network: Given the relevance of external networking to a company's resilience, it is necessary to think of it as a strategic rather than a tactical asset, building up and forging collaborations that contribute to the long-term growth objectives of the company.

Endnotes

1. Deloitte, “The next consumer recession. Preparing now”, 2018.
2. The following section and the empirical evidence referred to is based on the work of the following authors unless stated differently: Duchek Stephanie, “Organizational resilience: a capability-based conceptualization”, Business Research, 2019; Williams Trenton, Gruber Daniel, Sutcliffe Kathleen, Shepherd Dean, Yanfei Zhao Eric, “Organizational response to adversity: fusing crisis management and resilience research streams”, Academy of Management Annals, 2017; Barasa Edwine, Mbau Rahab, Gilson Lucy, “What is resilience and how can it be nurtured? A systematic review of empirical literature on organizational resilience”, International Journal of Health Policy and Management, 2018.
3. Deloitte, “The next consumer recession. Preparing now”, 2018.
4. Deloitte, “The next consumer recession. Preparing now”, 2018; Reeves Martin, Whitaker Kevin, Ketels Christian, “Companies need to prepare for the next economic downturn”, 2019, Harvard Business Review.
5. Gittell Jody, Cameron Kim, Lim Sandy, Rivas Victor, “Relationships, layoffs, and organizational resilience airline industry responses to September 11”, 2006, The Journal of Applied Behavioral Science 42: 300–329.
6. Berteschek Irene, Polder Michael, Schulte Patrick, “ICT and Resilience in Times of Crisis: Evidence from Cross-Country Micro Moments Data”, 2017, ZEW Discussion Paper 17-030.
7. Deloitte, Human Capital Trends 2019.
8. Cluster analysis is a statistical technique that, based on a mathematical definition of ‘similarity’, helps to identify groups of similar observations. There are various methods to define similarity and to aggregate observations. For this analysis, we used a hierarchical cluster analysis, applying the Ward method to create clusters and Euclidean distance to measure their similarity. After removing those respondents who did not diversify their answer, instead selecting all the available options, we analysed the answers of 916 CFOs in the Deloitte European CFO Survey, Spring 2019.

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