



The Upside of the Downturn
Ten Management Strategies to Prevail in the Recession and Thrive in the Aftermath

Notes by Frumi Rachel Barr, MBA, PhD.

Author: Geoff Colvin

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Author's Bio: GEOFF COLVIN Fortune's senior editor at large, writes its popular column "Value Driven." He lectures widely and is the regular lead moderator for the Fortune Global Forum. He also offers daily business commentary on the CBS Radio Network. His first book, Talent Is Overrated earned International acclaim and was a Wall St Journal, Business Week, and New York Times best seller.

Author's big thought: Some businesses—and some people—will emerge from this downturn stronger and more dominant than when it started. Others will weaken and fade. It all depends on critical choices they make right now. Geoff Colvin, one of America's most respected business journalists, says even the scariest recession has an upside. The best managers know that conventional thinking won't help them win in these tough times. They're taking smart, practical steps that will not only keep them strong, but will also distance them from the pack for years to come.

The dozens of top-performing leaders Colvin interviewed reject the common view that slashing costs and firing employees are all that matter. They see the recession as a rich opportunity to reinvent their organizations and lay the groundwork for future growth.

Chapter Notes:

Chapter 1: The Greatest Opportunity - Why this historic downturn is so rich with possibilities

- The author compares performance in the Tour de France to performance in business and, for that matter, in virtually every realm: the worst, most difficult conditions bring out differences in competitors that were not previously apparent. Such conditions turn leaders suddenly into laggards and vice versa.
- Periods of extreme stress and challenge are reliably when dramatic competitive change takes place. The pattern holds emphatically in business. This is that rare moment when we all face the greatest possible opportunity to make ourselves winners for a long time to come. That opportunity is what this book is about.

- This historic downturn really does offer new, possibilities. The reasons are specific and hardheaded:
- *This downturn is worldwide*, so your canvas of opportunity is huge. All nations, all groups are challenged, each in a different way. Your opportunity to respond is broader than in the experience of any living person.
- *This downturn is severe and painful*. If ever people were ready to be led toward new ways of doing things, they are now. That's the meaning of the phrase we hear everywhere, first popularized by President Obama's team: "Never let a crisis go to waste." Just remember that every crisis eventually ends, so there's no time to lose.
- *This downturn is deep*, meaning it's affecting people's most fundamental economic behaviors—spending, saving, borrowing, and investing—in ways that may last for years. Millions of people worldwide are being traumatized by debt obligations that they can't meet, an experience that may reshape their feelings about borrowing for decades into the future. Fundamental new consumer attitudes create opportunities for new kinds of businesses in every part of the economy. Such opportunities come along only rarely.
- *This downturn is long*, which means that many companies won't survive it. This one is the longest since the Depression, which lasted forty-three months in the United States, and while it probably won't approach the magnitude of that one, it will be more than enough to clear out wide swaths of business.
- *This downturn is novel*, so most managers have never experienced anything like it and no one has an advantage in knowing how to manage for it. Since no one has a head start in understanding how to respond, the advantage will go to those who work hardest now to see what is really happening in their business and industry and come up with bold, innovative responses for an unprecedented environment.
- *This downturn will test you personally, creating opportunities for growth and leadership that you have not faced before*. Times of crisis present genuinely great opportunities not just to demonstrate leadership but also to develop it—to build leadership capabilities beyond what you or others in your organization now possess.
- The great thing about a financial crisis and a recession is that they offer everyone the opportunity to be stretched in their current jobs.
- Certain practices can make the experience especially productive. Coaching helps. Getting specific in your own mind about exactly which abilities you want to improve, and how, will turbo charge the results. But the main idea is that continually trying things you can't quite do is what makes you better, and doing it for a long time is what makes you great.
- Everyone is facing the opportunities that are present, though sometimes concealed, in the global downturn. Only a subset of business people will recognize those opportunities. Of those people, only some will get past fear and defensiveness and even try to take advantage of the opportunities, and of that group only some will succeed.

- The winnowing is a merciless process, and getting all the way through it requires doing many things right. The foundation of them all is understanding first the very singular nature of this particular downturn.

Chapter 2: The New Normal -The strange story of how we got here and what it means

- Seeing the downturn as a bunch of statistics is easy, tempting, and almost useless. Think of it instead as just one episode – a big, dramatic one—in a continuing narrative, a story without beginning or end.
- This episode will play out, and another will follow, very differently from what most people were expecting just a year ago.
- The story is actually about individuals like ourselves making decisions every day.
- It's also important to focus on the story's most important elements, and in the current portion of the world's economic saga it's clear what they are. There are two. One is the behavior of American consumers. They're less than 5 percent of the world's consumers, but their massive spending power and, even more significant, their strange, unprecedented actions over the past several years have been critical in causing and shaping the recession.
- The other main story element is risk and how economic players around the world have regarded it—a volatile love-hate relationship that is central to the story of the recession and what will come next.
- Worldwide economic prosperity became a problem when combined with the easiness of money. That mixture ignited a cycle of borrowing that eventually turned into trouble. Risk seemed to be evaporating. Investors were willing to accept risk at no charge because the boom had lulled them into believing that risk might no longer even exist. So they borrowed and invested more, fueling the boom further—a self-reinforcing upward spiral.
- In the world's largest economy, the United States, the cycle worked itself most powerfully in housing. That's significant because housing is the most valuable asset owned by consumers, who live in the U.S. economy and in large measure the world economy. The logic of leverage was especially potent.
- The momentarily important result was that consumers felt rich and spent accordingly. They spent more every year, even when respectable economists argued that the party had gone on too long and they couldn't conceivably keep it up.
- The day the world changed, though no one knew it at the time, was June 13, 2007. Specifically, investors began to feel they weren't getting paid enough for making risky investments. At first the effects were barely noticeable, but by August they were unavoidable. That's when the subprime crisis began, for the simple reason that investors who had previously ignored the risks of subprime mortgages and the

securities built from them were now demanding to be paid a more realistic—that is, higher—return.

- The upward spirals of the boom slowed, stopped, and went into reverse, with all their self-reinforcing power now pushing down. Most important was housing and its effect on consumers. The value of U.S. homes had actually started falling more than a year earlier. Although mortgages were easily obtainable suddenly they weren't, and that changed everything. Consumer confidence fell. Spending slowed way down. Consumers faced the new logic of falling home prices: instead of buying a home right now, it was smarter to wait; but if you were selling one, you'd better get it on the market immediately, before prices fell further.
- Every recession is unique, and this one is different in many ways, including the bizarre nature of the financial securities that got banks into trouble and its interconnected global complexity. But for people in business, the most important difference centers on the strange behavior of the protagonists of our story, consumers.
- Consumers did everything backward. During the expansion from 2002 through 2007, the savings rate of U.S. consumers fell rather than rose. With the recession really taking hold, consumers again did the opposite of what they've usually done and increased their saving. As the economy shrank, the savings rate of U.S. consumers climbed well above 3 percent, then above 4 percent, the highest level in over a decade. That is the reverse of how consumers behaved during the Great Depression.
- That pattern moderates business cycles. It stabilizes the economy by damping down spending during expansions and fueling it during recessions. But the reverse behavior makes cycles more extreme, and that's a major reason this recession is so bad.
- The central mystery: Why did consumers go into hock in the fat years? One argument is that they were behaving rationally. The critical point is that consumers, like investors, had come to believe that risk had faded and maybe disappeared. That belief gave them the confidence to borrow when they should have been saving. And to spend like no people had ever spent before, just as financial institutions gained the confidence to lend more promiscuously than they ever had. That's how this strange story has led to a recession of historic proportions.
- Now businesspeople need to know what will happen in the story's next episode. They don't have to wait for the recession to end to see the new world that it's creating—to glimpse the next episode in the story. Specifically:
- The U.S. economy will become less consumer driven and consumer focused. There's no reason the United States couldn't return to a more historically normal level of consumption. In fact as the shopping fever cools, a large-scale, long-term pullback by U.S. consumers holds several further implications. The most important:
 - Social attitudes toward working, saving, spending, and borrowing will shift.
 - The world economy will become less U.S.-centric.
 - Investors will remain spooked by risk for a long time.

- Government will play a much larger role.
- For businesses there's no avoiding this new world, only embracing it and responding to it. You don't have to respond perfectly, just better and faster than your competitors. The best companies are responding in ten particular ways.

Chapter 3: Reset Priorities - The critical first response to a radically new reality

- In good times, the whole organization becomes aligned with goals based on assumptions about favorable conditions. When those conditions radically change, everything the organization is doing has to be rethought, and much of it must be altered.
- A lot of the actions you take in the middle of a crisis like this are admissions of your own failure— people don't want to tell the shareholders, don't want to admit they're wrong, so they sit there—and these problems don't age well. Reluctance to admit failure in the early stages means you'll probably be forced to admit a much larger failure later.
- We've all seen analysis paralysis, postponing a decision on the pretext of trying to make a better decision but generally doing just the opposite. Waiting for more data is usually an act of desperate self-delusion, a willful silencing of what your inner voice is trying to tell you. The inner voice is almost always right.
- None of the other strategies for managing in this recession will work until this one— facing the new reality and resetting priorities has been fully pursued.
- The changes in your reality are probably much more extensive than you realize. To grasp them fully, examine how your company's world has changed in six key categories that shape performance viability:
 1. *Financial strength.* In assessing its new financial reality, every company must now ask: What is our access to capital? If it stays like this, how long can we continue? What new sources of capital can we find? If we had to sell assets to raise capital—now, at the worst possible moment to sell assets—what could we get for them? How can we reduce our capital requirements? How can we reduce working capital? Will our cost of capital likely rise as lenders and investors worry about risk, or fall as central banks cut interest rates? Answering those questions is vital because the answers will paint a picture that's markedly different from what it was just a year ago.
 2. *Competitive advantage.* Has the recession changed your standing versus competitors? The worsening economy can pit you against companies that you didn't previously regard as competitors.
 - Overall demand can shift radically.
 - Your cost advantage or disadvantage can change.
 - Your talent advantage can change.
 3. *Government intervention.* A recession this bad leads inevitably to a greater government role in business than we've seen since the Depression. The trend holds worldwide.
 - Numerous companies that will be affected by new regulations.

- How will multitrillion-dollar global stimulus programs in the United States, Europe, China, Japan, and elsewhere affect you and our competitors?
 - Most of government intervention will also take the form of protectionism, a lose-lose development that will make the world poorer—but its happening anyway.
4. *The state of your customers.* Your company is only as healthy as your customers, and their condition may be changing fast in this environment.
 5. *Your reputation.* Long before this recession, corporate reputation was becoming more economically valuable than it had ever been previously. A clear-eyed view of your firm's reputation today is a vital element of your new reality.
 6. *Your risks.* Each company's new reality in this recession consists not just of changing levels of risk, but also of completely new risks. This recession is certainly increasing risks of the traditional type, such as financial leverage (high debt levels) and operating leverage (high breakeven points), plus risks in the areas described above, such as reputation and customer health.
- Understanding all the elements of your new reality is a big job, but the great thing about doing it is that it creates a picture—a rich overall view of your business in today's new environment. In a way, this analysis, this assessment of the new reality and revising of goals, is the easy part.
 - The hard part is responding— getting yourself and others to embrace the new reality, make decisions in a stressful, fast-changing, and uncertain environment, and take action.
 - There are three ways people blow decisions when the pressure is on, and most of us have seen all of them at work:
 1. People obsess about insignificant problems and ignore what's important.
 2. Their perceptions become distorted. Whatever you're focused on becomes bigger and more important in your perception, so if you're focused on insignificant details, you'll miss what really matters.
 3. They insist on proving that their mistaken hypothesis about the situation is actually correct.
 - Other researchers have figured out how stress hijacks the brain's ability to work. The crossover point varies by individual, but the stress levels in this recession can become so high that almost no one will be immune.
 - Closely related is the effect of uncertainty.
 - How to respond? The best and clearest explanation comes from studies of the military, where stress is worst and the consequences most serious .Soldiers avoid the effects of combat stress and uncertainty when
 - They feel in control.
 - They have strong group cohesion.
 - They trust their leaders.
 - They have high motivation.

- They feel well armed and protected.
- They feel well trained.
- They have a reliable medical corps.
- All of those factors that reduce stress are likely to weaken rather than strengthen in a recession. That's why it's especially important to give them extra attention. Overstressed decision makers are bad decision makers, so unless the stress problem is at least blunted, nothing else will turn out well.
- Forming a clear picture of your business's new reality, and then understanding the challenges of acting on what you see, is the crucial first step toward finding opportunities in this recession.
- It's irrefutably clear that the most influential factor in the success of any company today is its people—their knowledge, abilities, relationships, and development. What counts most is beyond doubt, however, and this recession, more than any in decades, is revolutionizing the relationship between companies and workers.

Chapter 4: Protect Your Most Valuable Asset - It's your people—yet they're often valued the least

- The first thing we all think of when a recession hits is the effect on employees. The reality is that for all kinds of reasons, sometimes layoffs genuinely cannot be avoided.
- The best companies and best leaders take a larger view of their people during a downturn. They avoid the reflexive responses that may be traditional in their company. When they stop and examine today's environment, they find that it's full of opportunities—to begin practices they always should have been using, to improve the quality of their people, to increase employees' loyalty and motivation, to build the culture.
- The best companies will emerge from this recession as better places to work, stronger magnets for great people, and more formidable competitors in their industries.
- In reality the last time business leaders had to respond to a recession anywhere near as large as today's, the role of good people was to make the machines run. Now the role of equipment is to enable the people.
- The most fundamental move is to manage the development and evaluation of people much more actively. This doesn't happen in most companies because of cultural inertia. Evaluations at most companies, if they happen at all, are infrequent, stiff, and superficial, dreaded by both parties; altering that deeply entrenched pattern will never be easy without some outside motivation.
- A deep financial crisis is obviously and undeniably a spur for change in how the business is run. An announcement that the company is going to get much more serious about developing employees just might be met with some enthusiasm.

- It's also possible that in a major recession, when employability becomes a top concern, people might be glad to hear that they're going to be developed a bit more thoughtfully and deliberately than they have been.
- At many companies the most valuable improvements in development would involve a series of candid conversations between employee and boss specifically about how the employee could get better, some goals to strive for, and a plan for getting there. This approach is free. It's effective—it makes almost everyone better.
- The other critical part of this system is frequent, rigorous evaluations. And in today's circumstances both parties are motivated like never before to take the process seriously
- The big opportunity for most other companies is to use the intensity of these times to get the process embedded in their corporate lives for the long run.
- Not only is business more reliant on human capital than ever before, but your most valuable employees— especially the best young employees—demand that their employers develop them. Your best people are probably the most grateful for continued formal training and development.
- In addition, continuing to offer training—adapted to the new environment—can help a company gain competitive advantage in the downturn.
- More broadly, a recession is a large opportunity for a company to be a hero to its people.
- This downturn may last a long time, but it will end, and when it does, everyone—not just employees but also customers, suppliers, investors, and regulators—will remember how your company behaved in the dark days.
- A classic pattern from past recessions: when good workers see colleagues treated badly, they leave as soon as they can.
- Not every company will behave so wisely, which presents another opportunity: stealing outstanding performers from companies that are mistreating them.
- Assuming you've done your homework, now is a rare chance to build the most valuable capital in your business.
- To grab the opportunity, you must offer that wonderful capital a pay package that will attract them without provoking mutiny among your current employees.
- The most fundamental pay question in a recession is how to distribute the pain. The best answer will depend heavily on a company's culture and circumstances.
- The larger point is that every company can use this downturn as motivation to get its pay practices right. Smart pay practices help stabilize a firm in tough times.
- Getting pay right is never easy. Company objectives shift; methods of measuring individual performance are always imperfect; formulas for rewarding performance can almost always be gained. Nonetheless, in a recession refining all those elements is especially valuable.

- Maybe you've tried everything and concluded that you're in one of those companies that honestly cannot avoid layoffs. Consider the true costs of layoffs and whether they will actually get you the benefits you're counting on.
- *Layoffs are expensive in direct costs.* Severance payments and other benefit costs that may be contractually required can add up to a substantial total. And most of those costs are immediate. Your layoff might not actually save you any money.
- *You'll face the costs and delays of hiring and training new employees when the economy turns back up*
- *Valuable knowledge will walk out the door.* The contents of your employees' brains may be worth more than anything else in the company.
- *Your company will lose productivity before, during, and after the layoff.*
- *Your company will damage its brand as an employer.*
- *Your leadership pipeline will suffer years from now.*
- *Even the survivors will pay a price.* Workers who remain after a layoff make considerably more medical claims, especially for mental health, substance abuse, and cardiovascular issues. Managers are twice as likely to suffer a heart attack in the week after they fire someone.
- *Wall Street's reaction may be the opposite of what you expect.*
- Put all those factors together and you realize why layoffs should be very nearly a company's last option in responding to a recession. If despite all the dangers, you absolutely must make a layoff, even in this last-resort situation, you can find a couple of opportunities.
- First is the opportunity to lose some people you should have lost long ago. Everyone in the company knows who the weakest performers are. Management's failure to get rid of them has been sapping morale and dragging the company down for years. Now is the time to get right with that issue—and then stay right.
- The second opportunity in a layoff is to send a message to the remaining employees and to the world. First you have to make the case that layoffs are truly unavoidable. Then you want to show that your company always treats its people well, even in the worst circumstances. Survivors will still be nervous, but such generosity makes a difference

Chapter 5: Engage the Outside World - Your relationships are changing—so take control of the process

- Today's crisis will change business's world for decades. Finding opportunity in that shift may seem tough when public attitudes appear to be moving massively against business. But remember, your company isn't business—it's one company.
- You needn't suffer from a growing anti-business animus if you can first resist the temptation to underestimate it, then get ahead of it and focus on distinguishing yourself

from the pack. There's no better time to look good than when the competition is despised.

- Some companies are still truly admired. The top five: Apple, Berkshire Hathaway, Toyota, Google, Johnson & Johnson. Note that number three, Toyota, is a most admired company in a most reviled industry.
- Research by the Hay Group, found traits these top companies share: a strong stable strategy, which confers important benefits in unstable times. Companies whose strategies hold up in a recession can press ahead undistracted and make major competitive gains. Hay found that in general, less admired companies change structures far more often than the most admired, the main reason being a strategy switch.
- Public regard is part of a virtuous circle that's especially powerful in a deep recession. Admiration and financial success feed each other, and in tough times economic strength helps a company look even better than competitors—and also enables it to shape its message to the public.
- As for what caused this financial crisis and recession, the short simple, flawed, accepted answer is likely to be one of these four:
 1. Free markets ran amok. The broad deregulatory trend of the past thirty years finally went too far.
 2. Greenspan did it. When one person gains so much influence over the financial system and screws up, the result is disaster.
 3. Clinton and the Democrat-controlled Congress twisted the system
 4. Americans, Britons, Spaniards, Australians, and many other consumers worldwide lost their self-discipline.
- Public opinion will settle on an explanation of one sentence, maybe two, and it's obvious how differing explanations imply deeply different policy responses and different directions for the culture.
- Answer number four is the most nearly correct. Answer number one will prevail, with far-reaching consequences—especially for government policy. Only a few companies are big enough to influence government
- During this critical period. The challenge for most of us will be understanding what's coming, then thinking deeply about what it will mean for our businesses and adapting to the new reality before our competitors.
- Change is on the way in four broad categories:
 - New regulation of leverage, risk, and risk markets
 - Large scale new regulatory frameworks
 - Protectionism and other employment programs
 - Greater government activism in areas less directly connected to resolving the crisis. The challenge for companies will be imagining all that might happen and

how it would affect them. In this, as in so much else, the bigger and bolder thinkers will probably be better prepared.

- The whole relationship between companies and owners is changing dramatically, and not just because of legislation. This exceptional time is an excellent opportunity for other companies to free themselves from the useless habit of publicly predicting their own earnings, otherwise known as giving guidance.
- As stock prices have dropped to levels not seen in more than a decade, shareholders have grown intensely interested in governance and are strongly positioned to make sudden gains.
- Companies will want to assess how they'd be affected by newly powerful shareholder demands for change in three areas:
 1. Majority voting for directors
 2. Shareholder access to the proxy - letting shareholders nominate director candidates to run against the board's own nominees
 3. Shareholder voting procedures. As shareholder democracy gets pushed forward on other fronts, watch for reform of fundamental voting procedures
- This downturn is reordering the relationship between companies and shareholders, so every company will need to form a position on these issues and decide how to respond. In all of a company's relationships with the larger world, communicating much more than usual is a big help in tough times. Communicating may seem like an obvious response, but in fact it's the opposite of most people's instincts.

Chapter 6: Reexamine Your Strategy and Business Model The importance of knowing what you must change—and what you must not

- Just as your relations with outside constituencies are being reordered in this recession, all the relationships you have in your industry—with customers, suppliers, competitors—are shifting as well, maybe dramatically. For that reason, your strategy and business model may need reexamining with a fresh eye.
- A large issue that all companies face in a bad recession is questioning whether an existing strategy is 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?
- 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.

- Excellent companies are certain of their 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.
- 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's possible for the core to change, especially in momentous times like these. Entire industries can be restructured, and companies may have to shift their core in response.

2. How is this recession changing our customers and their behavior? 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.
- This recession could affect today's young people in a way that is similar to how the Great Depression caused change, with long-lasting consequences for financial services firms and others.
- In developed economies physical health tends to improve during a downturn.
- 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.
- Consumers considerably increased their spending on health care, on personal insurance and pensions. A category of spending that increased most (among those studied by McKinsey, which compiled this information) was education.
- 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.

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.
 - 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 most successful companies no longer invent new products or services on their own. They do so 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 cocreation, the choices are infinite, and the company neither imagines nor delivers them all. The challenges are clear. Most companies, especially old ones, are organized exactly wrong to capitalize on cocreation.
 - Managers will be strongly incentivized to develop new business models that create value by using the resources of others.
 - *Brand building in developing economies*. There is a long list of products being faked in China. 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. Companies in these countries may command no special brand building talent, 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.
 - 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*. 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.
 - 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 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.

Chapter 7: Manage for Value - Most companies don't—an error that can be fatal in this recession

- 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 clear about their ultimate, bottom-line objective—yet on this matter many leaders go astray, with results that can be financially fatal.
- For every company, deciding how to measure itself in this recession is one of the most critically important decisions to be made. Yes, it's always important, but good times can conceal a lot of sins; in a recession, every decision is important. The way you decide to measure your performance is the foundational decision. Once it's made it guides virtually all your other decisions. If it's wrong, it will lead to many bad decisions, which in this environment may be disastrous.
- Management's ultimate goal is to create wealth, or value, as we may also call it. While it may seem obvious that every business wants to create value, many companies are managed as if that weren't true at all.
- Creating value means using capital to build a business that's worth more than the capital itself. And the way this is done is to earn a return on the capital that's greater than the cost of the capital, a measure that financial economists call economic profit. No standard financial statement as mandated by the accounting rules of any nation will tell you if a company is accomplishing this. Yet it is the most basic rule of business and it applies equally to the smallest vendor and to the largest corporations on earth.
- Wrong decisions may be survivable in a growing economy, but, they can be fatal in a deep recession. To understand exactly how, we must first explore two simple questions:
- *How much capital is in our business?* It's easy to identify the classic forms capital—land, buildings, machinery, and vehicles. Most businesses also require working capital, money that's always in use to pay for inventories and otherwise keep the business operating.
 - Capital is obviously tied up when a company buys another company.
 - The rules say that any money you spend on research and development is an expense, not an investment. But it's still reality. The money you spend on R & D is actually increasing the total capital invested in your firm. Accounting rules say marketing expenditures aren't investments, and it's the same story with employee training and development.

- To make the best decisions in a deep recession, it's vital that you acknowledge the financial reality of how much capital you have truly invested in your business, and where.
- *How much does your capital really cost?* Business uses two kinds of capital, debt and equity, and the equity's cost—while not in the form of cash—is actually quite high.
- Equity investments are riskier than debt investments because under the law, debt holders get paid before equity holders; to compensate for that extra risk, equity capital is more expensive than debt. Your company's real cost of capital is the weighted average of the costs of these two components.
- Decisions managers are making now are in three major categories:
- *Deciding what to manage for.* Suddenly even companies that never had to worry about how much cash was in the bank found themselves intensely worried about it. For these companies, the simple basics of cash management—collecting it as quickly as possible and paying it as slowly as possible—became critical management competencies.
 - Companies that have been managing for reported earnings become fervent converts to the doctrine of managing for cash in a recession. It turns out that managing for cash can gravely damage value. If a manager's assignment is simply to conserve cash, he'll probably cut spending in areas where it's easiest to do: marketing, employee training, research. If those were investments that made sense when properly analyzed, meaning they generated a return on capital exceeding the cost of the capital, then they probably still make sense. So cutting them would still destroy value, which is a bad thing to do. Even in a recession.
 - Companies that are managed for value generally become far more cash efficient in other ways as well. Because they see all assets as capital with a cost, they find innovative ways to operate with less. In this recession, when cash seems so especially dear, managing for value may show the way to finding additional cash that wasn't available prerecession.
 - The same holds true for all capital investments, regardless of how they must be classified for accounting purposes: if they're creating value, try your hardest to avoid cutting them.
- *Mergers and acquisitions.* A historic downturn is a terrific opportunity for companies to buy other firms at bargain prices, and it can even work out well for sellers. The key is remembering that any deal is a capital investment tended to create value.
 - Extensive research has shown that most acquisitions fail— the most common reason is that the acquiring company paid too much.
 - Deals that make financial sense should be done in bad times as well as good, yet often they are not. For potential buyers: use your stock as your currency. Research has shown that that in using stock as your currency, what you sacrifice in dilution you recoup through a higher multiple. So deals at a sensible price are still doable. For potential sellers: The hard reality is that yesterday's price has no

- bearing on the best decision for today. Would the after-tax sale proceeds, reinvested at the cost of capital, provide more earnings than the business provides? If so, then a sale makes sense.
- *Dividends*: Especially at a time when taxes on dividends are likely to rise in the United States and other developed economies, cutting dividends, or even eliminating them, looks smart. And for companies seeking value-friendly ways to increase cash, this one is hard to beat.
 - A wonderful thing about the principles of finance is that they don't change. In a deep downturn, when every company must operate within much narrower margins of error, observing them becomes much more critical. Yet many managers, disoriented by the unfamiliar conditions, lose sight of the basic principles at just this crucial moment.
 - The opportunity is to chart a course that may seem contrarian to avoid cutting costs that others are cutting, to do deals that others won't do—secure in the knowledge that you're actually pointed in the right direction, and when the storm ends, you'll be far ahead of your competitors.

Chapter 8: Create New Solutions for Customers' New Problems - You can do it in more ways than you may realize

- Deciding exactly how to alter the company's offer to its customers in response to a downturn—is one of the most important decisions a company can make.
- The decision is difficult because the many ways in which customers behave differently during a recession are not simple or obvious . Those decisions may not always seem logical.
- Complicating the decision further, there's good reason to believe that customers are deviating even from their usual recession patterns this time around.
- An unusually large number of consumers are thinking about changing careers, living in new places, or maybe being unemployed for a very long time—all of which changes their wants, needs, and actions.
- Responding to customers in any recession is hard enough, but it's yet another imperative that's even harder this time because experience may not tell us much.
- To meet this challenge at a time when nothing seems constant, it's vital to remember what hasn't changed and won't change. Most fundamentally every company offers its customers not just a product or service but a value proposition, and that value proposition consists of a complete customer experience. The experience comprises of many parts, of which price is only one.
- The most successful companies understand that through good times and bad, they're always creating complete experiences to meet their customers' changing wants and needs. The process doesn't start when a recession hits. Instead, these companies are constantly monitoring the state of their customers and are experimenting with new value propositions that could better serve customers.

That process, rigorously pursued, accounts for a good deal of Amazon's success. Its online business model allows it to test new value propositions quickly and easily,

- The best companies go even further: they create different value propositions for different customers or customer segments.
- In judging value propositions, deciding whether experiments were successes to be scaled up, the most successful companies remember the real bottom line, the economic profit.
- Only by looking at changes in economic profit for a customer segment can a firm make a sound judgment about the success of a value-proposition experiment—and such calculations are indeed possible.
- As companies create new value propositions for their customers' new recessionary wants and needs, they can do so on several dimensions, giving companies more options than many managers may realize.
- The simplest approach to creating a recession value proposition is devising a new product or service that offers the customer a reduced experience, carefully defined, at a lower price.
- An innovative variation on this theme uses clever partnering strategies.
- In a recession, consumers may be willing to make do with a little less in order to pay a little less; private label products might not be quite as good as the big brands, or offer some degree of confidence, but they're good enough for now. Yet in other settings there may be no trade-off at all; that is, a wise company may be able to create a new value proposition that asks the customer to make no sacrifices.
- A different category of response to this recession involves giving customers more control. Because consumers are so particularly uncertain about their future, and are thus less willing to make purchases that involve commitments, they like new value propositions that give them a way out if they need it.

Chapter 9: Price with Courage - Don't assume you have to mark down—it's riskier than you may think

- Every company is facing difficult decisions about pricing in this recession, and those decisions will be among the most far-reaching. Yet they're often made hastily and based on instinct, without an understanding of their potentially thundering repercussions.
- Few managerial decisions are more common in a recession than cutting prices. If you believe that you absolutely must do it, consider fully all the potential dangers, which are much more extensive than many businesspeople imagine.
- *Price cuts rarely pay for themselves.* They may even reduce profit more than holding prices steady would do. McKinsey research finds that in a typical S&P 1500 company, a

price cut of only 5 percent would have to generate increased sales volume of 19 percent in order to pay for itself. That almost never happens.

- The implication is that while holding prices steady may cause sales and profits to decline somewhat, that course may nonetheless be wiser.
- *Price cuts can destroy brand equity that took years to build and may take years to restore.* Many luxury brands and luxury retailers cut prices deeply in this recession, and they realize the implications may be game changing.
- *Price cuts train customers to behave badly.* Buyers of all kinds have a tendency to remember the lowest price they ever paid for your product or service.
- *Breaking a pattern of price cuts is even harder* than it may seem because customers hate price increases more than they like price cuts. When you cut a price from \$1,000 to \$800, that's a 20 percent cut. But when you return the price to \$1,000, that's a 25 percent increase.
- Pricing is a continuing process through good times and bad. It's just that in good times you probably don't have to get it exactly right. While in a serious recession the stakes are much higher.
- Some consumer packaged goods companies have been able to raise prices even in this recession. That's because they satisfy basic needs; they carry strong brands; they involve personal care and thus connect deeply with the consumer; and they perform at least as well as any competitor.
- On the other end of the spectrum are items considered to be discretionary commodities like the major airlines.
- The most important insight into pricing is that smart companies use tools like a matrix not to analyze products or services, but to analyze customers. Knowing where your product or service falls on the matrices of various customer segments—and how its location has changed as a result of the recession—enables you to create different value propositions in which price will play a greater or lesser role. The principle applies to any kind of offering, not just high-end products.

Chapter 10: Get Fitter Faster The right kind of operational discipline pays off powerfully in a recession

- For a business, even the most skillful pricing won't produce financial success if the company hasn't met the challenges of the recession on the inside. If its operations aren't competitive, if it isn't efficient, then it could still be crushed by the recession; while if it is, the recession can be a time of triumph.
- Reevaluating the economic value of customers, and of your products, services, facilities, and lines of business—is one of the most important steps a company can take in tough times.
- More generally, every business needs to take a fresh look at operations in a deep downturn. This isn't grand strategy- It's the nuts and bolts of business, the millions of

day-to-day decisions that add up to productivity, efficiency, and financial success. In a historically severe recession, they become more important than at any other time.

- The most successful companies think differently about operations and in this as in all things managerial, they face a rich opportunity to leap ahead of competitors in a downturn.
- The greatest rewards go to businesses that move fastest and best in following ten practices:
 1. *Understand the new economic profitability of all your business's components.*
 2. *Look at your world through a green lens.* Seeing the business from an environmental perspective can be a great idea in distressed times because it can reveal cost-saving opportunities that had previously been invisible.
 3. *Think twice before cutting the easy expenses.* Most companies immediately cut R & D, advertising, travel, entertainment, and others often categorized as SG&A. Any of those expenses are really investments that will still pay a worthwhile return, so continuing to make them in a recession can create a competitive advantage. The most successful companies play offense, not defense, during a recession. Poor performers focus on reducing vulnerabilities and surviving. Top performers see opportunities to build advantages when their competitors have, in effect, taken themselves out of the game. The ability of the champions to go big during a recession depends partly on their operational discipline during the preceding years.
 4. *Ask, what would we do if we had to sell this business?* This is another way to see your business from a new perspective and find new opportunities to build it, reshape it, and make it more efficient. Assume you'll be selling the business to a rational, well-informed buyer, so just slashing this year's expenses to produce a one-time jump in profits won't do the job. What would you do that you aren't doing now to make the company more valuable? The most immediate advantage of this model, which would benefit many companies in a deep recession, is that facing such a goal changes a manager's whole mind-set. If you knew the company had to be improved considerably and quickly—an apt description of what needs doing in a recession—one of the things you'd probably do is:
 5. *Focus intensely on a few clear goals.* Companies that are managed for value, the ultimate business reality, identify the handful of measurements that are most important.
 6. *Make executive pay a help, not a hindrance.* A deep recession is an excellent opportunity to make the game much more serious in a way that managers will embrace because it holds the potential for significant personal gain. When managers are required to buy company stock with a meaningful amount of their own money, everything changes. The other effect: people just try harder. Every company wants managers who are aligned with one another, and nothing aligns a team more strongly than heavily performance-based pay reinforced by a shared knowledge that everyone has skin in the game. The big opportunity presented by a recession is that most stock valuations are

deeply depressed; if ever a company were to require that managers buy stock, this would be the moment.

7. Don't spread the cuts evenly. Some parts of the business may perform much better than others in this recession, so shouldn't they be given more resources rather than deprived of them?
8. *Don't sacrifice cash just to improve reported earnings.* Especially in a deep recession, the right choice is to conserve the cash.
9. *Take a fresh look at offshoring.* It may be a smart time to bring manufacturing back to, or at least closer to, your home market. Manufacturing costs aren't the only factor in an offshoring decision. Taxes, tariffs, speed, and transition costs can make a big difference. But at a time when costs count more than ever, don't assume that offshoring is still your best option.
10. *Ask the employees where the opportunities are.*

Chapter 11: Understand All Your Risks - Seize this moment to take a broader view of what might go wrong in your business

- Just a few weeks before the subprime crisis researchers concluded that one grouping of companies was clearly better prepared for the risks of the future than any of the others, and that was financial services and real estate companies.
- If it seems ironic that the worst-hit industries in this recession were the ones most confident in their readiness for risk it shouldn't be. The most dangerous risk you face is by definition the one you can't even conceive of. Once you've thought of it, you can prepare for it—and your biggest risk becomes something else that has never crossed your mind.
- The possibility that the world financial system might seize up and this might be the largest risk facing every company, regardless of industry, was beyond imagining for most people. The greatest risk we face is something that we haven't imagined.
- Now is the moment when every company is most strongly motivated to get serious about managing risk, and that would be a good thing even if this recession hadn't happened.
- Economists call a secular shift a big, broad increase in uncertainty and volatility across the economy.
- More important than structure is how companies actually behave with respect to risk. The enormously destructive power of this recession teaches five lessons that every company can apply for much better understanding and control of its risks.
- *Turbocharge your imagination.* Because the events that do the worst damage are the ones you never conceived of, effective risk management begins with an eternal quest to imagine possibilities you hadn't even thought about before. Part of your job is to make sure that the biggest risks your business actually faces are at least on the list of

possibilities. The present moment is a great time to reimagine the dangers you might face, for two reasons.

- For the first time in a long while, it's safe to raise any possibility. We've all been reminded that truly anything can happen. The cultural challenge inside organizations will be to maintain that spirit of openness.
- The second reason this is such an excellent time to reimagine risks is that we can now look back and identify the voices that were in fact envisioning this crisis before it happened. It means listening to respectable thinkers who are fighting the tide of conventional wisdom, of whom there were plenty during the boom years.
- Even the McKinsey Quarterly—not exactly a journal of wild-eyed extremism—described the financial system's growing dangers in a stunningly prescient 2004 article on credit derivatives. Exactly how the system would actually blow up as laid out in clear prose for anyone who cared to read it. The point is that those viewpoints were available. What we have to do—but not many did—is open our minds to the possibility that they could be right. Unimaginable is always a sequence that unfolds in truly unexpected ways.
- Imagining sequences that have never previously occurred is so difficult that even the greatest geniuses fail at it.
- *Build scenarios.* Cold-war military strategists originated scenario planning. Properly aided, it can help managers see important possible events they wouldn't have imagined, because it's all about thinking through possible sequences. Historically, when Shell managers thought through possible sequences, they could see how events might be leading to an embargo. When it happened they were much better prepared than any competitors to respond.
- Scenario planning is sometimes criticized because it's only as good as the people doing it. But that fact shouldn't discourage any organization from using the technique.
- Thoroughly developed scenarios are publicly available and provide excellent launch points for your own thinking. In addition, the mere act of going through the exercise is guaranteed to expand your thinking about your organization's possible futures, which is always worthwhile.
- Think in probabilities while realizing their limitations. If you can imagine an event, you can try to assign a probability to it, either in absolute terms—0.1 percent, 3 percent, 50 percent—or at least relative to other events.
- We just do not think rationally about probabilities, a tendency every manager must fight. The strength of thinking in probabilities is that it forces us to bring to the surface and confront thoughts that we may not yet realize we're carrying around. It enables us to avoid mistakes, and more broadly, it leads us to act more rationally.
- The limitation of thinking probabilistically is that probabilities are meaningful only for events with some kind of history.

- *Use the power of markets.* Prediction markets, in which real people bet real money on the likelihood of specific events, have been around for years and they have also been remarkably successful at predicting many other events, from the outcomes of football matches to the winners of Academy Awards. Of course they aren't always right, especially when predicting events in the distant future, but at any given moment they are likely to be at least as accurate as any other type of prediction.
- Another way you can harness the power of these markets is by creating them among your own employees, generally with small amounts of money furnished by the company, focused on exactly the questions you want answered.
- Well-designed prediction markets can give managers new insight into specific risks and how they would affect the company.
- *Create an organization and culture that adapts quickly to new realities.* The key then becomes responding quickly and effectively to the bolt from the blue, and the number one impediment—incredible yet obvious—is failing to accept that the trouble has happened.
- A tendency to avoid reality, to minimize bad news, may lie deep in a corporate culture. But while most cultural change must start at the top, this change can start anywhere.
- Peter Drucker identified the key management challenge of the twenty-first century as leading change. He believed the most important policy for doing that was “to abandon yesterday.” By yesterday he meant whatever no longer works—a strategy, a business model, a form of organization, a product line.
- Thinking deeply about risk is a way of thinking about your company at the highest level, since it forces you to consider the future viability of everything, ranging from operational details to strategy and culture. The great opportunity of this recession is the chance not only to rethink your company's risks, but also to rethink its risk-management practices and make them much better.

Chapter 12: Don't forget to grow Yourself

- We've all had the experience of facing situations much worse than any we've ever encountered. They can be emergencies or accidents, or loved one facing serious illness, or the prospect of financial ruin. In the worst case, they damage us and leave us weaker, diminished. In the best case they change permanently into stronger people. Which of those two possible effects actually happens will shape the course of our whole lives, and the good news is that it's much more within our control than we tend to think.
- What determines whether we are damaged or strengthened is how we respond. The most valuable opportunities of all for many businesspeople—for their companies and above all for themselves are the opportunities for personal growth. We can find them at three Levels:
 1. At one level is the development of leadership; successful leaders reliably do a certain few things in a crisis, including confronting the unvarnished truth.

2. At another level is more specific personal development in any realm. Whether it's engineering, marketing, or anything else, the new demands of a deep recession turn out to be exactly the right prescription for making us better—or at least they can be if properly understood.
 3. At the third level is what we might call the personal growth of the organization, the development of its culture.
- But the growth isn't automatic. Plenty of organizations and people have been destroyed by crisis. Which outcome we reach is mostly up to us. It is the ultimate leadership opportunity, but not every leader rises to the challenge.
 - A crisis like this recession demands five actions of a leader. They're simple to state and may seem simple to do, but they aren't. Finding the strength to do them will contribute significantly to any leader's growth.
 - *Stand up and be seen.* This most basic requirement is important for a fundamental reason that is often forgotten: people want to be led. We want the leader to be a repository for our fears. When people are desperately worried, they want to know that someone with greater power than theirs is working to solve their problems. People also want the leader to speak for them, to fulfill their deep need to give voice to their anxieties. The leader commands a larger stage and can meet that need in a more satisfying way than can most people individually. And people want to be led because they understand that no group accomplishes much of anything without a leader.
 - Successful leaders in a crisis first make emphatically clear that they are present and on the job. This kind of visibility isn't easy, because the leader in a crisis has million things to do, most of which require being on the phone or meeting with small groups. In a business crisis, lawyers may be advising the leader not to make any public statements. Yet it must be done.
 - *Be calm and in control.* People assume that the leader knows more about the crisis than they do and thus look to him or her for cues about how serious it is. If a leader remains poised and indicates through his calm demeanor that the situation is serious but that there is no cause for a panic, he reduces the possibility of one.
 - *Be decisive.* At moments when it's most important that action be agreed upon, circumstances will often conspire to make that possible. The difficulty is that just when decisions are most easily accepted, they're hardest to make. All business decisions are made with incomplete information, and that's especially true in the heat of a crisis. At the same time, the stakes are much higher than usual. Every instinct tells you to decide more slowly than usual, yet it's vital that you decide more quickly.
 - *Show fearlessness.* We want our leaders to show us that they're not afraid. In business that means facing bad news head on without cringing. Fearlessness can be shown more tangibly as well, when a leader cuts his own pay or, even more powerfully uses his own money to buy company stock, as several CEOs have done in this recession.

- *Explain the crisis in a larger context.* When people who see events as normal, interesting elements of life from which they can learn and to which they can respond, they respond better to stress. A critical question for leaders is whether they can help everyone in the organization by portraying events that are occurring in that way. The way a leader makes sense of events and gives meaning to them is revealed as one of his or her most important jobs in a crisis. By the policies and priorities they establish, the directives they give, the advice and counsel they offer, the stories they tell, and perhaps most importantly the examples they provide, leaders may indeed alter the manner in which their subordinates interpret and make sense of their experiences,
- The great opportunity of this recession is that it has created the most intense and demanding environment for developing these abilities that most managers have ever experienced.
- The precise nature of the recession opportunity is clear. It pushes each of us past our current abilities without our having to take any special steps at all. The question is then how we will respond to being shoved outside our comfort zones.
- Anyone can grow significantly better at virtually anything by observing the principles of great performance. This recession, by pushing everyone past the limits of his or her current abilities, places us all on the first step of the process.
- Trying to change a corporate culture in a growing company during boom times is like trying to change anything else in that environment: it's almost impossible because no one feels urgency. But just as a crisis is the optimal moment for personal growth, it is also the best time for a company's own personal growth, the improvement of its culture. Time and again, that's when it happens.
- Changing any corporate culture takes a long time, and even a record-setting recession like this one isn't long enough to do the whole job. But culture change doesn't just happen. Leaders make it happen. And if the culture needs changing, a bad recession is the ideal moment to begin the process.
- Though the transformation will take time, the benefits will last even longer. A severe recession is obviously not a time for us to recover. It is rather the very best time for us to surge, to push ourselves ahead and develop the new skills and abilities that will change us and stay with us forever. To miss this window would be a shame.

Chapter 13: For Next Time

- The best managers never become so consumed by the present that they forget their place in the cycle. Smart managers are planning now for what they'll do when economic growth returns.
- The landscape of possibilities is broad, so it's useful to think of them in distinct categories:
- *Engaging the outside world.* Advice to the CEOs: "Show up every so often to talk about something that doesn't necessarily serve your immediate interests."

- *Managing people.* The temptations to become lax on this critical issue are almost overwhelming during a boom. In good times it's easier for people to look like stars, so evaluations tend to become less rigorous.
- Getting rid of poor performers is never fun, and in good times managers may persuade themselves that they don't have any. So they can skip that odious chore. Companies may even be tempted to cut back training and development, even though money for it is abundant, because it seems less necessary. Remaining rigorous on all aspects of people management is one of the hardest things to do during a boom because people issues are often so difficult. But in a world where human capital is every company's most valuable asset, it's one of the most critically important jobs.
- *Adjusting strategy and business model.* Just as every investing strategy works in a bull market, every business strategy may seem brilliant during an economic boom. That's the time to ask how well the strategy or business model would hold up in a recession.
- *Staying connected with customers.* The best companies never stop refining their customer value propositions—observing customer behavior, understanding how customer needs are changing, and experimenting with hypotheses for new value propositions. This is another form of discipline that's easy to lose when the money is rolling in, but its tremendous advantage is that it will always supply an early warning when the economy begins to tank.
- *Managing capital.* Misery can be avoided if a company manages capital rigorously when times are good. Companies that avoid dumb deals in a boom remain financially strong enough to make smart ones in a downturn.
- *Getting more efficient and productive.* Pushing for continual improvements can become a strong foundation for the company's new, slimmer way of life.
- *Adapting to changing risks.* For unsuccessful companies, risk is a hot topic at the depths of a recession. For great companies, it's a hot topic at the height of a boom. It's another element of the discipline of thinking about very bad possibilities when everything seems to be perfect. Listening to unpopular thinkers always helps.
- *Continuing to grow personally.* Managing intelligently during the next expansion, vital as it is, will be less of a chance to clobber competitors than a way of preparing the organization for the make-or break environment of the next recession. Keeping those cycles in mind is harder than it used to be because they're less frequent. For the past twenty-seven years we've had only four recessions, counting this one, and the two previous ones were so mild that they barely qualified for the term. We've forgotten how to think about business as progressing through a series of cycles. Good times are when you'll experience your greatest success. But bad times—these times—are your greatest opportunity.

Recommendation:

In tough times doing things harder just doesn't create the results you want. This book is about thinking differently – and the nuggets here are well worth incorporating into your thinking and your actions.

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ceoconfidante@frumi.com

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About the reviewer: Frumi Rachel Barr, MBA, PhD

Many CEO's find themselves asking "What now?" to sensitive situations that only an experienced former CEO can understand. Frumi is brought in to solve problems and often remains to work with you, as your confidante and secret weapon. She has an uncanny knack of getting to the heart of your corporate climate and maximizing your team's performance, profitability and sustainability.

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